South Derbyshire District Council

Treasury Management Report Q3 2018/19

Introduction

The Authority has adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

The Authority's treasury management strategy for 2019/20 was approved at a meeting of the Authority on 14th February 2019. The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Treasury Management Code of Practice. Additionally, in England MHCLG published its revised Investment Guidance which came into effect from April 2018.

The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority has produced its Capital Strategy which was approved by full Council on 17th January 2019.

The detail that follows is in accordance with the CIPFA Code and is written with support from the Council's Treasury Advisor, Arlingclose.

External Context

Economic background

After rising to over $80/barrel around the middle of the year, oil prices fell back sharply by 25% to just over $60 in December. UK Consumer Price Inflation (CPI) for November was up 2.3% year/year, in line with the consensus forecast and broadly in line with the Bank of England's November Inflation Report. The most recent labour market data for the three months to October 2018 showed the unemployment rate remained at 4.1% while the employment rate of 75.7% was the joint-highest estimate since comparable estimates began in 1971. The 3 month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pull on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level likely to only have a modest impact on consumer spending.

The rise in quarterly GDP growth to 0.6% in the third calendar quarter from 0.4% in the second was due to weather-related factors boosting overall household consumption and construction activity over the summer. At 1.5%, annual GDP growth continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy has been made since.

The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in November while lowering its forecast of rate rises in 2019 to two from the three previously projected.

A temporary truce in the ongoing trade war between the US and China was announced as the leaders of both countries agreed to halt new trade tariffs for 90 days to allow talks to continue. Tariffs already imposed will remain in place. The fallout continues to impact on economic growth and stock market volatility.

With less than a month until Article 50 expires on 29th March 2019, the Brexit deadlock continues and time is running out for a deal to be finalised. This ongoing uncertainty continues to weigh on sterling and UK markets.

Using its "Henry VIII" powers under the European Union (Withdrawal) Act 2018 to alter legislation without consultation, the government is changing which pooled funds are capital expenditure for local authorities in England. If the legislation is not further amended, then the vast majority of money market funds and other pooled funds will become capital expenditure when the UK leaves the EU. Funds operated by CCLA and Federated are not affected by this change. Arlingclose are in discussion with MHCLG about further amendments to these rules but cannot guarantee that any changes will be effective before Brexit.

Financial markets

Investors wrestled with a range of global concerns: an economic slowdown in China, rising trade tensions between the US and China, a sharply lower oil price, slowing Euro area output and, of course, the ongoing uncertainty surrounding Brexit. December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. But spreads on corporate bonds also widened reflecting concerns about tougher economic conditions ahead and the abilities of corporates to service their debt obligations.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising to 1.30% in October, gilts regained their safe-haven status in December - the 5-year benchmark gilt yield fell as low as 0.82% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.59% to 1.06% and from 2.05% to 1.62%. The higher Bank Rate continued to push up money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.58%, 0.76% and 1.03% respectively over the period.

Credit background

Credit Default Swap (CDS) spreads drifted up over the period, reflecting the ongoing uncertainty around Brexit but continuing to remain low in historical terms. The spread on non-ringfenced bank NatWest Markets plc rose sharply to around 129bps while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 44bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 44 and 94 bps at the end of the period.

The ringfencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc) is complete and the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) continues prior to starting trading as separate entities from 1st January 2019.

The Bank of England released its latest report on bank stress testing, illustrating that all entities tested were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

There were minimal credit rating changes during the period. Moody's revised the outlook on Nationwide Building Society to negative from stable as it believes Nationwide may become more reliant on retail deposit funding going forward, reducing the volume of wholesale deposits and senior debt available to a level where only a two-notch uplift is warranted rather than the current three notches.

Our treasury advisor Arlingclose will continue to provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities' flexibility during bail-in. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs but not senior unsecured bonds issued by commercial banks.

Local Context

On 31st March 2018, the Authority had net borrowing of £29.86m arising from its revenue and capital income and expenditure. This fell to £12.1m by the end of quarter 3. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). Debt outstanding is split between the HRA and General Fund and this represents the 'two pool' approach adopted for debt management.

Capital Financing Requirement (CFR)

	31.3.18 Actual £'000	**30.06.18 Actual £'000**	**30.09.18 Actual £'000**	**30.12.18 Actual £'000**
Housing Revenue Account				
Debt Outstanding	57,423	57,423	57,423	57,423
Capital Financing Requirement (CFR)	61,584	61,584	61,584	61,584
Statutory Debt Cap	66,853	66,853	66,853	N/A *
Borrowing Capacity (Cap less Debt Outstanding)	**9,430**	**9,430**	**9,430**	**N/A ***
General Fund				
Debt Outstanding	0	0	0	0
Capital Financing Requirement (CFR)	5,653	5,653	5,653	5,653
Borrowing Capacity (Cap less Debt Outstanding)	**5,653**	**5,653**	**5,653**	**5,653**
Total Capital Financing Requirement (CFR)	**67,237**	**67,237**	**67,237**	**67,237**

* In his Autumn 2018 Budget Statement, the Chancellor confirmed the abolition of the HRA Debt Cap with effect from 29th October 2018.

The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The overall treasury management position at 31st December 2018 and the change in the quarter is show in the table below.

Treasury Management Summary

	31.03.18 Balance £'000	30.06.18 Balance £'000	30.09.18 Balance £'000	Q3 2018 Movement £'000	31.12.18 Balance £'000
Long-term borrowing	57,423	57,423	57,423	0	57,423
Short-term borrowing	28	28	28	0	28
Total borrowing	**57,451**	**57,451**	**57,451**	**0**	**57,451**
Long-term investments	1,000	1,000	2,000	0	2,000
Short-term investments	23,500	25,000	30,500	9,500	40,000
Cash and cash equivalents	3,092	4,084	4,546	(1,164)	3,382
Total investments	**27,592**	**30,084**	**37,046**	**8,336**	**45,382**
Net borrowing	**29,859**	**27,367**	**20,405**		**12,069**

Borrowing Activity

At 31st December 2018 the Authority held £57.4m of loans. These loans were taken out by the Authority in 2011/12 for the purpose of HRA self-financing. The principal element of these loans is repayable in full on maturity, with interest being paid each March and September.

The short-term borrowing of £28k relates to deposits received from two Parish Councils within the District. These loans can be recalled on immediate notice. Interest is calculated at the Bank of England Base Rate, less 1%. No interest is currently being paid due to the Base Rate being less than 1%.

The following table shows the maturity dates of the loans and rate of interest payable.

Borrowing Position

Loan Profile	**Type**	**Value £'000**	**Rate %**	**Maturity**
Public Works Loan Board	Variable	10,000	0.79	2021/22
Public Works Loan Board	Fixed	10,000	2.70	2023/24
Public Works Loan Board	Fixed	10,000	3.01	2026/27
Public Works Loan Board	Fixed	10,000	3.30	2031/32
Public Works Loan Board	Fixed	10,000	3.44	2036/37
Public Works Loan Board	Fixed	7,423	3.50	2041/42
Total Long-term borrowing		**57,423**		
Short-term Parish Council Loans		**28**	0.00	
Total borrowing		**57,451**		

The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

Treasury Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the quarter, the Authority's investment balance ranged between £37m and £47m due to timing differences between income and expenditure. The investment position during the quarter is shown in the table below.

Treasury Investment Position

	31.03.18 Balance £'000	30.06.18 Balance £'000	Q1 Rate of Return %	30.09.18 Balance £'000	Q2 Rate of Return %	31.12.18 Balance £'000	Q3 Rate of Return %
Banks (unsecured)	3,092	4,084	0.23	4,546	0.35	3,382	0.55
Local Authorities	18,000	20,000	0.62	21,000	0.71	27,000	0.74
Debt Management Office	1,500	1,000	0.27	3,500	0.50	3,000	0.50
Money Market Funds	4,000	4,000	0.48	6,000	0.62	10,000	0.72
CCLA Property Fund	1,000	1,000	4.16	2,000	4.21	2,000	4.31
Total investments	**27,592**	**30,084**		**37,046**		**45,382**	

Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Authority has undertaken greater detailed cash flow forecasting which has enabled it to enter into longer-term deposits with other Local Authorities, therefore securing a higher rate of return.

The Authority is now participating in the Arlingclose quarterly investment benchmarking exercises. This will enable us to measure our investment portfolio against other similar Local Authorities. The table below is an extract from Arlingclose's benchmarking, and shows the risk and return metrics as at the end of quarter 3.

Investment Benchmarking – Treasury investments managed in-house (excludes CCLA)

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.12.2018	3.93	AA-	31%	92	0.71
Similar LAs	4.22	AA-	59%	77	0.81
All LAs	4.24	AA-	58%	34	0.81

Credit Score: This is a value-weighted average score calculated by weighting the credit score of each investment by its value. A higher number indicates a higher risk.

Credit Rating: This is based on the long-term rating assigned to each institution in the portfolio, by ratings agencies Fitch, Moody's and Standard & Poor's. Ratings rang from AAA to D, and can be modified by +/-

Bail-in Exposure: The adoption of a bail-in regime for failed banks results in a potential increased risk of loss of funds for local authority should this need to be implemented. Therefore a lower exposure to bail-in investments reduces this risk.

Weighted Average Maturity: This is an indicator of the average duration of the internally-managed investments. Similar authorities have a similar profile to South Derbyshire; other larger authorities tend to hold a greater proportion of fund in money markets than fixed-term deposits with other LAs, due to their cash flow requirements.

Rate of Return: This is the average rate received on internally managed investments. At the quarter-end we had a few lower rate investments that were secured prior to the base rate rise in August 2018, which reduced the average rate of return compared to other authorities.

The Authority deposited £1m in the CCLA Property Fund on 28th September 2017, with the investment purchasing 317,985 units at an offer price of 314.48p per unit. Following member approval, the Authority subsequently deposited a further £1m in the fund on 28th August 2018, with this investment purchasing 308,261 units at an offer price of 324.40p per unit.

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives is regularly reviewed.

The performance of the investment over the last four quarters is shown in the table below. Although past performance is no guarantee of future returns, the movement in the bid (selling) price so far shows how the value of the investment is moving closer to the original purchase price. This reinforces the notion that the Fund should only be considered for long-term investments.

CCLA Property Fund Performance

		2017/18	**2018/19**	**2018/19**	**2018/19**
		Q4	**Q1**	**Q2**	**Q3**
Dividend Received	£	10,215	10,432	13,871	20,782
Annual Equivalent Interest Rate	%	4.09%	4.16%	4.21%	4.31%
Bid (Selling) Price	pence/unit	297.33	298.90	298.97	303.75

Performance Indicators

The main indicator the Council uses to measure its return on short-term investments to average over the year, is the Average 7-Day Money Market Rate. This is a standard measure of performance. Performance for the first three quarters is shown below.

	As at 30.06.18	**As at 30.09.18**	**As at 31.12.18**
Average 7-Day Money Market Rate (Target)	0.49%	0.57%	0.62%
Average Interest Rate Achieved on Short Term Deposits	0.55%	0.63%	0.71%

Compliance

The Chief Finance Officer is pleased to report that all treasury management activities undertaken during quarter 3 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

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

Investment Limits

	Maximum Investment during Q3 £m	**Maximum Invested per Counterparty £m**	**Limit**	**Maximum Term**	**Complied**
Debt Management Office	£5m	£5m	£15m in total	364 days	✓
Other Local Authorities	£28m	£5m	£5m per Authority	364 days	✓
Money Market funds	£10m	£2m	£10m total, £2m per fund	60 days	✓
CCLA Property Fund	£2m	£2m	£2m	Indefinite period	✓
Named Counterparties (HSBC/Lloyds/BOS/Close Bros/Santander)	£1.95m	£1.95m	£2m per Bank	6 months	✓
Named Counterparties (Barclays/Goldman Sachs/NatWest/RBS)	£1.76m	£1.76m	£2m per Bank	100 days	✓
Named Counterparties (Nationwide/Coventry)	0	0	5% of total deposits	6 months	✓
Named Counterparties (Leeds Building Society)	0	0	5% of total deposits	100 days	✓
Foreign Counterparties	0	0	AAA rated - £1m per Bank	1 month	✓
Independent Building Societies	0	0	£1m per Society	100 days	✓

Outlook for the remainder of 2018/19

Having raised policy rates in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon.

The MPC has a bias towards tighter monetary policy as its members consider that tight labour markets will prompt inflationary pressure in the future, ultra-low interest rates result in other economic problems, and higher Bank Rate will be a more effective policy weapon if downside risks to growth crystallise.

Arlingclose's central case is for Bank Rate to rise twice in 2019, after the UK exits the EU. However, recent events around Brexit have dampened interest rate expectations and the risks are weighted to the downside. The potential for severe economic outcomes has increased following the poor reception of the Withdrawal Agreement by MPs. The Bank of England will hold at or reduce interest rates from current levels if serious Brexit risks materialise.

Recommendations

On 19th December 2018, the government laid the Local Government (Miscellaneous Amendments) (EU Exit) Regulations 2018 before Parliament. This legislation changes which pooled funds are classed as capital expenditure for local authorities in England. If the legislation is not further amended, then the vast majority of money market funds and other pooled funds will become capital expenditure when the UK leaves the EU. Purchases of a capital expenditure fund will result in an increase in the capital financing requirement (CFR) and hence a liability for minimum revenue provision (MRP) unless otherwise funded. Government guidance is to make MRP on shares over a 20-year asset life, which is a revenue cost that is likely to be in excess of the revenue income from the investment.

The Council currently holds 4 money market funds that are domiciled in either Luxembourg or Dublin, and are therefore affected by this change. We currently have £8m invested across these 4 funds. Arlingclose are in discussion with MHCLG about further amendments to these rules but cannot guarantee that any changes will be effective before Brexit.

As a contingency measure, we recommend that the Counterparty Limit for deposits with the UK Debt Management Office (DMO) is extended to £20m. This provides the Council with the facility to deposit additional funds with the DMO that would have otherwise been deposited in money market funds. The Council is also exploring the option of opening additional deposit accounts with banking providers already on its approved Counterparty List to provide a range of investment options.