Report to Cabinet

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

Date: 8 November 2018

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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.

Recommendation

That:

1. Members note the report, together with the Treasury Activity Report 2018/19 for Quarter 2, at Appendix 1, and the Prudential and Treasury Indicator Monitoring 2018/19 for Quarter 2, at Appendix 3.

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 (this 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 September 2018 and highlights compliance with the Council's policies.

Proposal

2.1 Economic update

UK - economic growth in the first half of 2018/19 has been modest, but sufficiently robust for the Monetary Policy Committee (MPC) to vote unanimously to increase Bank Rate from 0.5% to 0.75% on 2 August 2018. Although growth for the year is expected to be only around 1.5% in 2018, the Bank of England's (BOE) August Quarterly Inflation Report forecast that this will pick up to 1.8% in 2019, albeit with several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concern about a build-up of inflationary pressures, particularly with the pound again falling in value against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated that Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

Unemployment has continued at a 43 year low of 4%, and a combination of job vacancies hitting an all-time high in July, and negligible growth in total employment, indicates that employers are having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a 3 month average of 2.9%, with the figure for July at

3.1%. This means that in real terms, (ie. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the high of 0.5% since 2009. The UK economy is largely services sector driven, therefore an increase in household spending power is likely to feed through to provide some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August, as it views wage inflation in excess of 3% as increasing inflationary pressures within the economy. However, it will need to tread cautiously with further rises, especially given the uncertainties around Brexit.
Politically, there is a risk that the current Conservative minority government may be unable to muster a Commons majority over Brexit. However, the Link Asset Services (LAS) central view is that it will endure, despite any setbacks, on the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA - President Trump's easing of fiscal policy has fuelled a temporary boost in US consumption which has generated not only an upturn in the rate of growth from 2.2% in Q1 to 4.2% in Q2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Federal Reserve (Fed) increased rates by another 0.25% in September, making four increases in 2018, and indicated that they expected to increase rates four more times by the end of 2019.

EU - growth was unchanged at 0.4% in Q2, but has fallen short of early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of its manufacturing exports, e.g. cars. For that reason, although EU growth is still expected to be around 2% for 2018, the horizon is less clear than it seemed just a short while ago.

China - economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus and medium term risks are increasing. Major progress still needs to be made 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 has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. 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 7 August, after the quarterly Bank of England Inflation Report, and the MPC meeting on 2 August at which Bank Rate was increased from 0.5% to 0.75%.

The MPC emphasised again that future rate rises would be gradual and to a lower equilibrium rate than before the financial crash, ie. a rate where monetary policy is neither expansionary nor contractionary. MPC indications are that this may be around 2.5% in 2028, but they declined to give a medium term forecast. The LAS view is that a further rate rise in February, just before the Brexit deadline, is unlikely and that this is most likely to come in August 2019, followed by two more rises of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

The overall balance of risk to economic growth in the UK is probably neutral. The balance of risks to increases in Bank Rate and shorter term PWLB rates are probably also even, and are broadly dependent on how strong GDP growth turns out, and how quickly and how positively the Brexit negotiations move forward.

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

Link Asset Services Interest Rate View											
	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

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 September 2018.

During the period from 1 April to 30 September 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 0.63%, 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 <u>has</u> 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, valuing the initial £1m investment at £936k and 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, however for prudence an equivalent contribution of £64,000 was made to an earmarked reserve in 2017/18, and this will be used to mitigate the impact on the General Fund of any future

significant valuation movements arising from the accounting changes being introduced in 2018/19.

The Treasury Activity Report for the quarter ended 30 September 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 £57,981 was generated from MMF activity, term deposits with banks and building societies, and the property fund, during the period from 1 April to 30 September 2018. This represents an overall equated rate for the Council of 0.93% and outperforms the benchmark 7 day LIBID rate, which averaged 0.43% for the same period. In cash terms this represents additional income to the General Fund of around £31,200 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 0.60%, still represents additional income of £20,600.

Despite the recent Bank Rate rise, 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 is unlikely to rise again until August 2019, however there is much uncertainty and interest rates are still expected to rise only gradually, and not significantly.

It is currently anticipated that the outturn for investment interest will be £110,000, an increase of £24,000 on the current approved estimate of £86,000 for 2018/19. The impact of this increase is included in the Q2 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 September 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.

As any 2018/19 borrowing activity will now be during the second half of the year it is currently anticipated that the outturn for PWLB interest payable will be £291,700, which is a reduction of £14,500 on the current approved estimate of £306,200. The impact of this reduction is included in the Q2 revenue budget monitoring report elsewhere on this agenda.

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 very 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 since this places a further burden on the General Fund.

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 September 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 September 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 £9,775,600. 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 £14,710,500. This differs to 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, and to proposed variations to the capital programme during 2018/19.

iii) Ratio of Financing Costs to Net Revenue Stream

The projected outturn of 7.18% differs to the approved indicator of 7.49% due to reductions in MRP arising from the savings and slippage on the capital programme in 2017/18, and to additional investment interest. These reductions are partially offset by increased revenue contributions to capital expenditure.

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 September 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 by the Council, and this is given below:

The Council has a general preference for fixed rate borrowing in order to minimse 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 out in the TMSS, and to the overall limit per counterparty.

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 September 2018, and demonstrates that all activities are contained within the currently approved limits.

2.7 Other Issues

i) Revised Cipfa Codes of Practice

As previously reported to Members, 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 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.

Additional indicators relating to non-treasury investments will be considered during the development of the Council's Treasury Strategy (TMSS) and Capital Strategy for 2019/20, and advice will also be sought from Link Asset Services.

ii) Revised Investment and MRP Guidance

As previously reported, 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 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 2 (30 September 2018)
2. Definitions of LIBOR and LIBID
3. Prudential and Treasury Indicator Monitoring 2018/19 for Quarter 2 (30 September 2018).

Background Papers

None identified.

Reasons for Recommendation

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

For more information, please contact:

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