

Agenda Item No 6(d)

DERBYSHIRE COUNTY COUNCIL

CABINET

20 December 2018

Report of the Director of Finance & ICT

**MID-YEAR TREASURY MANAGEMENT REPORT 2018-19
(COUNCIL SERVICES)**

1 Purpose

To provide Cabinet with details on the latest performance of the Treasury Management function and to seek approval to adopt changes to the Council's borrowing limits.

2 Information and Analysis

(i) Introduction

The Chartered Institute of Public Finance and Accountancy's Treasury Management (CIPFA-TM 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 2018-2019.

(ii) Economic Background

Inflation - UK Consumer Price Inflation (CPI) for August rose to 2.7% year/year, above the consensus forecast and that of the Bank of England in its August *Inflation Report*, as the effects of sterling's large depreciation in 2016 began to fade.

Employment - The most recent labour market data for July 2018 showed the unemployment rate at 4%, the 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.

Growth - The rebound in quarterly Gross Domestic Product (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.

Monetary Policy - The Bank of England made no change to monetary policy at its meeting in May, however, a 6-3 vote to maintain interest rates in June, was followed by a unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.

Financial markets - Gilt yields displayed marked volatility during the period. 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.

Europe - 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 few months to go when Article 50 expires on 29 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.

USA - 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.

Credit Ratings - 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.

The Council's treasury advisor 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 certificates of deposits but not senior unsecured bonds issued by commercial banks.

(iii) Local Context

On 31 March 2018, the Authority had net borrowing of £36m 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 the table:

Balance Sheet Summary – 31 March 2018	Actual £m
General Fund CFR	457
Less: *Other debt liabilities	-76
Borrowing CFR	381
External borrowing	300
Internal borrowing	81
Less: Usable reserves	-307
Less: Working capital	-38
Net Borrowing	36

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

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 at 30 September 2018 and the change during the period is shown in the table below:

Treasury Management Summary	31 March 2018 Balance £m	Movement £m	30 Sept 2018 Balance £m	30 Sept 2018 Rate %
Long-term borrowing	293.944	(4.575)	289.369	4.69
Short-term borrowing	6.000	64.000	70.000	0.68
Total borrowing	299.944	59.425	359.369	3.91
Strategic pooled funds	19.854	49.478	69.332	4.48
Long-term investments	65.155	(3.048)	62.107	1.53
Short-term investments	160.891	(29.375)	131.516	0.94
Cash and cash equivalents	20.542	38.552	59.094	0.79
Total investments	266.442	55.607	322.049	1.79
Net borrowing	33.502		37.320	

An additional £50m has been invested into strategic pooled funds since 1 April 2018, with the aim to generate a real return (higher than the underlying rate of inflation). The £64m increase in short term borrowing is predominantly to fund investments in strategic pooled funds.

(iv) Borrowing

At 30 September 2018 the Authority held £359m of loans as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30 September 2018 are summarised in the table below:

Borrowing Position	31.3.18 Balance £m	Q1 Net Movement £m	30.9.18 Balance £m	30.9.18 Weighted Average Rate %	30.9.18 Weighted Average Maturity (years)
Public Works Loan Board	278.944	(4.575)	274.369	4.70	19.13
Banks (LOBO)	5.000	0	5.000	4.50	20.89
Banks (fixed-term)	10.000	0	10.000	4.69	25.73
Local authorities (short-term)	6.000	64.000	70.000	0.65	0.39
Total borrowing	299.944	59.425	359.369	3.91	18.89

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 borrowing plans change.

In keeping with these objectives, no new long term borrowing was undertaken, while £4.575m of existing loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

With short-term interest rates remaining much lower than long-term rates, the Authority considered it to be more cost effective in the short term to use internal resources and borrowed short-term loans instead. The net movement in short term loans is shown in the table.

Lender's Option Borrower's Option (LOBO) - The Authority continues to hold £5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the period.

Other Debt - After £3.998m repayment of prior years' Private Finance Initiative/finance leases/transferred debt liabilities, total debt other than borrowing stood at £75.592m on 30 September 2018, taking total debt to £434.961m.

(v) Treasury Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six-month period, the Authority's investment balance ranged between £257.294 m and £394.793 m due to timing differences between income and expenditure. The investment position is shown in table below:

Treasury Investment Position	31.3.18 Balance £m	Net Movement £m	30.9.18 Balance £m	30.9.18 Rate of Return % (#)	30.9.18 Weighted Average Maturity Days (*)
Banks & building societies (unsecured)	51.667	(9.582)	42.094	0.96	150
Government (incl. local authorities)	172.526	3.000	175.526	0.97	218
Registered Social Providers	20.000	(10.000)	10.000	1.78	383
Non-Treasury Management Loans	2.395	2.702	5.097	4.73	346
Money Market Funds	0	20.000	20.000	0.69	1
Strategic Pooled Funds:					
<i>Strategic bond</i>	0	4.977	4.977	2.74	n/a
- <i>Equity income</i>	0	15.207	15.207	5.74	n/a
- <i>Property</i>	10.086	14.157	24.243	4.27	n/a
- <i>Multi asset income</i>	9.768	15.219	24.905	4.24	n/a
Total investments	266.442	55.680	322.049	1.79	218

Some Strategic Pooled Funds have an estimated rate of return based upon historic returns (12 months to 30 June 2018), as no dividends have been received since the Authority invested into the fund.

* Weighted average maturity will apply to the first five categories above. Strategic Pooled Funds have no maturity date, but are realised when all units are sold.

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 further diversified into yielding asset classes. £50m that is available for longer-term

investment was moved from bank and building society deposits into pooled bond, equity, property & multi asset funds. As a result, investment risk was diversified while the average rate of return has increased by 0.76% to 1.79%. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in the table below:

Investment Benchmarking – Treasury investments managed in-house	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2018	4.18	AA-	17%	241	1.20
30.09.2018	4.17	AA-	25%	170	1.79
Similar LAs	4.00	AA-	44%	1026	1.85
All LAs	4.38	AA-	60%	37	1.25

The Authority's £70m of externally managed pooled bond, equity, property and multi asset funds generated an average total return of 2.26%, comprising a 3.50% income return which is used to support services in year, and -1.23% of capital growth. 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. In light of their performance and the Authority's latest cash flow forecasts, investment in these funds has been increased (£5m Bond, £5m Global Equity, £10m UK Equity, £15m Property, £15m Multi Asset).

The Ministry of Housing, Communities and Local Government (MHCLG) consulted on statutory overrides relating to the IFRS 9 Financial Instruments accounting standard from 2018-19. The consultation recognised that the requirement in IFRS 9 for certain investments to be accounted for as fair value through profit and loss may introduce "more income statement volatility" which may impact on budget calculations. The consultation proposed a time-limited statutory override and sought views whether it should be applied only to pooled property funds. The Authority responded to the consultation which closed on 28 September 2018. The Authority stated that the proposed override should apply to all strategic pooled funds (not just property) and should be indefinite (not just 3 years). The Authority will await the decision of the MHCLG.

(vi) Non-Treasury Investment Activity

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is

replicated in the MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The Authority also holds £5.097m of such investments in:

- £4.597m Regeneration Loan to Buxton Crescent Hotel & Thermal Spa Co Ltd
- £0.500m Loan to subsidiary (Derbyshire Developments Ltd)

These investments generated £0.197m of investment income for the Authority after taking account of direct costs, representing a rate of return of 4.73%. This compares favourably to the Authority's overall level of return of 1.79%, to reflect the higher level of risk incurred.

(vii) Treasury Performance

The Authority measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in the table:

Treasury Performance	Actual £m	Budget £m	Over/ under	Actual %	Over/ under
Short Term Borrowing	0.190	0.080	-0.110	238	+138
Long Term Borrowing	6.851	6.851	0.000	100	0
Total borrowing	7.041	6.931	-0.110	102	+2
Strategic Pooled Funds	1124	1.125	-0.001	100	0
Traditional Investments	1383	1.375	0.008	101	+1
Total treasury investments	2507	2500	+0.007	100	0

(viii) Compliance

The Director of Finance & ICT Officer reports that all treasury management activities undertaken during complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy with the exception of borrowing under 12 months, which exceeded the £62m actual limit (£82.5m) and the 20% of total borrowing limit (22%). This short-term borrowing was taken in July 2018 to cover the scheduled drawdown of £25m for the Sinfin Waste Plant, although it subsequently transpired, that completion was delayed. Also, the actual borrowing over 30 years (8%) is below the 10% lower limit. The Council policy of utilising internal borrowing rather than long term external borrowing since 2010, has gradually eroded this measure.

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

Debt Limits	H1 Maximum £m	30.9.18 Actual £m	2018-19 Operational Boundary £m	2018-19 Authorised Limit £m	Complied? Yes/No
Short Term Borrowing	82,500	70.000	n/a	62.000	No
Long Term Borrowing	293.944	289.369	n/a	n/a	n/a
PFI and Finance Leases	75.592	75.592	n/a	n/a	n/a
Total debt	452.036	434.961	600.000	628.000	Yes

Compliance with the authorised limit and operational boundary for external debt is demonstrated in the below:

Investment Limits	H1 Maximum £m	30.9.18 Actual £m	2018-19 Limit £m	Complied? Yes/No
Any single organisation, except the UK Gov't (Lloyds Bank – Additional £30m Operational Limit)	59.492	6.947	60.000	Yes
Any group of organisations under the same ownership (Lloyds Bank – See Above)	59.492	6.947	60.000	Yes
Any group of pooled funds under the same management (CCLA)	30.000	30.000	30.000	Yes
Negotiable instruments held in a broker's nominee account (King & Shaxson)	6.122	6.122	100.000	Yes
Limit per non-UK country (Sweden)	0.016	0.016	10.000	Yes
Registered providers	20.000	10.000	50.000	Yes
Unsecured investments with building societies	1.000	1.000	100.000	Yes
Loans to unrated corporates (Buxton Crescent & DDL)	5.097	5.097	11.890	Yes
Money Market Funds	30.000	20.000	30.000	Yes
Non-specified investments	72.976	63.607	150.000	Yes

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

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating 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.

	30.9.18 Actual	2018-19 Target	Complied?
Portfolio average credit rating	AA-	A	Yes

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.

	30.9.18 Actual £m	2018-19 Target £m	Complied?
Total cash available within 3 months	101.101	30.000	Yes

Interest Rate Exposure: 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 proportion of net principal borrowed was:

	30.9.18 Actual%	2018-19 Limit %	Complied ?
Upper limit on fixed interest rate borrowing	81	100	Yes
Upper limit on variable interest rate borrowing	19	40	Yes
Upper limit on fixed interest rate investments	18	40	Yes
Upper limit on variable interest rate investments	82	100	Yes

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.

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 all borrowing were:

	30.9.18 Actual	Upper Limit %	Lower Limit %	Complied?
Under 12 months	72.745	20	0	No
12 months and within 24 months	9.150	10	0	Yes
24 months and within 5 years	11.895	40	0	Yes
5 years and within 10 years	26.535	40	5	Yes
10 years and within 20 years	111.179	40	10	Yes
20 years and within 30 years	100.095	40	10	Yes
30 years and above	27.770	40	10	No

Time periods start on the first day of each financial year.

Principal Sums Invested for Periods Longer than 365 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:

	2018-19 £m	2019-20 £m	2020-21 £m
Actual principal invested beyond year end	72.607	18.510	0.000
Limit on principal invested beyond year end	100.000	80.000	60.000
Complied?	Yes	Yes	Yes
+ Strategic Pooled Funds	70.000	70.000	70.000

+ Strategic Pooled funds have a liquidity of 1 month or less, however their investment horizon is 5 years or more.

(ix) 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 ultra-low interest rates result in other economic problems, and that a 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.

3 Other Considerations

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

4 Background Papers

Papers held in Technical Section, Corporate Finance, Room 137

5 Key Decision

No

6 Is it necessary to waive the call-in period?

No.

7 Officer's Recommendations:

That Cabinet:

- 1 Notes the interim report on Treasury Management for 2018-19
- 2 Notes compliance with the prudential indicators as shown in the compliance section of this report.
- 3 Approves an increase in the short-term (1 year or less) borrowing limit from £62m to £100m, to give the Council additional capacity and flexibility to respond to unforeseen expenditure.
- 4 Approves that the maturity structure of borrowing is amended as follows:
 - a) Loans under 12 months – Upper Limit increased from 20% to 30% as additional short term borrowing is utilised to smooth out cash-flow peaks and troughs.

- b) Loans over 30 years – Lower Limit is reduced to Nil, as the Council continues to follow the policy of utilising internal borrowing rather than incurring additional interest costs from borrowing externally.

PETER HANDFORD

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