READING BOROUGH COUNCIL
REPORT BY HEAD OF FINANCE

TO:	**AUDIT & GOVERNANCE COMMITTEE**		
DATE:	**24th JANUARY 2019**	**AGENDA ITEM:**	**8**
TITLE:	**TREASURY MANAGEMENT HALF YEARLY REPORT**		
LEAD COUNCILLOR:	**CLLR BROCK**	**AREA COVERED:**	**CORPORATE & CONSUMER SERVICES**
SERVICE:	**FINANCE**	**WARDS:**	**BOROUGHWIDE**
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1. EXECUTIVE SUMMARY

1.1 The purpose of this report is to update Members on the activity of the Treasury Management function for 2018/19 as at 30 September 2018.

1.2 The report complies with CIPFA's Code of Practice on Treasury Management which requires that the Council receives a report on its Treasury Management activity at least twice a year. Specifically this report includes:

- a review of the Council's financial investment portfolio for 2018/19 as at 30 September 2018;
- a review of the Council's borrowing strategy for 2018/19;
- a review of compliance with the Council's Treasury and Prudential Limits for the first six months of 2018/19; and
- an economic update for the first part of the financial year.

1.3 The Council has complied with all elements of its Treasury Management Strategy Statement (TMSS) as agreed by Council in February 2018.

2. RECOMMENDED ACTIONS

That the Audit & Governance Committee:

2.1 Note the performance of the Treasury Management function for the six months to 30th September 2018 and the key issues emerging; and

2.2 Endorse the recommendations in the Treasury Management Strategy to Full Council in February 2019 to update the Minimum Revenue Provision policy and Commercial Investment policy set out in section 5. of this report.

APPENDICES

Appendix 1: Commentary on the economic backdrop for 2018/19.
Appendix 2: Approved counterparties and limits

3. BACKGROUND

3.1. The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

4. BORROWING

4.1. As at 30 September 2018 net borrowing was £328m, a decrease of £11m on the position at 31 March 2018. The decrease reflects the forecast pattern of the Authority's cash-flows and largely relates to the timing of grants, Council Tax and Business Rates received and capital programme slippage.

Table 1: Net borrowing position at 30th September 2018

	31 Mar 2018 £m	**30 Sep 2018 £m**
Total gross borrowing	382	382
Total cash invested	(43)	(54)
Net borrowing	**339**	**328**

4.2. As interest rates remain historically low, the Authority's main objective when borrowing is to strike a balance between securing low interest rates and achieving cost certainty over the period for which funds are required. This position provides short term savings with the flexibility to secure longer dated loans as and when financial forecasts indicate that external borrowing rates may increase.

4.3. Having raised the Base Rate in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee has maintained expectations of a slow rise in interest rates over the next few years. Appendix 1 provides further commentary on the economic backdrop for 2018/19.

4.4. The Council's underlying need to borrow for capital purposes is measured by its Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investment below their underlying levels, sometimes known as internal borrowing. In recent years this strategy has helped minimise the Council's net financing costs. Table 2 below sets out the CFR on the Council's Balance Sheet at 31.03.18, prior to Audit.

Table 2: Capital Financing Requirement at 31.03.18

	General Fund	**HRA**	**Total 31 Mar 2018 £m**
CFR	335	186	521
Less PFI liabilities	(27)		(27)
CFR / Underlying Borrowing Requirement	**308**	**186**	**494**
Less usable reserves and working capital	(155)		(155)
Net borrowing requirement	**153**	**186**	**339**

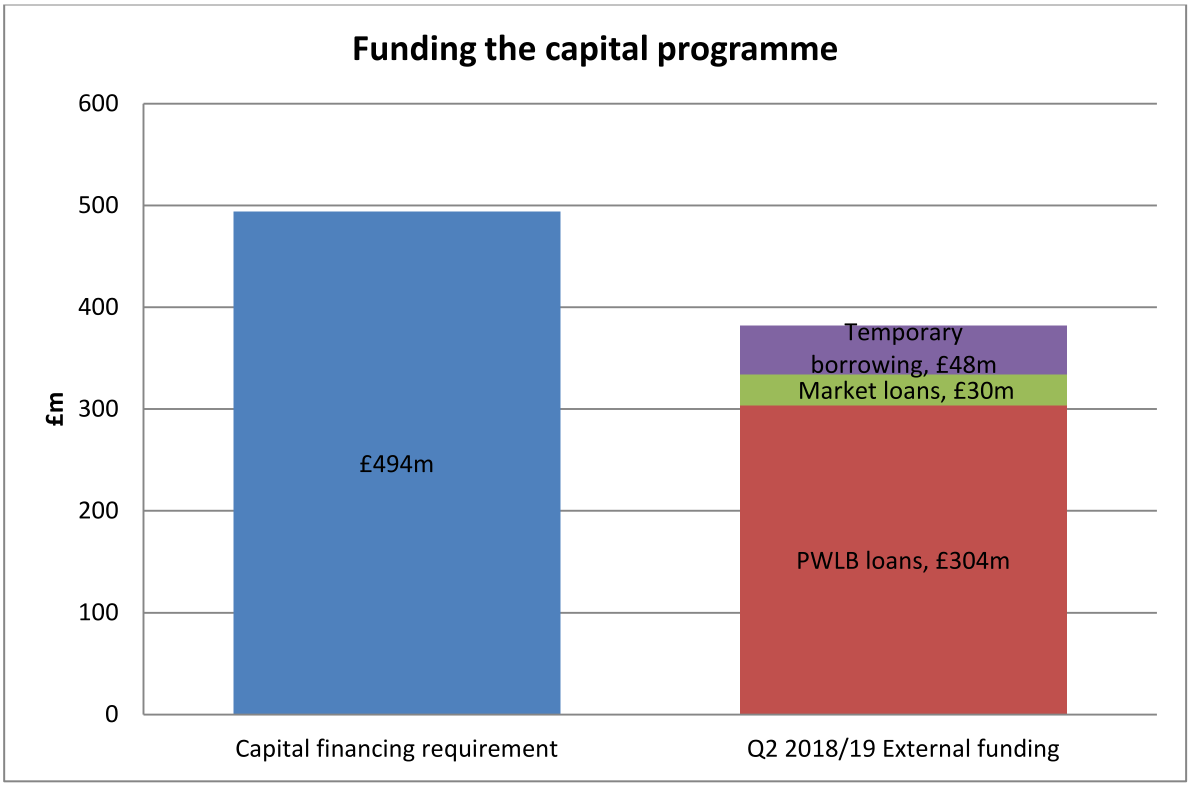
4.5. Table 3 below compares total external borrowing as at 30.09.18 to the position as at the end of the financial year 2017/18 and to the CFR available for borrowing after deducting PFI liabilities.

Table 3: Gross borrowing position

	31 Mar 2018 £m	**30 Sep 2018 £m**
PWLB	276	304
LOBO	25	25
Fixed term borrowing	5	5
Temporary borrowing – other LAs	76	48
Total Borrowing	**382**	**382**
CFR	494	494
Headroom	**112**	**112**

4.6. At £382m the Council's gross borrowing is well within the Prudential Indicator for external borrowing; £494m as set out in Table 3 above.

4.7. The graph below compares the Council's actual borrowing to its CFR after deducting PFI liabilities.



4.8. The Council sets both an annual Operational Boundary and Authorised Limit for borrowing. These limits are set above the CFR to accommodate day-to-day treasury operations and manage abnormal cash flows which may result in a temporary need to borrow. The Operational Boundary is the limit beyond which external borrowing is not normally expected to increase at any point during the year other than on a short term basis. The Authorised Limit is the limit beyond which external borrowing is prohibited.

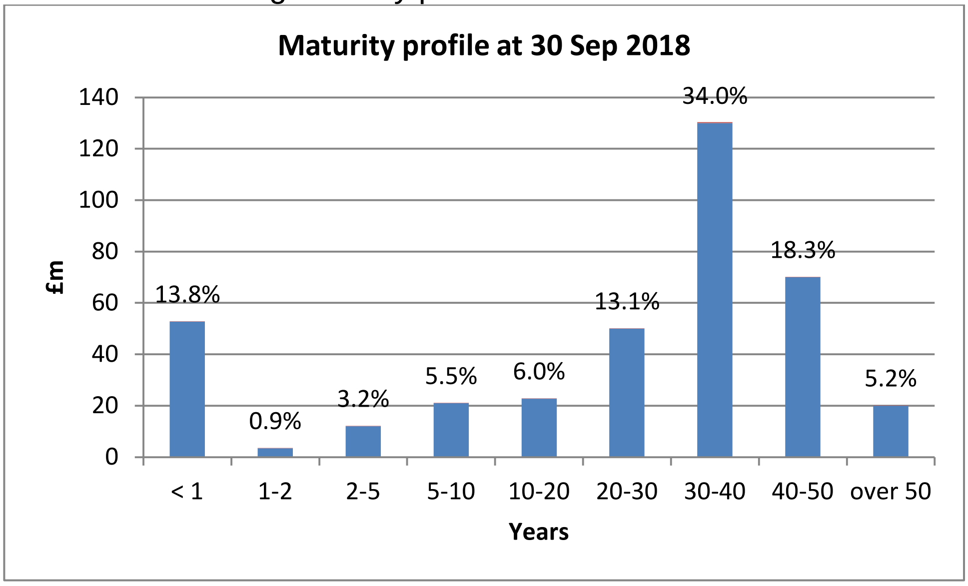
4.9. Table 4 below sets out the level of borrowing held as at 30 Sep 2018 against both the Operational Boundary and Authorised Limit for external borrowing. This demonstrates that the Council is comfortably within these limits.

Table 4: Borrowing vs. boundary/limits

	£m
External Borrowing as at 30 Sep 2018	382
Operational Boundary	540
Authorised Limit	560

4.10. Table 5 below sets out the maturity profile of the Council's borrowing portfolio as at the end of September 2018. As indicated in the graph at 4.7 above, the majority of loans are Public Works Loan Board (PWLB) loans and have a fixed interest rate and are long term in nature which limits the Council's exposure to interest rate fluctuations.

Table 5: Borrowing Maturity profile



4.11. The Treasury Management Strategy for 2018/19 anticipated new borrowing of up to £144m. To date the Council has so far just taken £30m of new borrowing. The additional borrowing has not been required because of slippage in anticipated capital spend, eg the Council have not made any further commercial property investments in 2018/19 and the capital programme anticipates £50m of spend.

5. REPAYING BORROWING – MINIMUM REVENUE PROVISION

5.1. Full Council approved the Minimum Revenue Provision (MRP) Statement for 2018/19 as part of its Council Tax and Budget Setting report in February 2018. This will be reviewed by Council in February as part of its consideration of the Council's Treasury Management Strategy alongside consideration of the Medium Term Financial Strategy 2019/20 – 2021/22.

5.2. It is proposed that the MRP Strategy is amended to reflect two specific changes:

- Not to charge MRP to the HRA on the basis that it has not been a mandatory requirement for a number of years and will allow greater freedom to spread the profile of HRA provision for debt repayment to later years, such that lower charges will be set aside in earlier years whilst broadly allowing for the same overall amount to be set aside over the 30 year planning horizon of the HRA Business Plan. This enables significant investment in additional social housing over the next few years. The business case and affordability of which sees rental income grow over the medium term, facilitating the financial benefits to mitigate debt financing costs.

- The Council's current Minimum Revenue Policy assumes no MRP charges will be made for the capital borrowing costs associated with the purchase of investment properties. Such a policy contradicts the guidelines set out in the regulations updated by MHCLG in February 2018. The new Policy will address this contradiction and provide for an MRP charge on borrowing to fund investment property acquisitions, thereby allowing for repayment of debt in a similar manner to other capital expenditure funded by borrowing.

5.3. Audit and Governance Committee are requested to endorse these changes.

5.4. To date no investment property purchases have been made during 2018/19. Any further acquisitions will be in accordance with Counsel opinion and in line with the updated Treasury and Investment strategies being considered by Full Council in February 2019.

6. INVESTMENTS

6.1. The Council's Annual Investment Strategy forms part of its annual Treasury Management Strategy Statement (TMSS). The 2018-19 Strategy was approved by the Council on 28 February 2018. The objective of the Strategy is the prudent investment of balances to achieve optimum returns on investments subject to maintaining adequate security of capital and a level of liquidity appropriate to the Council's projected need for funds over time.

6.2. Table 6 below provides a breakdown of the Council's investments as at 30.09.18 compared to 31.03.18.

Table 6: Breakdown of investments

	31 Mar 2018 £m	**30 Sep 2018 £m**
Money Market Funds - Aberdeen - Federated	 12 9	 20 4
CCLA property fund	15	15
Loan to Homes for Reading	4	12
Call Account	3	3
Total invested	**43**	**54**

6.3. The council budgeted to receive £1.3m from investments and is forecast to receive £1.4m for 2018/19.

6.4. Cash balances are managed through Money Market Funds providing same day access to funds while achieving a return on investment.

6.5. Other investments include the CCLA property fund and loans to Homes for Reading Ltd.

6.6. CCLA is a specialist investment management firm that acts on behalf of churches, charities and local authorities. The investment has produced quarterly returns ranging between 4% and 5%.

6.7. Although not currently classed as treasury management activities and therefore not covered by the CIPFA code, the Council also holds £26m of investments in directly owned investment property and £14m in loans to and shareholdings in its subsidiaries.

7. COMPLIANCE

7.1. During the financial year to September 2018, the Council operated within the Treasury Limits and Prudential Indicators set out in the TMSS approved by Council on 28 February 2018 as set out below.

PI ref	Indicator	2018/19 indicator	Actual as at 30.09.18	Indicator met
1	Capital Financing Requirement (CFR)	GF £425m HRA £190m	GF £335m HRA £186m	Met
2	Gross debt vs CFR less PFI liabilities	£112m under borrowed	£112m under borrowed	Met
3	Authorised limit for external debt	£560m	£382m	Met
4	Operational boundary	£540m	£382m	Met
5	HRA debt limit	£208m	£186m	Met
6	Limits for fixed interest rate borrowing maturity <10yrs	Upper limit 25% Lower limit 0%	23%	Met
7	Limits for fixed interest rate borrowing maturity >10yrs	Upper limit 100% Lower limit 40%	77%	Met
8	Investments in MMF (including CCLA)	Up to £20m each	See table 6	Met

8. FINANCIAL IMPLIACATIONS

8.1. Financial implications are contained in the body of this report

9. LEGAL IMPLICATIONS

9.1. The Local Government Act 2003 requires the Council to set out its Treasury Strategy for borrowing and to prepare an Annual Investment Strategy. This sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments. This report assists the Council in fulfilling its statutory obligation under the Local Government Act 2003 to monitor its borrowing and investment activities.

BACKGROUND PAPERS

- Treasury Management Strategy Statement for 2018/19 at Full Council 28 February 2018.
- CIPFA Code of Practice for Treasury Management in the Public Services 2018
- CIPFA The Prudential Code 2017

Appendix 1 – Economic background

Economy

A1 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/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.

A2 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%.

A3 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.

A4 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.

A5 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 less than 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.

Financial markets

A6 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 bet 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.

Credit background

A7 Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ringfenced bank NatWest Markets plc rose relatively sharply over the period to around 96bps. The CDS for the ringfenced entity, National Westminster Bank plc, has held steady below 40bps. Although the CDS of other UK banks rose marginally over the period, they continue to remain low compared to historic averages.

A8 The ringfencing 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 (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.

A9 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 ringfencing. 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.

A10 Our treasury advisor Arlingclose will henceforth provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities' flexibility during bail-in. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs but not senior unsecured bonds issued by commercial banks.

Interest Rates

A11 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

	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Ca:	0.75	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Downside risk	0.00	0.00	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75

A12 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.

Appendix 2 – Approved counterparties and limits

Counterparty		Cash limit	Time limit
Banks and other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:	AAA	£20m each	10 years
	AA+		5 years
	AA		4 years
	AA-		3 years
	A+		2 years
	A		1 year
	A-		
The Council's current account, Lloyds Bank plc should circumstances arise when it does not meet the above criteria		£1m	next day
UK Central Government (irrespective of credit rating)		unlimited	50 years
UK Local Authorities (irrespective of credit rating)		£20m each	50 years
UK Registered Providers of Social Housing whose lowest published long-term credit rating is A- or higher		£5m each	10 years
UK Registered Providers of Social Housing whose lowest published long-term credit rating is BBB- or higher and those without credit ratings		£2m each	5 years
UK Building Societies without credit ratings		£10m each	1 year
Money market funds and other pooled funds (including the CCLA Property Fund)		Up to £20m each	n/a
Any other organisation, subject to an external credit assessment and specific advice from the Council's treasury management adviser		£5m each	3 months
		£1m each	1 year
		£100k each	5 years