This Report will be made public on 2 October 2017

Folkestone
Hythe & Romney Marsh
Shepway District Council
www.shepway.gov.uk

Report Number **C/17/48**

To:	**Cabinet**
Date:	**11 October 2017**
Status:	**Non-Key Decision**
Head of service:	**Charlotte Spendley, Head of Finance**
Cabinet Member:	**Councillor Malcom Dearden, Finance**
SUBJECT:	**TREASURY MANAGEMENT MONITORING REPORT 2017-18**

SUMMARY: This report provides an update on the council's treasury management activities that have taken place during 2017/18 against the agreed strategy for the year. The report also provides an update on the treasury management indicators approved by Council earlier this year.

REASONS FOR RECOMMENDATIONS:
Cabinet is asked to agree the recommendations set out below because:

a) Both the CIPFA Code of Practice on Treasury Management and the Council's Financial Procedure Rules require Members to receive a report on the Council's treasury management activities during the year.

RECOMMENDATIONS:
1. To receive and note report C/17/48.

1. BACKGROUND

1.1 Full Council approved the Treasury Management Strategy Statement for 2017-18, including treasury management indicators, on 22 February 2017 (report A/16/24 refers).

1.2 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management requires the council, as a minimum, to produce a mid-year report reviewing its treasury management activity undertaken so far against the approved strategy for the year and to consider any significant issues which may impact upon the function for the remainder of the year. This includes reviewing the approved treasury management indicators. This report meets CIPFA's reporting requirement.

1.3 The authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk.

2. ECONOMIC UPDATE AND INTEREST RATE OUTLOOK

2.1 A summary of the key factors affecting the UK economy for 2017-18 is shown below and is based on information supplied by Arlingclose Limited, the council's Treasury Adviser:-

i) The UK's economic outlook remains uncertain as the government continues to negotiate the country's exit from the European Union.

ii) UK business confidence is currently muted due to Brexit concerns and is expected to remain so in the short to medium term while the exit negotiations take place.

iii) UK Gross Domestic Product (GDP) has softened due to subdued consumer spending because of higher inflation and a contraction in real wages and is forecast to be around 1.6% for 2017 and 1.4% in 2018.

iv) UK Inflation (CPI) rose to 2.9% in May 2017, fell to 2.6% in July but increased back to 2.9% in August. Inflation is expected to remain above the Bank of England's Monetary Policy Committee's (MPC) 2% target for the year and, in part, is being impacted on higher cost of imports following the weakening of sterling over the past year.

v) The impact of inflation and a contraction in real wage on consumers means savings rates are at an all-time low. When inflation eventually eases, savings will begin to be replenished, further diverting money away from consumption.

vi) The outlook for the global economy, although mixed, appears reasonably steady overall. Eurozone growth has picked up and remains robust, US growth may cool although it should remain satisfactory. China's growth rate was ahead of expectations but seems likely to weaken.

vii) Geo-political risks remain elevated helping to anchor safe-haven cash flows into the UK government bond (gilt) market.

2.2 **Interest Rate Outlook**

2.2.1 Given the UK's weaker economic conditions, Arlingclose's central case is for the MPC to leave the Bank Base Rate at its historically low rate of 0.25% for the remainder of the current financial year and also for 2018/19 and 2019/20. However, the minutes of the MPC's meeting held on 14 September 2017 suggest that the first rate rise may happen much sooner, possibly by the end of the current financial year if inflation remains around its current level and productivity does not weaken. The general expectation is when the Bank Rate does start to rise it will be in shallow steps over time.

2.2.2 Arlingclose's central case for gilt yields is for them to remain broadly stable in 2017/18 and 2018/19 before beginning to rise slowly after that. Interest rates on loans from the Public Works Loan Board (PWLB) are directly linked to the gilt yields.

2.2.3 The following table, based on information from Arlingclose, is the latest forecast of interest rates for the short and medium term. PWLB rates are for their standard new maturity loans.

	Apr 17 – Aug 17 average	**Dec 17**	**Mar 18**	**2018/19 average**	**2019/20 average**
Bank Rate	0.25%	0.25%	0.25%	0.25%	0.25%
Investments					
3 month LIBID	0.18%	0.25%	0.25%	0.30%	0.30%
12 month LIBID	0.52%	0.50%	0.50%	0.58%	0.89%
Borrowing					
5 year PWLB	1.47%	1.39%	1.39%	1.39%	1.47%
10 year PWLB	2.13%	1.95%	1.90%	1.85%	1.88%
20 year PWLB	2.78%	2.57%	2.48%	2.49%	2.60%

2.2.4 With the authority's borrowing portfolio currently being all of fixed rate debt, it is its investment portfolio that is much more exposed to changes in interest rates.

3. LOCAL CONTEXT

3.1 On 31 March 2017, the authority had net borrowing of £25.2m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.17 Actual £m
General Fund CFR	18.5
HRA CFR	47.4
Total CFR	**65.9**
Less: Usable reserves	(37.2)
Less: Working capital	(3.5)
Net borrowing	**25.2**

3.2 The authority’s current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31 August 2017 and the change since the 31 March 2017 is show in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £m	**Movement £m**	**31.8.17 Balance £m**	**31.8.17 Rate %**
Long-term borrowing	57.8	(1.5)	56.3	3.4%
Short-term borrowing	1.7	-	1.7	8.3%
Total borrowing	**59.5**	**(1.5)**	**58.0**	**3.6%**
Long-term investments	(6.9)	(6.8)	(13.7)	2.2%
Short-term investments	(22.5)	6.8	(15.7)	0.5%
Cash and cash equivalents	(4.9)	(9.0)	(13.9)	0.3%
Total investments	**(34.3)**	**(9.0)**	**(43.3)**	**1.0%**
Net borrowing	**25.2**	**(10.5)**	**14.7**	

3.3 The reduction of £1.5m in borrowing covers planned repayments of loans to the PWLB. The overall increase of £9m in investments is not unexpected and broadly represents the in-year benefit of cash flows from local taxation. Based on medium term cash flow projections, long term investments, investments made for a period of greater than 1 year, have increased by £6.8m. This includes a £5m investment made with the London Borough of Croydon. The cash and cash equivalent investments, investments where the council can normally access its cash immediately or within a short notice period, have increased by £9m. Although not untypical at this stage of the year, the amount held as cash and cash equivalents is more than required for immediate liquidity needs and the position is being closely monitored.

4. BORROWING STRATEGY AND ACTIVITY 2017/18

4.1 At 31 August 2017, the Authority held £58.0m of loans, a reduction of £1.5m compared to 31 March 2017, as part of its strategy for funding previous years' capital programmes. Following the introduction of the Housing Revenue Account (HRA) Self-Financing regime in 2012 the authority operates a two pool debt approach allocating its loans between the General Fund and HRA. The borrowing position at 31 August 2017 compared to 31 March 2017 is shown in table 3 below.

Table 3: Borrowing Position – Two Pool Debt Approach

	31.3.17 Balance £m	**Net Movement £m**	**31.8.17 Balance £m**	**31.8.17 Rate %**
General Fund Public Works Loan Board Local authorities (long-term)	 8.4 0.5	 (0.7) -	 7.7 0.5	 5.25% 2.32%
Total General Fund borrowing	8.9	(0.7)	8.2	5.09%
Housing Revenue Account Public Works Loan Board	50.6	(0.8)	49.8	3.36%
Total HRA borrowing	50.6	(0.8)	49.8	3.36%
Total borrowing	**59.5**	**(1.5)**	**58.0**	**3.60%**
CFR	**65.9**	**-**	**65.9**	
Under-borrowed	**(6.4)**	**(1.5)**	**(7.9)**	

4.2 The weighted average maturity of the overall loans portfolio at 31 August 2017 was 14.2 years.

4.3 The authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the authority's long-term plans change being a secondary objective.

4.4 In furtherance of these objectives no new borrowing has so far been undertaken in 2017/18, while existing loans have been allowed to mature without replacement. This strategy has enabled the authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

4.5 The “cost of carry” analysis performed by Arlingclose has not indicated any value in borrowing in advance for future years’ planned expenditure and therefore none has been taken or, at this stage, is planned to be for the remainder of the current financial year.

4.6 **Debt Rescheduling** – Opportunities to undertake debt rescheduling have been monitored during the year in conjunction with Arlingclose. However, as expected, PWLB interest rates have not reached a level where it would be beneficial to undertake debt rescheduling to create a net saving in borrowing costs. The position is not expected to change for the remainder of the current financial year.

5. INVESTMENTS

5.1 The council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the period to 31 August 2017, the authority’s investment balance has ranged between £34.3m and £52.1m due to timing differences between income and expenditure. The average investment balance held to 31 August 2017 was £43.5m. The investment position during the period to 31 August 2017 is shown in table 4 below. A list of the individual investments held at 31 August 2017 is shown in appendix 1 to this report.

Table 4: Investment Position

	31.3.17 Balance £m	**Net Movement £m**	**31.8.17 Balance £m**	**Average Return**
Banks & building societies (unsecured)	13.0	(6.6)	6.4	0.64%
Covered bonds (secured)	3.3	1.9	5.2	0.53%
Government (incl. local authorities)	8.0	5.0	13.0	0.90%
Money Market Funds	4.8	6.7	11.5	0.22%
Other Pooled Funds	5.2	2.0	7.2	3.60%
Total investments	**34.3**	**9.0**	**43.3**	**1.00%**

5.2 The weighted average maturity of the investment portfolio at 31 August 2017 was 196 days.

5.3 Both the CIPFA Code and government guidance require the authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The authority’s objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

5.4 In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the authority has further diversified into more secure asset classes. A net £6.6m that is available for longer-term investment was moved from bank and building society deposits into investments with other local authorities and covered bonds. Additionally, £2m of cash balances has been invested in a short dated pooled bond fund that has a typical investment duration of up to 6 months. As a result, investment risk was more diversified than the previously. The average income return in 2017/18 has fallen by 0.31% compared to that being received at 31 March 2017 due to both the move towards lower risk investments and the continued impact of a the low interest rate environment. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 5 below.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Income Return
Shepway					
31.03.2017	4.3	AA-	61%	141	1.35%
30.06.2017	3.6	AA-	51%	231	1.04%
Similar LAs	4.3	AA-	66%	118	1.13%
All LAs	4.3	AA-	65%	45	0.89%

5.5 The investment benchmarking, which is a snapshot at the end of each quarter, demonstrates the authority had a lower risk profile than both its peer group and the wider local authority population at 30 June 2017 (measured against other Arlingclose clients only). However the Authority's return was slightly lower than its peer but higher than the overall population.

5.6 Given the increasing risk and continued low returns from short-term unsecured bank investments and in line with advice from Arlingclose, it is the council's aim to continue to diversify into more secure and/or higher yielding asset classes during the remainder of this financial year and beyond.

5.7 The authority's best performing investment in 2017/18 remains its £5.2m externally managed pooled property fund. The CCLA Local Authorities' Property Fund generated a total net income return of £61k or 4.7% for the quarter to 30 June 2017 and the capital value of the Authority's investment increased during the same period by 1% or £50k. The authority's investment in the fund has grown by approximately 4.5% or £228k compared to its original investment of £5m. Because this fund has no defined maturity date, but is available for withdrawal after a notice period, its performance and continued suitability in meeting the authority's investment objectives is regularly reviewed. In light of the fund's continued strong income return and the authority's latest cash flow forecasts, investment in this fund has been maintained for the year.

6. CREDIT RISK AND COUNTERPARTY UPDATE

6.1 Credit Risk

6.1.1 The structure of the authority's approved credit risk methodology for new investments is in line with that suggested by Arlingclose. Based on this approved methodology, Arlingclose provides the Authority with a regular up to date list of eligible counterparties to use and also notifies it immediately of any changes required to this.

6.2 Counterparty Update

6.2.1 UK bank credit default swap prices (the banking sector's insurance against default) have continued their positive downward trend during the first part of 2017/18, reaching a 3 year low during the summer. Bank share prices have not moved in any particular pattern during this period.

6.2.2 There have been a small number of credit rating changes to 31 August 2017. The main ones affecting the authority's investment counterparty list are summarised below:-

i) Standard Chartered Bank's long term rating downgraded by Moody's one notch to A1 from Aa3 due to an expectation that their profitability will be lower following efforts to de-risk their balance sheet.

ii) Major Canadian banks' long term ratings downgraded by Moody's due to an expectation of a more challenging operating environment potentially leading to a deterioration in banks asset quality. Arlingclose had already undertaken a bail in analysis for Canadian banks which resulted in them reducing their recommended maximum investment duration for new investments from 13 months to 6 months.

iii) Major Australian banks' long term ratings downgraded one notch by Moody's to Aa3 from Aa2 due to concerns over their exposure to rising risks from the Australian housing market and the increased proportion of lending to the residential market.

6.2.3 In anticipation of the impact of the UK banking reforms where banks retail operations will be ring-fenced and separated from the remainder of their activities, expected to be implemented over the next year, Arlingclose has reduced the recommended duration for new deposits at Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months. There is some uncertainty which banking entities the Authority will be dealing with once ring-fencing is implemented.

6.2.4 In late September 2017 Moody's downgraded its long term sovereign rating for the UK by one notch to Aa2 from Aa1 and, at the same time, revised their outlook to stable from negative. The main reason behind Moody's rating change is their expectation the UK will suffer from weaker public finances going forward. Arlingclose remains comfortable with their existing investment advice for UK financial institutions although they have warned that Moody's are likely to issue a similar downgrade to UK banks and building societies in the near future.

7. FINANCIAL SUMMARY

7.1 The projected outturn for the net cost of treasury management to the General Fund in 2017/18 is summarised in table 6 below:

Table 6: Financial Summary

	2017/18 Original Estimate	**2017/18 Projection**	**Variance**
	£'000	£'000	£'000
Interest on all Borrowing	2,114	2,114	-
Related HRA Charge	(1,676)	(1,676)	-
General Fund Borrowing Cost	**438**	**438**	**-**
Investment Income	(357)	(418)	(61)
HRA Element	52	44	(8)
Net General Fund Investment Income	**(305)**	**(374)**	**(69)**
Net General Fund Borrowing Cost	**133**	**64**	**(69)**

7.2 The projected reduction in the net borrowing cost to the General Fund is mainly due to additional investment income expected to be received from higher than anticipated cash reserves and balances held during 2017/18.

7.3 Opportunities to reduce the net cost of treasury management will continue to be sought as part of the pro-active management to the council's debt and investment portfolios by its officers in consultation with the Portfolio Holder.

8. COMPLIANCE REPORT

8.1 The Corporate Director for Organisational Change is pleased to report that all treasury management activities undertaken to 31 August 2017 complied fully with the CIPFA Code of Practice and the authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	Maximum to 31.8.17	31.8.17 Actual	2017/18 Limit	Complied
Any single organisation, except UK Government	£5m	£5m	£5m each	✓
UK Central Government	nil	nil	Unlimited	✓
Any group of funds under the same management	nil	nil	£5m per group	✓
Negotiable instruments held in a broker's nominee account	£6.3m	£5.3m	£10m per broker	✓
Foreign countries	nil	nil	£5m per country	✓
Registered Providers	nil	nil	£10m in total	✓
Unsecured investments with Building Societies	nil	nil	£5m in total	✓
Loans to unrated corporates	nil	nil	£5m in total	✓
Money Market Funds	£24.1m	£11.5m	£25m in total	✓
Any group of pooled funds under the same management	£7.2m	£7.2m	£10m per manager	✓

8.2 Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 8: Debt Limits

	Maximum to 31.8.17	31.8.17 Actual	2017/18 Operational Boundary	2017/18 Authorised Limit	Complied
Borrowing	59.5	58.0	65.0	69.9	✓
PFI & finance leases	-	-	-	-	✓
Total debt	**59.5**	**58.0**	**65.0**	**69.9**	✓

8.3 Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

9. TREASURY MANAGEMENT INDICATORS

9.1 The authority measures and manages its exposures to treasury management risks using the following indicators.

9.2 **Security:** The authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating *or* of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.8.17 Actual	2017/18 Target	Complied
Portfolio average credit rating	AA-	A	✓

9.3 **Liquidity:** The authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	31.8.17 Actual	2017/18 Target	Complied
Total cash available within 3 months	£21.9m	£5m	✓

9.4 **Interest Rate Exposures**: This indicator is set to control the authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed was:

	31.8.17 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure	£58m	£63m	✓
Upper limit on variable interest rate exposure	£0m	£0m	✓

9.4.1 Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

9.5 **Maturity Structure of Borrowing:** This indicator is set to control the authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

	31.8.17 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	2.9%	30%	0%	✓
12 months and within 24 months	0.7%	40%	0%	✓
24 months and within 5 years	6.4%	50%	0%	✓
5 years and within 10 years	36.2%	80%	0%	✓
10 years and above	53.8%	100%	0%	✓

9.5.1 Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

9.6 **Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2017/18	2018/19	2019/20
Actual principal invested beyond year end	£8.5m	£8.5	£3.5
Limit on principal invested beyond year end	£20m	£15m	£10m
Complied	✓	✓	✓

Note – Although the investment with the CCLA LA Property Fund is viewed as a long term, its terms allow the authority to seek principal redemption on a monthly basis. Therefore this investment is not included within the above indicator.

10. MiFID II

10.1 Currently the authority is classified as a professional client. As a result of the implementation in the UK of the Markets in Financial Instruments Directive (2014/65/EU) (MiFID II) from 3rd January 2018 financial services firms will be obliged to treat all local authority clients as retail clients unless they have elected to opt to professional client status and meet certain conditions. These conditions are that the authority's investment portfolio exceeds £10m and either it has carried out more than forty transactions in the relevant market in the past year or that the person carrying out the transactions has at least one year's experience working in the financial sector. In addition there are qualitative criteria around financial services firms assessing that the authority has sufficient knowledge and expertise.

10.2 If the authority does not opt up to professional status it may gain extra protections. However it is also likely that the authority will face an increased cost and potentially restricted access to certain products including money market funds, pooled funds, t-bills, bonds, shares and financial advice.

10.3 The authority expects to meet the conditions to opt up to professional status and intends to do so in order to maintain their current MiFID status.

11. CONCLUSIONS

11.1 The UK's economic outlook means interest rates are expected to remain broadly unchanged for the remainder of the current financial year.

11.2 The authority will maintain its strategy keeping borrowing and investments below their underlying levels (internal borrowing) in order to reduce risk and keep interest costs lower.

11.3 The loan and investment portfolios will continue to be closely monitored to ensure they efficiently contribute towards the authority's medium term financial strategy.

11.4 The authority's treasury management activities undertaken to 31 August 2017 complied fully with the approved Treasury Management Strategy.

12. LEGAL/FINANCIAL AND OTHER CONTROLS/POLICY MATTERS

12.1 Legal Officer's Comments (DK)

There are no legal implications arising directly out of this report. Part 1 of the Local Government Act 2003 gives the Council the power to borrow and to invest for any purpose relevant to its functions or for the purposes of the prudent management of its financial affairs. It also requires the Council to act prudently when carrying out these activities, including an obligation to determine and keep under review how much money it can borrow. In addition, the Council is required by the Local Government Finance Act 1992 to produce a balanced budget. The Council must bear in mind its fiduciary duties to local tax payers and its continuing obligation to ensure it has funding to perform the statutory undertakings it has to comply with.

12.2 Finance Officer's Comments (LW)

Prepared by Financial Services, no further comments.

12.3 Diversities and Equalities Implications

The report does not cover a new service or policy or a revision of either and therefore does not require an Equality Impact Assessment.

13. CONTACT OFFICERS AND BACKGROUND DOCUMENTS

Councillors with any questions arising out of this report should contact the following officer prior to the meeting:

Lee Walker, Group Accountant
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The following background documents have been relied upon in the preparation of this report:

None

Appendices:
Appendix 1 – Investments held at 31 August 2017

APPENDIX 1 – INVESTMENTS HELD AT 31 AUGUST 2017

Counterparty	Amount £	Terms	Interest Rate %
Banks and Building Societies (unsecured)			
Lloyds	3,000,000	1 Year Fixed to 15/02/18	0.90
Goldman Sachs International Bank	3,000,000	95 day Notice account	0.46
National Westminster	424,000	Business Reserve instant access	0.01
Covered Bonds (Secured)			
Royal Bank Scotland	1,000,842	Covered Floating Rate Note to 15/05/20	0.54
Royal Bank Scotland	2,505,136	Covered Floating Rate Note to 15/05/20	0.50
Yorkshire Building Society	1,740,167	Covered Fixed Rate Bond to 12/04/18	0.57
Government			
Peterborough City Council	3,000,000	2 Year Fixed Deposit to 29/09/17	0.92
Lancashire County Council	5,000,000	2 Year Fixed Deposit to 16/11/17	1.00
London Borough Croydon	5,000,000	2 Year Fixed Deposit to 31/05/19	0.80
Money Market Funds			
Standard Life MMF	5,000,000	Money Market Fund instant access.	0.22
BNP Paribas MMF	5,000,000	Money Market Fund instant access.	0.23
Legal & General MMF	1,449,000	Money Market Fund instant access.	0.20
Other Pooled Funds			
CCLA Property Fund	5,187,015	Commercial Property Fund	*4.70
JP Morgan	2,000,000	Sterling Managed Reserve	**0.65
Total Investments	**43,306,160**		
* Net of Fees			
** Indicative Variable Rate			