APPENDIX 1

Detailed Treasury Management Mid-Year Report 2017/18

Introduction

In March 2005, the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

The Authority's treasury management strategy for 2017/18 was approved at a meeting of the council on 9th March 2017. The Authority has borrowed and 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. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

External Context

Economic backdrop: Commodity prices fluctuated over the period with oil falling below $45 a barrel before inching back up to $58 a barrel. UK Consumer Price Inflation (CPI) index rose with the data print for August showing CPI at 2.9%, its highest since June 2013 as the fall in the value of sterling following the June 2016 referendum result continued to feed through into higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.7%.

The unemployment rate fell to 4.3%, its lowest since May 1975, but the squeeze on consumers intensified as average earnings grew at 2.5%, below the rate of inflation. Economic activity expanded at a much slower pace as evidenced by Q1 and Q2 GDP growth of 0.2% and 0.3% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings falling and real wage growth negative, there are concerns that these will be a constraint on economic activity in the second half of calendar 2017.

The Bank of England made no change to monetary policy at its meetings in the first half of the financial year. The vote to keep Bank Rate at 0.25% narrowed to 5-3 in June highlighting that some MPC members were more concerned about rising inflation than the risks to growth. Although at September's meeting the Committee voted 7-2 in favour of keeping Bank Rate unchanged, the MPC changed their rhetoric, implying a rise in Bank Rate in "the coming months". The Council's treasury advisor Arlingclose is 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. By the time you read this report the November Committee will have met and may have increased rates.

In contrast, near-term global growth prospects improved. The US Federal Reserve increased its target range of official interest rates in June for the second time in 2017 by 25bps (basis points) to between 1% and 1.25% and, despite US inflation hitting a soft patch with core CPI at 1.7%, a further similar increase is expected in its December 2017 meeting. The Fed also confirmed that it would be starting a reversal of its vast Quantitative Easing programme and reduce the $4.2

trillion of bonds it acquired by initially cutting the amount it reinvests by $10bn a month.

Geopolitical tensions escalated in August as the US and North Korea exchanged escalating verbal threats over reports about enhancements in North Korea's missile programme. The provocation from both sides helped wipe off nearly $1 trillion from global equity markets but benefited safe-haven assets such as gold, the US dollar and the Japanese yen. Tensions remained high, with North Korea's threat to fire missiles towards the US naval base in Guam, its recent missile tests over Japan and a further testing of its latent nuclear capabilities.

Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty but the surprise result has led to a minority Conservative government in coalition with the Democratic Unionist Party. This clearly results in an enhanced level of political uncertainty. Although the potential for a so-called hard Brexit is diminished, lack of clarity over future trading partnerships, in particular future customs agreements with the rest of the EU block, is denting business sentiment and investment. The reaction from the markets on the UK election's outcome was fairly muted, business confidence now hinges on the progress (or not) of Brexit negotiations, the ultimate 'divorce bill' for the exit and whether new trade treaties and customs arrangements are successfully concluded to the UK's benefit.

In the face of a struggling economy and Brexit-related uncertainty, Arlingclose expects the Bank of England to take only a very measured approach to any increase in interest rates. Any increase will be gradual and limited as the interest rate backdrop will have to provide substantial support to the UK economy through the Brexit transition.

Financial markets: Gilt yields displayed significant volatility over the six-month period with the appearing change in sentiment in the Bank of England's outlook for interest rates, the push-pull from expectations of tapering of Quantitative Easing (QE) in the US and Europe and from geopolitical tensions, which also had an impact. The yield on the 5-year gilts fell to 0.35% in mid-June, but then rose to 0.80% by the end of September. The 10-year gilts similarly rose from their lows of 0.93% to 1.38% at the end of the quarter, and those on 20-year gilts from 1.62% to 1.94%.

The FTSE 100 nevertheless powered away reaching a record high of 7548 in May but dropped back to 7377 at the end of September. Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.30% and 0.65% over the period from January to 21st September.

Credit background: UK bank credit default swaps continued their downward trend, reaching three-year lows by the end of June. Bank share prices have not moved in any particular pattern.

There were a few credit rating changes during the quarter. 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. The agency downgraded long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment and the ratings of the large Australian banks on its view of the rising risks from their exposure to the Australian housing market and the elevated proportion of lending to residential property investors.

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+.

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.

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.

Regulatory Updates

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.

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

The Authority has not held a balance of £10 million in investments continuously for the last 12 months. It has held an average of £11.8m and a range from £1 million to £31 million. The lower levels result from our policy to maximise internal borrowing and the cyclical nature of cash-flows. The Authority is currently working towards a position where it carries a minimum of £10 million in investments for the majority of the year from 3rd January 2018 in order to meet all the conditions to opt up to professional status to maintain our current MiFID status. A decision not to do so could restrict our access not only to certain investment and loan products but also to a Treasury Management advisor at an affordable cost.

CIPFA Consultation on Prudential and Treasury Management Codes: In February 2017 CIPFA canvassed views on the relevance, adoption and practical application of the Treasury

Management and Prudential Codes and after reviewing responses launched a further consultation on changes to the codes in August with a deadline for responses of 30th September 2017.

The proposed changes to the Prudential Code include the production of a new high-level Capital Strategy report to full council which will cover the basics of the capital programme and treasury management. The prudential indicators for capital expenditure and the authorised borrowing limit would be included in this report but other indicators may be delegated to another committee. There are plans to drop certain prudential indicators, however local indicators are recommended for ring fenced funds (including the HRA) and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties to be included in the definition of "investments" as well as loans made or shares brought for service purposes. Another proposed change is the inclusion of financial guarantees as instruments requiring risk management to be addressed within the Treasury Management Strategy. Approval of the technical detail of the Treasury Management Strategy may be delegated to a committee rather than needing approval of full Council. There are also plans to drop or alter some of the current treasury management indicators.

CIPFA intends to publish the two revised Codes towards the end of 2017 for implementation in 2018/19, although CIPFA plans to put transitional arrangements in place for reports that are required to be approved before the start of the 2018/19 financial year. The Department of Communities and Local Government (DCLG) and CIPFA wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. It is understood that DCLG will be revising its Investment Guidance (and its MRP guidance) for local authorities in England; however there have been no discussions with the devolved administrations including Wales yet.

Local Context

On 31st March 2017, the Authority had net borrowing of £84.9m arising from its revenue and capital income and expenditure. 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 below.

Table 1: Balance Sheet Summary

	31.3.17 Actual £m
Total CFR	134.6
Less: Other debt liabilities *	(1.9)
Borrowing CFR	**132.7**
Less: Usable reserves	(35.0)
Less: Working capital	(12.8)
Net borrowing	**84.9**

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

The Authority'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 30th September 2017 and the change over the period is show in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £m	Movement £m	30.9.17 Balance £m	30.9.17 Rate %
Long-term borrowing Short-term borrowing	70.3 19.0	0.0 16.0	70.3 35.0	3.9% 0.5%
Total borrowing	**89.3**	**16.0**	**105.3**	
Long-term investments Short-term investments including overnight	0.0 4.4	0.0 2.8	0.0 7.2	NA 0.2%
Total investments	**4.4**	**2.8**	**7.2**	
Net borrowing	**84.9**	**13.2**	**98.1**	

Borrowing Strategy during the half year

At 30/9/2017 the Authority held £105.3m of loans, (an increase of £16.0m from 31/3/2017), as part of its strategy for funding current and previous years' capital programmes. The 30th September 2017 borrowing position is show in table 3 below.

Table 3: Borrowing Position

	31.3.17 Balance £m	Movement £m	30.9.17 Balance £m	30.9.17 Weighted average maturity years
Public Works Loan Board Banks (LOBO) WG Loans Local authorities	51.7 13.6 5.0 19.0	0.0 0.0 0.0 16.0	51.7 13.6 5.0 35.0	| 3.9% | 0.5%
Total borrowing	**89.3**	**16.0**	**105.3**	**2.8%**

The Authority'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 Authority's long-term plans change being a secondary objective.

In furtherance of these objectives, for the first half of the year, external borrowing was only taken out when cash levels fell below a manageable level on a day to day basis. When cash was too low, external borrowing was sourced via brokers from other Local Authorities and other similar institutions for a range of maturities from 10 to 365 days. Existing long term loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

The "cost of carry" analysis performed by the Authority's treasury management advisor Arlingclose did not indicate any value in borrowing in advance for future years' planned expenditure and therefore none was taken.

The Authority continues to hold £13.6m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the first half of 2017/18.

Other Debt Activity

Total debt other than borrowing stood at £1.9m on 30th September 2017, taking total gross debt to £107.2m. The most significant elements are the outstanding balances on the Monnow Vale PFI scheme (£0.8m) and Welsh Government Funds held by Monmouthshire CC pending lending onto external parties (£0.7m).

Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the first half of 2017/18 the Authority's investment balance ranged between £3 million and £20 million due to timing differences between income and expenditure. The investment position during the half year is shown in table 4 below.

Table 4: Investment Position

	31.3.17 Balance £m	Movement £m	30.9.17 Balance £m	30.9.17 Weighted average rate %	30.9.17 Weighted average maturity
Banks & building societies (unsecured)	1.0	0.1	1.1	0.26%	1 day
Government (incl. local authorities)	3.4	2.4	5.8	0.10%	1 day
Money Market Funds	0.0	0.3	0.3	0.16%	1 day
Total investments	**4.4**	**2.8**	**7.2**	**0.2%**	

Both the CIPFA Code and government guidance require the Authority 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 Authority'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.

Maximisation of internal borrowing means that only low levels of cash have been available for investment. The cash is mainly held to cover expenditure within the next month so the cash is held very short often in overnight investments. To ensure security and liquidity we have been mainly using strong counterparties such as Barclays, Santander and UK Government and also Money market funds which are diversified and therefore lower risk. The low yields are offset by the savings from the cost of carry.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 5 below. Some Authorities are getting higher returns but that is often due to their higher levels of cash to invest for longer.

Table 5: Arlingclose Investment Benchmarking

	Value Weighted Credit Score	Value Weighted Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	3.43	AA	23%	3	0.11%
30.06.2017	4.95	A+	100%	1	0.25%
30.09.2017	3.72	AA-	32%	2	0.14%
Similar LAs	**4.45**	**AA-**	**59%**	**96**	**0.29%**
All LAs	**4.44**	**AA-**	**64%**	**40**	**1.12%**

*Weighted average maturity

Other Investment Activity

Although not currently classed as treasury management activities and therefore not covered by the CIPFA Code, the Authority also held £46.3m of investments in directly owned properties at the 30th September 2017. This represents an increase of £4.4m from the 31st March 2017 due to our Solar Farm, a 'Land & Buildings' asset becoming operational.
The long held Investment properties generated investment income for the Authority after taking account of direct costs of approximately 1% of asset values. The Solar Farm is expected to return considerably more than this, much higher than the return earned on treasury investments, but reflects the additional risks to the Authority of holding such an investment.

If CIPFA's proposed amendments to the Treasury Management Code are adopted in the revised Code from 2018/19, these will henceforth be included in the expanded definition of "investments".

Performance **Report**

The Authority measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and also its relationship to benchmark interest rates

The Authority held £7.4m of investments at the 30th September 2017. So far this year, these have earned £10,000 of income an average of 0.2% return on investments. This compares favourably with the budget of £8,500 based on an average of £6m of investments earning 0.15%.

If we increase our investment levels to meet the minimum investment levels required by MiFID II, as discussed above then this return could increase by 31st March 2018 but at the cost of additional borrowing. This has not been assumed here.

The Authority's budget for external debt interest was set at £3.1m with an additional £0.55m to cover the borrowing costs for other anticipated capital expenditure. The current forecast for external debt interest for 2017/18 is £2.9m against the budget of £3.1m. The average level of short term and new debt during 2017/18 at budget setting was £39.5m. The forecast average at this point is £34.5m resulting in the £0.2m saving against the main external debt budget. Only limited borrowing has occurred as a result of the other anticipated capital expenditure to date so this budget will also mainly be a saving in 2017/18. The largest variable remains the Future schools programme. These costs will arise in later years, but currently a forecast saving of £0.75m on external debt has been presumed.

Compliance Report

On the 18th April 2017, the balance held in Barclays, the Authority's current account overnight was £7.1m. This exceeds the amount allowed in the Treasury Strategy of £1.0m of total positive balances. The reason was that this was a Council tax & NNDR payment date but a non-working day for the Authority. This was known about in advance but due to the strong state of Barclays bank at that time, this was considered to be an acceptable risk. Other than that, the Head of Finance (S151 Officer) is pleased to report that all treasury management activities undertaken during the first half of 2017/18 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 6 below.

Table 6: Investment Limits per Counterparty

	H1 Maximum £m	30.9.17 Actual £m	2017/18 Limit £m	Complied
Unsecured Investments in institutions with lowest credit rating of A- OR groups of institutions under the same management, except UK Government	2.0	0.85	2.0	✓
Secured Investments as above	**0.0**	**0.0**	**4.0**	✓
Money Market Funds	**2.0**	**0.2**	**2 and 10%**	✓
Local Authorities	**0.0**	**0.0**	**2 or 10%**	
Investments held in a broker's nominee account	**0.0**	**0.0**	**10 or 50%**	✓
Foreign countries	**0.0**	**0.0**	**4.0**	✓
Registered Providers	**0.0**	**0.0**	**2.0**	✓
Non-specified investments	**0.0**	**0.0**	**10.0**	✓
Any other limits specified in the 2017/18 Treasury Strategy				✓

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 7: Debt Limits

	H1 Maximum £m	30.9.17 Actual £m	2017/18 Operational Boundary £m	2017/18 Authorised Limit £m	Complied
Borrowing	105.3	105.3	127.2	147.4	✓
PFI & finance leases	**1.9**	**1.9**	**1.2**	**2.7**	✓ #
Total debt	**107.2**	**107.2**	**128.4**	**150.1**	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Treasury Management Indicators

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

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	30.9.17 Actual	2017/18 Target	Complied
Portfolio average credit rating	AA-	A-	✓

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk. Where cash is forecast to drop below £2m in the following 5 working days, additional short term borrowing should be taken out. Where cash falls below £1m this should be reported to the S151 officer or deputy. In the first 6 months of this year the overnight cash deposits did not fall below £2 million.

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. These are the upper limits on fixed and variable interest rate exposures, expressed as the amount of principal borrowed less the principal Invested:

	30.9.17 Actual	2017/18 Upper Limit	Complied
Fixed interest rate exposure	£51.8m	£100m	✓
Variable interest rate exposure	£41.3m	£58m	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing for 2017/18 were:

	30.9.17 Actual % - £m	Upper Limit %	Lower Limit %	Complied
Under 12 months – LOBO's	28% £14m	50	0	✓
Under 12 months - Other	1% £0.5m			
12 months and within 24 months	3% £2m	25	0	✓
24 months and within 5 years	3% £2m	45	0	✓

5 years and within 10 years	21% £10m	30	0	✓
10 years and above	44% £21m	100	0	✓
Total	100% £48m			

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Authority’s exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2017/18
Actual principal invested beyond year end	£0.0m
Limit on principal invested beyond year end	£5.0m
Complied	✓

Outlook for the remainder of 2017/18

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 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.

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

This decision is still very data dependant and Arlingclose is, for now, maintaining its central case for Bank Rate at 0.25% whilst introducing near-term upside risks to the forecast as shown below. Arlingclose’s central case is for gilt yields to remain broadly stable across the medium term, but there may be near term volatility due to shifts in interest rate expectations.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Official Bank Rate													
Upside risk	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Downside risk	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25