CABINET

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TREASURY MANAGEMENT STRATEGY MID-YEAR REVIEW REPORT 2019/20

Portfolio Holder: Councillor Alan Jarrett, Leader

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Summary

Full Council approved the Treasury Management Strategy for 2019/20 alongside the Capital and Revenue Budgets on the 21 February 2019. 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 2019/20.

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 is also scheduled for consideration by Audit Committee on 26 September 2019 and full Council on 10 October 2019.

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 2019/20
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- A review of the Council's investment portfolio for 2019/20
- A review of the Council's borrowing strategy for 2019/20
- A review of any debt rescheduling undertaken during 2019/20
- A review of compliance with Treasury and Prudential Limits for 2019/20.

3. REVIEW OF ECONOMIC CONDITIONS

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

3.1 ECONOMICS UPDATE

3.1.1 **UK.** This first half year has been a time of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on 31 October, with or without a deal. However, so far, there has been no majority of MPs for any one option to move forward on enabling Brexit to be implemented. At the time of writing, (first week in September), the whole political situation in the UK over **Brexit** is highly fluid and could change radically by the day. The vote in the Commons on 3 September looks likely to lead to a delay in the date for Brexit to 31 January 2020, but there is also likelihood that there will be an imminent general election. In such circumstances, any interest rate forecasts are subject to material change as the situation evolves. At present, if the UK does soon achieve an agreed deal on Brexit, including some additional clarification wording on the Irish border backstop, then it is possible that growth could recover quickly. The Monetary Policy Committee (MPC) would then need to address the issue of whether to raise Bank Rate when there is very little slack left in the labour market; this could cause wage inflation to accelerate which would then feed through into general inflation. On the other hand, if there was a no deal Brexit and there was a significant level of disruption to the economy, then growth could falter and the MPC would be likely to cut Bank Rate in order to support growth. However, with Bank Rate still only at 0.75%, it has relatively little room to make a big impact and the MPC would probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by way of tax cuts and / or expenditure on infrastructure projects, to boost the economy. However, infrastructure projects generally take a long time to plan and to start up, and so to feed through into impacting the economy; tax cuts would be much quicker in impacting the level of consumption in the economy.

3.1.2 The first half of 2019/20 has seen UK **economic growth** fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. This mirrored investor confidence around the world which is now expecting a significant downturn or possibly even a recession in some developed economies. It was therefore no surprise that the MPC left Bank Rate unchanged at 0.75% throughout 2019, so far, and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit.

3.1.3 As for **inflation** itself, Consumer Price Index (CPI) has been hovering around the Bank of England's target of 2% during 2019, (July 2.1%), and is likely to shift only a little upwards over the rest of 2019/20. It does not therefore pose any immediate concern to the MPC at the current time.

3.1.4 With regard to the **labour market,** despite the contraction in quarterly GDP growth of -0.2%q/q, (+1.2% y/y), in quarter 2, employment rose by 115,000 in the same quarter: this suggests that firms are preparing to expand output and suggests there could be a return to positive growth in quarter 3. Unemployment has continued near to a 44 year low, edging up from 3.8% to 3.9% on the Independent Labour Organisation measure in June; however, that

was caused by a rise in the participation rate to an all-time high. Job vacancies fell for a sixth consecutive month, hitting record levels, and indicating that employers are having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a high point of 3.9%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 1.8%. As 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 could mean that the MPC will need to take action to raise Bank Rate if there is an agreed Brexit deal as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

3.1.5 In the **political arena**, if there is a general election soon, 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 although, conversely, a weak international backdrop could provide further support for low yielding government bonds and gilts.

3.1.6 **USA.** President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of strong growth to 2.9% y/y. Growth in 2019 has been falling back after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2. Quarter 3 is expected to fall further. The Fed finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a 'midterm adjustment' but flagged up that this was not to be seen as the start of a series of cuts to ward off a downturn in growth. Financial markets are, however, expecting another cut in September. Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This trade war is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

3.1.7 **BOND YIELDS.** It is this souring of investor confidence that has largely contributed to the sharp fall in bond yields on government debt in mid-2019 in the major western economies as investors have switched out of risky assets - equities, fearing an impending recession, and buying into bonds, so pushing their prices up and correspondingly, pushing yields down. Investors have little confidence that the US China trade war will have a satisfactory outcome in the near future and both sides look as if they are digging in to entrenched positions. However, most domestic US economic indicators are not currently pointing to a recession in the US, only to a slowing of growth. Provided the major world economies do avoid recession, then it is likely that there will be some reversal of this flow from equities into bonds and, therefore, that bond yields will recover to a limited extent from recent truly exceptional lows. However, the near-term reality is that we have seen 10 year bond yields fall below 2 year yields in the US; this has historically been a prime indicator of impending recession in the US, though this correlation has been much weaker in the UK. All German bond yields between 2 and 30 years are actually

negative while many other EZ countries have bond yields which are also negative, at least in some maturity years.

3.1.8 **EUROZONE**. Growth has been slowing from +1.9% during 2018 to +0.4% q/q (+1.2% y/y) in quarter 1 and then to +0.2% q/q (+1.0% y/y) in quarter 2; there appears to be little upside potential to the growth rate in the rest of 2019. German GDP growth fell to -0.1% in quarter 2; industrial production was down 5.2% y/y in June with car production especially being hit. Germany would be particularly vulnerable to a no deal Brexit depressing exports further and if President Trump imposes tariffs on EU produced cars. The European Central Bank (ECB) meeting in July expressed concern as to the weak outlook for growth and how low inflation was despite all the monetary stimulus the bank still has in place. The ECB is therefore expected to take action to cut its main rate of -0.4% further, but only marginally, and to look at the potential for more quantitative easing and/or other instruments of monetary policy to provide further stimulus to economic growth. On the political front, Spain and Italy are in the throes of trying to form coalition governments while the very recent results of two German state elections will put further pressure on the frail German CDU/SDP coalition government.

3.1.9 **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. The trade war with the US does not appear to have had a significant effect on GDP growth as yet as some of the impact of tariffs has been offset by falls in the exchange rate and by transhipping exports through other countries, rather than directly to the US.

3.1.10 **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.

4. Treasury Management Strategy Statement and Annual Investment Strategy update

4.1 Full Council approved the 2019/20 Treasury Management Annual Investment Strategy on the 21 February 2019.

4.2 The strategy stated that officers would aim to smooth out the maturity profile and reduce reliance on short term debt. This objective has been largely achieved and the table in paragraph 6.10 below shows a much more even repayment profile than in previous years. However, it is now envisaged that much borrowing during the remainder of the year will be short term. The reason for this is partly to save interest expense (short term rated being lower than long term borrowing rates) and also to fund developments by Medway Development Company (MDC) Ltd which are expected to generate receipts enabling repayment of the borrowing relating to construction work within a year of the expenditure.

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 2019/20 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.

	2018/19 Original Estimate £000	**Current Position 27 Aug 2019 £000**
Gross borrowing	260,496	266,890
CFR (year end position)	282,284	278,758

4.3.2 The CFR position forecast in the Strategy published in January 2019 (£282.3m) reflects estimated new borrowing of £30.6m in respect of 2018/19 capital expenditure. The current CFR shown (£278.8m) is as reported in the audited Statement of Accounts at 31 March 2019.

4.3.3 Gross borrowing at 27 August is broadly in line with the level anticipated for 31 March 2020 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 much of the debt funded expenditure on the capital programme has yet to take place, hence the gross borrowing at 3 September (£266.9m) is lower than the estimated year end figure (£299.1m).

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 2019/20 is £462.797 million and it will not exceed this limit.

5. Investment Portfolio 2019/20

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 (as at 2 September 2019). Given the risk environment, investment returns are likely to remain low.

5.2 The Council held £42.5m of investments as at 3 September 2018 inclusive of property funds (market value £22.5m). The investment portfolio yield on cash investments has fallen to around 0.7% following redemption of the long term loans to other local authorities.

5.3 A full list of in house investments held as at 3 September 2019 is shown below:

Investments	**Principal 2 Sept 2019 £**	**Interest %**
Core Investments (Local Authorities)		
CCLA Property Fund (Sept. 2019 market value)	12,481,952	n/a
Patriza Hannover Property UT (June 2019 market value)	5,134,770	n/a
Lothbury Property Trust (31/8/19 market value)	4,898,350	n/a
Total Core Investments	**22,515,072**	
Liquid Investments		
Svenska Handelsbanken	27	0.15%
Lloyds	15,575,646	0.70%
Barclays	4,264	0.50%
CCLA Public Sector Deposit Fund	4,421,882	Approx. 0.74%
Total Liquid Investment	**20,001,819**	
Total In house Investments	**42,516,891**	

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 2019 to 3 September 2019.

5.5 The Council's budgeted net interest payments for 2019/20 is £8.15m however due to tight management of borrowing and slippage in certain elements of the capital programme, the outturn is estimated to be around £7.3m.

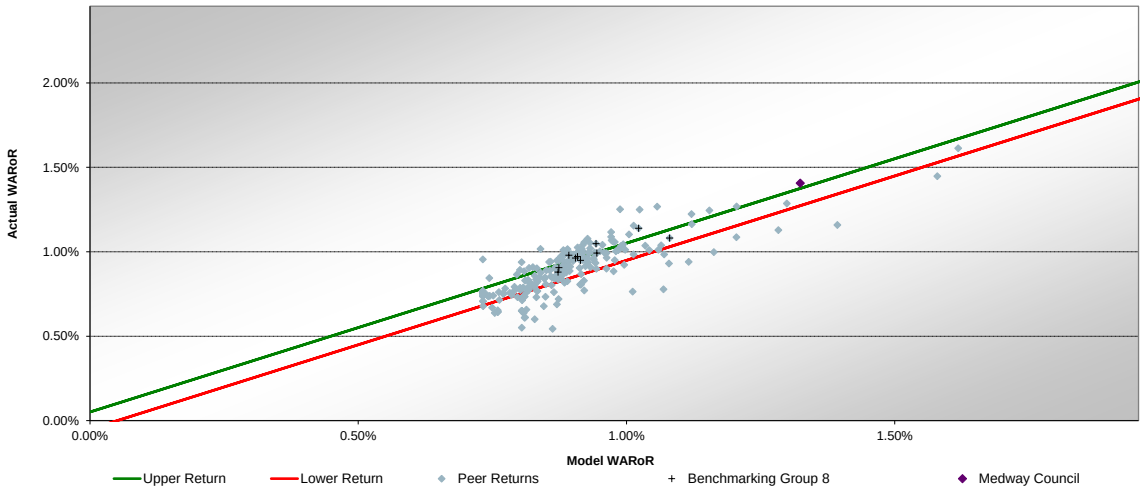
5.6 Investment Counterparty Criteria

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 Benchmarking

5.7.1 The in-house Treasury team, contribute to the Link Asset Services benchmarking club which produces quarterly reports. Shown below is a graph showing Medway's performance to June. Performance benefitted from the inclusion of fixed rate loans to other local authorities advanced some years

ago when interest rates were higher than today. The last of these loans was repaid in August 2019 so future investment performance will be lower.



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 above 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 2019 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	**1.32%**	**15**	**775**	**2.16**	**1.41%**
Average English Unitaries (23)		78	208	2.32	0.93%
Average Total Population (224)		85	168	3.00	0.90%
Average Local Benchmarking Group (11)		125	267	2.33	1.03%
Brighton & Hove CC	0.95%	90	190	2.51	0.95%
East Sussex CC	0.89%	111	157	3.48	0.98%
Sevenoaks DC	0.87%	58	142	2.84	0.91%
Tonbridge and Malling BC	0.94%	158	252	3.79	0.94%

6. Borrowing

6.1 The Council's revised estimated capital financing requirement (CFR) at 31 March 2020 is £327.984 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 Public Works Loan Board (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 £266.890 million (at 27 August 2019) against a CFR of £278.758 million (at 31 March 2019).

6.2 Recent strategy has been to reduce interest rate risk and smooth the borrowing repayment profile by taking out new borrowing for longer repayment terms. This has resulted in a more even repayment schedule as shown in the table in 6.10 below. However continued low interest rates and the inclusion in the capital programme of housing developments, where funding is expected to be repaid from receipts within about a year, favours shorter term borrowing for some new loans. 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 19	Dec 19	Mar 20	June 20	Sept 20	Dec 20	Mar 21	Jun 21
Bank rate	0.75%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.25%
5 yr PWLB	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%	2.30%	1.80%
10 yr PWLB	1.50%	1.60%	1.80%	1.90%	2.00%	2.00%	2.10%	2.20%
25 yr PWLB	2.10%	2.30%	2.40%	2.50%	2.60%	2.70%	2.70%	2.80%
50 Yr PWLB	2.00%	2.20%	2.30%	2.40%	2.50%	2.60%	2.60%	2.70%

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.

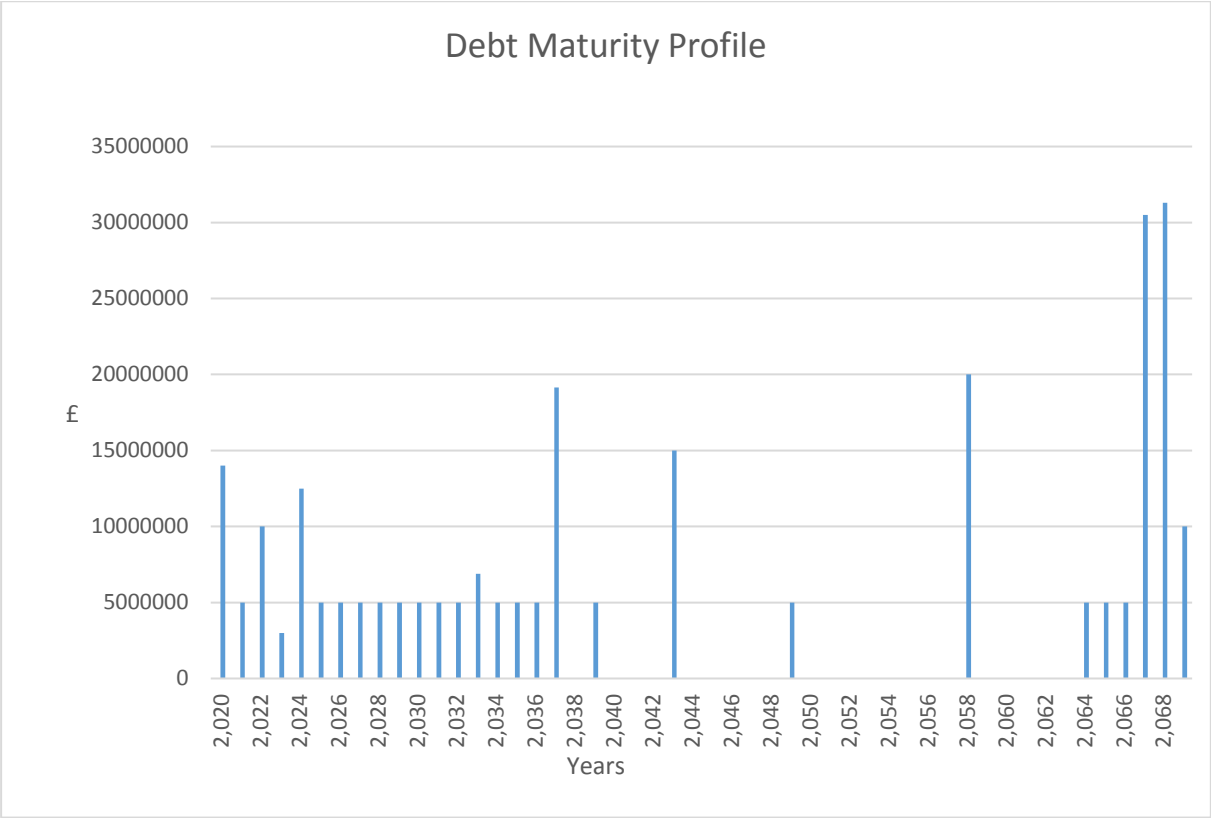
6.5 In order to protect against this risk it is prudent to spread repayment dates over a number of years thereby reducing the risk of a large proportion of the portfolio being affected by adverse interest rates.

6.6 The graph in paragraph 6.10 below shows the long term debt portfolio repayment profile as at 2 September 2019. 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 2020 (£5m), April 2021 (£10m). April 3022 (£3m).

6.8 As at 3 September 2019 the Council owed some £14m in short term borrowing compared with £55m at the same time last year. Additional short term borrowing will also be required before the year end.

6.9 The current debt maturity profile is shown in the table below. All debts are being shown as repayable at term, although the LOBO's (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 to 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 Treasury Management Strategy Statement (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. Risk Management

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

10. Financial and Legal Implications

10.1 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.

11. Recommendations

11.1 The Cabinet is requested to consider this report, note its contents and pass comments on this report to Audit Committee.

12. Suggested Reason for Decision

12.1 In accordance with the Chartered Institute of Public Finance Accountancy's (CIPFA) Code of Practice for Treasury Management, there should be a review of the strategy at least half yearly.

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Appendices

None

Background Papers

None