AG017
AUDIT & GOVERNANCE COMMITTEE

TREASURY MANAGEMENT MID YEAR MONITORING REPORT FOR 2019/20

9 JANUARY 2020

REPORT OF DEPUTY LEADER AND CABINET MEMBER FOR FINANCE AND RISK: CLLR NEIL CUTLER

Contact Officer: Neil Aitken Tel No: 01962 848099 Email naitken@winchester.gov.uk

WARD(S): ALL WARDS

PURPOSE

This report provides detail of the performance of the treasury management function. This includes the effects of the decisions taken in the past six months, and confirmation that there were no instances of non-compliance with the Council's Treasury Management Policy Statement and Treasury Management Practices, for 2019/20 to date.

RECOMMENDATIONS:

That the Audit Committee:

1. Note the Treasury Management Mid-Year Monitoring Report 2019/20.

IMPLICATIONS:

1 COUNCIL STRATEGY OUTCOME

1.1 Treasury management is an integral part of helping deliver the Council's Strategy and all of its outcomes. The Council set a target of achieving a 1% return on its investments in 2019/20 and to date has achieved a return of 1.30%.

2 FINANCIAL IMPLICATIONS

2.1 Effective treasury management ensures both the financial security and liquidity of the Council.

3 LEGAL AND PROCUREMENT IMPLICATIONS

3.1 With effect from September 2014 Hampshire County Council (HCC) and Winchester City Council (WCC) established arrangements for the joint discharge of functions under Section (101)(1) and (5) of the Local Government Act 1972 and Section 9EA and 9EB Local Government Act 2000.

3.2 Under this arrangement, HCC's Investments and Borrowing Team provide a Treasury Service which includes the management of WCC's cash balances and investment of surplus cash or sourcing of short-term borrowing in accordance with the agreed Treasury Management Strategy Statement.

4 WORKFORCE IMPLICATIONS

4.1 None

5 PROPERTY AND ASSET IMPLICATIONS

5.1 None

6 CONSULTATION AND COMMUNICATION

6.1 This report has been produced in consultation with Hampshire County Council's Investments & Borrowing team that provides the Treasury Management Service.

7 ENVIRONMENTAL CONSIDERATIONS

7.1 The Council currently has no direct or indirect (via pooled funds) equity investments in companies involved in the fossil fuel industry. Following the Council's declaration of a Climate Emergency in June 2019, this position will be formalised as part of the 2020/21 Treasury Management Strategy in February 2021.

8 EQUALITY IMPACT ASSESSEMENT

8.1 None

9 DATA PROTECTION IMPACT ASSESSMENT

9.1 None required

10 RISK MANAGEMENT

Risk	Mitigation	Opportunities
Returns from investments are too low	A diversified strategy that attempts to manage the balance between liquidity risk, credit risk and yield within the Council's risk appetite.	Returns above budgeted levels
A counterparty fails	A diversified strategy that has relatively low levels of counter-party risk	
Cash is not available	A balanced portfolio of liquid and long-term funds is held to ensure cash is available to utilise. The Council also mitigates this risk through cashflow forecasting	More accurate and immediate cashflow forecasting can help improve the return on investments through more active treasury management activity

11 SUPPORTING INFORMATION:

12 Introduction

12.1 The Council adopts the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code), last updated in 2017. The CIPFA code requires the Council to approve a treasury management strategy before the start of the year and semi-annual and annual treasury management reports.

12.2 This report fulfils the Council's legal obligation to have regard to the CIPFA Code and provides an update on the performance of the treasury management function during 2019/20.

13 Summary

13.1 Treasury management in the context of this report is defined as:

"The management of the organisation'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."

13.2 The Council's Treasury Management Strategy (TMS) for 2019/20 was approved at a meeting of the Council in February 2019. The Council has borrowed and invested sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's TMS.

13.3 Hampshire County Council's Investments & Borrowing Team has been contracted to manage the Council's treasury management balances since September 2014 but overall responsibility for treasury management remains with Winchester City Council. No treasury management activity is without risk and the effective identification and management of risk are integral to the Council's treasury management objectives.

13.4 All treasury activity has complied with the Council's TMS and Investment Strategy for 2019/20, and all relevant statute, guidance and accounting standards. In addition, the Council's treasury advisers, Arlingclose, provide support in undertaking treasury management activities.

13.5 The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, which is a summary document approved by the Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital and Investment Strategy, complying with CIPFA's requirement, was approved by Council on 28 February 2019.

14 External Context

14.1 The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions have been made to date in 2019/20.

Economic Commentary

14.2 UK Consumer Price Inflation (CPIH) fell to 1.5% year on year in October 2019 from 1.7% in September below the Bank of England's target; it remained unchanged at 1.5% in November.

14.3 Labour market data for the three months to October 2019 showed the unemployment rate edged down to 3.8% while the employment rate increased slightly to 76.2%. Once adjusted for inflation, real wages were up 1.8% on an annual basis as wages continue to rise steadily and provide some upward pressure on general inflation.

14.4 There was an increase of 0.3% in quarterly GDP growth in the third calendar quarter of 2019 following a 0.2% contraction in Q2. Both the services and construction sectors registered growth in the quarter (0.4% and 0.6% respectively) with production remaining flat. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 2012.

14.5 The Bank of England maintained Bank Rate at 0.75% in December and in its November Monetary Policy Report noted that the risk of a no-deal Brexit had fallen and that it expected global growth to recover gradually. If this does not happen it may be necessary to lower rates; conversely, if upward pressure on prices builds over the next few years, a modest increase in interest rates is likely.

14.6 Globally, the European Central Bank cut its deposit rate by 10 basis points in September 2019 alongside announcing another round of stimulus, which was closely followed by a 25 basis points cut by the US Federal Reserve.

15 Local Context

15.1 At 31 March 2019 the Council had net borrowing of £150.8m arising from financing its housing programme. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 overleaf.

Table 1: Balance Sheet Summary

	31/03/19 Balance £m
General Fund CFR	(27.1)
Housing Revenue Account CFR	(162.9)
Total CFR	(190.0)
Less: Resources for investment	39.2
Net borrowing	(150.8)

15.2 The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 30 September 2019 and the movement since 31 March 2019 is shown in Table 2 below.

Table 2: Treasury Management Summary

	31/03/2019 Balance £m	Movement £m	30/09/2019 Balance £m	30/09/2019 Rate %
Long-term borrowing	(156.7)	-	(156.7)	(3.30)
Short-term borrowing	-	-	-	-
Total borrowing	(156.7)	-	(156.7)	(3.30)
Long-term investments	15.0	(2.9)	12.1	2.47
Short-term investments	15.0	14.8	29.8	0.89
Cash and cash equivalents	8.1	(4.5)	3.6	0.73
Total investments	38.1	7.4	45.5	1.30
Net external borrowing	(118.6)	7.4	(112.2)	

Note: the figures in the table above as at 31 March 2019 are from the balance sheet in the Council's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

15.3 The increase in total investments since 31 March 2019 shown in Table 2 reflects the annual position of 31 March being the lowest point for investment balances, due to many government grants being front-loaded.

16 Borrowing Activity

16.1 As shown in Table 2, at 30 September 2019 the Council held £156.7m of loans, the majority of which being in relation to the refinancing resettlement of the HRA in 2012.

16.2 The mid-year treasury management borrowing position and movement since 31 March 2019 is shown in Table 3.

Table 3: Borrowing Position

	31/03/2019 Balance £m	Movement £m	30/09/2019 Balance £m	30/09/2019 Rate %	30/09/2019 WAM* years
Public Works Loan Board	156.7	-	156.7	3.30	21.10
Total borrowing	156.7	-	156.7	3.30	21.10

* Weighted average maturity

Note: The figures in the table above as at 31 March 2019 are from the balance sheet in the Council's statement of accounts but adjusted to exclude accrued interest.

16.3 The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

16.4 In keeping with these objectives, no new borrowing was undertaken in the period. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

16.5 The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with the monitoring of internal and external borrowing.

16.6 In October 2019, HM Treasury implemented a change to the margin above gilts charged for borrowing through the PWLB. This unexpected move increased the margin from 80 basis points to 180 basis points making it more expensive to borrow in this way and may therefore affect future borrowing decisions. Arlingclose will provide advice on how to structure any future borrowing to best achieve the Council's objectives.

17 Investment Activity

17.1 The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held.

17.2 The Council's investment holding was £45.5m at 30 September 2019 which was £11.4m (20%) lower than the same time last year. The main cause of this is the increase in capital expenditure particularly as the construction of the new Leisure Centre has commenced; capital expenditure to the end of September 2019 was £17m and in the same period a year earlier was £8m.

17.3 During the six-month period from 1 April to 30 September 2019, the Council's investment balance ranged between £39m and £58m due to timing differences between income and expenditure.

17.4 Table 4 overleaf shows investment activity for the Council as at 30 September 2019 in comparison to the reported position as at 31 March 2019.

Table 4: Investment Position (Treasury Investments)

	31/03/2019 Balance £m	Movement £m	30/09/2019 Balance £m	30/09/2019 Rate %	30/09/2019 WAM* years
Short term investments					
Banks and Building Societies:					
- Unsecured	6.0	4.8	10.8	0.86	0.22
- Secured	2.0	3.0	5.0	0.84	0.56
Treasury Bills	-	4.0	4.0	0.71	0.08
Money Market Funds	7.1	(4.5)	2.6	0.74	0.00
Local Authorities	7.0	3.0	10.0	0.95	0.39
Cash Plus Funds	1.0	-	1.0	1.46	n/a
	23.1	**10.3**	**33.4**	**0.88**	**0.29**
Long term investments					
Banks and Building Societies:					
- Secured	8.5	(2.9)	5.6	1.13	2.18
Local Authorities	1.5	-	1.5	1.33	1.70
	10.0	**(2.9)**	**7.1**	**1.17**	**2.08**
High yield investments					
Pooled Property Funds**	5.0	-	5.0	4.30	n/a
	5.0	**-**	**5.0**	**4.30**	**n/a**
TOTAL INVESTMENTS	**38.1**	**7.4**	**45.5**	**1.30**	**0.61**

* Weighted average maturity

** The rate provided for pooled property fund investments is reflective of the average annual dividend return to 30 September 2019

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts but adjusted to exclude operational cash and accrued interest.

17.5 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.

17.6 The Council's objective when investing is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults against the risk of receiving unsuitably low investment income.

17.7 During the first half of 2019/20, total investment balances increased by £7.4m, in line with the usual profile of balances across the financial year, due to the receipt of council tax and front-loaded grants.

17.8 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 2019/20.

17.9 Counterparty credit quality was assessed and monitored with reference to credit ratings, analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

17.10 The Council has also used secured investment products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

17.11 To ensure sufficient liquidity, the Council makes use of call accounts and money market funds. With the ongoing uncertainty around Brexit, the Council will ensure there are enough accounts open at UK domiciled banks and Money Market Funds to hold sufficient liquidity and that its account with the Debt Management Account Deposit Facility (DMADF) remains available for use in an emergency.

17.12 The progression of credit risk and return metrics for the Council's investments managed in-house (excluding pooled funds) are shown in the extracts from Arlingclose's quarterly investments benchmarking in Table 5 below.

Table 5: Investment Benchmarking (investments managed in-house)

	Credit Rating	Bail-In Exposure	WAM* (days)	Rate of Return
31/03/2019	AA	40%	354	1.01%
30/09/2019	AA+	34%	226	0.92%
Similar LAs	AA-	61%	80	0.86%
All LAs	AA-	62%	28	0.83%

* Weighted average maturity

17.13 Table 5 shows the Council's exposure to bail-in risk has reduced to 34% when compared with the position at 31 March 2019, a figure that compares favourably to other similar authorities and the LA universe used for Arlingclose's benchmarking. Similarly, the credit rating of investment counterparties has improved and again presents favourably compared with the benchmark.

17.14 The weighted average maturity of investments and average rate of return have both decreased. This is as a result of the requirement to keep a proportion of funds liquid due to an impending major acquisition, with the reduced returns being generated also reflective of market conditions during the period.

17.15 The Council has targeted a proportion of funds towards high yielding investments as shown in Table 4. Investments yielding higher returns will contribute additional income to the Council, although some come with the risk that they may suffer falls in the value of the principal invested.

17.16 The £5m investment in an externally managed pooled property fund generated an average annual total return of 4.36%, comprising 4.30% income return which is used to support services in year, and 0.05% of capital growth. As this fund has no defined maturity date, but the balance is available for withdrawal after a notice period, the performance and continued suitability in meeting the Council's investment objectives is regularly reviewed.

17.17 Any investments in pooled funds are made in the knowledge that capital values will move both up and down in the short term, but with the confidence that over a three- to five- year period total returns should exceed cash interest rates, whilst also providing regular income, diversification and the potential for capital growth and it is the Council's intention to hold these investments for at least the medium term.

17.18 Recent changes to accounting regulations (IFRS9) have introduced a new risk related to the Council's investments in pooled funds whereby any fall in the capital value of the funds would now have to be taken as an expenditure charge to the Council's Income and Expenditure account. This does not present an immediate risk to the Council; however, as there is currently a statutory override in place that provides a 4 year grace period before this requirement is implemented.

17.19 If no further changes are made at the end of the 4 year period, the risk of a fall in value resulting in an expenditure charge for the Council will be mitigated by reserves accrued through any increases in the value of the Council's investments over the next 4 years.

17.20 The performance and ongoing suitability of pooled funds in meeting the Council's investment objectives is monitored regularly and discussed with Arlingclose.

18 Non-Treasury Investments

18.1 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

18.2 This includes service investments for operational and/or regeneration as well as commercial investments which are made mainly for financial reasons.

18.3 The total value of investments properties as at 31 March 2019 was £53.8m (£47.7m as at 31 March 2018). Net rental income after costs to the end of September 2019 amounted to £1.1m representing a yield of 4.1% to date (3.9% average yield in 2018/19).

19 Compliance Report

19.1 The Council confirms compliance of all treasury management activities undertaken during the period with the CIPFA Code of Practice and the Council’s approved Treasury Management Strategy.

19.2 Compliance with the authorised limit and operational boundary for external debt is demonstrated in Tables 6 below.

Table 6: Debt Limits

	2019/20 Maximum £m	30/09/2019 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied
Borrowing	156.7	156.7	266.9	284.3	✓
Other long term liabilities	0.0	0.0	0.0	0.0	✓
Total debt	156.7	156.7	266.9	284.3	✓

20 Treasury Management Indicators

20.1 The Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

20.2 The following indicator shows the sensitivity of the Council’s current investments and borrowing to a change in interest rates:

Table 7: Interest Rate Exposures

	30/09/2019 Actual	Impact of +/-1% interest rate change
Variable interest rate investment exposure	£35m	+/- £0.4m
Variable interest rate borrowing exposure	0	n/a

20.3 Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

<u>Maturity Structure of Borrowing</u>

20.4 This indicator is set to control the Council's exposure to refinancing risk.

Table 8: Maturity Structure of Borrowing

	30/09/2019 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	0%	25%	0%	✓
12 months and within 24 months	0%	25%	0%	✓
24 months and within 5 years	6%	25%	0%	✓
5 years and within 10 years	19%	30%	0%	✓
10 years and within 20 years	32%	50%	0%	✓
20 years and within 30 years	13%	50%	0%	✓
30 years and within 40 years	13%	75%	0%	✓
40 years and within 50 years	17%	100%	0%	✓

<u>Principal Sums Invested for Periods Longer than 365 days</u>

20.5 The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments.

Table 9: Principal Sums Invested for Periods Longer than 365 days

	2019/20	2020/21	2021/22
Actual principal invested beyond year end	£12m	£12m	£2m
Limit on principal invested beyond year end	£15m	£15m	£10m
Complied	×	✓	✓

20.6 As reported in the Treasury Management Outturn Report for 2018/19 to the Committee on 25 July 2019, the principal sum invested for longer than 364 days was £15.035m as at the 31 March 2019 and fell below £15m on 16 May 2019.

20.7 This was the result of one investment made on 12 March 2019 shortly after the limit was revised from £20m to £15m as part of the Treasury Management Strategy update in February 2019.

20.8 The Council sought assurances from Hampshire's Investment and Borrowing team that action had been taken to prevent this happening again and they confirmed their internal controls had been reviewed. There have been no further breaches of the limit.

20.9 In addition, Hampshire County Council's rolling internal audit plan for 2019/20 included a review of the Treasury Management function. This review is currently underway, and the matter will therefore be covered as part of the audit, with any results being reported to the next meeting of the Audit and Governance Committee subsequent to the completion of the audit.

21 Outlook for the remainder of 2019/20

21.1 The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US, and there appears no near-term resolution to the trade dispute between China and the US.

21.2 The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity.

21.3 In response, global and UK interest rate rise expectations have eased, and central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

21.4 The Council's treasury advisor Arlingclose expects Bank Rate to remain at 0.75% for the foreseeable future but there remain substantial risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy.

21.5 Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judge the risks to be weighted to the downside and that volatility will continue to offer longer-term borrowing opportunities.

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Cas	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Downside risk	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75

BACKGROUND DOCUMENTS:-

Previous Committee Reports:-

AUD119: Treasury Management Practices, 22 June 2015

CAB3013: Treasury Management Strategy 2019-20, 28 February 2019

CAB3064: Treasury Management Outturn 2018/19, 25 July 2019

AUD197: Treasury Management Mid-Year Review 2018/19, 29 November 2018

Other Background Documents:-

None

APPENDICES:

None