

Report to Cabinet

Subject: Prudential Code Indicator Monitoring 2018/19 and Quarterly Treasury Activity Report for Quarter ended 30 June 2018

Date: 2 August 2018

Author: Service Manager Financial Services

Wards Affected

All

Purpose

To inform Members of the performance monitoring of the 2018/19 Prudential Code Indicators, and to advise Members of the quarterly treasury activity as required by the Treasury Management Strategy.

Key Decision

This is not a key decision.

Background

- 1.1 The Council is required by regulations issued under the Local Government Act 2003 to report on its Prudential Code indicators and treasury activity. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).
- 1.2 For 2018/19 the minimum reporting requirements are that the Full Council should receive the following reports:
 - An annual Treasury Strategy in advance of the year (the TMSS, considered by Cabinet on 15 February 2018 and subsequently approved by Full Council on 5 March 2018);
 - A mid-year treasury update report;
 - An annual review following the end of the year describing the activity compared to the Strategy.

In accordance with best practice, quarterly monitoring reports for treasury activity are provided to Members, and this exceeds the minimum requirements.

- 1.3 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report provides details of the position at 30 June 2018 and highlights compliance with the Council's policies.

Proposal

2.1 Economic update

UK - growth in 2017 was weak in the first half of the year but picked up to 0.5% in Q3, and to 0.4% in Q4. Growth in Q1 of 2018 was again disappointing, although at 0.2% fears were allayed that the economy may have started a prolonged period of very weak growth. Indications in Q2 are that growth has picked up to around 0.4%. The main reason for weak growth during 2017 and 2018 has been inflation exceeding pay growth until recently, meaning that there has been negative growth in consumer disposable income when consumer expenditure is the biggest driver of the services sector - which accounts for about 75% of GDP.

The manufacturing sector did relatively well in 2017, but Q1 of 2018 was the weakest quarter for one and a half years, and forward indicators do not suggest that a return to strong growth is likely.

During January and February, financial markets were viewing a Bank Rate increase at the May Monetary Policy Committee (MPC) meeting as a near certainty after strong growth in the second half of 2017. However, the weeks before the meeting saw opinion turn, and the MPC left rates unchanged due to concerns as to whether the weak growth in Q1 was indicative of the start of a prolonged slow down, or just a temporary blip, to which bad weather had been one contributor. Since May, opinion has again turned to suggest that an August Bank Rate increase is likely. However, there remains much uncertainty around the Brexit negotiations, consumer spending levels and business investment, so it is too early to be confident about how strong growth and inflationary pressures will develop over the next two years, and therefore the pace of any rate increases.

EU - a recovery to strong growth in 2016 and 2017 looks likely to weaken going forward. Despite providing massive monetary stimulus, the European Central Bank (ECB) has been struggling to raise inflation to its 2% target. In April, the headline Eurozone rate jumped up from 1.4% to 1.9% although core inflation remained subdued, rising from 0.7% to 1.1%. At its June meeting, the ECB announced that it would halve its monthly quantitative easing purchases from €30bn to €15bn, and then end all purchases after December. It is unlikely to start increasing interest rates until late in 2019.

USA - growth in the American economy was volatile in 2015, 2016 and 2017. The annual rate of GDP growth for 2017 was 2.3% and Q1 of 2018 was 2.0%, down from 2.9% in the previous quarter. President Trump's \$1.5 trillion income tax cut package came into effect in January 2018 and is likely to boost growth towards the administration's 3% target. However, it is also likely to boost inflation at a time when spare capacity in the economy is minimal and unemployment has fallen to the lowest level for 17 years, reaching 3.8% in May. The Federal Reserve (the Fed) has started increasing rates, with seven increases since December 2015, the latest in June 2018 to lift the central rate to 2.00%. There could be two further increases during 2018.

In October 2017, the Fed became the first major western central bank to start unwinding its quantitative easing by phasing in a gradual reduction in respect of reinvesting maturing debt.

China - economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus, and medium term risks are increasing. Major progress is still needed to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

Japan - the best economic run of positive growth since the 1980s came to an end in Q1 of 2018, with a contraction of -0.6% blamed on weak exports. However, Japan is still struggling to get inflation up to its target rate of 2%, despite huge monetary and fiscal stimulus, with inflation falling to only 0.4% in May. It is also making little progress on fundamental reform of the economy.

2.2 Interest rate forecast

The Council's treasury advisers, Link Asset Services undertook its last review of interest rate forecasts on 11 May after the quarterly Bank of England Inflation Report, and MPC meeting at which Bank Rate was unchanged at 0.5%. The minutes of this meeting indicated that they wanted to see whether the slowdown in growth in Q1 had been a temporary blip, or a potential first sign of a prolonged period of weak growth.

The overall balance of risk to economic recovery in the UK is probably even, however given the uncertainties around Brexit there is a wide diversity of possible outcomes for the strength of economic growth and inflation, and correspondingly to the rate of increase in Bank Rate.

Link Asset Services (LAS) have provided the following forecast:

	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%
10yr PWLB View	2.40%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%
25yr PWLB View	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%

2.3 Investment strategy

The Treasury Management Strategy Statement (TMSS) for 2018/19, which includes the Annual Investment Strategy, was approved by Council on 5 March 2018, and sets out the Council's investment priorities as:

- security of capital;
- liquidity;
- yield

Whilst the Council will always seek to obtain the optimum return (yield) on its investments, this will at all times be commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate either to keep investments short term to cover cash flow needs, or to extend the period up to 12 months with highly rated financial institutions, selected by the use of the LAS creditworthiness methodology (see below) which includes consideration of sovereign ratings.

Investment counterparty limits for 2018/19 are generally **£3m** per individual counterparty, however a higher limit of **£4m** per Money Market Fund is considered prudent since such funds are already by definition highly diversified investment vehicles. The Chief Financial Officer has delegated authority to vary these limits as appropriate, and to report any change to Cabinet as part of the next quarterly report. The limits have not been exceeded during the period 1 April to 30 June 2018.

During the period from 1 April to 30 June 2018, significant use has been made of the Council's two Money Market Funds (MMFs). These are AAA rated investment vehicles which allow the pooling of many billions of pounds into highly diversified funds, thus reducing risk. The current rate of return on these funds is around 0.50%, and this is generally higher than overnight treasury deposit rates and of the rate obtainable from the Debt Management Office (DMO).

An investment of £1m was made in the CCLA Local Authority Property Fund (LAPF) on 1 December 2017. The LAPF is a local government investment scheme approved by the Treasury under the Trustee Investments Act 1961 (section 11). Dividends are currently averaging around 4% per annum and are treated as revenue income. This investment

has allowed the Council to introduce a property element into its investment portfolio without the risks associated with the direct purchase of assets. The main risk around Property Funds is the preservation of the capital sum, however evidence from recent years shows that over time the property market has been a positive long-term investment. It is accordingly anticipated that this investment will be held for at least five years to minimise any risk.

The property fund investment purchased a number of units, determined by the unit price on the entry date. This valued the initial investment of £1m at £936k, setting the entry fee at £64k, or 6.4%. As indicated above, the property fund investment is for the long-term, and it is expected that this will be recovered as the fund grows, and by 31 March 2018 the value had risen to £956k representing an in year gain of £20k. A contribution of £64,000 was made to a reserve in 2017/18 and this will be used to mitigate the impact of variations on the General Fund if necessary, in the light of accounting changes due to take place in 2018/19.

The Treasury Activity Report for the quarter ended 30 June 2018 is attached at Appendix 1, in accordance with the Treasury Management Strategy. For reference, definitions of LIBOR and LIBID are given at Appendix 2.

Members will note that investment interest of £25,922 was generated from MMF activity, term deposits with banks and building societies, and the property fund during the period from 1 April to 30 June 2018. This represents an overall equated rate for the Council of 0.89% and outperforms the benchmark 7 day LIBID rate, which averaged 0.21% for the same period. In cash terms this represents additional income to the General Fund of around £19,800 and was achieved by positive investment management and a favourable return on the property fund. Performance in respect of the longer 3 month LIBID rate, which averaged 0.29%, still represents additional income of £17,500.

Rates in the market remain low, and this is likely to continue following the UK's vote to leave the EU. As loans mature every effort is made to replace them at favourable rates, however security and liquidity will always be the overriding factors in the Council's treasury management. LAS currently forecast that Bank Rate might rise in November 2018, however there is much uncertainty and interest rates are expected to rise only gradually, and not significantly.

It is currently anticipated that the outturn for investment interest will be £86,000, an increase of £13,000 on the current approved estimate of £73,000 for 2018/19. The impact of this increase is included in the Q1 revenue budget monitoring report elsewhere on this agenda.

Credit ratings advice is taken from LAS and the Chief Financial Officer has adopted the LAS credit rating methodology for the selection of investment counterparties. This employs a sophisticated modelling approach utilising credit ratings from all three of the main rating agencies to give a suggested maximum duration for investments. Accordingly it does not place undue reliance on any one agency's ratings.

The methodology subsequently applies an "overlay" to take account of positive and negative credit watches and/or credit outlook information, which may increase or decrease the suggested duration of investments. It then applies a second overlay based on the credit default swap spreads for institutions, the monitoring of which has been shown to give an early warning of likely changes in credit ratings. It also incorporates sovereign ratings to ensure selection of counterparties from only the most creditworthy countries. The current Treasury Strategy permits the use of any UK counterparties subject to their individual credit ratings under the LAS methodology. It also permits the use of counterparties from other countries with a minimum sovereign rating of AA. For information, the UK currently has a rating of AA.

The LAS modelling approach combines all the various factors in a weighted scoring system and results in a series of colour coded bands which indicate the creditworthiness of counterparties. The colour bandings are as follows:

- Yellow 5 years (UK Government debt or its equivalent)
- Purple 2 years
- Blue 1 year (nationalised or semi nationalised UK banks only)
- Orange 1 year
- Red 6 months
- Green 100 days
- No colour not to be used

Credit ratings are monitored weekly and the Council is also alerted to interim changes by its use of the LAS creditworthiness service, however ratings under the methodology, including sovereign ratings, will not necessarily be the sole determinant of the quality of an institution. Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

The ultimate decision on what is prudent and manageable for the Council will be taken by the Chief Financial Officer under the approved scheme of delegation.

2.4 New borrowing

No new long-term borrowing was undertaken during the quarter ended 30 June 2018.

The Council's Capital Financing Requirement (CFR) represents its underlying need to borrow to finance capital investment. Due to favourable interest rates, borrowing in advance of need is sometimes desirable, with the result that the CFR can differ to the actual borrowing planned in the year. Updated investment guidance issued in February 2018 confirms that borrowing in advance of need purely to profit from the investment of the extra sums borrowed, rather than prudent early borrowing for a service objective, is however unlawful.

£1m of planned borrowing in 2017/18 did not take place, and It is currently anticipated that this £1m, plus the estimated £2.5m for 2018/19 will be undertaken during the year, at a point when interest rates are deemed most favourable by the Chief Financial Officer in conjunction with LAS. Interest rates remain low and the PWLB certainty rate, available to all authorities providing relevant information to CLG, allows the Council to take advantage of a discount of 20 basis points.

It is currently anticipated that the outturn for PWLB interest payable will be broadly in line with the currently approved budget for 2018/19.

The Council has embarked upon a commercialisation programme aimed at the generation of funding to replace central government support, which is scheduled to be withdrawn by 2020. Significant additional borrowing may be required to support this commercial programme, and this will be supported by individual business case assessments and appropriate budget approvals, to demonstrate that each project generates a return sufficient to cover any borrowing costs. Advice will be taken from LAS with regard to the amount and timing of any additional borrowing, and should conditions become advantageous, some borrowing in advance of need will also be considered by the Chief Financial Officer.

Whilst borrowing rates remain historically low, investment rates are also low, and serious consideration must be given to the cost of carrying any additional borrowing during the period prior to it being required for the financing of capital expenditure.

2.5 Debt rescheduling

Debt rescheduling opportunities are limited in the current economic climate, and due to the structure of interest rates. Advice in this regard will continue to be taken from LAS. No debt rescheduling has been undertaken during

the period from 1 April to 30 June 2018.

2.6 Compliance with Prudential and treasury indicators

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limit. The Council's approved Prudential and Treasury Indicators (affordability limits) are included in the Treasury Management Strategy Statement (TMSS) approved by Full Council on 5 March 2018.

During the financial year to date the Council has at all times operated within the treasury limits and Prudential Indicators set out in the Council's TMSS, and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators as at 30 June 2018 are shown at Appendix 3.

a) Prudential Indicators:

These indicators are based on estimates of expected outcomes, and are key indicators of "affordability". They are monitored on a quarterly basis, and Appendix 3 compares the approved indicators with the projected outturn for 2018/19, and shows variances on some of the indicators, as described below:

i) Capital Expenditure

The latest projected outturn shows that capital expenditure is expected to be £10,173,700. This differs to the original estimate of £8,374,000 due to the inclusion of approved carry-forward requests from 2017/18 and to proposed variations to the capital programme during 2018/19.

ii) Capital Financing Requirement (CFR)

The projected closing CFR for 2018/19 is £14,986,700. This is lower than the approved indicator of £15,086,500, due to savings on the 2017/18 capital programme and slippage of schemes to 2018/19, both of which reduced the borrowing requirement in that year.

iii) Ratio of Financing Costs to Net Revenue Stream

The projected outturn of 7.50% shows a minor increase on the approved indicator of 7.49%. This is due to increased revenue contributions to capital expenditure, offset by reductions in MRP arising from the savings and slippage on the capital programme in 2017/18, and additional investment interest.

iv) Maximum gross debt

The Council must ensure that its gross debt does not, except in the short term, exceed the opening capital financing requirement, plus estimates of any additional CFR for 2018/19 and the following two financial years. This allows flexibility for early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes. The Council's gross debt at 30 June 2018 was £6.812m which was well within the approved indicator.

b) Treasury Management Indicators:

These indicators are based on limits, beyond which activities should not pass without management action. They include two key indicators of affordability and four key indicators of prudence.

Affordability:

i) Operational boundary for external debt

This is the limit which external debt is not "normally" expected to exceed. In most cases, this would be a similar figure to the CFR, but it may be lower or higher depending on the levels of actual debt.

ii) Authorised limit for external debt

This limit represents a control on the "maximum" level of borrowing. It is the statutory limit determined under s3 (1) of the Local Government Act 2003 and represents the limit beyond which external debt is prohibited. The Authorised Limit must be set, and revised if necessary, by Full Council. It reflects a level of external debt which, while not desirable, could be afforded in the short term, but is not sustainable in the longer term. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised

Prudence:

iii) Interest rate exposure

Prior to the December 2017 revisions to the Treasury Management Code there was a requirement to set indicators for the Council's maximum exposure to fixed and variable interest rates for net borrowing (ie. external borrowing less investments). This requirement has now been removed in favour of a statement in the TMSS stating how interest rate exposure is managed and monitored, and this is given below:

The Council has a general preference for fixed rate borrowing in order to minimise uncertainty and ensure stability in the charge to revenue, however it is acknowledged that in certain circumstances, some variable rate borrowing may be prudent, for example if interest rates are expected to fall. The Council's investments are generally for cashflow purposes and accordingly a mix of fixed and variable rates will be used to maximise flexibility and liquidity. Interest rate exposure will be managed and monitored on a daily basis by the Chief Financial Officer.

Local indicators, simply for the proportions of fixed and variable rate loans, have been retained by the Council for information purposes.

- iv) Maximum new principal sums to be invested during 2018/19 for periods in excess of one year (365 days) such investments are classified as a “non-specified”. This indicator is subject to the overall limit for non-specified investments set in the TMSS.
- v) Upper limits for the maturity structure of borrowing - set to reduce the Council's exposure to large fixed rate sums falling due for refinancing.

Appendix 3 shows the actual position as at 30 June 2018, and demonstrates that all activities are contained within the currently approved limits.

2.7 Other Issues

i) Revised Cipfa Codes of Practice

Revised editions of the Prudential Code and the Treasury Management Code and Cross Sectoral Guidance Notes were published in December 2017, with changes effective from 2018/19. These focus particularly on how to deal with local authority investments which are not “treasury investments”, eg. property purchases, in order to generate income for the authority at a higher level than can be attained by treasury investments.

The revised Prudential Code includes an explicit requirement for the preparation of a Capital Strategy, setting out the long term context in which capital expenditure and investment decisions are made. The strategy must consider both risks and rewards, as well as any impact on the achievement of the Council's priority outcomes. The Council already produces a Capital Programme and Capital Investment Strategy and this is being reviewed to ensure that any additional requirements of the revised Code are incorporated.

The revised Codes acknowledge the drive for income generation and the

use of non-treasury related investment instruments, such as investment property, but they reiterate the need for risk management - including proportionality in respect of overall resources.

ii) Revised Investment and MRP Guidance

The Ministry of Housing, Communities and Local Government (MHCLG) issued revised Investment Guidance and Minimum Revenue Provision (MRP) Guidance in February 2018, again for implementation in 2018/19. The definition of “investment” has been changed to include expenditure driven activity, eg. commercial property, as well as simple treasury cash. Such activity would represent “non-treasury investments”, ie investments in “non-financial assets”.

The effective definition in the 2010 guidance of short term investment being that repayable “within 12 months” has been removed from the 2018 guidance. A long term investment now is therefore one in excess of 365 days (previously 364 days).

The revised MRP guidance also focuses on expenditure on non-financial investments, eg. property, making it clear that the duty to make MRP extends to investment property where its acquisition has been partially or fully funded by an increase in borrowing. The guidance also confirms that borrowing may only be undertaken for strategic purposes and not purely for financial return.

Alternative Options

There are no alternative options in that this report is a requirement of the Council’s Treasury Management Strategy Statement (TMSS).

Financial Implications

No specific financial implications are attributable to this report.

Appendices

1. Treasury Activity Report 2018/19 for Quarter 1 (30 June 2018)
2. Definitions of LIBOR and LIBID
3. Prudential and Treasury Indicator Monitoring 2018/19 for Quarter 1 (30 June 2018).

Background Papers

None identified.

Recommendation

That:

1. Members note the report, together with the Treasury Activity Report 2018/19 for Quarter 1, at Appendix 1, and the Prudential and Treasury Indicator Monitoring 2018/19 for Quarter 1, at Appendix 3.

Reasons for Recommendation

To comply with the requirements of the Council's Treasury Management Strategy Statement.

For more information, please contact:

Alison Ball, Financial Services Manager, on 0115 901 3980