Treasury Management Review up to 31st August 2018

1.1 Background

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 ensure this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

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 need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly, 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."

1.2 Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017) was adopted by this Council.

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the 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 during the previous year.
4. 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.
5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Governance and Audit Committee.

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 the 2018/19 financial year.
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy.
- The Council's capital position (prudential indicators).

- 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.
- A review of the Council's investment portfolio for 2018/19.

2 Economics and interest rates

2.1 Economics update

UK The economy has bounced after temporary factors saw a slow start to the year. With consumer spending growth likely to be boosted by falling inflation, GDP should post reasonable expansion over the quarters ahead. Indeed, the consumer sector has driven the Q2 recovery, with retail sales growing strongly, helped by the Royal Wedding, good weather and the World Cup. The recent pick up in oil prices may, though, rein in growth in real wages. There could also be a temptation for households to start to save, having run down savings over the last year or so as the squeeze has hit finances. Consumer confidence levels are certainly consistent with solid spending growth, while the labour market should underpin spending.

The boost from exports, on the back of a post referendum decline in the value of Sterling, has continued to dissipate, so net trade's input to growth may diminish. However, investment should grow and survey evidence indicates that firms' investment intentions remain high. With capacity constraints now a factor, the incentive to invest is obvious. Commentators still hope the UK/EU to deliver a status quo transition period, which will lead to some form of free trade agreement a further couple of years down the line. However, failure of negotiations and/or a change in government would be significant for the outlook. On the basis that these conditions are met, analysts are looking at reasonable growth in the coming years.

During January and February financial markets were viewing a Bank Rate increase at the May Monetary Policy Committee (MPC) meeting as likely to be a near certainty after strong growth in the second half of 2017. However, the ensuing weeks before the meeting saw opinion turn right around and the MPC did not disappoint by leaving rates unchanged due to concerns as to whether the weak growth in quarter 1 was indicative of the start of a prolonged slow down or just a temporary blip, to which bad weather had been just one contributor. Since May, opinion changed to an expectation of increase in August which duly happened with the bank rate now standing at 0.75%.

However, there remains much uncertainty around the Brexit negotiations, consumer spending levels and business investment, so it is still far too early to be confident about how strong growth and inflationary pressures will be over the next two years, and therefore the pace of any rate increases.

EU Growth in the bloc has slowed markedly from 2017, with Q2 GDP coming in lower than hoped, and at 0.3% the weakest for two years. Despite providing massive monetary stimulus, underlying price pressures remain weak. This comes despite headline inflation breaching the 2% target, resulting in gains across most of the bloc. However, Germany and Spain are exceptions. Gains are largely down to higher oil price effects on energy inflation. Core inflation has also edged a little higher but remains some way short of 2%.

Gains have been, in part, due to the timing of public holidays, and current increases should not indicate an upward trend in price pressures. 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.

USA Annualised Q2 GDP growth is projected to improve to 4.5% on a recovery in consumption growth and a healthier contribution from net exports. There is no apparent impact from the US tariff impositions as iron and steel production slowed over the month. The boost when it comes, will likely be more than offset by the impact on those areas which rely on metal 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.

China 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.

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.

2.2 Interest rate forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast:

Link Asset Services Interest Rate View											
	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

The MPC increased interest rates on the 2 August 2018 from 0.50% to 0.75%. It is not thought that the MPC will increase Bank Rate, ahead of the deadline in March for Brexit. It is also felt that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by the next increases in May and November 2020 to reach 1.5%.

The financial markets are expecting the next increase in Bank Rate to be in February 2019 and then only one more in February 2020, therefore ending March 2021 at only 1.25%. The MPC commented that the markets were too cautious with their view of the pace of increases.

However, and this is a very big caveat, the forecasts above by the MPC and Link Asset Services are predicated on an assumption that sufficient progress is made, in respect of negotiations, to produce a reasonable agreement for Brexit that benefits both the EU and the UK in a sensible manner. If no agreement is reached at all, then our forecasts for increases in Bank rate and PWLB rates will be subject to greater change, most likely downwards.

2.3 Treasury Management Strategy Statement and Annual Investment Strategy Update

The Treasury Management Strategy Statement (TMSS) for 2018/19 was noted by Governance and Audit on 22nd March 2018 and passed through for approval by the Council on 16th October. The underlying TMSS approved previously, requires revision in the light of a review of the Minimum Revenue Provision (MRP) Policy during 2017/18. The changes are set out below:

Minimum Revenue Provision Policy Update

The MRP is the amount of principal capital repayment that is set aside each year in order to repay the CFR based on the requirement of statutory regulation and the Council's own accounting policies.

The Council's 2017/18 MRP Policy (as required by the Ministry of Housing, Communities and Local Government (MHCLG) Guidance) was approved as part of the Capital Investment Plan on 23 February 2017. Following a review to ensure the policy complied with the statutory duty to make a prudent provision it has been amended and approved by Council on the 17th July 2018.

The Council's 2017-18 MRP Policy reviewed and approved by Full Council (23 February 2017) was:

a) The policy for charging MRP on historic supported borrowing is on the asset life method calculated on an equal instalment basis over 50 years.
b) Unsupported or prudential borrowing MRP is based on the Asset Life method – that is, the expenditure financed from borrowing is divided by the expected asset life. For schemes funded before 31st March 2012 the MRP is calculated on the annuity basis and for schemes funded after 1st April 2012 the MRP is calculated on an equal instalment basis.
c) Since 2009-10 the appropriate financing costs for the Council's Building Schools for the Future (BSF) Private Finance Initiative (PFI) schemes have been included in MRP calculations. Appropriateness includes an on going consideration of asset lives.

The policy change to historic supported borrowing was introduced in 2016-17. Prior to this, MRP for capital expenditure pre 1 April 2008 was charged at 4% on a reducing balance basis. At this time the change to the policy was not applied backwards to 2008.

Following an MRP review, two changes have been approved to the policy.
These are:

- To apply the 2% straight line method on its historic supported borrowing back to 2008-09 from 2017/18.
- The future charge for PFI schools from 2018/19 onwards being calculated using asset lives.

2.4 The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans.
- How these plans are being financed.
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow.
- Compliance with the limits in place for borrowing activity.

2.4.1. Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure by Service	**2018/19 Original Estimate £m**	**Current Position 31 August 2018 £m**	**2018/19 Revised Estimate £m**
Total capital expenditure	£176m	£27m	151m

2.4.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	**2018/19 Original Estimate £m**	**2018/19 Revised Estimate £m**
Total capital expenditure	£176m	£151m
Financed by:		
Capital receipts	£8m	£4m
Capital grants	£61m	£70m
Capital reserves	£0m	£1m
Revenue	£3m	£1m
Total financing	£72m	£76m
Borrowing requirement	**£104m**	**£75m**

Projected changes to the Capital Programme have resulted in a reduced new borrowing requirement of £29m.

2.4.3 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It is essentially a measure of the Council's indebtedness and so the underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

The table also shows the expected debt position over the period, which is termed the Operational Boundary. This is the limit beyond which external debt is not normally expected to exceed.

	2018/19 Original Estimate £m	**2018/19 Revised Estimate £m**
Prudential Indicator – Capital Financing Requirement		
Total CFR	£745m	£740m
Net movement in CFR		-£5m
Prudential Indicator – the Operational Boundary for external debt		
Borrowing	£400m	£363m
Other long term liabilities	£200m	£178m
Total debt (year end position)	**£600m**	**£541m**

2.4.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of 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.

The Assistant Director of Finance and Procurement reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

	2018/19 Original Estimate £m	**Current Position 31 August £m**	**2018/19 Revised Estimate £m**
Borrowing	£417m	£313m	£363m
Other long term liabilities	£174m	£178m	£178m
Total debt	**£591m**	**£491m**	**£541m**
CFR (year end position)	£745m		£740m

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 the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	**2018/19 Original Indicator £m**	**2018/19 Revised Estimate £m**
Borrowing	£420m	£363m
Other long term liabilities	£220m	£178m
Total	**£640m**	**£541m**

2.4.5 Borrowing

The Council's capital financing requirement (CFR) for 2018/19 is expected to be slightly below the original forecast of £745m; due to changes in the profiling of spend. 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 Council currently has borrowings of £491m and has utilised cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

The current context, though, is that the Council's cash balances are reducing and there is a future draw on cash from the Capital Investment Plan. Based on the revised estimate for capital expenditure current projections are that the Council will need to borrow an additional £50m this year. Cash balances and capital spend will be closely monitored and projected forward. If it is felt that cash balances are getting too low or likely to be too low in the future, borrowing will be undertaken in appropriate tranches. In deciding the appropriate tranches of borrowing, caution will be exercised in projecting forward capital spend.

£9.4m of loans have matured in May and August 2018. However it is anticipated that borrowing will be undertaken during this financial year to finance commitments in the capital plan.

2.4.6 Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

2.5 Investment Portfolio 2018/19

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 shown by forecasts in section 2.2, 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. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

The Council held £37m of investments as at 31st August 2018 (£35m at 31 March 2018) and the investment portfolio yield for the first 5 months of the year is 0.66% against a benchmark of LBID one week of 0.43%. £4.9m in Euro's is also held in our Euro account in connection with the Waste Disposal Contract.

The Assistant Director of Procurement and Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first 5 months of 2018/19.

The Council's budgeted investment performance for the year to date is expected to be below budget.

Investment Counterparty criteria

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

2.6 School Bank Balances

Bradford schools have their own individual bank accounts spread across the four main UK Banks. At 31 March 2018 the overall bank balances with Lloyds was £17.54m, Barclays £4.89m, HSBC £1.65m and Nat West £1.61m.

At the last Treasury report the issue of the UK banks going through legislative changes put in place by the government aimed at strengthening the financial system was raised. One of these reforms is to separate the retail banking (ringfenced bank) from investment banking (unringfenced). All of the four major banks have had to go through this process.

The school balances will be in the retail or ringfenced part of the bank for Lloyds, Nat West and HSBC but not for Barclays.

This raises the following issues.

i) The credit rating for the Barclays unringfenced part of the bank is lower than for the ring fenced bank.
ii) If the credit rating was to reduce in the future it could be below the Council's credit limit.

Schools converting to Academies

Of the schools with Barclays, 8 out of 32 are expected to convert to academies during 2018-19 (these schools hold balances of £1.18m). We expect further conversions on an ongoing basis and for cash balances held by schools in their bank accounts to steadily reduce as a result .Once converted to academies their bank balances no longer count towards the Council Treasury limits.

2.6.1 With the above changes in status for the schools and the reduction in school balances, it is proposed that the school balances continue to have a temporary exemption from the Treasury Policy until the main academy conversion process has been finished.

3. Other considerations

3.1 None

4. Financial and Resources Appraisal

4.1 The financial implications are set out in section 2 of this report

5. Risk Management and Governance Issues

5.1 The principal risks associated with treasury management are:

Risk: Loss of investments as a result of failure of counterparties.

Mitigation: Limiting the types of investment instruments used, setting lending criteria for counterparties, and limiting the extent of exposure to individual counterparties.

Risk: That the council will commit too much of its investments in fixed term investments and might have to recall investments prematurely resulting in possible additional costs or new borrowing (Liquidity risk).

Mitigation: Ensuring that a minimum proportion of investments are held in short term investments for cashflow purposes.

Risk: Increase in the net financing costs of the Council due to borrowing at high rates of interest.

Mitigation: Planning and undertaking borrowing and lending in light of assessments of future interest rate movements, and by undertaking mostly long term borrowing at fixed rates of interest (to reduce the volatility of capital financing costs).

Risk: Associated with cash management, legal requirements and fraud.

Mitigation: These risks are managed through:

i) Treasury Management Practices covering all aspects of Treasury management procedures including cashflow forecasting, documentation, monitoring, reporting and division of duties.
ii) All Treasury management procedures and transactions are subject to inspection by internal and external auditors.

iii) The council also employs external financial advisors to provide information on market trends, credit rating alerts, lending criteria advice and investment opportunities.

6. Legal Appraisal

6.1 Any relevant legal considerations are set out in the report

7. Other Implications

7.1 Equality & Diversity – no direct implications

7.2 Sustainability implications – no direct implications

7.3 Green house Gas Emissions Impact – no direct implications

7.4 Community safety implications – no direct implications

7.5 Human Rights Act – no direct implications

7.6 Trade Unions – no direct implications

7.7 Ward Implications – no direct implications

7.8 Implication for Corporate Parenting – no direct implications

7.9 Issues arising from Privacy Impact Assessment– no direct implications

8. Not for publications documents – none

9. Options

9.1 None

10. Recommendations

10.1. That the details in section 2.6.1 be noted by Governance and passed to the full council meeting on 16 October 2018 for adoption.

11. Appendices

Appendix 1Prudential and Treasury Indicators as at 31st August 2018

12. Background Documents

Treasury Management Schedules

Treasury Management Practices

Treasury Policy

APPENDIX 1: Prudential and Treasury Indicators as at 31st August 2018

Treasury Indicators	**2018/18 Budget £m**	**(Apr - Aug) Actual £m**
Authorised limit for external debt	£640m	£640m
Operational boundary for external debt	£600m	£600m
Gross external debt	£591m	£491m
Upper limit for principal sums invested over 365 days	£20m	£0m

Maturity structure of fixed rate borrowing -	**Upper Limit**	**(Apr-March) Actual**
Under 12 months	20%	2%
12 months to 2 years	20%	4%
2 years to 5 years	50%	7%
5 years to 10 years	75%	18%
10 years and above	90%	69%

Prudential Indicators	**2018/19 Budget £m**	**(Apr - Aug) Actual £m**
Capital expenditure (Revised Budget)	£151m	£27m
Capital Financing Requirement (CFR)	£745m	£740m
Ratio of financing costs to net revenue stream	16%	16%