REPORT of
DIRECTOR OF RESOURCES

to
FINANCE AND CORPORATE SERVICES COMMITTEE
28 NOVEMBER 2017

HALF YEARLY TREASURY MANAGEMENT UPDATE

1. PURPOSE OF THE REPORT

1.1 To report on the Council's investment activity for the first half of 2017 / 18 in accordance with the Chartered Institute of Public Finance and Accountancy Treasury Management Code (CIPFA's TM Code) and the Council's Treasury Management Policies (TMPs).

2. RECOMMENDATIONS

(i) That Members review and comment on the Treasury Management report for compliance purposes;

To the Council:

(ii) That the proposed amendment to the Treasury management Strategy 2017 / 18 relating to Prudential Indicators for an Operational Boundary for External debt and an Authorised limit for External debt, be approved;

(iii) that the proposed amendments in relation to investment strategy be approved.

3. SUMMARY OF KEY ISSUES

3.1 Background

3.1.1 The CIPFA's TM Code requires that authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end).

3.1.2 The Council's Treasury Management Strategy for 2017 / 18 was presented to the Finance and Corporate Services Committee on 31 January 2017 and subsequently approved by the Council on 16 February 2017 (Minute No. 995 refers).

3.1.3 The Council has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk.

3.2 **External Context**

3.2.1 The Council currently engages Arlingclose to provide treasury management consultancy and advice. Attached at **APPENDIX 1** is information prepared by Arlingclose providing an overview of the external economic environment.

3.3 **Local context**

3.3.1 The Council is currently debt free and its capital expenditure plans do not currently imply any need to borrow over the forecast period. Investments forecast to fall as capital receipts are used to finance capital expenditure and reserves are used to finance the revenue budget.

3.4 **Investment Activity (April 2017 – September 2017)**

3.4.1 The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

3.4.2 Over the period from April to September 2017, the level of investments held by the Council has seen an increase of £3,500,000 with a total of investments held on 30 September 2017 of £15,000,000. These are comprised of:

	Balance on 01/04/2017 £000s	**Movement £000s**	**Balance on 30/09/2017 £000s**
Short term Investments			
Fixed Deposits	2,000	2,000	4,000
Instant Access and Money Market	4,500	1,500	6,000
Certificates of Deposit	2,000	-2,000	0
Long Term Investments	3,000	2,000	5,000
TOTAL	**11,500**	**3,500**	**15,000**

3.4.3 Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2017 / 18. New investments can be made with the following:

- the Debt Management Office;
- Other Local Authorities;
- AAA-rated Stable Net Asset Value Money Market Funds;
- UK Banks and Building Societies meeting the set minimum credit rating;

- Bonds issued by Multilateral Development Banks, such as the European Investment Bank.

3.4.4 Counterparty credit quality is assessed and monitored with reference to credit ratings. The Council's minimum long term counterparty rating is BBB+ across rating agencies Fitch, Standard and Poors (S&P) and Moody's.

3.5 **Counterparty Update**

3.5.1 There were a few credit rating changes during the period. 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.

3.5.2 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+.

3.5.3 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.

3.5.4 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.

3.6 **Regulatory Update**

3.6.1 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. But 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.

3.6.2 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 Council has declined to opt down to retail client status in the past as the costs were thought to outweigh the benefits.

3.6.3 The Council meets the conditions to opt up to professional status and intends to do so in order to maintain their current MiFID status.

3.7 **Performance – Budgeted Income and Outturn**

3.7.1 The UK Bank Rate was cut to 0.25% in August 2016. Arlingclose is, for now, maintaining its central case for it to remain at this level. Short-term money market rates have remained at relatively low levels. Debt Management Account Deposit Facility (DMADF) rates remain at 0.10% for four – six month deposits.

3.7.2 One new investment has been made on an unsecured basis with Lloyds Bank over the six month period at a rate of 0.31%.

3.7.3 A subscription of £2,000,000 has been made in the Investec Diversified Income Fund, income distribution is currently estimated at 4% per annum,

3.7.4 Investments in Money Market Funds have generated an average rate of 0.16%.

3.7.5 Investment in the Property Fund has yielded an average dividend of 3.55%.

3.7.6 The Authority's budgeted investment income for the year is estimated at £157,800. Projected income for the year is currently £215,900

3.8 **Compliance with Prudential Indicators**

3.8.1 The Prudential Indicators for 2017 / 18, which were set on 31 January 2017 as part of the Treasury Management Strategy Statement, have been complied with to date. These are shown at **APPENDIX 2**.

3.9 **Outlook for the remainder of 2017 / 18**

3.9.1 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 Gross Domestic Product (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.

3.9.2 The Bank of England's Monetary Policy Committee has changed its rhetoric, implying a rise in Bank Rate in "the coming months". Arlingclose were 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.

3.9.3 Since drafting this report, the Bank of England base rate has increased to 0.5%. Arlingclose's view is now for rates to increase to 1% by 2020.

3.10 **Treasury Management Strategy update**

3.10.1 Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

3.10.2 In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Council has diversified into more secure and/or higher yielding asset classes. £2m that is available for longer-term investment was moved from bank and building society deposits into an Investec Diversified Income Account.

3.10.3 The strategy changes that are being proposed to the 2017 / 18 Treasury Management Strategy are summarised in **APPENDIX 3**.

4. CONCLUSION

4.1 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. 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.

4.2 In light of the Council's wishes to become more commercial, the 2017 / 18 Strategy has been updated to enable its available funds to be invested to make better returns.

5. IMPACT ON CORPORATE GOALS

5.1 This report links to the Corporate Goal of delivering good quality, cost effective and valued services in a transparent way.

6. IMPLICATIONS

(i) **Impact on Customers** – None directly.

(ii) **Impact on Equalities** – None identified.

(iii) **Impact on Risk** – This report is mainly about managing credit risk. A prudent approach continues to be taken in relation to investment activity with priority being given to security and liquidity over yield.

(iv) **Impact on Resources (financial)** – Income is projected to exceed the Council's budgeted figure (£157,800) by £58,137 in 2017.

(v) **Impact on Resources (human)** - None directly.

(vi) **Impact on the Environment** – None.

Background Papers: None.

Enquiries to: Ann Nagy, Senior Accountant, (Tel: 01621 875727).