Agenda Item No 4(g)

DERBYSHIRE COUNTY COUNCIL

AUDIT COMMITTEE

22 November 2017

Report of the Director of Finance & ICT

TREASURY MANAGEMENT

1 Purpose of the Report

The Chartered Institute of Public Finance and Accountancy's (CiPFA) Treasury Management Code (the Code) requires that authorities report on the performance of the treasury management function at least twice a year. This report is the mid-year update for 2017-2018.

2 Information and Analysis

Economic Background

Prime Minister Theresa May called an unscheduled General Election in June 2017, to resolve uncertainty but the surprise result has led to a minority Conservative government in coalition with the Democratic Unionist Party.

Monetary Policy - The Bank of England made no change to monetary policy at its meetings in the first half of the financial year. The vote to keep Base Rate at 0.25% narrowed to 5-3 in June, highlighting that some Monetary Policy Committee (MPC) members were more concerned about rising inflation than the risks to growth. Although at September's meeting, the Committee voted 7-2 in favour of keeping Base Rate unchanged, the MPC changed their rhetoric, implying a rise in Base Rate in "the coming months". The Council's treasury advisor, Arlingclose, is unconvinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

Growth - Economic activity expanded at a much slower pace as evidenced by Q1 and Q2 Gross Domestic Product (GDP) growth of 0.2% and 0.3% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings falling and real wage growth negative, there are concerns that these will be a constraint on economic activity in the second half of the 2017 calendar year. .

Inflation - UK Consumer Price Inflation (CPI) index rose with August showing CPI at 2.9%, its highest since June 2013 as the fall in the value of sterling

following the June 2016 EU Referendum result continued to feed through into higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.7%.

Unemployment - The unemployment rate fell to 4.3%, the lowest since May 1975, but the squeeze on consumers intensified as average earnings grew at 2.5%, below the rate of inflation.

Europe - Although the potential for a so-called hard Brexit is diminished, lack of clarity over future trading partnerships, in particular future customs agreements with the rest of the European Union block, is denting business sentiment and investment. The reaction from the markets on the UK election's outcome was fairly muted, business confidence now hinges on the progress of Brexit negotiations, the cost of the exit and whether new trade treaties and customs arrangements are successfully concluded to the UK's benefit.

USA - The US Federal Reserve increased its target range of official interest rates in June for the second time in 2017 by 0.25% to between 1% and 1.25%, a further similar increase is expected in its December 2017 meeting.

Interest Rates

Local Authority to Local Authority rates fell from a year end spike of 0.50% for 6 months and 0.65% for 1 year, to a mid-year low of 0.30% for 6 months and 0.40% for 1 year. Bank account rates also fell from 0.80% to 0.60% in the year and market funds fell from 0.30% to 0.20% for instant access.

The 20-Year Public Works Loan Board (PWLB) interest rates rose from 2.77% on 3 April 2017 to 2.94% on 29 September 2017. The 5-Year PWLB rates have increased from 1.45% at 3 April 2017 to 1.79% on 29 September 2017. The Council is eligible for the Certainty Rate discount of 0.20% on all new PWLB borrowing.

In the face of a struggling economy and Brexit-related uncertainty, Arlingclose expects the Bank of England to take only a very measured approach to any monetary policy tightening, any increase will be gradual and limited as the interest rate backdrop will have to provide substantial support to the UK economy through the Brexit transition.

Borrowing

As accountable body for the Local Growth Fund, the Council received £67.5m of short-term callable borrowing taken from the D2N2 LEP on 11 April 2017. This sum is due to be repaid in full by 31 March 2018.

The Capital Financing Requirement at 31 March 2017 was £468.670m (£498.590m at 31 March 2016). Long-term borrowing (excluding PFI and Finance Leases) stands at £311.519m of which £4.575m is due for repayment

on 16 October 2017. The average interest rate paid is 4.71% on long term debt and 0.25% on short term debt.

Internal borrowing (use of the Council's available reserves) is being used to fund any shortfall. At 31 March 2017, the Council had £62.333m of internal borrowing. Approximately £1.035m was saved by following this strategy being the difference between the 2.57% new borrowing rate (2.77% - 0.20% certainty rate discount) and the 0.91% average interest rate received on investment balances.

The relative position of short-term and long-term interest rates are being constantly monitored. The Council has to assess the savings of locking into long-term borrowing when market conditions are advantageous against the cost-of-carry (the difference between the cost and financial benefit of holding a particular asset for a specified period) of borrowing in advance of need. Similarly, the Council must also assess any savings generated by repaying borrowing now compared against the anticipated costs of borrowing in the future when interest rates are forecast to be higher.

Lending

The average return on investments for the period 1 April 2017 to 30 September 2017 was 0.85% (compared to 0.89% in 2016-17). This return may improve if the expected 0.25% increase in Base Rate in November 2017, or February 2018 transpires.

The average level of Council investments for the half-year to 30 September 2017 is £353m (2016-17: £351m). The availability of funds for short-term lending arises from a combination of front-ended government grants and, working capital, with longer term lending funded from the Council's available reserves.

Money Market Funds - The new EU regulations were finally approved and published in July and existing funds will have to be compliant by no later than 21 January 2019. The key features include Low Volatility Net Asset Value (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements.

Regulatory Updates

Markets in Financial Instruments Directive II (MiFID II) - Local authorities are currently treated by regulated financial services firms as professional clients who can "opt down" to be treated as retail clients instead. From 3 January 2018, as a result of the second directive (MiFID II), local authorities will be treated as retail clients who can "opt up" to be professional clients, providing that they meet certain criteria. Regulated financial services firms include banks, brokers, advisers, fund managers and custodians, but only where they are selling, arranging, advising or managing designated investments. In order

to opt up to professional status, the authority must have an investment balance of at least £10 million and the person authorised to make investment decisions on behalf of the authority must have at least one year's relevant professional experience. In addition, the firm must assess that that person has the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The Authority meets the conditions to opt up to professional status and intends to do so in order to maintain their current MiFID status.

In February 2017 CIPFA canvassed views on the relevance, adoption and practical application of the Treasury Management and Prudential Codes and after reviewing responses launched a further consultation on changes to the codes in August with a deadline for responses of 30 September 2017.

The proposed changes to the Prudential Code include the production of a new high-level Capital Strategy report to full council which will cover the basics of the capital programme and treasury management. The prudential indicators for capital expenditure and the authorised borrowing limit would be included in this report but other indicators may be delegated to another committee. There are plans to drop certain prudential indicators, however local indicators are recommended for ring fenced funds (including the HRA) and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties in the definition of "investments" as well as loans made or shares brought for service purposes. Another proposed change is the inclusion of financial guarantees as instruments requiring risk management and addressed within the Treasury Management Strategy. Approval of the technical detail of the Treasury Management Strategy may be delegated to a committee rather than needing approval of full Council. There are also plans to remove or amend some of the current treasury management indicators.

CIPFA intends to publish the two revised Codes towards the end of 2017 for implementation in 2018-19, although CIPFA plans to put transitional arrangements in place for reports that are required to be approved before the start of the 2018-19 financial year. The Department of Communities and Local Government (DCLG) and CIPFA wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. It is understood that DCLG will be revising its Investment Guidance (and its Minimum Revenue Provision guidance) for local authorities in England; however there have been no discussions with the devolved administrations yet.

Prudential Indicators

A summary of the Prudential Indicators set for 2017-2018 as shown in the Cabinet report dated 8 February 2017 is attached as Appendix One. It compares the original limits set by the Cabinet and the actual position at the half-year stage. All Prudential indicators have been met.

3 Considerations

In preparing this report the relevance of the following factors has been considered: financial, human resources, legal and human rights, equality of opportunity, health, environmental, transport, property, social value and crime and disorder considerations.

4 Background Papers

Papers held in Technical Section, Corporate Finance & ICT, Room 137

5 Officer's Recommendations

That Audit Committee notes:

i. the interim report on Treasury Management for 2017-18
ii. compliance with the prudential indicators as shown in Appendix One

PETER HANDFORD

Director of Finance & ICT

Prudential Indicators Monitoring 2017-18	**2017-18 Estimate or Limit**	**Actual at 30 September 2017**
Ratio of financing costs to net revenue stream	5.40%	No change
Incremental impact on Council Tax of capital programme	£10.40	No change
Capital expenditure – estimate	£197.22m	No change

Gross Borrowing Capital Financing Requirement	**£m**	**£m**
Gross Borrowing (including PFI, Leases, excluding net Transferred debt) + Temporary (D2N2) debt	**383** 307 PWLB/LOBO's 76 – PFI/Leases Nil – Derby City Nil – D2N2	**451.5** 312 – PWLB/LOBO's 79 – PFI/Leases - 2 – Derby City 58.5 - D2N2
Capital Financing Requirement – estimate	613.09	613.09
Gross Borrowing < Capital Financing Requirement	Yes	Yes

External Debt	**£m**	**£m**
Authorised limit	674	674
Operational boundary	644	644
External debt – actual (including PFI, Leases, D2N2)	76 (PFI)	137.5 (79 PFI, 58.5 D2N2)

Treasury Management		
Adoption of CIPFA code of practice	Confirmed	Confirmed

Interest rate exposures	Limit %	Actual %
Borrowing		
Fixed – upper limit	100	87.0
Variable – upper limit	40	13.0
Investment		
Fixed – upper limit	25	27.1 (24% when investment made)
Variable – upper limit	100	72.9

APPENDIX 1

Maturity Structure - Borrowing (years)	Limit %	Actual %
Temporary (D2N2)	0 – 15	15
<1	0 – 15	1
>1 – 2	0 – 15	2
>2 – 5	0 – 40	6
>5 – 10	0 – 40	7
>10 – 20	10 – 40	30
>20 – 30	10 – 40	31
>30	0 – 40	8
Average maturity of external borrowing (not PFI/Leases)	10 – 35 years	19.23 years

Investments (County Fund)		
Security:		
Average Credit Rating	A- (Minimum)	AA-
Liquidity:		
Cash available within 1 month	£30m (Minimum)	£78.9m
Long Term Investments > 1 year	£100m (Maximum)	£87.5m
Yield:		
Avg Base Rate v Actual Return	0.25%	0.85%