South
Derbyshire
District Council

Treasury Management Report Q2 2018/19

Introduction

The Authority has adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

The Authority's treasury management strategy for 2018/19 was approved at a meeting of the Authority on 15th February 2018. 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. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Treasury Management Code of Practice. Additionally, in England MHCLG published its revised Investment Guidance which came into effect from April 2018.

The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority has produced its Capital Strategy which will be approved by full Council in January 2019.

The detail that follows is in accordance with the CIPFA Code and is written with support from the Council's Treasury Advisor, Arlingclose.

External Context

Economic background

Oil prices rose by 23% over the six months to around $82/barrel. UK Consumer Price Inflation (CPI) for August rose to 2.7% year/year, above the consensus forecast and that of the Bank of England's in its August *Inflation Report*, as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4%, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9% providing some evidence that a shortage of workers is providing support to wages. However real wages, (i.e. adjusted for inflation), grew only by 0.2%, a marginal increase unlikely to have had much effect on households.

The rebound in quarterly GDP growth in Q2 to 0.4% appeared to overturn the weakness in Q1 which was largely due to weather-related factors. However, the detail showed much of Q2 GDP growth was attributed to an increase in inventories. Year/year GDP growth at 1.2% also remains below trend. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.

Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in each of June and September by 0.25% to the current 2%-2.25%. Markets now expect one further rise in 2018.

The escalating trade war between the US and China as tariffs announced by the Trump administration appeared to become an entrenched dispute, damaging not just to China but also other Asian economies in the supply chain. The fallout, combined with tighter monetary policy, risks contributing to a slowdown in global economic activity and growth in 2019.

The EU Withdrawal Bill, which repeals the European Communities Act 1972 that took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament. With just months to go when Article 50 expires on 29th March 2019, neither the Withdrawal Agreement between the UK and the EU which will be legally binding on separation issues and the financial settlement, nor its annex which will outline the shape of their future relationship, have been finalised, extending the period of economic uncertainty.

One possible outcome of a disorderly Brexit is a UK recession as economic growth contracts. In this scenario the Bank of England would be expected to cut interest rates. However, November's Monetary Policy Committee minutes indicated that interest rates could rise in the event that supply falls faster than demand, leading to domestically generated inflation. Similar uncertainty applies to the interest rate outlook following the agreement of an early and "good" transitional deal, since the likely rise in the exchange rate will import deflation to the UK.

Financial markets

Gilt yields displayed marked volatility during the period, particularly following Italy's political crisis in late May when government bond yields saw sharp moves akin to those at the height of the European financial crisis with falls in yield in safe-haven UK, German and US government bonds. Over the period, despite the volatility, the bet change in gilt yields was small. The 5-year benchmark gilt only rose marginally from 1.13% to 1.16%. There was a larger increase in 10-year gilt yields from 1.37% to 1.57% and in the 20-year gilt yield from 1.74% to 1.89%. The increase in Bank Rate resulted in higher in money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.56%, 0.70% and 0.95% respectively over the period.

It is understood that the UK is close to agreeing a deal for UK and European financial service firms to continue "passporting" their regulatory permissions post-Brexit, however this has not been signed yet. Therefore, even though Arlingclose remain comfortable that banks and money market funds domiciled outside the UK will repay client investments, there remains a possibility that regulatory issues will interfere with the timely transfer of cash. They therefore recommend that clients ensure that they do not hold the entirety of their liquid funds outside the UK over the Brexit period. There are only two money market funds domiciled in the UK - the CCLA Public Sector Deposit Fund and the Federated Short-Term Sterling Prime Fund. The Authority currently holds £2m in the Federated Fund.

Credit background

Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ringfenced bank NatWest Markets plc rose relatively sharply over the period to around 96bps. The CDS for the ringfenced entity, National Westminster Bank plc, has held steady below 40bps. Although the CDS of other UK banks rose marginally over the period, they continue to remain low compared to historic averages.

The ringfencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc – is complete, the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.

There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ringfencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody's and to A- from BBB+ by both Fitch and Standard & Poor's (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody's.

Arlingclose will henceforth provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities' flexibility during bail-in. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs but not senior unsecured bonds issued by commercial banks.

Arlingclose considers that the strongest UK banks and building societies hold sufficient levels of capital to weather a no-deal Brexit for a rolling period of at least three or six months as indicated by the advice they provide upon which we base our Counterparty List. Weak banks unprepared for a systemic event, and strong banks suffering an idiosyncratic event may be at an increased risk of bail-in. However, Arlingclose are confident the Bank of England, and if necessary HM Treasury, will take action to prevent widespread bank defaults caused by a systemic event such as Brexit.

Local Context

On 31st March 2018, the Authority had net borrowing of £29.86m arising from its revenue and capital income and expenditure. This fell to £20.41m by the end of quarter 2. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). Debt outstanding is split between the HRA and General Fund and this represents the 'two pool' approach adopted for debt management.

Capital Financing Requirement (CFR)

	31.3.18 Actual £'000	30.06.18 Actual £'000	30.09.18 Actual £'000
Housing Revenue Account			
Debt Outstanding	57,423	57,423	57,423
Capital Financing Requirement (CFR)	61,584	61,584	61,584
Statutory Debt Cap	66,853	66,853	66,853
Borrowing Capacity (Cap less Debt Outstanding)	**9,430**	**9,430**	**9,430**
General Fund			
Debt Outstanding	0	0	0
Capital Financing Requirement (CFR)	5,653	5,653	5,653
Borrowing Capacity (Cap less Debt Outstanding)	**5,653**	**5,653**	**5,653**
Total Capital Financing Requirement (CFR)	**67,237**	**67,237**	**67,237**

In his Autumn 2018 Budget Statement, the Chancellor confirmed the abolition of the HRA Debt Cap with effect from 29th October 2018. The quarter 3 treasury report will be updated to reflect this change.

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 overall treasury management position at 30th September 2018 and the change in the quarter is show in the table below.

Treasury Management Summary

	31.03.18 Balance £'000	30.06.18 Balance £'000	Q2 2018 Movement £'000	30.09.18 Balance £'000
Long-term borrowing	57,423	57,423	0	57,423
Short-term borrowing	28	28	0	28
Total borrowing	**57,451**	**57,451**	**0**	**57,451**
Long-term investments	1,000	1,000	1,000	2,000
Short-term investments	23,500	25,000	5,500	30,500
Cash and cash equivalents	3,092	4,084	462	4,546
Total investments	**27,592**	**30,084**	**6,962**	**37,046**
Net borrowing	**29,859**	**27,367**		**20,405**

Borrowing Activity

At 30th September 2018 the Authority held £57.4m of loans. These loans were taken out by the Authority in 2011/12 for the purpose of HRA self-financing. The principal element of these loans is repayable in full on maturity, with interest being paid each March and September.

The short-term borrowing of £28k relates to deposits received from two Parish Councils within the district. These loans can be recalled on immediate notice. Interest is calculated at the Bank of England Base Rate, less 1%. No interest is currently being paid due to the Base Rate being less than 1%.

The following table shows the maturity dates of the loans and rate of interest payable.

Borrowing Position

Loan Profile	Type	Value £'000	Rate %	Maturity
Public Works Loan Board	Variable	10,000	0.79	2021/22
Public Works Loan Board	Fixed	10,000	2.70	2023/24
Public Works Loan Board	Fixed	10,000	3.01	2026/27
Public Works Loan Board	Fixed	10,000	3.30	2031/32
Public Works Loan Board	Fixed	10,000	3.44	2036/37
Public Works Loan Board	Fixed	7,423	3.50	2041/42
Total Long-term borrowing		**57,423**		
Short-term Parish Council Loans		**28**	0.00	
Total borrowing		**57,451**		

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.

Treasury Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the quarter, the Authority's investment balance ranged between £34m and £43m due to timing differences between income and expenditure. The investment position during the quarter is shown in the table below.

Treasury Investment Position

	31.03.18 Balance £'000	30.06.18 Balance £'000	Q1 Rate of Return %	30.09.18 Balance £'000	Q2 Rate of Return %
Banks (unsecured)	3,092	4,084	0.23	4,546	0.35
Local Authorities	18,000	20,000	0.62	21,000	0.71
Debt Management Office	1,500	1,000	0.27	3,500	0.50
Money Market Funds	4,000	4,000	0.48	6,000	0.62
CCLA Property Fund	1,000	1,000	4.16	2,000	4.21
Total investments	**27,592**	**30,084**		**37,046**	

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 treasury investments before seeking the optimum 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.

In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Authority has undertaken greater detailed cash flow forecasting which has enabled it to enter into longer-term deposits with other Local Authorities, therefore securing a higher rate of return.

The Authority is now participating in the Arlingclose quarterly investment benchmarking exercises. This will enable us to measure our investment portfolio against other similar Local Authorities. The table below is an extract from Arlingclose's benchmarking, and shows the risk and return metrics as at the end of quarter 2.

Investment Benchmarking – Treasury investments managed in-house (excludes CCLA)

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
30.09.2018	3.98	AA-	30%	107	0.63
Similar LAs	4.28	AA-	56%	88	0.78
All LAs	4.38	AA-	60%	37	0.76

Credit Score: This is a value-weighted average score calculated by weighting the credit score of each investment by its value. A higher number indicates a higher risk.

Credit Rating: This is based on the long-term rating assigned to each institution in the portfolio, by ratings agencies Fitch, Moody's and Standard & Poor's. Ratings rang from AAA to D, and can be modified by +/-

Bail-in Exposure: The adoption of a bail-in regime for failed banks results in a potential increased risk of loss of funds for local authority should this need to be implemented. Therefore a lower exposure to bail-in investments reduces this risk.

Weighted Average Maturity: This is an indicator of the average duration of the internally-managed investments. Similar authorities have a similar profile to South Derbyshire; other larger authorities tend to hold a greater proportion of fund in money markets than fixed-term deposits with other LAs, due to their cash flow requirements.

Rate of Return: This is the average rate received on internally managed investments. At the quarter-end we had a few lower rate investments that were secured prior to the base rate rises in November 2017 and/or August 2018, which reduced the average rate of return compared to other authorities.

The Authority deposited £1m in the CCLA Property Fund on 28th September 2017, with the investment purchasing 317,985 units at an offer price of 314.48p per unit. Following member approval, the Authority subsequently deposited a further £1m in the fund on 28th August 2018, with this investment purchasing 308,261 units at an offer price of 324.40p per unit.

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives is regularly reviewed.

The performance of the investment since purchase is shown in the table below. Although past performance is no guarantee of future returns, the movement in the bid (selling) price so far shows how the value of the investment is moving closer to the original purchase price. This reinforces the notion that the Fund should only be considered for long-term investments.

CCLA Property Fund Performance

		2017/18	**2017/18**	**2018/19**	**2018/19**
		Q3	**Q4**	**Q1**	**Q2**
Dividend Received	£	10,738	10,215	10,432	13,871
Annual Equivalent Interest Rate	%	4.30%	4.09%	4.16%	4.21%
Bid (Selling) Price	pence/unit	294.60	297.33	298.90	298.97

Performance Indicators

The main indicator the Council uses to measure its return on short-term investments to average over the year, is the Average 7-Day Money Market Rate. This is a standard measure of performance. Performance for the first two quarters is shown below.

	As at 30.06.18	**As at 30.09.18**
Average 7-Day Money Market Rate (Target)	0.49%	0.57%
Average Interest Rate Achieved on Short Term Deposits	0.55%	0.63%

Compliance

The Chief Finance Officer is pleased to report that all treasury management activities undertaken during quarter 2 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

Compliance with specific investment limits is demonstrated in the table below:

Investment Limits

	Maximum Investment during Q2 £m	**Maximum Invested per Counterparty £m**	**Limit**	**Maximum Term**	**Complied**
Debt Management Office	£11m	£11m	£15m in total	364 days	✓
Other Local Authorities	£24m	£5m	£5m per Authority	364 days	✓
Money Market funds	£6m	£2m	£10m total, £2m per fund	60 days	✓
CCLA Property Fund	£2m	£2m	£2m	Indefinite period	✓
Named Counterparties (HSBC/Lloyds/BOS/Close Bros/Santander)	£1.95m	£1.95m	£2m per Bank	6 months	✓
Named Counterparties (Barclays/Goldman Sachs/NatWest/RBS)	£1.93m	£1.93m	£2m per Bank	100 days	✓
Named Counterparties (Nationwide/Coventry)	0	0	5% of total deposits	6 months	✓
Named Counterparties (Leeds Building Society)	0	0	5% of total deposits	100 days	✓
Foreign Counterparties	0	0	AAA rated - £1m per Bank	1 month	✓
Independent Building Societies	0	0	£1m per Society	100 days	✓

Outlook for the remainder of 2018/19

Having raised policy rates in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon.

The MPC has a definite bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that (a) ultra-low interest rates result in other economic problems, and that (b) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise and cuts are required.

Arlingclose's central case is for Bank Rate to rise twice in 2019. The risks are weighted to the downside. The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2% remains well below the long term average

The view is that the UK economy still faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Central bank actions and geopolitical risks, such as prospective trade wars, have and will continue to produce significant volatility in financial markets, including bond markets.