HIGHLAND COUNCIL

Agenda Item	**10 (b)**
Report No	**RES/57/18**

Committee:	Corporate Resources Committee
Date:	21 November 2018
Report Title:	Treasury Management Mid-Year Review 2018/19
Report By:	Depute Chief Executive/Director of Corporate Resources

1. Purpose/Executive Summary

1.1 This report is the mid-year treasury management review for the financial year 2018/19 which is prepared in compliance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) revised Code of Practice on Treasury Management in Local Authorities.

1.2 The report highlights the Council's treasury management activities undertaken, provides a commentary on the year to 30 September 2018 and compares activity to the expected activities contained in the annual Treasury Management Strategy Statement and Investment Statement (TMSS) which was approved by Council on 8 March 2018.

1.3 This Treasury Management Mid-Year Review 2018/19 is submitted to the Committee for consideration. The Report will then be submitted to Council for approval in December 2018.

1.4 The Prudential Code also requires the Council to report the actual prudential indicators after the financial year end and these are shown as at 30 September 2018 in **Appendix 1.**

2. Recommendations

2.1 Members are asked to:

i. Consider the Treasury Management Mid-Year Review 2018/19.

3. Background

3.1 Treasury Management is defined as: "*The management of the local authority's borrowing, 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*".

3.2 The CIPFA Code of Practice on Treasury Management (revised November 2009) was adopted by the Council on 4 March 2010. The Code was further updated in December 2017.

3.3 The primary requirements of the Code are the:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the Council of an Annual Strategy Report for the year ahead, a mid–year report and an Annual Review Report of the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management policies to a specific named body, which in this Council is the Corporate Resources Committee.

3.4 The Treasury Management Mid-Year Review 2018/19 has been prepared in compliance with CIPFA's Code of Practice and covers the following:

- An economic update for the first six months of 2018/19, provided by the Council's Treasury Advisers, Link Asset Services
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- The Council's capital expenditure (prudential indicators)
- A review of the Council's investment portfolio for 2018/19
- A review of the Council's borrowing strategy for 2018/19
- A review of any debt rescheduling undertaken during 2018/19
- A review of compliance with Treasury and Prudential Limits for 2018/19.

4. Economic update (provided by Link Asset Services)

4.1 The Council has appointed Link Asset Services as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. **Appendix 2** provides an economic update from Link Asset Services.

4.2 Link Asset Services undertook its last review of interest rate forecasts in October 2018 after the quarterly Bank of England Inflation Report.

Due to generally positive economic statistics, the Monetary Policy Committee (MPC) decided to increase Bank Rate for the first time since the financial crash from 0.50% to 0.75% on 2 August 2018. However, the MPC emphasised that future Bank Rate increases would be more gradual than before the crash rising to around 2.5% in ten years' time.

4.3 It is the view of Link Asset Services that MPC will do the following but even these limited increases are dependent on a reasonably orderly Brexit:

- increase Bank Rate in February 2019, ahead of the deadline in March for Brexit
- wait until August 2019, rather than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%.

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%

4.4 The overall balance of risks to economic growth in the UK is probably neutral. The balance of risks to increases in Bank Rate and shorter term PWLB rates depend on the strength of GDP, how slowly inflation pressures subside, and how quickly the Brexit negotiations progress positively.

5. Treasury Management Strategy Statement and Annual Investment Strategy update

5.1 The Treasury Management Strategy Statement (TMSS) for 2018/19 was approved by Council on 8 March 2018. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as security of capital, liquidity and then yield.

5.2 There have been no policy changes to the TMSS since it was agreed in March 2018.

6. Investment portfolio 2018/19

6.1 Cash deposits placed by the Council are categorised as investments. In accordance with the Code the key considerations when investing are security of capital, liquidity and to obtain a level of return consistent with the Council's risk appetite.

6.2 The investment portfolio yield for the first six months of the year is an average rate of 0.68% against a benchmark (7 Day London Inter-bank Offer Rate – LIBID average) of 0.44%.

6.3 The average level of funds available for investment purposes in the first six months of 2018/19 was £69.8m (2017/18 £87.3m). These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of council tax payments, receipt of grants and progress of the capital programme.

6.4 In line with the investment strategy, the Council will only place deposits with counter-parties with a high-creditworthiness. The forecasts in section 4.3 demonstrate that it is a very difficult investment market as rates are very low compared to the previous decade generally around the current 0.75% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

7. Money Market Fund Regulatory Change

7.1 The Council regularly uses two Money Market Funds (MMFs) for depositing cash. These are secure, liquid investments that generate a reasonable rate of return. The Money Market Fund sector will be introducing new regulations with effect from the beginning of 2019.

7.2 Money Market Funds are defined using the following categories under EU regulation:

- Constant Net Asset Value (CNAV) Public Debt Funds
- Low Volatility Net Asset Value (LVNAV) Prime Funds
- Variable Net Asset Value (VNAV) Prime Funds

7.3 The Council's current MMFs are CNAV but will convert to LVNAV under the new regulations. LVNAV Funds maintain a constant price but the new regulations state that an LVNAV fund must be accounted for as an asset with a variable net value if the underlying net asset value deviates from its constant price by 20 basis points (0.2%)..

7.4 The Council will continue to invest in MMFs that have a AAA credit rating as set out in the Treasury Management Strategy Statement 2018/19. These funds are widely diversified, using a broad selection of money market securities. The Council will continue to benefit from both the high level of expertise and scrutiny applied by fund managers in maintaining such funds and the large investments contained within them. Short term MMFs can also help an authority to diversify its own portfolio and is an effective way of minimising risk exposure while still getting better rates of return.

8. New External Borrowing

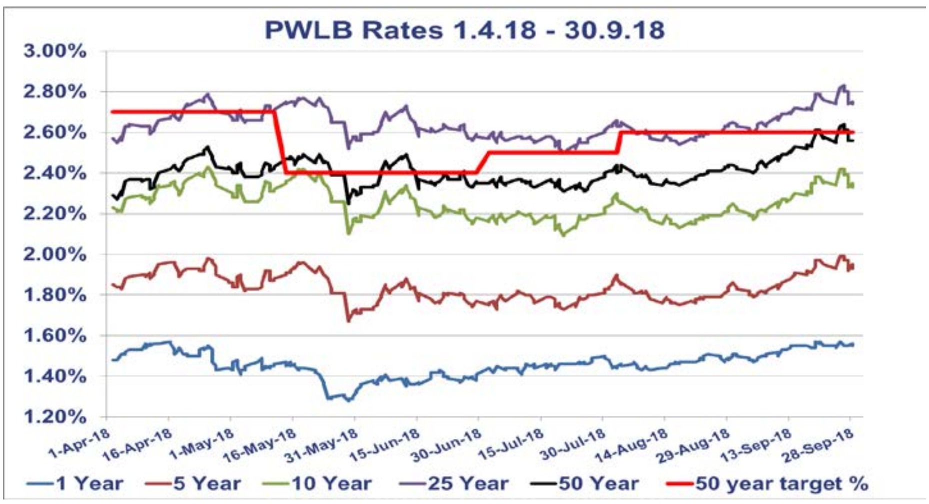
8.1 The Capital Financing Requirement (CFR) represents the accumulated net capital expenditure which the Council requires to fund by way of long term debt until the capital projects, comprising the CFR, are fully written off by way of annual loan charges to revenue accounts.

8.2 The balance of external and internal borrowing is generally driven by market conditions, and the need to take a balanced view of savings available from short term and internal borrowing, versus the mitigation of re-financing risk which can be achieved from longer-term borrowing, but at potentially higher cost.

8.3 The graph below shows the estimated CFR at 31/03/19 and how it is expected to be funded by short term borrowing and historic long term borrowing.

	£m
Estimated Capital Financing Requirement (CFR) at 31/03/19 See appendix 1 – indicator 2	1,164.0
Less PPP	-157.2
Estimated CFR 31/03/19	**1,006.8**
Opening Long Term Debt 01/04/18	767.9
Long term maturities (PWLB)	-22.5
New PWLB loans	35.0
Market Loan repays	-6.0
New market loans (Period of 2 years)	7.5
Estimated Long Term Debt 31/03/19	**781.9**
Opening short term borrowing 01/04/18	151.0
Raised and repaid to 31 October 2018	-26.0
Add estimated net borrowing for new capital expenditure in 2018/19 (November to March)	35.9
Add Borrowing for cashflow	20.0
Estimated Short Term Debt at 31/03/19	**180.9**
Estimated total long term and short term debt 31/03/19	**962.8**
Difference between CFR and borrowing = Funding from internal balances and cash flow	44.0

8.4 The graph and table below shows the movement in PWLB rates for the first six months of the year incorporating the certainty rate (0.20% discount on rates for local authorities who have applied for rate).. The general trend has been an overall increase in interest rates for PWLB loans though rates remain volatile.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.28%	1.67%	2.09%	2.50%	2.25%
Date	01/06/18	29/05/18	20/07/18	20/07/18	29/05/18
High	1.57%	1.99%	2.43%	2.83%	2.64%
Date	17/04/18	25/09/18	25/04/18	25/09/18	25/09/18
Average	1.46%	1.84%	2.25%	2.64%	2.41%

8.5 During April 2018 and May 2018, the following PWLB borrowing was undertaken partly to replace the PWLB loans of £22.5m that were repaid on 3 April 2018 (£15m 3.57% and £7.5m 3.62%). This borrowing was undertaken at the lowest rates between April and September 2018.

Counterparty	**Amount £m**	**Rate %**	**Start Date**	**Maturity Date**
Public Works Loan Board	25.0	2.27	05/04/2018	30/09/2067
Public Works Loan Board	10.0	2.25	03/05/2018	31/03/2067
Total PWLB	**35.0**			

8.6 Market loans of £7.5m were replaced at a rate of 1.30% for a duration of 2 years which compares favourably to the lowest 1 year PWLB rate of 1.28%.

8.7 It is anticipated that over the remainder of the financial year, no further new long-term borrowing will be undertaken. Markets remain volatile, and favourable short-term borrowing opportunities are likely to be available to the Council. However, the strategy remains flexible and consideration will be given to long term borrowing based on prevailing market conditions.

8.8 In consultation with Link Asset Services, the market situation is constantly monitored and borrowing strategies reviewed on a regular basis.

9. Debt rescheduling

9.1 No debt rescheduling was undertaken during the first six months of 2018/19 as there were no cost effective opportunities.

10. Compliance with Treasury and Prudential Limits

10.1 It is a statutory duty for the Council to determine and keep under review the “Affordable Capital Expenditure Limits”. The Council’s approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved Treasury Management Strategy Statement (TMSS) agreed in March 2018.

10.2 During the financial year to date the Council has 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 are shown in **Appendix 1**, comparing the initial limits agreed for the year, and updated year-end forecasts.

11. Capital Strategy

11.1 In December 2017 CIPFA issued revised Prudential and Treasury Management Codes.

As from 2019/20, all local authorities will be required to prepare a Capital Strategy which is intended to provide the following: -

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability

A report setting out our Capital Strategy will be taken to the Corporate Resources Committee before 31 March 2019.

12. Implications

12.1 Resource – it is likely that loan charges will be as forecast. However, this figure depends on the level of capital expenditure undertaken during the rest of the financial year and market interest rates for short term borrowing and deposits which will continue to be monitored.

12.2 There are Risk implications associated with a strategy of short term borrowing that rates increase and the Council is exposed to refinancing a large portfolio of short term debt at higher interest rates and missing the opportunity to secure favourable rates for longer term borrowing. Modelling of scenarios where interest rates rise are at Appendix 3.

12.3 Other Treasury management risk considerations are:-

- Volatility on PWLB/borrowing rates due to huge uncertainty rates have recently moved from 2.40% up to 2.79% and now easing back down.
- Political risk would in theory places the UK's sovereign credit rating under some pressure, remembering the UK rating is already on a negative watch from the ratings agencies.
- Potential credit risk/uncertainty to UK Banks. The Governor of the Bank of England has highlighted risks to economic growth issues and the willingness of the BoE to act as required (monetary stimulus/rate changes to support the economy).
- A fall in the value of sterling would raise the possibility of higher inflation/costs from suppliers due to higher import costs for raw materials.
- Possibility of bank rate reduction by the MPC to counteract any financial/market volatility, thus meaning risk to investment returns.
- Wider funding considerations such reductions in grants/contributions will impact budget and borrowing plans.

12.4 There are no Legal, Equalities; Climate Change/Carbon Clever; Gaelic or Rural implications relating this report.

Designation:	Head of Corporate Finance and Commercialism
Date:	6 November 2018
Author:	Catriona Stachan, Accountant
Background Papers:	Treasury system and financial ledger reports TMSS 2018/19

Appendix 1

Estimated and Actual Treasury Position and Prudential Indicators

Figures are for financial year unless otherwise titled in italics

Prudential Indicator		2018/19 Original £m	2018/19 Revised £m
1.	**Capital expenditure**		
	Gross capital expenditure		
	General Fund including PPP	112.20	102.7
	Housing Revenue Account	35.3	45.8
	Total gross capital expenditure	**147.5**	**148.5**
	Income - General Fund	(46.5)	(44.4)
	Income - HRA	(16.2)	(18.9)
	Total income	**(62.7)**	**(63.3)**
	Net capital expenditure		
	General Fund	65.7	58.3
	HRA	19.1	26.9
	Total net capital expenditure	**84.8**	**85.2**
	Loan charge instalments General Fund	(29.6)	(29.8)
	Loan charge instalments HRA	(7.5)	(7.0)
	Total instalments	**(37.1)**	**(36.8)**
	Net borrowing for new capital expenditure		
	General Fund	36.1	28.5
	HRA	11.6	19.9
	Total net borrowing for new capital expenditure	**47.7**	**48.4**
2.	**Capital Financing Requirement (CFR) at 31 March**		
	General Fund excluding PPP	715.8	724.0
	Housing Revenue Account	256.9	263.7
	Joint Boards	19.0	19.1
	PPP	157.2	157.2
	Total	**1,148.9**	**1,164.0**

Prudential Indicator		2018/19 Original £m	2018/19 Revised £m
	Treasury Position at 31 March		
	Borrowing – Long term	755.3	781.9
	Borrowing – Short term	200.0	180.9
	Other Long Term Liabilities (PPP)	157.2	157.2
	Total Debt	**1,112.5**	**1,120.0**
	Investments	50.0	50.0
	Net Borrowing	**1,062.5**	**1,070.0**
3.	**Authorised Limit for Borrowing** (against maximum position)	1,003.7	935.0 (13/04/18)
4.	**Operational Boundary for Borrowing**	967.3	935.0 (13/04/18)
5.	**Ratio of financing costs to net revenue stream**		
	General Fund including PPP	13.5%	13.9%
	Housing Revenue Account	33.7%	32.8%
6.	**Interest rate exposures of debt net of investments**		
	Upper Limit (Fixed)	990.2	787.7 (Sept 2018)
	Upper Limit (Variable)	346.6	75.7 (June 2018)
7.	**Maturity structure of fixed rate borrowing (against maximum position**)		
	Under 12 months	30.0%	22.1% (Sept 2018)
	12 months to 2 years	30.0%	5.1% (Sept 2018)
	2 years to 5 years	30.0%	8.1% (June 2018)
	5 years to 10 years	50.0%	12.2% (June 2018)
	10 years and above	100.0%	54.5% (June 2018)
8.	**Upper limit for the maturing of investments made for periods longer than 364 days (against maximum position**)	20.0	Nil
9.	**Short term borrowing (net of investments) as a % of outstanding long term debt (maximum position)**	25.0%	16.3% (April 2018)
10.	**Variable interest debt (net of investments) as a % of outstanding long term debt (maximum position)**	35.0%	12.9% (June 2018)

Appendix 2

Economic update (provided by Link Asset Services)

UK

The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the MPC, to unanimously (9-0) vote to increase Bank Rate on 2 August 2018 from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were 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 concerns about a build-up of inflationary pressures, particularly with the pound falling in value again 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 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.

As for the labour market, unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the high of 0.5% in 2009, the previous high point was in July 2015. Given the UK economy is very much services 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. 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 UK economy.

In the political arena, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along 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 massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September from 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

EU
Growth was unchanged at 0.4% in quarter 2, but has undershot 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 manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 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; 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
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.

Appendix 3 – Impact of interest rate rises on refinancing costs (planned new debt excluded)

Forecast rates	**2018-19**	**2019-20**	**2020-21**	**2021-22**	**2022-23**	**Totals**
Short term debt to be refinanced	£70m for 5 months	Replace £130m	Replace £130m	Replace £130m	Replace £130m	
	0.75%	1.00%	1.25%	1.50%	1.75%	
Short term debt	£218,750.00	£1,300,000.00	£1,625,000.00	£1,950,000.00	£2,275,000.00	£7,368,750.00
Long term debt to be refinanced	Market debt £15m for 3 months	PWLB £44.9m, Market debt £3m	PWLB £13.2m	Market debt £9m	PWLB £29.8m	
Market debt	£89,753.42	£510,000.00	£606,410.96	£928,701.37	£936,000.00	£3,070,865.75
PWLB	-	£943,086.31	£1,827,256.37	£2,506,672.49	2,506,672.49	£7,783,687.66
						£18,223,303.42
0.25% increase						l
Short term debt	£291,666.67	£1,625,000.00	£1,950,000.00	2,275,000.00	2,600,000.00	£8,741,666.67
Market debt	£117,000.00	£547,500.00	£651,000.00	995,694.52	1,003,500.00	£3,314,694.52
PWLB	-	£1,016,543.58	£1,780,602.54	2,689,486.13	3,294,019.10	£8,780,651.34
						£20,837,012.53
0.50% increase						
Short term debt	£364,583.33	£1,950,000.00	£2,275,000.00	£2,600,000.00	£2,925,000.00	£10,114,583.33
Market debt	£125,013.70	£585,000.00	£695,589.04	£1,062,687.67	£1,071,000.00	£3,539,290.41
PWLB	-	£1,088,959.17	£1,904,767.07	£2,872,299.77	£3,514,149.59	£9,380,175.60
						£23,034,049.34
0.75% increase						
Short term debt	£437,500.00	£2,275,000.00	£2,600,000.00	£2,925,000.00	£3,250,000.00	£11,487,500.00
Market debt	£133,027.40	£622,500.00	£740,178.08	£1,129,680.82	£1,138,500.00	£3,763,886.30
PWLB	-	£1,163,458.11	£2,019,141.00	£3,030,532.22	£3,709,698.88	£9,922,830.21
						£25,174,216.51

1% increase	2018-19	2019-20	2020-21	2021-22	2022-23	
Short term debt	£510,416.67	£2,600,000.00	£2,925,000.00	£3,250,000.00	£3,575,000.00	£12,860,416.67
Market debt	£141,041.10	£660,000.00	£784,767.12	£1,196,673.97	£1,206,000.00	£3,988,482.19
PWLB	-	£1,236,915.37	£2,119,346.12	£3,200,427.06	£3,916,910.57	£10,473,599.12
						£27,322,497.98