APPENDIX 1

FLINTSHIRE COUNTY COUNCIL

TREASURY MANAGEMENT

MID YEAR REPORT 2017/18

1.00 PURPOSE OF REPORT

1.01 To provide members with a mid-year update on matters relating to the Council's Treasury Management function.

2.00 BACKGROUND

2.01 Treasury management comprises the management of the Council's 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.

2.02 The Council's primary objectives for the investment of its surplus funds are to protect the principal sums invested from loss, and to ensure adequate liquidity so that funds are available for expenditure when needed. The generation of investment income to support the provision of local authority services is an important, but secondary, objective.

2.03 The Council's policy is to appoint external consultants to provide advice on its treasury management function. In September 2016 Arlingclose Ltd were reappointed as the Council's advisors for a period of 3 years, following a competitive tendering exercise.

2.04 The Council has adopted the 2012 edition of the CIPFA Treasury Management in the Public Services: Code of Practice, which requires the Council to approve a treasury management strategy before the start of each financial year, a mid-year report, and an annual report after the end of each financial year.

2.05 In addition, the Welsh Government (WG) Guidance on Local Government Investments recommends that local authorities amend their investment strategies in light of changing internal or external circumstances.

2.06 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the WG Guidance.

2.07 The Council approved the 2017/18 Treasury Management Strategy at its meeting on 14th February 2017.

3.00 ECONOMIC & INTEREST RATE REVIEW APRIL – OCTOBER 2017.

Provided by Arlingclose Ltd the Council's Treasury Management advisors.

Economic backdrop: Commodity prices fluctuated over the period with oil falling below $45 a barrel before inching back up to $58 a barrel. UK Consumer Price Inflation (CPI) index rose with the data print for August showing CPI at 2.9%, its highest since June 2013 as the fall in the value of sterling following the June 2016 referendum result continued to feed through into higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.7%.

The unemployment rate fell to 4.3%, it's lowest since May 1975, but the squeeze on consumers intensified as average earnings grew at 2.5%, below the rate of inflation. Economic activity expanded at a much slower pace as evidenced by Q1 and Q2 GDP growth of 0.2% and 0.3% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings falling and real wage growth negative, there are concerns that these will be a constraint on economic activity in the second half of 2017.

The Bank of England made no change to monetary policy at its meetings in the first half of the financial year. The vote to keep Bank Rate at 0.25% narrowed to 5-3 in June highlighting that some MPC members were more concerned about rising inflation than the risks to growth. Although at September's meeting the Committee voted 7-2 in favour of keeping Bank Rate unchanged, the MPC changed their rhetoric, implying a rise in Bank Rate in "the coming months". The Council's treasury advisor Arlingclose is not convinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

In contrast, near-term global growth prospects improved. The US Federal Reserve increased its target range of official interest rates in June for the second time in 2017 by 25bps (basis points) to between 1% and 1.25% and, despite US inflation hitting a soft patch with core CPI at 1.7%, a further similar increase is expected in its December 2017 meeting. The Fed also announced confirmed that it would be starting a reversal of its vast Quantitative Easing programme and reduce the $4.2 trillion of bonds it acquired by initially cutting the amount it reinvests by $10bn a month.

Geopolitical tensions escalated in August as the US and North Korea exchanged escalating verbal threats over reports about enhancements in North Korea's missile programme. The provocation from both sides helped wipe off nearly $1 trillion from global equity markets but benefited safe-haven assets such as gold, the US dollar and the Japanese yen. Tensions remained high, with North Korea's threat to fire missiles towards the US naval base in Guam, its recent missile tests over Japan and a further testing of its latent nuclear capabilities.

Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty but the surprise result has led to a minority Conservative government in coalition with the Democratic Unionist Party. This clearly results in an enhanced level of political uncertainty. Although the potential for a so-called hard Brexit is diminished, lack of clarity over future trading partnerships, in particular future customs agreements with the rest of the EU block, is denting business sentiment and investment. The reaction from the markets on the UK election's outcome was fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations, the ultimate 'divorce bill' for the exit and whether new trade treaties and customs arrangements are successfully concluded to the UK's benefit.

In the face of a struggling economy and Brexit-related uncertainty, Arlingclose expects the Bank of England to take only a very measured approach to any monetary policy tightening, any increase will be gradual and limited as the interest rate backdrop will have to provide substantial support to the UK economy through the Brexit transition.

Financial markets: Gilt yields displayed significant volatility over the six-month period with the appearing change in sentiment in the Bank of England's outlook for interest rates, the push-pull from expectations of tapering of Quantitative Easing (QE) in the US and Europe and from geopolitical tensions, which also had an impact. The yield on the 5-year gilts fell to 0.35% in mid-June, but then rose to 0.80% by the end of September. The 10-year gilts similarly rose from their lows of 0.93% to 1.38% at the end of the quarter, and those on 20-year gilts from 1.62% to 1.94%.

The FTSE 100 nevertheless powered away reaching a record high of 7548 in May but dropped back to 7377 at the end of September. Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.30% and 0.65% over the period from January to 21st September.

Credit background: UK bank credit default swaps continued their downward trend, reaching three-year lows by the end of June. Bank share prices have not moved in any particular pattern.

Outlook for the remainder of 2017/18

The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Both consumer and business confidence remain subdued. Household consumption growth, the driver of UK GDP growth, has softened following a contraction in real wages. Savings rates are at an all-time low and real earnings growth (i.e. after inflation) struggles in the face of higher inflation.

The Bank of England's Monetary Policy Committee has changed its rhetoric, implying a rise in Bank Rate in "the coming months". Arlingclose is not convinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

This decision is still very data dependant and Arlingclose is, for now, maintaining its central case for Bank Rate at 0.25% whilst introducing near-term upside risks to the forecast as shown below. Arlingclose's central case is for gilt yields to remain broadly stable in the across the medium term, but there may be near term volatility due to shifts in interest rate expectations.

	Dec 17	Mar 18	Jun 18	Sept 18	Dec 18	Mar 19	Jun 19	Sept 19	Dec 19	Mar 20	Jun 20
Upside Risk	0.25%	0.25%	0.25%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
Interest Rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%
Downside Risk	0.00%	0.00%	0.00%	0.00%	0.00%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%

4.00 BORROWING REQUIREMENTS AND DEBT MANAGEMENT

4.01 PWLB (Public Works Loans Board) Certainty Rate Update.

The Authority submitted its application to WG along with the 2017-18 Capital Estimates Return to access this reduced rate for a further 12 months from 1st November 2017.

4.02 The total long term borrowing outstanding totals £253.7 million.

4.03 Loans with the Public Works Loans Board are in the form of fixed rate (£222.41m) and variable rate (£10m), £18.95m is variable in the form of Lobo's (Lender's Option, Borrower's Option) and £2.341m is interest free loans from government.

The Council's average borrowing rate is currently 4.96%.

	Balance 01/04/2017 £m	Debt Maturing £m	New Debt £m	Balance 30/09/2017 £m
Long Term Borrowing	251.36	0.00	0.00	251.36
Government Loans	1.29	0.00	1.05	2.34
TOTAL BORROWING	252.65	0.00	0.00	253.70
Other Long Term Liabilities *	6.50	0.55	0.00	5.95
TOTAL EXTERNAL DEBT	259.15	0.00	0.00	259.65
Increase/ (Decrease) in Borrowing £m				**0.50**

4.04 No other new long term borrowing has been undertaken so far during 2017/18. Other than specific government loans available for specific capital schemes.

Affordability (interest costs charged on new loans) and the "cost of carry" (costs associated with new long term loans) remain important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of long term borrowing.

4.05 Loans at Variable Rates

The extent of variable rate borrowing the Council can potentially undertake is influenced by the level of Reserves and Balances. The interest rate on the Council's £10m variable rate loans averaged 0.36%.

The Council has determined that exposure to variable rates is warranted. It also assists with the affordability and budgetary perspective in the short-to-medium term. Any upward movement in interest rates and interest paid on variable rate debt would be offset by a corresponding increase in interest earned on the Council's variable rate investments. The interest rate risk associated with the Council's strategic exposure of £10m is regularly reviewed with our treasury advisor against clear reference points, this being a narrowing in the gap between short and longer term interest rates. If appropriate, the exposure to variable interest rates will be reduced by switching into fixed rate loans.

4.06 Internal Borrowing and Short Term Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the borrowing strategy is to minimise debt interest payments without compromising the longer-term stability of the portfolio. With short-term interest rates currently lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term instead.

The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant at around 2.73%.

The use of internal resources in lieu of borrowing has therefore continued to be used over the period as the most cost effective means of funding capital expenditure. This has lowered overall treasury risk by reducing both external debt and temporary investments.

Short term borrowing was undertaken as necessary. The total short term (temporary) borrowing as at 30th September 2017 was £15.1m with an average rate of 0.29%.

The Council acknowledges that this position is not sustainable over the medium term. The Council's capital expenditure plans will be monitored throughout 2017/18 to inform and confirm the Council's long term borrowing need. This is to ensure that the Council does not commit to long term borrowing too early and borrow unnecessarily which will be costly. The continued use of short-term borrowing will assist with such. This will be balanced against securing low long term interest rates currently being forecast.

4.07 Lender's Option Borrower's Option Loans (LOBOs)

The Authority holds £18.95m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. The option to change the terms on £18.95m of the Council's LOBOs was not exercised by the lender. The Authority acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

4.08 Debt Rescheduling

FCC has a long term debt portfolio of £259m, a mix of PWLB maturity loans, bank loans and loans from government. Options for debt rescheduling have been explored and the following can be surmised from work in conjunction with our treasury management advisors:

PWLB Loans:

The premium charged for early repayment of PWLB debt remained relatively expensive for the loans in the Authority's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

LOBOs:

The authority explored the option to repay LOBOs early and received valuations for the LOBO loans from the bank. Following a review it has been established that the premium would cost £11.7m is 62% of principal amount of the LOBOs. Therefore, to repay the loans the Council would need to repay the principal of £18.95m and the premium of £11.7m a total of £30.65m. This reflected the expected prolonged low interest rate environment. FMS (the lender of the Lobos) did not offer any discounts on the premium cost.

Given the valuations offered by FMS and the Council's financial position, costs were unlikely to be lower due to the need to refinance both the principal and premium. The Council was advised not to repay unless FMS agrees a lower valuation of the loans and have decided at this time to not to refinance.

While the Council could reduce its exposure to the optionality contained within the loans, i.e. uncertain refinancing risk, this risk is very low in the short to medium term.

The Corporate Finance Manager, in conjunction with the Council's treasury advisors will continue to review any potential opportunities for restructuring the Council's debt in order to take advantage of potential savings as interest rates change and to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility).

5.0 INTERIM INVESTMENT AND PERFORMANCE REPORT

5.01 The Welsh Government's Investment Guidance gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

5.02 The maximum investments the Authority had on deposit at any one time totalled £29.6m. The average investment balance for the period was £13.8m and the average rate of return was 0.25%, generating investment income of £16k.

5.03 Investments have been made with UK banks and building societies up to periods of 35 days, as well as utilising investment opportunities afforded by money market funds and call accounts.

5.04 The average of long and short term borrowing was £266.4m and the average rate paid was 4.73% generating interest payable of £6,300m in line with budget forecasts (to date).

	Investments		Borrowing	
	Interest received £'000	Interest rate %	Interest paid £'000	Interest rate %
Actual	16	0.25	6,300	4.73
Budget	22.5	0.30	6,600	4.47
Difference	-6.5	-	300	-

Year-end projections are as follows:

	Investments		Borrowing	
	Interest received £'000	Interest rate %	Interest paid £'000	Interest rate %
Actual	32	0.20	13,060	5.00
Budget	45	0.30	13,200	4.47
Difference	-13	-	140	-

5.05 *Credit Risk (security)*

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Authority's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Counterparty Update (provided by Arlingclose Ltd)

There were a few credit rating changes during the quarter. The significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1, placed Lloyds Bank's A1 rating on review for upgrade, revised the outlook of Santander UK plc, and Nationwide and Coventry building societies from negative to stable but downgraded the long-term rating of Leeds BS from A2 to A3. The agency downgraded long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment and the ratings of the large Australian banks on its view of the rising risks from their exposure to the Australian housing market and the elevated proportion of lending to residential property investors.

S&P also revised Nordea Bank's outlook to stable from negative, whilst affirming their long-term rating at AA-. The agency also upgraded the long-term rating of ING Bank from A to A+.

Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May, following Arlingclose's advice, the Authority reduced the maximum duration of unsecured investments with Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as until banks' new structures are finally determined and published, the different credit risks of the 'retail' and 'investment' banks cannot be known for certain.

The new EU regulations for Money Market Funds were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility NAV (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

5.06 *Liquidity*

In keeping with the WG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds and call accounts.

5.07 *Yield*

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The Council's investment yield is outlined in 5.02.

6.00 REGULATORY UPDATES

6.01 MiFID II: Local authorities are currently treated by regulated financial services firms as professional clients who can "opt down" to be treated as retail clients instead. From 3rd January 2018, as a result of the second Markets in Financial Instruments Directive (MiFID II), local authorities will be treated as retail clients who can "opt up" to be professional clients, providing that they meet certain criteria. Regulated financial services firms include banks, brokers, advisers, fund managers and custodians, but only where they are selling, arranging, advising or managing designated investments. In order to opt up to professional, the authority must have an investment balance of at least £10 million and the person authorised to make investment decisions on behalf of the authority must have at least one year's relevant professional experience. In addition, the firm must assess that that person has the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The main additional protection for retail clients is a duty on the firm to ensure that the investment is "suitable" for the client. However, local authorities are not protected by the Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service whether they are retail or professional clients. It is also likely that retail clients will face an increased cost and potentially restricted access to certain products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice. The Authority has declined to opt down to retail client status in the past as the costs were thought to outweigh the benefits.

The Council meets the majority of conditions to opt up to professional status, the one exception being holding an investment balance of £10m. As previously reported the Council has a forecast borrowing requirement. This is due to an increased capital programme which includes prudential borrowing to fund the 21st century schools programme, and the investment in improving the quality of Council housing and building new Council homes. In the current low interest rate environment the strategy has been to use hold minimal investments and maximise the use of internal borrowing to fund capital expenditure reducing the Council's exposure to counterparty risk and reducing borrowing costs, without compromising the long term stability of the Council's debt portfolio.

As outlined in 4.06 over the period the Council has been utilising short term borrowing to confirm the need for longer term borrowing. Ensuring the Council doesn't commit to any unnecessary and costly long term borrowing. Over the past six months the daily average investment balance has been £13.7m with highs of £29.6m and lows of £3.7m. The Councils monthly investment balance can vary by £19.7m as shown in quarterly updates. To continue to operate Treasury Management activities of investing and borrowing as present a daily investment balance of £10m will need to be held.

Having considered the differing impacts of remaining a professional client or changing to a retail client on the security, liquidity and yield of any investments held and on the availability, flexibility and costs of short and long term borrowing Officers would recommend that the Council maintains its current MiFID status of professional and seeks approval from Members to do so.

6.02 CIPFA Consultation on Prudential and Treasury Management Codes: In February 2017 CIPFA canvassed views on the relevance, adoption and practical application of the Treasury Management and Prudential Codes and after reviewing responses launched a further consultation on changes to the codes in August with a deadline for responses of 30th September 2017.

The proposed changes to the Prudential Code include the production of a new high-level Capital Strategy report to full council which will cover the basics of the capital programme and treasury management. The prudential indicators for capital expenditure and the authorised borrowing limit would be included in this report but other indicators may be delegated to another committee. There are plans to drop certain prudential indicators, however local indicators are recommended for ring fenced funds (including the HRA) and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties in the definition of "investments" as well as loans made or shares brought for service purposes. Another proposed change is the inclusion of financial guarantees as instruments requiring risk management and addressed within the Treasury Management Strategy. Approval of the technical detail of the Treasury Management Strategy may be delegated to a committee rather than needing approval of full Council. There are also plans to drop or alter some of the current treasury management indicators.

CIPFA intends to publish the two revised Codes towards the end of 2017 for implementation in 2018/19, although CIPFA plans to put transitional arrangements in place for reports that are required to be approved before the start of the 2018/19 financial year. The Department of Communities and Local Government (DCLG) and CIPFA wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. It is understood that DCLG will be revising its Investment Guidance (and its MRP guidance) for local authorities in England; however there have been no discussions with the devolved administrations yet.

The impacts of the changes are currently being considered by Officers who will report to Members in due course.

7.00 <u>COMPLIANCE</u>

7.01 The Council can confirm that it has complied with its Prudential Indicators for the period April to September 2017. These were approved on 14th February 2017 as part of the Council's 2017/18 Treasury Management Strategy.

7.02 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during the period April – September 2017. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

8.00 OTHER ITEMS

8.01 Other treasury management related activity that took place during April – September 2017 includes:

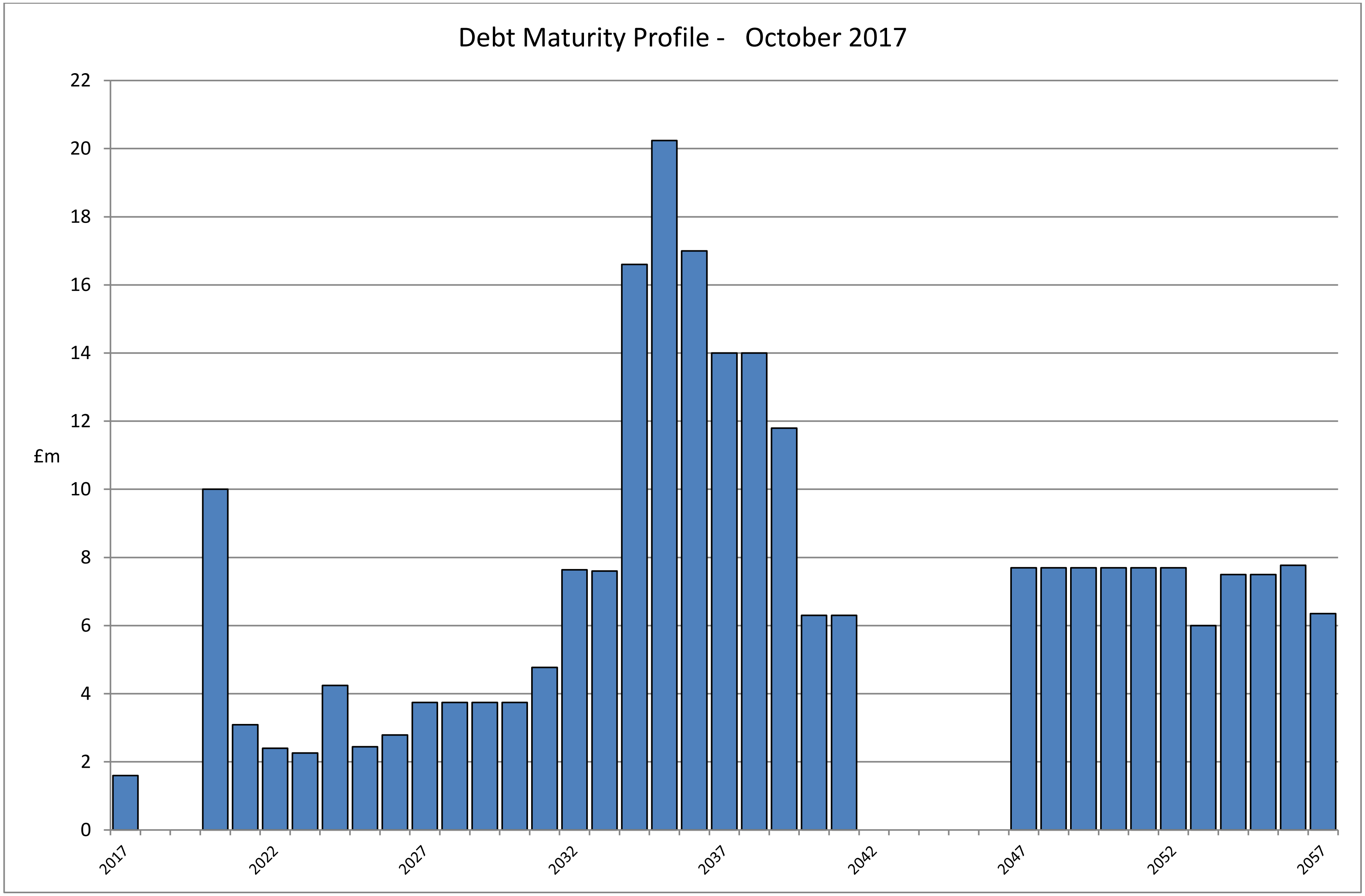
- The Treasury Management Annual Report 2016/17 was reported to Audit Committee on 19th July 2017, Cabinet on 26th September 2017 and approved by Council on 27th September 2017.
- Quarterly Treasury Management updates were reported to the Audit Committee.
- The Council continues to be a member of the CIPFA Treasury Management Forum and the TM Network Advisory Group.

9.00 CONCLUSION

9.01 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during the first half of 2017/18.

9.02 As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

9.03 In order to continue to manage the Council's daily treasury management activities as at present, the Council elects to 'opt up' to professional client status by regulated financial services firms as a result of the second Markets in Financial Instruments Directive (MiFID II). This will result in a slight change to operating procedures to maintain a daily investment balance of £10m. The status will be reviewed regularly and can be changed subsequently.


Debt Maturity Profile - October 2017
£m
22
20
18
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2032
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