Cherwell District Council

Accounts, Audit and Risk Committee

12 April 2018

Quarter 3 Treasury Management Report

Report of Deputy Section 151 Officer

This report is public
Appendix 1 is exempt from publication by virtue of paragraph 3 of Schedule 12A of Local Government Act 1972

Purpose of report

To receive information on treasury management performance and compliance with treasury management policy for 2017/18 as required by the Treasury Management Code of Practice.

1.0 Recommendations

The meeting is recommended:

1.1 To note the contents of the third quarter (Q3) Treasury Management Report

2.0 Introduction

2.1 As part of the Council's investment strategy and governance arrangements this committee considers the investment and borrowing performance to date and compliance with the Council's Treasury Management Strategy.

2.2 The Code of Practice on Treasury Management approved by the Chartered Institute of Public Finance and Accountancy (CIPFA) and adopted in full by the Council in 2013, requires that a Treasury Management Strategy is produced prior to the beginning of the financial year to which it relates.

2.3 The Treasury Management Strategy is the cornerstone of proper treasury management, and is central to the operation, management reporting and performance assessment. The revised annual strategy for Cherwell District Council for 2017/18 was approved at full Council in December 2017. The Council re-appointed Arlingclose as its Treasury Management advisor in April 2017.

2.4 The highest standard of stewardship of public funds remains of the utmost importance to the Council. This document details the Council's management of borrowing, investments and treasury management activities during the first nine months of 2017/18.

3.0 Report Details

2017/18 Summary

3.1 At the end of December 2017 the Council had borrowing of £34m, and investments of £12m, a net borrowing position of 22m.
Appendix 1 provides further details of these borrowing and investment totals.

Strategy

3.2 The revised Treasury Management Strategy for 2017/18, which includes the Annual Investment Strategy, was approved by the Council in December 2017 and sets out the Council's investment priorities as being:

- Security of Capital; Liquidity; and Yield

3.3 The Council will aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover short term cash flow needs. The Council also seeks out value available in higher rates in periods up to 12 months with highly credit rated financial institutions. The Council uses Arlingclose's suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information (this applies in particular to nationalised and semi nationalised UK banks).

3.4 The Council'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 Council's long-term plans change being a secondary objective.

3.5 In furtherance of these objectives new borrowing was kept to a minimum, whilst options for securing lower rates for longer term borrowing were reviewed. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

3.6 The "cost of carry" analysis performed by the Council's treasury management advisor Arlingclose did not indicate any value in borrowing in advance for future years' planned expenditure and therefore none was taken.

Investment performance for 9 months ended 31 December 2017:

3.7 Investment rates available in the market have continued at low levels, although there was an increase in the Bank Of England Base rate from 0.25% to 0.50% in November 2017 which has had a gradual positive effect on investment returns.
The ***average*** level of funds available for investment purposes up to December 2017 was £13.8m. Funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants, and the funding the Capital Programme.

3.8 The position as at 31 December 2017 shows:-

Investment Amount £	Interest Budget £	Interest Actual £	Variance £	Annualised rate of return £
12,016,839	51,750	32,597	-19,153	0.31%

3.9 Interest for the full year is forecast to be approximately £24k below budget, due to low level of investments being held. The Council is now a net borrowing authority and investment balances are held primarily for liquidity purposes.

Borrowing performance for 9 months ended 31 December 2017:

3.10 The Council commenced external borrowing in April 2017 to fund it's capital programme, and had total debt of £34m at the report date. Part of the current debt is at fixed rate for the medium term, with the remainder short term variable rate. As borrowing will increase further, and the prospect of rate increases grows, we will seek to take a higher proportion of the debt at long term fixed rates. This may cost more in the short term but will provide certainty of cost and provide savings in the longer term.

3.11 The position as at 31 December 2017 shows:-

Borrowing Amount £	Interest Budget £	Interest Actual £	Variance £	Annualised interest rate £
34,000,000	18,750	143,954	-125,204	1.08%

Interest for the full year is forecast to be significantly over budget due to the higher than expected borrowing in the year. This is for capital projects/acquisitions that were not approved when the budget was set.

3.10 **Non-treasury investment activity.**

Although not currently classed as treasury management activities and therefore not covered by the CIPFA Code, the Council also holds £51m of investments in the form of shares in and loans to subsidiary companies

These non-treasury investments generate or are expected to generate a higher rate of return than earned on treasury investments, but reflects the additional risks to the Council of holding such investments.

If CIPFA's proposed amendments to the Treasury Management Code are adopted in the revised Code from 2018/19, these will henceforth be included in the expanded definition of "investments".

3.13 Arlingclose provided the following reports (on 8 January 2018) for the quarter ending 31 December 2017:

Economic backdrop: The significant economic event was the increase in the Bank Rate in November by 0.25% to 0.50%, making it the first increase by the Bank of England's MPC to rates since July 2007. The vote to increase Bank Rate was 7-2, reflecting the MPC's growing concern that rising inflation had finally outweighed the risks to growth and largely to meet expectations the Bank itself created. The Bank has reiterated that it expects any future increases in Bank Rate to be at a gradual pace and limited in extent.

Commodity prices rose over the period with oil increasing to around $67 a barrel from a low of $42 in June. UK Consumer Price Inflation (CPI) index continued to rise with the data print for November showing CPI at 3.1%, its highest since March 2012 as the fall in the value of sterling following the June 2016 referendum result continued to feed through into higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.8%.

The number of unemployed in the economy continued to decrease, although the unemployment rate remained at 4.3%. Consumers' wages continued to shrink, in real terms, given average earnings growth remained subdued at 2.5%, a good deal below the rate of inflation. Economic activity expanded at a much slower pace as evidenced by Q2 and Q3 GDP growth of 0.3% and 0.4% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings remaining relatively low and real wage growth negative, there are concerns that these will be a constraint on future economic activity.

In contrast, near-term global growth prospects improved. The US economy grew steadily and inflation increased to 2.2%. As was expected, the Federal Reserve increased its target range of official interest rates in December for the third time in 2017 by 25 basis points to between 1.25% and 1.50%. The Fed is expected to deliver three more increases in 2018 and a further two in 2019. The central bank's growth forecasts were revised up based on the newly-passed personal and corporate tax rate cuts proposed by Donald Trump.

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

Financial markets: Gilt yields were broadly stable over the quarter as much of the uncertainty which plagued the first half of the year dissipated. The yield on the 5-year gilts fell slightly to 0.72% at the end of the quarter, down from 0.80% in September. The 10-year gilts similarly fell from 1.38% to 1.19% at the end of the quarter and the 20-year gilts from 1.94% to 1.73%.

The FTSE 100 continued to climb, reaching yet another record high of 7688 at the end of calendar year. Money markets rates, unsurprisingly, have increased over the quarter: 1-month, 3-month and 12-month LIBID rates have averaged 0.43%, 0.47% and 0.76% over the period October-December.

Credit background: UK bank credit default swaps have remained broadly stable throughout the quarter. Bank share prices have not moved in any pattern.

Much of the activity by credit rating agencies during the quarter has related to the upcoming UK bank ringfencing which will take effect in 2018. Ringfencing requires the larger UK banks to separate their core retail banking activity from the rest of their business, resulting in two separate banks. In general, the agencies expect to give the ringfenced "retail" bank a higher credit rating than the non-ringfenced "investment" bank. In practice, this will only affect Barclays, HSBC, Lloyds and RBS as other UK banks and building societies either only conduct retail banking activities or have less than £25 billion of deposits covered by the Financial Services Compensation Scheme.

Barclays Bank plc was upgraded to A from A- by Standard & Poor's (S&P), after the bank announced its plans for its ringfenced bank, Barclays Bank UK plc, and the non-ringfenced bank, Barclays Bank plc. S&P also assigned preliminary ratings of 'A/A-1' to Barclays Bank UK plc.

In November S&P revised upwards the outlook of various UK banks and building societies to positive or stable and simultaneously affirmed their long and short-term ratings. These reflect the agency's view that the institutions now show increased resilience, have made substantial progress in meeting regulatory capital requirements and are now better positioned to deal with uncertainties and potential turbulence in the run-up to the UK's exit from the EU in March 2019.

There have been no changes to Arlingclose's investment advice regarding banks and building societies during the quarter.

Regulatory Updates

MiFID II: As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities will be treated as retail clients but can "opt up" to professional client status, providing that they meet certain criteria which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a year's relevant professional experience. In addition, the regulated financial services firms to whom this directive applies must assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The Authority has met the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. The Authority will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

CIPFA Codes: CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The Authority is currently considering the changes from the 2011 Code for incorporation into future Treasury Management Strategies and monitoring reports.

The 2017 Prudential Code introduces the requirement for a Capital Strategy which sets out the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for future financial sustainability. Where this strategy is produced, it must be approved by full Council, and the determination of the Treasury Management Strategy can then be delegated to a committee.

In the 2017 Treasury Management Code the definition of 'investments' has been widened to include financial assets as well as non-financial assets held primarily for financial returns such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be discussed in the Capital Strategy or Investment Strategy.

DCLG Consultations on Investment Guidance and Minimum Revenue Provision (MRP): In November the DCLG consulted on proposed changes to its Guidance on Local Government Investments and Statutory Guidance on Minimum Revenue Provision (MRP) with a deadline for responses of 22nd December.

Proposed changes to the Investment Guidance include a wider definition of investments to include non-financial assets held primarily for generating income return and a new category called "loans" (e.g temporary transfer of cash to a third party, joint venture, subsidiary or associate). The draft Guidance introduces the concept of proportionality, proposes additional disclosure for borrowing solely to invest and also specifies additional indicators. Investment strategies should detail the extent to which core expenditure is reliant on investment income and a contingency plan should yields on investments fall.

There is a proposed change to the basis of prudent MRP to "cover the gap between the Capital Financing Requirement (CFR) and grant income/capital receipts"; it cannot be a negative charge and can only be zero if the CFR is nil or negative. Guidance on asset lives has been updated, applying to any calculation using asset lives. Any change in MRP policy cannot create an overpayment; the new policy must be applied to the outstanding CFR going forward only.

Outlook for the remainder of 2017/18

The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Both consumer and business confidence remain subdued. Household consumption growth, the driver of UK GDP growth, has softened following a contraction in real wages. Savings rates are relatively low and real earnings growth (i.e after inflation) struggles in the face of higher inflation.

The Bank of England's Monetary Policy Committee's decision to raise bank rate is likely to reduce inflation, all other things remaining equal, but is likely to have negative effect on what was already a weak growth outlook.

Arlingclose's central case is for Bank Rate to remain at 0.50% over the forecast period, whilst introducing upside risks from September 2018, as shown below, and downside risks from March 2019. Arlingclose's central case is for gilt yields to remain broadly stable across the medium term.

	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25

4.0 Conclusion and Reasons for Recommendations

4.1 This report details the Treasury Performance for the Council for the period ending 31 December 2017.

5.0 Consultation

None

6.0 Alternative Options and Reasons for Rejection

6.1 The following alternative options have been identified and rejected for the reasons as set out below.

Option 1: To request further information on the performance reported.

7.0 Implications

Financial and Resource Implications

7.1 There are no financial implications arising directly from any outcome of this report.

Comments checked by:
Cecilie Booth, Deputy Section 151 Officer
Cecilie.booth@cherwellandsouthnorthants.gov.uk 01295 227946

Legal Implications

7.2 There are no legal implications arising directly from any outcome of this report.

Comments checked by:
Richard Hawtin, Team Leader – Non-contentious Business, 01295 221695
richard.hawtin@cherwellandsouthnorthants.gov.uk

Risk Management Implications

7.3 It is essential that this report is considered by the Audit Committee as it demonstrates that the risk of not complying with the Council's Treasury Management Policy has been avoided

Comments checked by:
Louise Tustian, Team Leader – Strategic Intelligence & Insight, 01295 221786
louise.tustian@cherwellandsouthnorthants.gov.u

Equality and Diversity

7.4 There are no equality and diversity implications from this report.

Comments checked by:
Caroline French, Corporate Policy & Projects Officer, 01295 221586
caroline.french@cherwellandsouthnorthants.gov.uk

8.0 Decision Information

Wards Affected

All wards are affected

Links to Corporate Plan and Policy Framework

Links to all elements of Corporate Plan

Lead Councillor

None

Document Information

Appendix No	Title
Appendix 1	Schedule of in-house investments and borrowing - EXEMPT
Background Papers	
None	
Report Author	Cecilie Booth, Deputy Section151 Officer
Contact Information	Cecilie.booth@cherwellandsouthnorthants.gov.uk 01295 227946