AUDIT COMMITTEE 26 OCTOBER 2018

TREASURY MANAGEMENT MID-YEAR MONITORING REPORT 2018/19

1. **PURPOSE**

1.1. New Forest District Council adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes an annual report on the treasury management strategy after the end of each financial year as well as a mid year monitoring report.

2. **SUMMARY**

2.1. The Council's Treasury Management Strategy (TMS) for 2018/19 was approved at a meeting of the Council in February 2018. The Council has borrowed and invested 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 Council's TMS.

2.2. 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 but has yet to publish the local authority specific Guidance Notes to the latter. In England the Ministry of Housing, Communities & Local Government (MHCLG) published its revised Investment Guidance which came into effect from April 2018.

2.3. 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 Council will be producing its Capital Strategy later in 2018/19 for approval by Council.

2.4. Treasury management in the context of this report is defined as:

"The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2.5. Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

2.6. All treasury activity has complied with the Council's TMS and Investment Strategy for 2018/19, and all relevant statute, guidance and accounting standards. In addition the Council's treasury advisers, Arlingclose, provide support in undertaking treasury management activities. The Council has also complied with all of the prudential indicators set in its TMS.

3. EXTERNAL CONTEXT

3.1. The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions have been made to date in 2018/19.

Economic commentary

3.2. UK Consumer Price Inflation (CPI) index fell to 2.4% in June, a 12-month low, as the effects of sterling's large depreciation in 2016 began to fade. However CPI ticked back up marginally to 2.5% in July, mostly due to higher energy prices, and up again to 2.7% in August from cultural services, where theatre admission prices rose by more than a year ago, and games, toys and hobbies, where prices for computer games rose this year but fell a year ago. The most recent labour market data for July 2018 showed the unemployment rate at 4%; the lowest since 1975. The three month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9%. However, real wages (i.e. adjusted for inflation) grew only by 0.4%, a marginal increase unlikely to have had much effect for households.

3.3. The rebound in Gross Domestic Product (GDP) growth in Quarter 2 of 2018 to 0.4% confirmed that the weakness in economic growth in Quarter 1 was temporary and largely due to weather-related factors. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25% in August, taking the Bank Rate to 0.75%. No further change was made to monetary policy at the Bank of England's meeting in September.

Credit background

3.4. The big four UK banks are progressing well with ringfencing. Barclays Bank PLC and HSBC Bank PLC have created new banks (Barclays Bank UK and HSBC UK Bank) and transferred ringfenced (retail) business lines into the new companies. Lloyds Bank PLC has created Lloyds Bank Corporate Markets as a new non-ringfenced (investment) bank. RBS has renamed existing group entities and transferred accounts to leave NatWest Markets as the non-ringfenced bank and NatWest Bank, Royal Bank of Scotland and Ulster Bank as the ring-fenced banks. The Council's day-to-day banking contract remains with Lloyds Bank PLC.

4. LOCAL CONTEXT

4.1. On 31 March 2018, the Council had net borrowing of £82.9m arising from financing its housing programme. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below:

Table 1: Balance Sheet Summary

	31/03/2018 Balance £m
General Fund CFR	(5.5)
Housing Revenue Account CFR	(1.9)
HRA Settlement	(138.6)
Total CFR	(146.0)
Less: Resources for investment	63.1
Net borrowing	(82.9)

4.2. The Council'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 treasury management position as at 30 September 2018 and the year-on-year change is shown in Table 2 below:

Table 2: Treasury Management Summary

	31/03/2018 Balance £m	Movement £m	30/09/2018 Balance £m	30/09/2018 Rate %
Long-term borrowing	(135.5)	0.1	(135.4)	(3.21)
Short-term borrowing	(4.3)	-	(4.3)	(1.80)
Total borrowing	(139.8)	0.1	(139.7)	(3.17)
Long-term investments	21.2	4.7	25.9	2.73
Short-term investments	36.7	5.2	41.9	0.82
Cash and cash equivalents	5.2	5.0	10.2	0.70
Total investments	63.1	14.9	78.0	1.44
Net borrowing	(76.7)	15.0	(61.7)	

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

4.3. The reduction in net borrowing of £15m shown in Table 2 above reflects the combination of repayment of Public Works Loan Board (PWLB) borrowing of £0.1m, and an increase in investment balances of £14.9m. The repayment of borrowing is in line with the Council's policy on internal borrowing, whilst the increase in total investments since 31 March 2018 reflects the annual position of 31 March being the lowest point for investment balances, due to many government grants being front-loaded.

5. BORROWING ACTIVITY

5.1. As shown in Table 2, at 30 September 2018 the Council held £139.7m of loans, a decrease of £0.1m to 31 March 2018, with the vast majority of loans being in relation to the resettlement of the HRA in 2012/13. The mid-year treasury management borrowing position and movement since 31 March 2018 is shown in Table 3 below.

Table 3: Borrowing Position

	31/03/2018 Balance £m	Movement £m	30/09/2018 Balance £m	30/09/2018 Rate %	30/09/2018 WAM* years
Public Works Loan Board	139.8	(0.1)	139.7	3.17	16.82
Total borrowing	139.8	(0.1)	139.7	3.17	16.82

* Weighted average maturity

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts, but adjusted to exclude accrued interest.

5.2. 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.

5.3. In keeping with these objectives, no new borrowing was undertaken in the period, while £0.1m of existing loans were allowed to mature without replacement. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

5.4. The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with the monitoring of internal and external borrowing.

6. INVESTMENT ACTIVITY

6.1. The Council holds invested funds representing income received in advance of expenditure plus balances and reserves held. The Council's investment holding was £77.4m principal at 30 September 2018, which was £0.4m (0.5%) higher than the same time last year. During the six month period from 1 April to 30 September 2018, the Council's investment balance ranged between £64m and £93m due to timing differences between income and expenditure. Table 4 below shows investment activity for the Council as at 30 September 2018 in comparison to the reported activity as at 31 March 2018. Asset values have been used rather than principal values to provide a better comparison to the reported investment activity as at 31 March 2018.

Table 4: Investment Position (Treasury Investments)

Investments	31/03/2018 Balance £m	Movement £m	30/09/2018 Balance £m	30/09/2018 Rate %	30/09/2018 WAM* years
Short term Investments					
Banks and Building Societies:					
- Unsecured	3.5	10.4	13.9	0.73	0.11
- Secured	10.1	(4.6)	5.5	1.06	0.38
Money Market Funds	2.2	4.1	6.3	0.70	0.00
Local Authorities	16.0	(3.0)	13.0	0.75	0.36
Corporate Bonds	6.1	1.2	7.3	0.70	0.20
Registered Providers	4.0	-	4.0	1.25	0.35
Cash Plus Funds	0.0	2.0	2.0	0.68	n/a
	42.0	**10.0**	**52.0**	**0.80**	**0.22**
Long term investments					
Banks and Building Societies:					
- Secured	8.1	(0.1)	8.0	0.96	2.60
Local Authorities	2.0	4.0)	6.0	1.25	2.17
	10.1	**3.9**	**14.0**	**1.09**	**2.42**
High yield investments					
Pooled Property Funds**	6.2	0.5	6.7	4.20	n/a
Pooled Equity Funds**	3.0	0.2	3.2	6.05	n/a
Pooled Multi-Asset Funds**	2.0	-	1.9	4.08	n/a
	11.1	**0.8**	**11.9**	**4.68**	**n/a**
TOTAL INVESTMENTS	**63.2**	**14.8**	**78.0**	**1.44**	**0.70**

* Weighted average maturity
** The rates provided for pooled fund investments are reflective of the average of the most recent dividend return as at 30 September 2018.

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts, but adjusted to exclude operational cash and accrued interest.

6.2. Both the CIPFA Code and the government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the highest rate of return, or yield. The Council's objective when investing 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.

6.3. During the first half of 2018/19, total investment balances increased by £14.8m, which is in line with what is expected at this point in the year; this is due to the receipt of council tax, as well as the receipt of front-loaded grant. £10m of this balance has been invested in short term options due to the requirement to pay out these balances within the next 12 months. Long term investment balances, including high yield investments, have increased by £4.7m; these balances have been invested in instruments which provide an increased rate of return, as well as not being liable to bail-in risk. Currently a further £1m has been committed to pooled property funds, which will be invested in tranches during October and November 2018.

6.4. Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2018/19.

6.5. Counterparty credit quality was assessed and monitored with reference to credit ratings, for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

6.6. The Council will also consider the use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

6.7. The Council maintained a sufficient level of liquidity through the use of call accounts and money market funds. The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate increased by 0.25% to 0.75% in August 2018 and short-term money market rates have remained at relatively low levels which continued to have a significant impact on cash investment income.

6.8. The progression of credit risk and return metrics for the Council's investments managed in-house (excluding external pooled funds) are shown in the extracts from Arlingclose's investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking

	Credit Rating	Bail-In Exposure	WAM* (days)	Rate of Return
31/03/2018	AA	11%	302	0.73%
30/09/2018	AA+	25%	257	0.82%
Similar LAs	AA-	56%	88	0.78%
All LAs	AA-	60%	37	0.76%

* Weighted average maturity

6.9. In Table 5 above, the bail-in exposure of the Council's investments that are managed in-house has increased and the weighted average maturity of these investments has reduced when comparing the position at 30 September to 31 March 2018 – this is a direct result of total investment balances increasing at this time of year, due to the receipt of council tax and front-loaded grant. However both of these measures still compare favourably to both similar local authorities and all local authority clients of Arlingclose.

6.10. The Council has targeted a proportion of funds towards high yielding investments as shown in Table 4. Investments yielding higher returns will contribute additional income to the Council, although some come with the risk that they may suffer falls in the value of the principal invested.

6.11. The £11.9m portfolio of externally managed pooled multi-asset, equity and property funds generated an average total return of 7.63%, comprising 4.67% income return used to support services in year, and 2.95% of capital growth. As these funds have no defined maturity date but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives are regularly reviewed.

6.12. The investments in pooled funds allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. The funds, which are operated on a variable net asset value (VNAV) basis, offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short-term. All of the Council's pooled fund investments are in the respective funds' distributing share classes which pay out the income generated. The Council's intention is to hold them for at least the medium term.

6.13. MHCLG released a consultation on statutory overrides relating to the introduction of IFRS 9 Financial Instruments accounting standard from 2018/19. The consultation recognises that the requirement in IFRS 9 for certain investments to be accounted for a fair value through profit and loss may introduce "more income statement volatility" which may impact on budget calculations. The consultation proposes a time-limited statutory override and has sought views whether it should be applied only to pooled property funds. The Council has responded to the consultation which closed on 30 September. The Council's response stated that the Council agrees that there should be a statutory override, but that it should not be time limited, as the circumstances meaning an override is appropriate now will still apply in April 2021 and beyond. The statutory overrise should apply to all pooled investment funds, as the Council sees no reason for the Government to incentivise property funds over other pooled funds. Good treasury risk management requires long-term investments to be diversified over a range of asset classes, and the government should support this by extending the proposed override to all types of collective investment scheme.

7. NON-TREASURY INVESTMENTS

7.1. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

7.2. The Council's investment property holdings totalled £4.695m as at 31/03/18. No purchases have been made in the period between 01/04/18 – 30/09/2018. These investment holdings are expected to generate £216k of investment income for the Council in 2018/19 after taking into account direct costs, representing a rate of return of 4.6%.

8. COMPLIANCE REPORT

8.1. The Council confirms compliance of all treasury management activities undertaken during the period with the CIPFA Code of Practice and the Council's approved revised Treasury Management Strategy. Compliance with specific investment limits, as well as the authorised limit and operational boundary for external debt, is demonstrated in Tables 6 and 7 below.

Table 6: Debt Limits

	2018/19 Maximum £m	30/09/2018 Actual £m	2018/19 Operational Boundary £m	2018/19 Authorised Limit £m	Complied
Total debt	141.8	139.7	191.2	206.4	✓

Table 7: Investment Limits

	2018/19 Maximum	30/09/2018 Actual	2018/19 Limit	Complied
Any single organisation, except the UK Central Government	£5.5m	£5.5m	£12m	✓
Any group of organisations under the same ownership	£5.5m	£5.5m	£12m	✓
Any group of pooled funds under the same management	£5.5m	£5.5m	£12m	✓
Registered providers	£4m	£4m	£10m	✓
Money market funds	11%	8%	50%	✓

9. TREASURY MANAGEMENT INDICATORS

9.1. The Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

9.2. This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed will be:

Table 8: Interest Rate Exposures

	30/09/2018 Actual	2018/19 Limit	Complied
Upper limit on fixed interest rate investment exposure	£6m	£40m	✓
Upper limit on variable interest rate investment exposure	£71m	£120m	✓
Upper limit on fixed interest rate borrowing exposure	£135.4m	£206.4m	✓
Upper limit on variable interest rate borrowing exposure	£4.3m	£206.4m	✓

9.3. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing

9.4. This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 9: Maturity Structure of Borrowing

	30/09/2018 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	3%	25%	0%	✓
12 months and within 24 months	3%	25%	0%	✓
24 months and within 5 years	9%	25%	0%	✓
5 years and within 10 years	15%	25%	0%	✓
10 years and above	70%	100%	0%	✓

Principal Sums Invested for Periods Longer than 365 days

9.5. The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

Table 10: Principal Sums Invested for Periods Longer than 365 days

	2018/19	2019/20	2020/21
Actual principal invested beyond year end	£26m	£19m	£15m
Limit on principal invested beyond year end	£40m	£40m	£40m
Complied	✓	✓	✓

10. CRIME AND DISORDER AND ENVIRONMENTAL IMPLICATIONS

10.1. None arising directly from this report.

11. RECOMMENDATIONS

Members are recommended to:

11.1. consider the performance of the treasury function detailed in this report.

Further information	Background papers
Please contact Andrew Boutflower (HCC), or Alan Bethune	The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance
	Local Government Act 2003
email: andrew.boutflower@hants.gov.uk alan.bethune@nfdc.gov.uk	SI 2003/3146 Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
	Treasury Management Strategy Report 2018/19 Audit Committee – 26 January 2018 Council – 26 February 2018 Treasury Management Mid-Year Monitoring Report 2017/18 Audit Committee – 25 August 2017 Treasury Management Annual Outturn Report 2017/18 Audit Committee – 31 May 2018 Cabinet – 4 July 2018 Council – 9 July 2018
	Published Papers