Gedling Borough Council

Report to Cabinet

Subject: Prudential Code Indicator Monitoring 2018/19 and Quarterly Treasury Activity Report for Quarter ended 31 December 2018

Date: 31 January 2019

Author: Deputy Chief Executive and Director of Finance

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 3, at Appendix 1, and the Prudential and Treasury Indicator Monitoring 2018/19 for Quarter 3, at Appendix 2.

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 31 December 2018 and highlights compliance with the Council's policies.

Proposal

2.1 Economic update

UK - after weak economic growth of only 0.1% in Q1, growth picked up to 0.4% in Q2 and to 0.6% in Q3. However, uncertainties over Brexit look likely to cause growth to have weakened again in Q4. The Monetary Policy Committee (MPC) raised Bank Rate from 0.5% to 0.75% in August 2018, but unsurprisingly has refrained from any further increases. Further MPC action is unlikely until uncertainty over Brexit lessens. In the event of a "disorderly" Brexit, the MPC has indicated that rates could go up or down, though it is more likely to be down, to support growth. The MPC does however have concerns over the trend in wage inflation, which peaked at a new post financial crisis high of 3.3%, (excluding bonuses), in the three months to October. This is largely due to a lack of suitably skilled staff due to the continuing increase in total employment and unemployment being near to 43 year lows. Correspondingly, the total level of vacancies has risen to new highs.

CPI inflation has been falling, reaching 2.3% in November, however, the Bank of England's November Inflation Report raised the forecast for inflation over the two year time horizon to marginally above the MPC's target of 2%, indicating a slight build-up in inflationary pressures.

A rise in wage inflation combined with a fall in CPI inflation is good news for consumers, improving their spending power. The differential is now around 1%, i.e. a real term increase. Given that the UK economy is largely service sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months.

In the political arena, there is a risk that the current Conservative minority government may remain unable to muster a majority in the Commons over Brexit. However, Link Asset Services' central position remains that it will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in 2019, 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, and this could have an impact on interest rates.

USA - President Trump's easing of fiscal policy in 2018 fuelled a temporary boost in consumption, which generated an upturn in the rate of growth from 2.2% in Q1 to 4.2% in Q2 and 3.5% in Q3. Strong growth in employment led to an upturn in wage inflation, which hit 3.1% in November. However, CPI inflation overall fell to 2.2% in November and looks to be on a falling trend to drop below the Federal Reserve's (Fed) target of 2% during 2019. The Fed increased the range for its benchmark Fed Fund Rate by another 0.25% in December, to between 2.25% and 2.50%, this being the fifth increase in 2018, and the ninth in this cycle. However, they also reduced their forecast for further increases from three to two. This latest increase compounded investor fears that the Fed is over doing the rate and level of increases in rates, and that it may cause a US recession as a result - there is evidence from previous monetary policy cycles of the Fed's series of increases doing exactly that. Consequently, stock markets around the world have fallen, under the weight of fears around the Fed's actions, the trade war between the US and China, an expectation that world growth will slow, and Brexit.

EUROZONE - growth fell to 0.2% in Q3 from 0.4% in Q2, but this is likely to be a one-off caused primarily by a fall in car production. The European Central Bank (ECB) forecasts overall growth in 2018 to be 1.9%, falling to 1.7% in 2020. The ECB ended its programme of quantitative easing (QE) purchases of debt in December, which means that the central banks in the US, UK and EU have all now ended their post financial crisis expansion of liquidity, supporting world financial markets.

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 - 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 <u>Interest rate forecast</u>

The Council's treasury advisers, Link Asset Services (LAS) undertook its last review of interest rate forecasts on 6 November. After the August increase in Bank Rate to 0.75%, the first rise above 0.5% since the financial crash, the MPC has put any further action on hold – probably until the uncertainty around Brexit lessens and there is some degree of certainty around where the UK is headed. It is particularly unlikely that the MPC would increase Bank Rate in February 2019, just ahead of the current 29 March deadline, if no agreement on Brexit has been reached by then.

On the LAS central assumption of a reasonably orderly Brexit, the expectation is for the next rise in Bank Rate to be in May 2019, with a further rise in February 2020. However, in the light of ongoing failures to achieve any sort of agreement, this assumption could yet be confounded, and in the event of a disorderly Brexit, cuts in Bank Rate could follow.

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, how slowly inflation pressures subside, and how quickly and positively the Brexit negotiations move forward.

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

Link Asset Services Interest Rate View	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	1.75%	2.00%
3 Month LIBID	0.90%	1.00%	1.10%	1.20%	1.30%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	1.00%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%
5yr PWLB Rate	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%
10yr PWLB Rate	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%
25yr PWLB Rate	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%

2.3 <u>Investment strategy</u>

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 31 December 2018.

During the period from 1 April to 31 December 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 0.73%, and this is generally higher than overnight treasury deposit rates, and 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 31 December 2018 is attached at Appendix 1, in accordance with the Treasury Management Strategy.

Members will note that investment interest of £98,407 was generated from MMF activity, term deposits with banks and building societies, and the property fund, during the period from 1 April to 31 December 2018. This represents an overall equated rate for the Council of 0.96% and outperforms the benchmark 7 day LIBID rate, which averaged 0.48% for the same period. In cash terms this represents additional income to the General Fund of around £49,200 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 0.65%, still represents additional income of £31,800.

Rates in the market remain low, and this is likely to continue following the UK's vote to leave the EU and the uncertainty surrounding Brexit. As loans mature every effort is made to replace them at favourable rates, however security and liquidity will <u>always</u> be the overriding factors in the Council's treasury management. LAS currently forecast that Bank Rate is unlikely to rise again until May 2019 at the earliest, 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 £127,000, an increase of £17,000 on the current approved estimate of £110,000 for 2018/19. The impact of this increase is included in the Q3 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 <u>subject</u> 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)
- Dark pink 5 years for Ultra Short Dated Bond Funds (credit score 1.25)
- Light pink 5 years for Ultra Short Dated Bond Funds (credit score 1.50)
- 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

New long-term borrowing of £1m was undertaken during the quarter ended 31 December 2018 and long term borrowing now totals £7.812m. No further borrowing is anticipated during 2018/19 and it is currently anticipated that the outturn for PWLB interest payable will be £284,600, which is a reduction of £7,100 on the current approved estimate of £291,700. The impact of this reduction is included in the Q3 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 2019/20. 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.

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 reaffirms 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.

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 31 December 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 31 December 2018 are shown at Appendix 2.

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 2 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 £4,954,700. This differs to the original estimate of £8,374,000 due to the inclusion of approved carry-forward requests from 2017/18, as well as the approved and proposed variations to the capital programme during 2018/19.

ii. Capital Financing Requirement (CFR)

The projected closing CFR for 2018/19 is £10,949,800. 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, as well as the approved and proposed variations to the capital programme during 2018/19.

iii. Costs to Net Revenue Stream

The projected outturn of 6.38% 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, the reduced PWLB interest payable, and the additional investment interest receivable. 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 31 December 2018 was £7.812m 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, and must allow for unusual cashflow movements.

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 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 repeated 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 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 “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 2 shows the actual position as at 31 December 2018, and demonstrates that all activities are contained within the currently approved limits.

2.7 Other Issues

Revised Cipfa Codes of Practice

As previously noted, revised editions of the Prudential Code and the Treasury Management Code and Cross Sectoral Guidance Notes were published in 2017, with particular focus on non-treasury (non-financial) investments, eg. commercial property purchases, which are made primarily to generate income 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 investments such as commercial property, but they reiterate the need for risk management - including proportionality in respect of overall resources.

Additional indicators relating to non-treasury investments and proportionality are currently being developed and will be included in the Council's 2019/20 Treasury Strategy (TMSS).

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. 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. commercial 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 reaffirms that borrowing may only be undertaken for investments made 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 3 (31 December 2018)
2. Prudential and Treasury Indicator Monitoring 2018/19 for Quarter 3 (31 December 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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