East Lothian Council

REPORT TO:	Audit and Governance Committee
MEETING DATE:	27 November 2018
BY:	Depute Chief Executive (Resources and Peoples Services)
SUBJECT:	Treasury Management Strategy Statement and Annual Investment Strategy – Mid Year Review 2018/19

1 PURPOSE

1.1 To update the Committee on Treasury Management activity during the first half of 2018/19.

2 RECOMMENDATIONS

2.1 The Committee are asked to note the content of the report.

3 BACKGROUND

3.1 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 required. Surplus monies are invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

3.2 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 obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

3.3 Accordingly, treasury management can be defined as:

"The management of the local authority's borrowing, 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."

3.4 In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities will be required to prepare a Capital Strategy which will be presented to the full Council before 31st March 2019.

The strategy will complement the Treasury Management Strategy and will provide the following: -

- a high-level overview of how the capital expenditure, capital financing and treasury management activities contribute to the provision of services;
- an overview of how the associated risk is managed and;
- the implications for future financial sustainability for the council

The strategy is a high level document linked to the strategic objectives of the council and will be fully aligned with the Strategic Asset Management Plan, the Finance Strategy and the Treasury and Investment Strategy.

3.5 This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

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 for the year ahead (approved by Council in February 2018), a Mid-year Review Report (this 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 the Audit and Governance Committee.

3.6 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 expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2018/19;
- 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.

Mid Year Position

3.7 The first half of 2018/19 has seen UK **economic growth** post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase **Bank Rate** on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

3.8 Some MPC members have expressed concerns about a build-up of **inflationary pressures**, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

3.9 Wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point was in July 2015.) Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

Interest rate forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast as at 30th September 2018:

Table 3.1

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%

Treasury Management Strategy Statement and Annual Investment Strategy update

3.10 The Treasury Management Strategy Statement (TMSS) for 2018/19 was approved by the Council on 27th February 2018.

3.11 There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

Table 3.2

Prudential Indicators 2018/19	Approved £m	Current Estimated Prudential Indicator £m
Authorised Limit	487	487
Operational Boundary	456	456
Capital Financing Requirement	456	447

Includes on balance sheet PFI schemes and finance leases etc.

The Council's Capital Position (Prudential Indicators)

3.12 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; and

- Compliance with the limits in place for borrowing activity.

Prudential Indicator for Capital Expenditure

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

Table 3.3

Capital Expenditure by Service	**2018/19 Original Estimate £m**	**2018/19 Revised Estimate £m**
General Services	45	45
HRA	25	22
Total capital expenditure	**70**	**67**

Revised budget estimates based on provisional Q2 2018 outturn forecasts

Changes to the Financing of the Capital Programme

3.14 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. This external borrowing need may also have additional increases due to maturing debt and other treasury requirements.

Table 3.4

Capital Expenditure	**2018/19 Original Estimate £m**	**2018/19 Revised Estimate £m**
Total capital expenditure	**70**	**67**
Financed by:		
Capital receipts	13	14
Capital grants	15	15
Capital reserves		
Revenue	2	2
Total financing	**30**	**31**
Borrowing requirement	**40**	**36**

Revised budget estimates based on provisional Q2 2018 outturn forecasts

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

3.15 The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary. We are projecting to be within the approved limits for both CFR and Operational Boundary.

Table 3.5

	2018/19 Approved Limits £m	**2018/19 Revised Estimate £m**
Prudential Indicator – Capital Financing Requirement		
CFR – General Services	222	217
CFR – HRA	196	192
Total CFR	**418**	**409**
Net movement in CFR	**24**	**20**
Prudential Indicator – the Operational Boundary for external debt		
Borrowing	418	409
Other long term liabilities*	38	38
Total debt (yearend position)	**456**	**447**

** On balance sheet PPP schemes and finance leases etc.*

Limits to Borrowing Activity

3.16 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.

Table 3.6

	2018/19 Original Estimate £m	**2018/19 Revised Estimate £m**
Borrowing	380	377
Other long term liabilities*	38	38
Total external debt	418	415
CFR* (year end position)	**456**	**447**
Underborrowing		**32**

**Includes on balance sheet PPP schemes and finance leases etc.*

3.17 The Head of Council Resources reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

3.18 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 in Scotland Act 2003.

Table 3.7

Authorised limit for external debt	2018/19 Approved Limit £m	2018/19 Current Position £m
Borrowing	448	377
Other long term liabilities *	39	38
Total	487	409

** Includes on balance sheet PPP schemes and finance leases etc.*

Investment Portfolio 2018/19

3.19 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 3.11, 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.

3.20 Investment decisions during the first 6 months of 2018/19 were taken in accordance with the approved strategy.

3.21 There were two short term investments made and repaid during the period, remaining surplus cash balances were held in the Council's bank account.

Table 3.8

Date of Lending	Borrower	Amount	Interest rate	Date repaid
09/05/18	Telford & Wrekin Council	£ 5m	0.57%	10/09/18
21/06/18	North Lanarkshire Council	£ 5m	0.50%	21/09/18

3.22 East Lothian Council Common Good funds and Charitable Trust funds are managed in two separate portfolios by an external investment management company, Investec. At 30th September 2018, the East Lothian Charitable Trust portfolio was valued at £3.489m, which represents an increase of £0.192m over the 6 month period. The performance of this portfolio for the first 6 months is on a par with the benchmark.

3.23 The Common Good portfolio was valued at £3.562m which represents an increase of £0.194m over the 6 month period. The expectation is that this portfolio should grow the fund and generate the best income at the minimal risk, the performance in the first 6 months is in line with this expectation given the current market conditions.

Investment Counterparty criteria

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

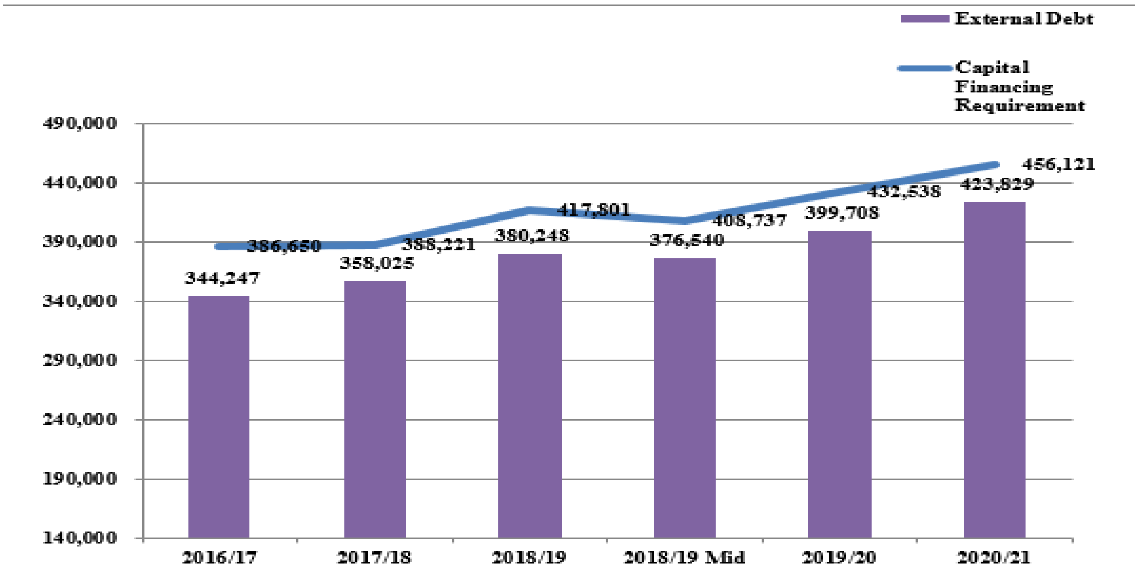
Borrowing

3.25 The Council's capital financing requirement (CFR) for 2018/19 is projected to be £409m. The net 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. Table 3.6 shows the Council expects to have borrowings of £377m and utilise £32m of 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.

Comparison of Capital Financing Requirement to actual/estimated external borrowing

Graph 3.1

See over//



3.26 No external borrowing was taken in the first 6 months of the financial year.

3.27 Due to the overall financial position and the underlying need to borrow for capital purposes (the capital financing requirement - CFR), new external borrowing of £36m is estimated to be undertaken during the second half of this financial year. The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates 1 April 2018 to 30 September 2018

Graph 3.2

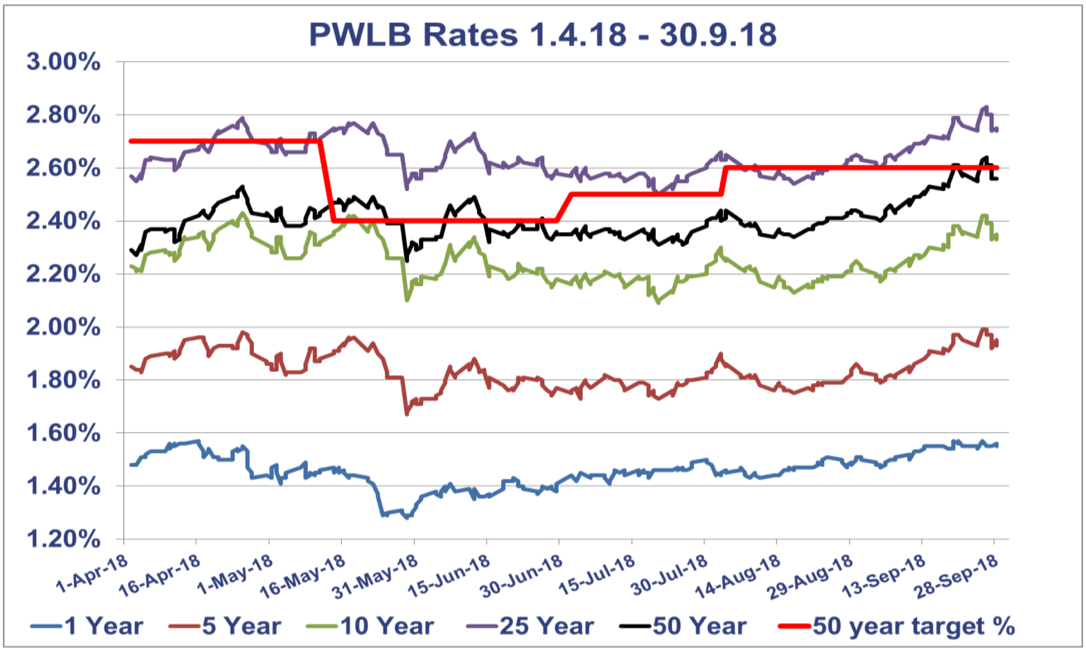


Table 3.9

	1 Year	5 Year	10 Year	25 Year	50 Year
3.4.18	1.48%	1.84%	2.22%	2.55%	2.27%
30.9.18	1.55%	1.93%	2.33%	2.74%	2.56%
Low	1.28%	1.67%	2.09%	2.50%	2.25%
Date	01/06/2018	29/05/2018	20/07/2018	20/07/2018	29/05/2018
High	1.57%	1.99%	2.43%	2.83%	2.64%
Date	17/04/2018	25/09/2018	25/04/2018	25/09/2018	25/09/2018
Average	1.46%	1.84%	2.25%	2.64%	2.41%

3.28 Two PWLB loans matured during the first six months and were repaid:

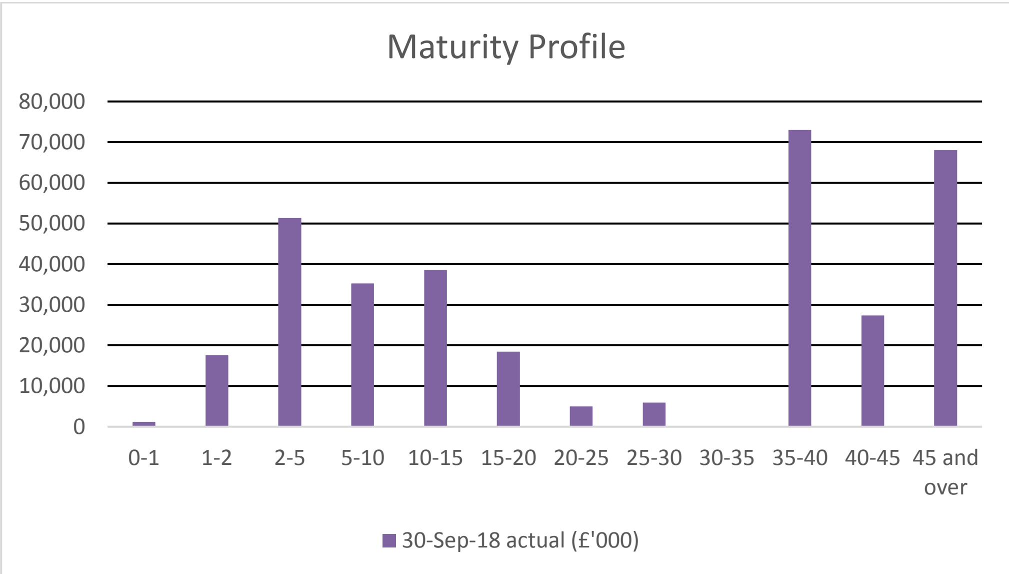
Table 3.10

Date repaid	Principal	Maturity	Interest rate
24/09/18	£5m	8 years	3.86%
24/09/18	£10m	8 years	3.89%

There were no short term loans taken or repaid.

Current Maturity Profile

Graph 3.3



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.

IFRS9 accounting standard

This accounting standard came into effect from 1st April 2018. This means that the category of investments valued under the available for sale category will be removed and any potential fluctuations in market valuations may impact onto the Surplus or Deficit on the Provision of Services, rather than being held on the balance sheet. This change is unlikely to materially affect the commonly used types of treasury management investments but more specialist types of investments, (e.g. pooled funds, third party loans, commercial investments), are likely to be impacted. The full effects of IFRS9 are being assessed and the Treasury impact will be reported in the Annual Report due to be presented to the Committee in June 2019.

4 POLICY IMPLICATIONS

4.1 There are no direct policy implications associated with this report however the Council's treasury management activity is determined by the policy framework set out in the approved Treasury Management Strategy.

5 EQUALITIES IMPACT ASSESSMENT

5.1 This report is not applicable to the well-being of equalities groups and an Equality Impact Assessment is not required.

6 RESOURCE IMPLICATIONS

6.1 Financial - There are no direct financial implications associated with this report however the Council's Treasury Management activity clearly has a significant impact on the management of the Council's financial resources.

6.2 Personnel – None

6.3 Other – None

7 BACKGROUND PAPERS

7.1 Treasury Management Strategy 2018/19 to 2020/21 – East Lothian Council 27 February 2018.

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