APPENDIX 1

Treasury Management Mid-year Report 2018/19

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* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

The Authority's treasury management strategy for 2018/19 was approved at a meeting on 6th March 2018. 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 is therefore central to the Authority's treasury management strategy.

Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Treasury Management Code of Practice but has yet to publish the local authority specific Guidance Notes to the latter.

The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority will be producing its Capital Strategy later in 2018/19 for approval by full Council.

External Context

Economic background: 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.

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%.

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.

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.

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 just 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: 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 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: 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.

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.

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.

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.

Local Context

On 31st March 2018, the Authority had net borrowing of £111.9m 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

	31.3.18 Actual £m
General Fund CFR	146.1
Less: *Other debt liabilities	-1.9
Borrowing CFR	**144.2**
Less: Usable reserves	-18.2
Less: Working capital	-14.1
Net Borrowing	**111.9**

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

The treasury management position at 30th September 2018 and the change during the period is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.18 Balance £m	**Movement £m**	**30.9.18 Balance £m**	**30.9.18 Rate %**
Long-term borrowing	76.4	3.1	79.5	3.49
Short-term borrowing	52.6	29.1	81.7	0.91
Total borrowing	**129.0**	**32.2**	**161.2**	**2.18**
Long-term investments	0.1	0.0	0.1	0.18
Short-term investments	10.0	-2.0	8.0	0.84
Cash and cash equivalents	7.0	5.8	12.8	0.49
Total investments	**17.1**	**3.8**	**20.9**	**0.62**
Net Borrowing	**111.9**	**28.4**	**140.3**	

Short term borrowing was increased more in year than long term borrowing. This was a policy decision to reduce the overall cost of borrowing required to fund the Authority's 21st Century schools programme. It is expected that further capital receipts coming in over the next few years will replenish cash levels. An independent decision was taken early in this calendar year to hold investment balances above £10m so that the Authority meets the definition of a professional investor under the Mifid II regulations.

Borrowing Strategy during the period

At 30th September 2018 the Authority held £161.2m of loans, (an increase of £32.2m from 31.03.18), as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30th September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	**Q1 Net Movement £m**	**30.9.18 Balance £m**	**30.9.18 Weighted Average Rate %**

Public Works Loan Board	51.7	6.3	58.0	3.92
Banks (LOBO)	13.6	0.0	13.6	4.79
Banks (fixed-term)	0.0	0.0	0.0	-
Local authorities (long-term)	5.9	0.0	5.9	1.12
Local authorities (short-term)	52.6	24.9	77.5	0.67
Interest free loans / Other	5.2	1.1	6.3	-
Total borrowing	**129.0**	**32.2**	**161.2**	**2.18**

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.

With short-term interest rates remaining much lower than long-term rates, the Authority considered it to be more cost effective in the near term to use internal resources or rolling short-term loans instead. The net movement in temporary loans is shown in table 3 above.

As the Authority has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital, the Authority borrowed £11.44m medium/longer-term fixed rate loans, details of which are below, to provide some longer-term certainty and stability to the debt portfolio.

Long-dated Loans	Amount £m	Rate %	Period Years
PWLB Maturity Loan	3.0	2.34	14
PWLB Annuity Loan	2.5	2.55	25
PWLB Annuity Loan	0.4	1.89	8
PWLB Annuity Loan	0.45	1.86	8
PWLB Annuity Loan*	5.09	2.53	25
Total borrowing	**11.44**		

* Loan to be received 01.10.2018 and therefore not included in Table 3 above

The Authority continues to hold £13.6m of LOBO (Lender's Option Borrower's Option) loans, details of which are outlined in Table 3 above. The lender has the option to vary 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. Should a lender raise interest rates above that offered by the PWLB, then Monmouthshire would redeem the LOBO loan and take out PWLB loans of a suitable maturity and type instead. No banks exercised their option during the period.

Other Debt Activity

Total debt other than borrowing stood at £1.9m on 30th September 2018, taking total gross debt to £163.1m. The most significant elements are the outstanding liability brought on balance sheet relating to the Monnow Vale PFI scheme (£0.8m) and Welsh Government Funds held by Monmouthshire CC pending lending onto external parties (£0.7m).

Treasury Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six-month period, the Authority's investment balance increased by £3.7m from £17.1m to £20.8m due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.18 Balance £m	Movement £m	30.9.18 Balance £m	30.9.18 Rate of Return %
Banks & building societies (unsecured)	0.0	6.0	6.0	0.55%
Government (incl. local authorities)	16.1	-6.0	10.1	0.70%
Money Market Funds	1.0	3.7	4.7	0.55%
Total investments	**17.1**	**3.7**	**20.8**	**0.62%**

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 treasury investments before seeking the optimum 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.

Since the introduction of Mifid II in January 2018, balances have risen so some longer term investments achieving higher returns are being used. These have been maintained in investments meeting the criteria as set out in the treasury strategy. It is planned to increase the amount of longer term investments to £8-10m by April 2019 to minimise the net cost of borrowing and investments.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2018	3.1	AA	6%	5	0.26
30.06.2018	4.82	A+	81%	120	0.52
30.09.2018	4.16	AA-	51%	91	0.62
Similar LAs	4.63	A+	62%	121	0.70
All LAs	4.38	AA-	60%	37	1.17

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return.

The Authority holds £45m of investment properties, being mainly agricultural properties and a solar farm. The agricultural properties have been held for a considerable time.

During the reporting period full Council agreed to a £50m 3-year commercial investments strategy creating an investment sub committee to oversee business cases and evaluate and agree such investment opportunities, with the proviso that any funding costs be met in full by the returns on such investments. That Committee has recently completed on its first such investment in the form of procuring Castlegate business park for circa £7.5m afforded by rents, to derive a net income, after borrowing costs, to the Council, with a further £850k capital costs earmarked for landlord improvement works to be recovered through a separate service charge to tenants.

The Investment Committee will also actively monitor the performance/returns of investments made, also making decisions to divest of any poorly performing assets or to allow cashflow to be utilised on potentially higher performing opportunities, such reports being available to the scrutiny function periodically through monitoring reports.

Compliance

The Chief Finance Officer reports that all treasury management activities undertaken during the reporting period complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below:

Table 7: Debt Limits

	Max in period	30.9.18 Actual	2018/19 Operational Boundary	2018/19 Authorised Limit	Complied?
Borrowing	161.2	161.2	161.3	191.5	✓ **
PFI, Finance Lease & other LT liabilities	**1.9**	**1.9**	**1.3**	**2.8**	✓ **
Total debt	**163.1**	**163.1**	**162.6**	**194.3**	✓

** The prudential code states that the operational boundary is a management tool for in-year monitoring and it will probably not be significant if the operational boundary is breached on occasions and this is not counted as a compliance failure.

The increase in other long term liabilities relates to the inclusion of loans from Welsh Government not yet loaned onwards for community benefit before the end of 2017/18.

The high level of Borrowing, which has almost reached the Operational Boundary is mainly due to the Property Investment program and the City deal Funding program progressing more quickly than anticipated in the 2018/19 Capital MTFP and Treasury Strategy together with the higher level of borrowing required in practice to maintain £10m of Investments for Mifid II already mentioned above.

Compliance with specific investment limits is demonstrated in table 8 below.

Table 8: Investment Limits per Counterparty

	Max in period £m	30.9.18 Actual £m	2018/19 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	2.0	2.0	✓
Secured Investments as above	0.0	0.0	4.0	✓
Money Market Funds	2.0	1.0	2 and 10%	✓
Local Authorities	2.0	2.0	2 or 10%	✓
Investments held in a broker's nominee account	5.0	2.0	10 or 50%	✓
Foreign countries	2.0	2.0	4.0	✓
Registered Providers	0.0	0.0	2.0	✓
Non-specified investments	0.0	0.0	11.0	✓

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 A- or 5.0 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.

	30.9.18 Actual	2018/19 Target	Complied?
Portfolio average credit	AA- / 4.16	A- / 5.0	✓

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk. Where cash is forecast to drop below £10m in the following 5 working days, additional short term borrowing should be taken out.

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:

	30.9.18 Actual	2018/19 Limit	Complied?
Upper limit on net fixed interest rate exposure	67.6m	110m	✓
Upper limit on net variable interest rate exposure	71.3m	78m	✓

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 were:

	30.9.18 Actual	Lower Limit	Upper Limit	Complied?
Under 12 months	13.6m	0	50m	✓
12 months and within 24 months	0.0m	0	25m	✓
24 months and within 5 years	14.7m	0	45m	✓
5 years and within 10 years	8.7m	0	30m	✓
10 years and above	24.7m	0	100m	✓

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 365 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:

	2018/19	2019/20	2020/21
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	6m	6m	6m
Complied?	Yes	Yes	Yes

** meaning for longer than 1 year*

Outlook for the remainder of 2018/19

Having raised policy rates in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon.

The MPC has a definite bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that (a) ultra-low interest rates result in other economic problems, and that (b) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise and cuts are required.

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

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.