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TREASURY MANAGEMENT STRATEGY MID-YEAR REVIEW REPORT 2018/19

Portfolio Holder: Councillor Alan Jarrett, Leader

Report from: Phil Watts, Chief Finance Officer

Author: Jonathan Lloyd, Principal Accountant

Summary

Full Council approved the Treasury Management Strategy for 2018/19 alongside the Capital and Revenue Budgets on the 22 February 2018. In accordance with the Chartered Institute of Public Finance Accountancy's (CIPFA) Code of Practice for Treasury Management, there should be a review of that strategy at least half yearly. This report represents the mid-year review of the Treasury Management Strategy 2018/19.

1 Budget and Policy Framework

1.1 Audit Committee is responsible for the scrutiny of the Council's Treasury Management, Investment Strategy and Minimum Revenue Provision Policy Statement along with Treasury Management Practices and associated Schedules.

1.2 There needs to be, as a minimum, a mid-year review of treasury management strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved.

1.3 This report has also been considered by the Cabinet on 25 September 2018 and the Audit Committee on 27 September 2018.

2 Background

2.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensures this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially, before looking to maximise investment return.

2.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing requirements of the Council, essentially the longer-term cash flow planning to ensure the Council can meet its capital spending liabilities. This management of longer-term cash may involve arranging long or short-term loans, or using long-term cash flow surpluses, and on occasion, debt previously incurred may be restructured to meet Council risk or cost objectives.

2.3 As a consequence treasury management is defined as:

"The management of the local authority'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. "

2.4 The principal requirements of the Code are as follows:

(i) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities

(ii) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives

(iii) Receipt by full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities undertaken during the previous year

(iv) 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

(v) Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific committee. For this Council the delegated body is the Audit Committee.

2.5 This mid year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of 2018/19
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- 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.

3 Review of Economic Conditions

This section has been prepared by the Authority's Treasury Advisors, Link.

3.1 ECONOMIC PERFORMANCE 2018/19

3.1.1 **UK.** Growth in 2017 was disappointingly weak in the first half of the year but picked up to 0.5% in quarter 3 and 0.4% in quarter 4. Growth in quarter 1 of 2018 was again disappointing, although on the first revision the rate improved from 0.1 to 0.2% to allay fears that the economy may have started a prolonged period of very weak growth. Initial indications in quarter 2 are that growth may have picked up speed to around 0.4%. The main reason for weak growth during 2017 and 2018 has been that inflation has been exceeding pay growth until recently, meaning that there has been negative growth in consumer disposable income when consumer expenditure is the biggest driver of the services sector which accounts for about 75% of GDP.

3.1.2 The manufacturing sector was the bright spot in the economy in 2017 in terms of strong growth but quarter 1 was the weakest quarter for one and a half years and forward indicators do not suggest a return to strong growth is likely.

3.1.3 The August MPC meeting delivered the expected 25 basis point rate hike, to 0.75% but the 9-0 outcome was a surprise. The committee reaffirmed that further rate moves will likely be gradual, though inflationary pressures will be monitored. The markets are not factoring in another rate hike at any of the last three meetings this year

3.1.4 **EU.** A recovery to strong growth in 2016 and 2017 looks as if it will weaken somewhat going forward. Despite providing massive monetary stimulus, the ECB has been struggling to get inflation up to its 2% target. However, in April the headline Eurozone rate jumped up from 1.4% to 1.9% although the core inflation rate was still subdued in rising from 0.7% to 1.1%. At its June meeting, the ECB announced it would halve its monthly quantitative easing purchases from €30bn to €15bn, and then end all purchases after December. It is unlikely to make a start on increasing interest rates until late in 2019.

3.1.5 **USA**. Growth in the American economy was volatile in 2015, 2016 and 2017 during each year, with quarter 1 being particularly weak. The annual rate of GDP growth for 2017 was 2.3%. Quarter 1 in 2018 came in at 2.0%, down from 2.9% in the previous quarter. The Trump $1.5 trillion income tax cut package coming into effect in January 2018, is likely to boost growth to the Trump administration's 3% target. However, it is also likely to boost inflation at a time when spare capacity in the economy is minimal and unemployment, in particular, has fallen to the lowest level for 17 years, reaching 3.8% in May. The Fed has started on an upswing in rates with seven increases since the first one in December 2015, the latest one being in June 2018 to lift the central rate to 1.75 – 2.00%. There could be a further two or more increases in 2018. In October 2017, the Fed became the first major western central bank to make a start on unwinding quantitative easing by phasing in a gradual reduction in respect of reinvesting maturing debt.

3.1.6 **Chinese economic growth** has been weakening over successive years, despite repeated rounds of central bank stimulus and 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.

3.1.7 **Japan.** The best economic run, (of positive growth for eight quarters), since the 1980s came to an end in quarter 1 with a contraction of -0.6% blamed on weak exports. However, it is still struggling to get inflation up to its target rate of 2% despite huge monetary and fiscal stimulus, with inflation falling to only 0.4% in May. It is also making little progress on fundamental reform of the economy

4 Treasury Management Strategy Statement and Annual Investment Strategy update

4.1 Full Council approved the 2017/18 Treasury Management Annual Investment Strategy on the 22 February 2018.

4.2 There are no policy changes to the strategy.

4.3 Limits to Borrowing Activity

4.3.1 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowing less investments) will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of Capital Financing Requirement (CFR) in the preceding year plus the estimates of any additional CFR for 2018/19 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2017/18 Original Estimate £000	**Current Position 3 Sept 2018 £000**
Gross borrowing	235,969	217,324
CFR (year end position)	286,381	255,054

4.3.2 The forecast CFR position (£286.3m) reflects estimated new borrowing of £24.5m in respect of 18/19 capital expenditure. The current CFR shown (£255.0m) is as reported in the audited Statement of Accounts at 31 March 2018.

4.3.3 Gross borrowing at 3 September is broadly in line with the level anticipated for 31 March 2019 when the Strategy was formulated. The Council enjoys higher liquidity in the summer months than towards the year end which enables the Council to avoid renewal of short term borrowing and hence the gross borrowing at 3 September is lower than the estimated year end figure.

4.3.4 The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in ensuring that borrowing does not exceed CFR.

4.3.5 A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit, which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in longer-term scenario. It is a forecast of maximum borrowing requirement with some capacity for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Council's authorised borrowing limit for 2018/19 is £425.569 million and it will not exceed this limit.

5 Investment Portfolio 2018/19

5.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.75% Bank Rate. Given the risk environment, investment returns are likely to remain low.

5.2 The Council held £52m of investments as at 3 September 2018 inclusive of property funds (market value £22.3m at 31 March 2018) and the investment portfolio yield on cash investments for the first five months of the year was 1.11%.

5.3 A full list of in house investments held as at 3 September 2018 is shown below:

Investments	**Principal 3 Sept 2018 £**	**Interest %**
<u>Core Investments (Local Authorities)</u>		
City of Newcastle Upon Tyne	5,000,000	2.35%
Doncaster Metropolitan Borough	5,000,000	2.32%
CCLA Property Fund (31/3/18 market value)	12,413,483	n/a
Rockspring Hannover Property UT (31/3/18 market value)	5,051,580	n/a
Lothbury Property Trust (31/3/18 market value)	4,843,155	n/a
Total Core Investments	**32,308,218**	
Liquid Investments		
Svenska Handelsbanken	3.334	0.15%
Lloyds	19,800,000	0.70%
Barclays	4,270	0.30%
Total Liquid Investment	**19,807,604**	
Total In house Investments	**52,115,822**	

5.4 The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the period from 1 April 2018 to 3 September 2018.

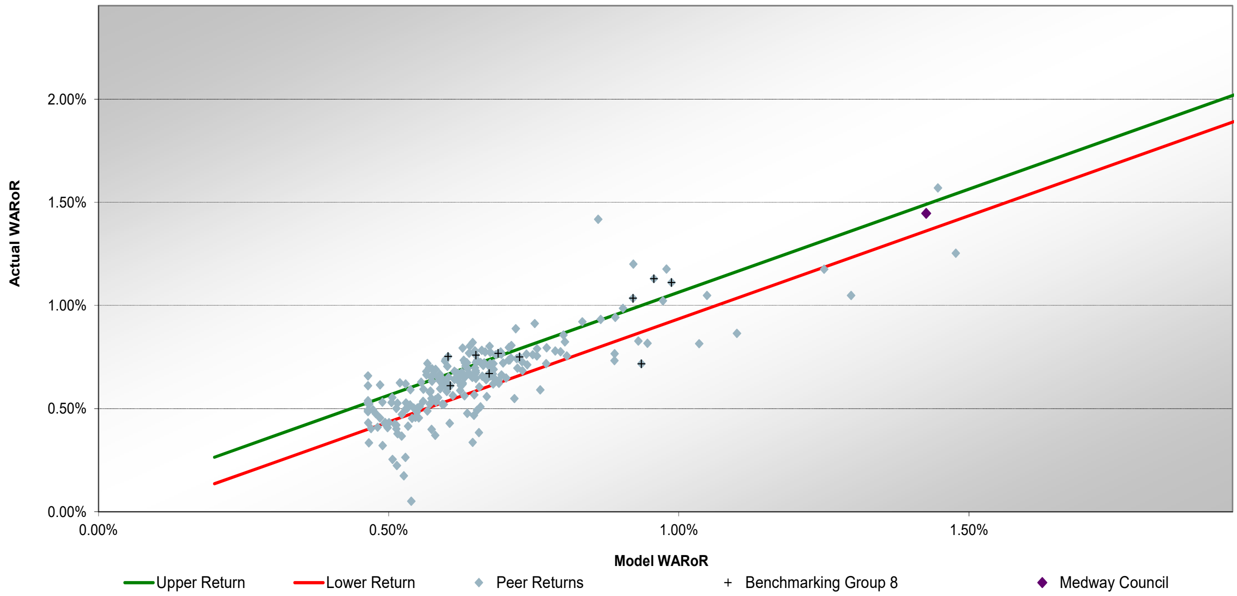
5.5 The Council's budgeted net interest payments for 2017/18 is £5.25m however the deterioration in cash flow have resulted in a revised prediction of around £5.712m.

5.6 <u>Investment Counterparty Criteria</u>

5.6.1 The current investment counterparty criteria selection approved in the Treasury Strategy is meeting the requirement of the treasury management function.

5.7 <u>Benchmarking</u>

5.7.1 The in-house Treasury team, contribute to the Capita Asset Services benchmarking club which produces quarterly reports. Shown below is a graph showing Medway's performance to June.



5.7.2 The "x" axis of the graph shows the "Model Weighted Average Rate of Return", this is easiest interpreted as the level of return we should expect for the level of risk that we are taking with our investment portfolio. This is then plotted against the "Actual Weighted Average Rate of Return" on the "y" scale, running diagonally upwards across the graph are two parallel lines, if a Council performance falls between these lines then they are deemed to be receiving a return as would be expected for their level of risk, below these two lines and performance is considered below that expected and above then the return being received is above that expected. As can be seen Medway's return fell slightly below that expected for our level of risk. However the data includes only at cash deposits and excludes property funds which currently yield dividends in excess of 4%.

5.7.3 In assessing the risk inherent in an Investment Portfolio for the benchmarking, three factors are taken into account,

(i) The number of days to maturity of an investment. With a larger the number of days left to maturity the greater the risk that an adverse event could occur
(ii) The total number of days that the investment was originally invested for, again the longer an authority is comfortable to invest for the greater the risk it is willing to take.
(iii) The creditworthiness of the counterparties that the authority invests with.

5.7.4 The table below shows some detail from the June 2018 benchmarking data comparing Medway in-house performance against all participants of the benchmarking group; Unitaries and other local councils.

Comparison of risk and returns

	Model Weighted Average Rate of Return	Risks			Weighted Average Rate of Return
		Weighted Average Maturity (Days)	Weighted Average Total Time (Days)	Weighted Average Credit Risk	
Medway	**1.47%**	**156**	**957**	**2.32**	**1.45%**
Average English Unitaries (23)	0.72%	107	235	2.45	0.72%
Average Total Population (224)		93	180	3.19	0.66%
Average Local Benchmarking Group (11)		165	367	3.60	0.89%
Brighton & Hove CC	0.96%	243	357	3.03	0.72%
East Sussex CC	0.68%	123	150	3.48	0.67%
Sevenoaks DC	0.61%	81	129	3.57	0.61%
Tonbridge and Malling BC	0.66%	126	190	3.51	0.76%

6 Borrowing

6.1 The Council's capital financing requirement (CFR) for 2018/19 is £286.381 million. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The table in section 4.3.1 shows the Council has gross external borrowings of £217.324 million against a CFR of £286.381 million.

6.2 The current borrowing strategy is to postpone new long term borrowing and use short term borrowing when necessary. This policy has been adhered to for the first six months of this financial year. Further short term borrowing is expected to be needed before the year end. However, as specified within the strategy, we will evaluate the economic and market factors to form a view on future interest rates so as to determine whether it is advantageous to borrow for a longer term.

6.3 Link's current forecast of interest rates are as follows:

	Sept 18	Dec 18	Mar 19	June 19	Sept 19	Dec 19	Mar 20	Jun 20
Bank rate	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%
5 yr PWLB	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%
10 yr PWLB	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%
25 yr PWLB	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%
50 Yr PWLB	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%

6.4 One of the important risks inherent within Treasury management is "Interest rate risk". This risk is high where a large proportion of an organisation's borrowing portfolio reach termination point at the same time. The organisation has then to re-finance a large proportion of their portfolio at a set point of time whereby they run the risk that interest rates may not be beneficial to the organisation.

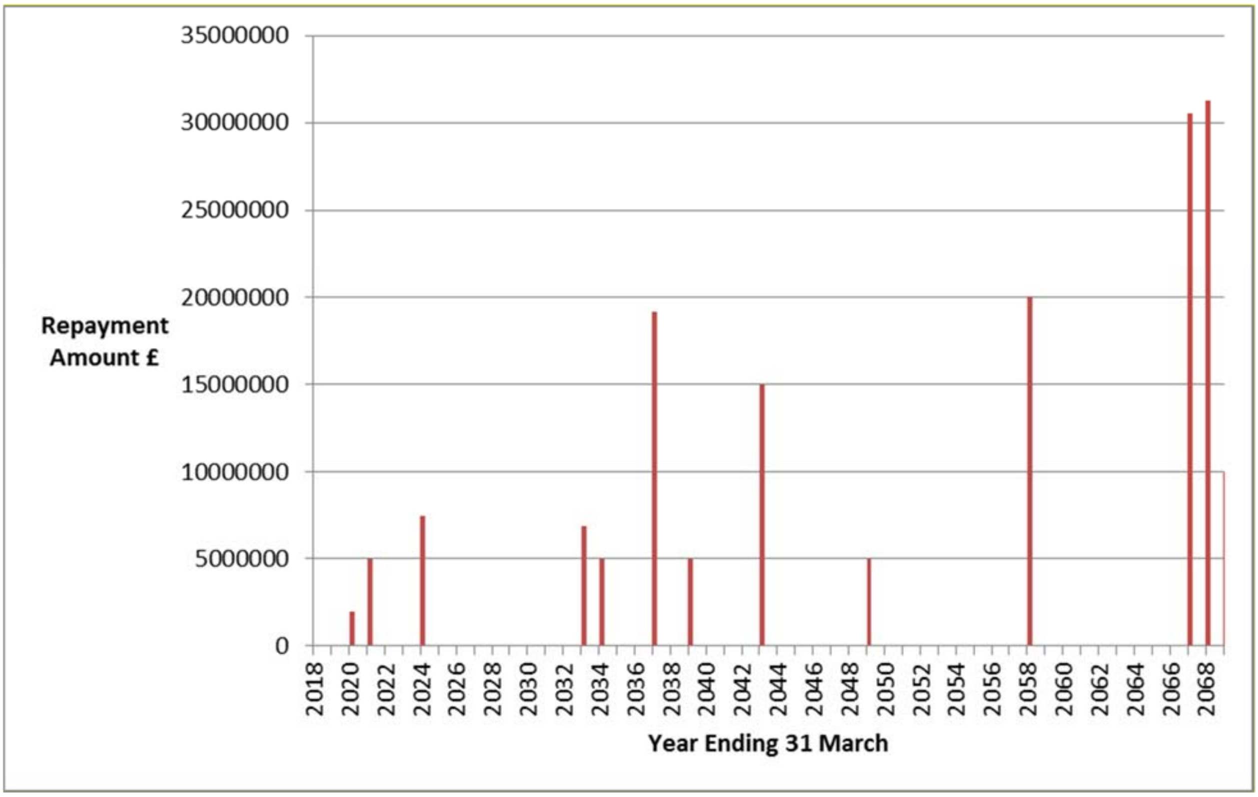
6.5 In order to protect against this risk it is prudent to spread repayment dates over a number of years thereby reducing the risk of a large proportion of the portfolio being affected by adverse interest rates.

6.6 The graph in paragraph 6.10 below shows the long term debt portfolio repayment profile as at 1 April 2018. It can be seen that the debt repayments are reasonably spread over the forthcoming decades, thereby reducing any impact of interest rate risk.

6.7 The earliest repayments of long term debt are due in November 2019, £2m, November 2020, £5m and November 2023, £7.5m.

6.8 As at 3 September 2018 the Council owed some £55m in short term borrowing. These loans are planned to be replaced as they mature at various dates between 12 October 2018 and 2 July 2019. Additional short term borrowing will also be required before the year end.

6.9 Long term debts in the table below are all being shown as repayable at term, although the LOBOs (Lender Option Borrower Option) have a variety of "call" periods of between 6 months and every 5 years. The risk of a call occurring is currently low and therefore these have been shown as running full term.



7 Debt Rescheduling

7.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year, no debt rescheduling was undertaken and it is not envisaged that any will occur before the end of the financial year. However, officers and the council's financial advisers, Link Asset Services, will continue to monitor the situation and opportunities will be carefully considered.

8 Compliance with Treasury and Prudential Limits

8.1 It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". Council's approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved TMSS.

8.2 During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices.

9 Cabinet – 25 September 2018

9.1 The Cabinet considered this report on 25 September 2018, noting the contents of the report and congratulated staff on their performance including, in particular, their success in achieving a significantly higher weighted average rate of return on the Council's investment portfolio in comparison to other local authorities, as set out in paragraph 5.7.4 of the report and referred these comments to the Audit Committee.

10 Audit Committee – 27 September 2018

10.1 Members considered a report regarding the mid-year review of the Treasury Management Strategy 2018/19.

10.2 The Head of Financial Strategy reported that, since the report had been published, the Council had taken out a 10 year loan totalling £5m with the Public Works Loan Board and also a £10m loan over 2.5 years with Barking and Dagenham London Borough Council. This was a start of a process to smooth out the maturity profile of its long term debts.

10.3 Members were also advised that the Cabinet, at its meeting held on 25 September, had congratulated treasury management staff on their performance including, in particular, their success in achieving a significantly higher weighted average rate of return on the Council’s investment portfolio in comparison to other local authorities and asked that these comments be referred to the Audit Committee.

10.4 A Member queried whether the Council would now not be lending money to other Councils. The Head of Finance Strategy advised that the Treasury Management Strategy still provided for this but the priority was to achieve the highest returns possible and, at present, that was not with local authorities.

10.5 The Chief Legal Officer commented that the Council had recently invested in a £6.4m distribution network which would yield approximately £200,000 pa income for the Council. A Member asked for clarity with regard to commercial investments whether there were any areas the Council would not invest in order to prevent a conflict with the organisation’s priorities or policies. The Chief Legal Officer advised that there were criteria for investments and a commercial strategy had recently been drafted with the initial aim of investments which would yield around 6% pa. This included the possibility of residential investments but this needed further work. He was happy to look at developing a policy on avoiding conflicts of interest regarding commercial investments.

10.6 A Member expressed concern about councils speculating on the housing market given the financial crash 10 years ago which followed speculation on housing and which led to several councils suffering a financial loss. The housing market produced big returns but that was because the risks were higher. The recent warning from the Governor of the Bank of England that withdrawal from the European Union could lead to a 30% fall in house prices should be seen as a real concern and the Council should be cautious about future speculation in the housing market. Medway Development Company (MDC) also exposed the Council to this risk on another front. In response the Chief Legal Officer advised that the MDC business case had been developed with the help of external advisors and factored in what would happen if the market dropped. For each scheme the financial viability of the project was tested at 4 different stages. In addition investments were typically over a 5-10 year period.

10.7 Other Members commented that, compared to the 2008 financial crash, the Council was investing in physical assets that could be understood. Also if the Council’s cash remained in bank accounts then any devaluation in the currency would also pose a risk. Decisions about investments were based on evidence which gave some assurance to Members.

10.8 The Committee agreed to note the report.

11 Risk management

11.1 Risk and the management thereof is a feature throughout the strategy and in detail within the Treasury Management Practices 1.

12 Financial and legal implications

12.1 The finance and legal implications are highlighted throughout this report. The Council has delegated responsibility for the execution and administration of treasury management decisions to the Chief Finance Officer, who will act in accordance with the Council's policy statement and Treasury Management Practices.

13 Recommendation

13.1 The Council is requested to note the comments of the Cabinet and the Audit Committee and note the contents of this report.

Lead officer contact
Jonathan Lloyd, Principal Technical Accountant
Telephone No: 01634 332787 Email: jonathan.lloyd@medway.gov.uk

Appendices
None

Background papers
None