South Derbyshire District Council

Treasury Management Report Q1 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. This report provides an additional quarterly update.

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 but has yet to publish the local authority specific Guidance Notes to the latter. 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 will be producing its Capital Strategy later in 2018-19 for approval by Full Council.

External Context

Economic background

Commodity prices fell during the quarter, although oil prices rose, peaking at $75 a barrel before falling slightly to just over $73. The primary factor in the oil price's recent fall was the OPEC's (Organisation of Petroleum Exporting Countries) announcement that a deal had been reached with non-OPEC nations to increase nominal production by 1 million barrels a day.

UK Consumer Price Inflation (CPI) index fell over the quarter and the data released for May showed CPI at 2.4%, a 12-month low. The most recent labour market data for April 2018 showed the unemployment rate at 4.2%, a low last seen in 1975. However real wages (i.e. adjusted for inflation) grew only by 0.4%, a marginal increase unlikely to have had much effect for households. Q1 GDP data released in April and revised in May showed economic activity slowing to 0.2%.

The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. Although it made no change to monetary policy at its meetings in May and June, at its meeting on 2nd

August 2018, the MPC voted unanimously to increase Bank Rate by 0.25 percentage points, to 0.75%.

Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in June by 0.25% to between 1.75% and 2% and markets now expect two further rises in 2018.

Fears rose of a global trade war on the announcement of the Trump Administration implementing tariffs on $200bn of imports, notably steel, aluminium, food and chemicals. Canada, the EU and China contemplated announced retaliatory tariffs as did Mexico. Many of these have since been instituted in early July. The announcements sparked a sell-off in global equity markets, with the major equity global indices falling.

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 a vote of 319 to 303, after the government gave assurances that Parliament would have a meaningful vote in the event of a no-deal Brexit. Very little progress was made in negotiating future trading arrangements, extending the period of uncertainty.

Financial markets

Gilt yields displayed marked volatility during the quarter, 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. The yield on the 5-year benchmark gilt fell from 1.13% to 1.04% during the quarter, the 10-year gilt fell from 1.36% to 1.28% and the yield on the 20-year gilt rose marginally from 1.71% to 1.72%. Money markets rates remained low: 1-month, 3-month and 12-month LIBID rates averaged 0.38%, 0.55% and 0.84% in the quarter respectively.

Credit background

UK bank credit default swaps rose marginally over the quarter, but the overall level was still low against historic averages.
There were a few credit rating changes during the quarter. Moody's downgraded Barclays Bank Plc's long-term rating to A2 from A1 after the banking group completed its restructure to be compliant with UK bank ring-fencing requirements which come into effect in 2019. The agency also downgraded Royal Bank of Scotland plc's (RBS plc) long-term ratings to Baa2 from A3 on its view that the credit metrics of RBS plc, which will become the non-ring-fenced NatWest Markets plc, will become weaker and less diversified and the main functions of the bank would be in higher risk activities. Moody's and Fitch upgraded the long-term ratings of NatWest Bank and Ulster Bank on the view that their credit profiles are expected to improve following ring-fencing. As a result the Authority has removed RBS and NatWest from its counterparty list.

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 £27.37m by the end of the quarter. 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**
Housing Revenue Account		
Debt Outstanding	57,423	57,423
Capital Financing Requirement (CFR)	61,584	61,584
Statutory Debt Cap	66,853	66,853
Borrowing Capacity (Cap less Debt Outstanding)	**9,430**	**9,430**
General Fund		
Debt Outstanding	0	0
Capital Financing Requirement (CFR)	5,653	5,653
Borrowing Capacity (Cap less Debt Outstanding)	**5,653**	**5,653**
Total Capital Financing Requirement (CFR)	**67,237**	**67,237**

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 June 2018 and the change in the quarter is show in the table below.

Treasury Management Summary

	31.03.18 Balance £'000	Q1 2018 Movement £'000	30.06.18 Balance £'000
Long-term borrowing	57,423	0	57,423
Short-term borrowing	28	0	28
Total borrowing	**57,451**	**0**	**57,451**
Long-term investments	1,000	0	1,000
Short-term investments	23,500	1,500	25,000
Cash and cash equivalents	3,092	992	4,084
Total investments	**27,592**	**2,492**	**30,084**
Net borrowing	**29,859**		**27,367**

Borrowing Activity

At 30th June 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 £28m and £37m due to timing differences between income and expenditure. The investment position during the quarter is shown in table 4 below.

Treasury Investment Position

	31.03.18 Balance £'000	Q1 2018 Movement £'000	30.06.18 Balance £'000	30.06.18 Rate of Return %
Banks (unsecured)	3,092	992	4,084	0.23
Local Authorities	18,000	2,000	20,000	0.62
Debt Management Office	1,500	-500	1,000	0.27
Money Market Funds	4,000	0	4,000	0.48
CCLA Property Fund	1,000	0	1,000	4.16
Total investments	**27,592**	**2,492**	**30,084**	

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 1.

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

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
30.06.2018	4.01	AA-	29%	99	0.55
Similar LAs	4.37	AA-	61%	98	0.66
All LAs	4.46	AA-	62%	42	0.65

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 rise in November 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. 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 **Q3**	**2017/18** **Q4**	**2018/19** **Q1**
Dividend Received	£	10,738	10,215	10,432
Annual Equivalent Interest Rate	%	4.30%	4.09%	4.16%
Bid (Selling) Price	pence/unit	294.6	297.33	298.9

In light of the above performance and the Authority's latest cash flow forecasts, the Authority has sought approval to invest a further £1m into the CCLA Property Fund. This is due to be invested during quarter 2.

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 quarter is shown below.

	As at 30.6.18
Average 7-Day Money Market Rate (Target)	0.49%
Average Interest Rate Achieved on Short Term Deposits	0.55%

Compliance

The Chief Finance Officer is pleased to report that all treasury management activities undertaken during quarter 1 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 Q1 £m	Maximum Invested per Counterparty £m	Limit	Maximum Term	Complied
Debt Management Office	£9m	£9m	£15m in total	364 days	✓
Other Local Authorities	£20m	£5m	£5m per Authority	364 days	✓
Money Market funds	£4m	£2m	£10m total, £2m per fund	60 days	✓
CCLA Property Fund	£1m	£1m	£1m	Indefinite period	✓
Named Counterparties (HSBC/Lloyds/BOS/Close Bros/Santander)	£1.95m	£1.95m	£2m per Bank	6 months	✓
Named Counterparties (Barclays/Goldman Sachs)	£1.89m	£1.89m	£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

Arlingclose's central case is for Bank Rate to rise twice more in 2019, possibly in March and September. The MPC has a definite bias towards tighter monetary policy. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that: 1) ultra-low interest rates result in other economic problems, and that 2) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise.

Arlingclose's 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.