FLINTSHIRE COUNTY COUNCIL

DRAFT TREASURY MANAGEMENT

MID YEAR REPORT 2018/19

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 2018/19 Treasury Management Strategy at its meeting on 20th February 2018.

3.00 ECONOMIC & INTEREST RATE REVIEW APRIL – OCTOBER 2018.

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

3.01 **Economic background**: Oil prices rose by 23% over the six months to around $82/barrel. UK Consumer Price Inflation (CPI) for August rose to 2.7% year on year, above the consensus forecast and that of the Bank of England's in its August Inflation Report, as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4%, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9% providing some evidence that a shortage of workers is providing support to wages. However real wages (i.e. adjusted for inflation) grew only by 0.2%, a marginal increase unlikely to have had much effect on households.

3.02 The rebound in quarterly GDP growth in Q2 to 0.4% appeared to overturn the weakness in Q1 which was largely due to weather-related factors. However, the detail showed much of Q2 GDP growth was attributed to an increase in inventories. Year/year GDP growth at 1.2% also remains below trend. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.

3.03 Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in each of June and September by 0.25% to the current 2%-2.25%. Markets now expect one further rise in 2018.

3.04 The escalating trade war between the US and China as tariffs announced by the Trump administration appeared to become an entrenched dispute, damaging not just to China but also other Asian economies in the supply chain. The fallout, combined with tighter monetary policy, risks contributing to a slowdown in global economic activity and growth in 2019.

3.05 The EU Withdrawal Bill, which repeals the European Communities Act 1972 that took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament. With just six months to go when Article 50 expires on 29th March 2019, neither the Withdrawal Agreement between the UK and the EU which will be legally binding on separation issues and the financial settlement, nor its annex which will outline the shape of their future relationship, have been finalised, extending the period of economic uncertainty.

3.06 **Financial markets:** Gilt yields displayed marked volatility during the period, particularly following Italy's political crisis in late May when government bond yields saw sharp moves akin to those at the height of the European financial crisis with falls in yield in safe-haven UK, German and US government bonds. Over the period, despite the volatility, the change in gilt yields was small. The 5-year benchmark gilt only rose marginally from 1.13% to 1.16%. There was a larger increase in 10-year gilt yields from 1.37% to 1.57% and in the 20-year gilt yield from 1.74% to 1.89%. The increase in Bank Rate resulted in higher in money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.56%, 0.70% and 0.95% respectively over the period.

3.07 The ring-fencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/NatWest Bank plc – is complete, the transfer of their business lines into retail (ring-fenced) and investment banking (non ring-fenced) is progressing and will need to be completed by the end of 2018.

3.08 **Outlook for the remainder of 2018/19**

3.09 Having raised policy rates in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon.

3.10 The MPC has a definite bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that (a) ultra-low interest rates result in other economic problems, and that (b) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise and cuts are required.

3.11 Arlingclose's central case is for Bank Rate to rise twice in 2019. The risks are weighted to the downside. The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2% remains well below the long term average.

	Dec 18	Mar 19	Jun 19	Sept 19	Dec 19	Mar 20	Jun 20	Sept 20	Dec 20	Mar 20
Upside Risk (%)	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25
Interest Rate (%)	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Downside Risk (%)	0.00	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75

3.12 The view is that the UK economy still faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Central bank actions and geopolitical risks, such as prospective trade wars, have and will continue to produce significant volatility in financial markets, including bond markets.

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 2018-19 Capital Estimates Return to access this reduced rate for a further 12 months from 1st November 2018.

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 (£220.81m) and variable rate (£10m), £18.95m is variable in the form of Lobo's (Lender's Option, Borrower's Option) and £3.989m are interest free loans from government. The Council's average long term borrowing rate is currently 4.94%.

	Balance 01/04/2018 £m	Debt Maturing £m	New Debt £m	Balance 30/09/2018 £m
Long Term Borrowing	249.76	0.00	0.00	249.76
Government Loans	3.99	0.00	0.00	3.99
TOTAL BORROWING	253.75	0.00	0.00	253.75
Other Long Term Liabilities *	5.39	0.00	0.00	5.39
TOTAL EXTERNAL DEBT	259.14	0.00	0.00	259.14
Increase/ (Decrease) in Borrowing £m				0.00

** relates to finance leases in respect of Deeside Leisure Centre and Jade Jones Pavilion*

4.04 Long term borrowing

No other new long term borrowing has been undertaken so far during 2018/19. 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 0.64%.

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 has been 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 1.95%.

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 2018 was £37m with an average rate of 0.69%.

The Council's capital expenditure plans will continue to be monitored throughout 2018/19 to inform and assess the Council's long term borrowing need. This is to ensure that the Council does not commit to long term borrowing too early and refinance unnecessarily which will be costly and have significant revenue implications. The continued use of short-term borrowing will assist with this. It is likely that there will be further long term borrowing during the financial year, as the balance between securing low long term interest rates currently being forecast and assessing the affordability of long-term borrowing continues to be considered.

The Council is currently fixing long term borrowing which will finance its loan to New Homes for the recent development it has undertaken on affordable homes.

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

The premium charge 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.

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 Council's aim is to achieve a yield commensurate with these principles.

5.02 The maximum investments the Council had on deposit at any one time totalled £42.8m. The average investment balance for the period was £27.5m and the average rate of return was 0.52%, generating investment income of £75k.

5.03 Investments have been made with UK banks, building societies and other Councils 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 £276.9m and the average rate paid was 5.71% generating interest payable of £6.4m in line with budget forecasts (to date).

	Investments		Borrowing	
	Interest received £'000	Interest rate %	Interest paid £'000	Interest rate %
Actual	75	0.52	6,400	5.71
Budget	22.5	0.30	6,600	4.47
Difference	52.5	-	200	-

Year-end projections are as follows:

	Investments		Borrowing	
	Interest received £'000	Interest rate %	Interest paid £'000	Interest rate %
Actual	102	0.50	13,060	5.84
Budget	45	0.30	13,200	4.47
Difference	57	-	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 our treasury advisers Arlingclose Ltd)

There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ring-fencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody's and to A- from BBB+ by both Fitch and Standard & Poor's (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody's. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs but not senior unsecured bonds issued by commercial banks.

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 Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Treasury Management Code of Practice but has yet to publish the local authority specific Guidance Notes to the latter.

6.02 The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council will be updating its Capital Strategy later in 2018-19 for approval by full Council.

6.04 The new EU regulations for Money Market Funds (MMFs) were published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility Net Asset Value (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. The Council's treasury management advisors expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund. This is not expected to have any impact on the Council's investment strategy as the risks arising from the changes are considered minimal.

7.00 COMPLIANCE

7.01 The Council can confirm that it has complied with its Prudential Indicators for the period April to September 2018. These were approved on 20th February 2018 as part of the Council's 2018/19 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 2018. 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

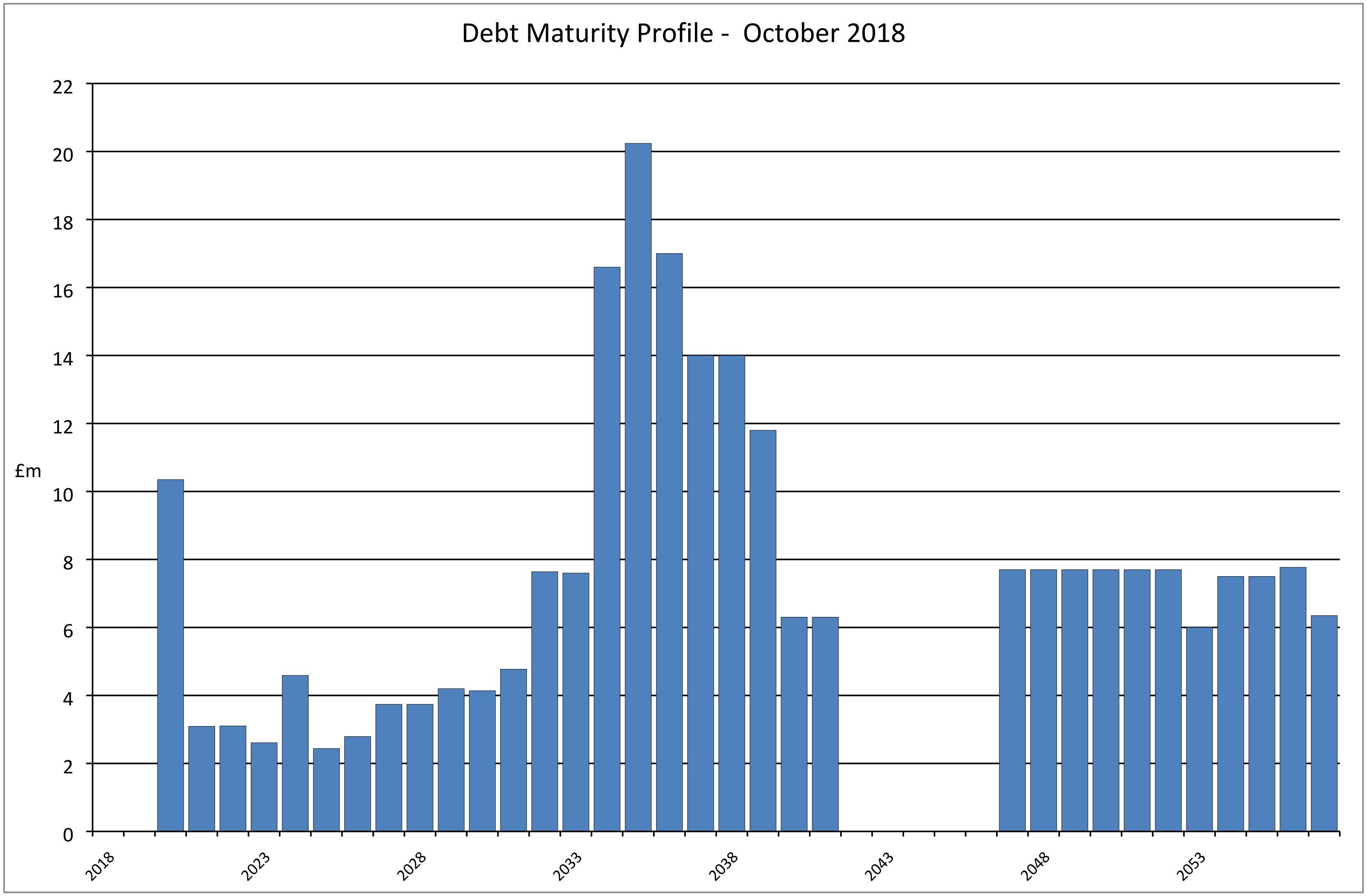
8.01 Other treasury management related activity that took place during April – September 2018 includes:

- The Treasury Management Annual Report 2017/18 was reported to Audit Committee on 11th July 2018, Cabinet on 17th July 2018 and approved by Council on 12th September 2018.
- 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 2018/19.

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.


Debt Maturity Profile - October 2018
£m
22
20
18
16
14
12
10
8
6
4
2
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2018
2023
2028
2033
2038
2043
2048
2053