Sutton

Report to:	Audit Committee	**Date:**	11 January 2018
Report title:	Treasury Management Update - Mid Year 2017/18		
Report from:	Gerald Almeroth - Strategic Director Resources		
Ward/Areas affected:	Borough Wide		
Chair of Committee/Lead Member:	Councillor David Hicks		
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Corporate Plan Priorities:	• A Smart Council		
Open/Exempt:	Open		
Signed:	G. Almeroth	**Date:**	22 December 2017

1. Summary

1.1 This report is the treasury management review for the quarter ended 30 September 2017. It summarises the Council's Treasury Management operations during the first six months of 2017/18. It is presented for the purpose of monitoring and review and meets best practice as suggested by the Treasury Management Code of Practice.

1.2 The Council invested surplus funds when available and complied with the requirements of the Prudential Code. The Council is operating the agreed Treasury Management Strategy for 2017/18.

2. Recommendations

The Audit Committee is recommended to:

2.1 Note the treasury management activity undertaken during the first six months of the year.

2.2 Adopt this report as the mid year treasury management review and recommend that it is reported to Full Council.

3. Background

3.1 The Council approved the Treasury Management Strategy for operation during 2017/18 at its meeting on 6 March 2017. The strategy is carried out under delegated authority and quarterly monitoring reports are brought to this Committee. This is in line with best practice as outlined in the CIPFA Treasury Management Code of Practice.

3.2 The treasury management function covers the borrowing and investment of Council money. This includes both the management of the Council's day-to-day cash position and the management of its long-term debt. All transactions are conducted in accordance with the Council's Treasury Management Policy Statement, which complies with the latest CIPFA Code of Practice. Good treasury management plays an important part in underpinning the Council's sound financial health.

4. Issues

Treasury Management Activity from April to September 2017

Long Term Borrowing.

4.1 Indicator 8 requires that no more than 15% of the debt portfolio should mature in any year. This is to minimise the risk of needing to refinance a large part of the portfolio at one time when interest rates might be unfavourable. There is a planned exception to this in 2042 when the loan to fund the HRA self-financing payment matures. It is intended that an element of the HRA surpluses will be set aside in future years so that the loan can be repaid on maturity without needing to refinance. In light of this, the indicator has been RAG rated as Green despite the exception.

4.2 Under the prudential regime the Council can borrow as required as long as this falls within the 2017/18 Prudential Limits. The Authorised Limit and Operational Boundary are shown in Appendix A. The Council's overall external debt at 30 September 2017 totalled £252.5m of which £227.2m was with the Public Works Loan Board (PWLB) and £25.3m was with individual banks. This falls within the Authorised Limit and Operational Boundary. The average annual interest rate of the Council's long term debt at 30 September 2017 is 3.60%. No new PWLB borrowing was undertaken in the second quarter of 2017/18.

4.3 As part of the Council's longer term borrowing, five Lender Option Borrower Option (LOBO) loans totalling £25m are held with three counterparties. The interest rates on these loans are between 3.49% and 4.55%, if the Lender opts to give notice to increase rates then the Council can choose to redeem them without penalty.

4.4 No new long term borrowing was undertaken in the second quarter of 2017/18. The Council had a £0.25m PWLB loan that matured in September 2017, given that this was a small sum, refinancing was not required.

Temporary borrowing

4.5 The Council set an original temporary borrowing limit of £95.5m for 2017/18. It has not been necessary for the Council to undertake any temporary borrowing during the first six months of 2017/18.

Investments

4.6 During the first six months of the financial year, the Council has had surplus funds available for investment. The amount fluctuates on a day to day basis, as shown in Appendix B where the Council's investment balances are shown.

4.7 The following table shows the breakdown of investments as at the end of September. Colour ratings are explained in paragraph 4.31.

Counterparty	Investment Type	Investment Duration	£'000	Colour Rating	Interest Rate %
Santander	Notice a/c	95 day notice	15,000	Red	0.40
Standard Life (Ignis)	MMF	Instant	8,900	N/A	0.21
Federated	MMF	Instant	8,050	N/A	0.21
Legal and General	MMF	Instant	3,750	N/A	0.21
Municipal Bond Agency	Shares	Open	100	N/A	N/A
Total			**35,800**		

4.8 The average level of funds available for investment purposes in the first six months of 2017/18 was £34m. These funds were available on a temporary basis, with the in year fluctuation of this amount largely dependent on the timing of payments, receipt of council tax and grants and progress of the capital programme. Interest earned during that period on these deposits totalled £0.03m and represented a weighted average interest rate earned by the Council of 0.34%. This is very low given the prevailing market conditions, however, this compares favourably with the average of the 7 day and 3 month LIBID (London Interbank Bid Rate) figure of 0.15%.

4.9 During the first six months of 2017/18 the Council continued to make use of Money Market Funds (MMFs) to manage liquidity risk. A 95 day notice account with Santander has also been in use, however from June 2017 the rate on this account dropped from 0.65% to 0.40%.

Current Investment Strategy & Revisions for 2018/19

4.10 The Council continues to ensure that cash balances are utilised to the maximum advantage for the Council. Given the very low level of interest available on invested balances this involves using cash balances to replace planned external borrowing to support the capital programme and keeping cash balances to a minimum level. This strategy is planned to continue into 2018/19. However the only revision is that a minimum level of investments of £10m is required for the Council to maintain its ‘opted up’ professional status under the new MIFID II arrangements due to begin on 3 January 2018 as outlined below.

Proposed changes to Prudential Code and Minimum Revenue Provision

4.11 During 2017 CIPFA has consulted on changes to the Prudential Code which 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.

4.12 Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in property to be included in the definition of “investments” as well as loans made or shares bought for service purposes. Another proposed change is the inclusion of financial guarantees as instruments requiring risk management and 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.

4.13 CIPFA intended to publish the two revised Codes towards the end of 2017 for implementation in 2018/19, however at the point of dispatching this report this has not been achieved. 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.

4.14 In addition in November 2017 the Department of Communities and Local Government (DCLG) released a consultation on revisions to the Local Authorities Investment Code and guidance for the Minimum Revenue Provision. The closing date for this consultation is 22 December 2017 and the Council has submitted a response including setting out it’s key concerns. The main changes being proposed in this document that may affect the Council are the classification of investments in commercial property as ‘borrowing in advance of need’ and the reduction of the maximum life that can be applied to building assets as part of the Minimum Revenue Provision (MRP) calculation from 50 years to 40.

4.15 The overall intention behind the revisions to the Prudential Code, Treasury Management Code, Investment and Minimum Revenue Provision guidance is currently unclear. Taken together the result is that local authorities will not be able to borrow for in order to invest in yield bearing opportunities since this would be considered as borrowing in advance of need. However looking individually at the investment guidance produced by the DCLG it suggests that this is still allowed but will require a greater disclosure of information particularly around the scale of activity undertaken and risk management arrangements in place to mitigate against the impact any adverse outcomes on the revenue budget. Clarification has been requested as part of the Council response to the consultation.

4.16 The reduction in the maximum asset life that can be applied to building assets will effectively mean that a higher annual sum will need to be provided for the minimum revenue provision for the repayment of debt as it will be spread over a maximum of 40 years instead of 50. This could affect the viability of future invest to save projects that relate to expenditure on buildings. A bigger impact would result from the Council having to adjust the MRP retrospectively which does not seem to be the case, but this is one of the issues being raised in the consultation response.

Municipal Bond Agency

4.17 During the first and second investment phases in the Municipal Bonds Agency (MBA), the Council has purchased a total of 100,000 subscription shares at a cost of £1 per share, representing a total investment of £100,000.

4.18 On 8 December 2016 the Committee endorsed the detail contained within the local authority financing framework agreement issued by the agency. This sets out the terms for loans from the MBA to local authorities.

4.19 The MBA is currently preparing for its first bond issue with a small cohort of councils and a total borrowing requirement of approximately £100m. In order to ensure that the agency receives a strong rating from the rating agencies it is important that they can demonstrate a flow of future issues. Following a request from the agency, officers have confirmed the estimated borrowing requirement of the Council for 2017/18 and 2018/19 and the intention to consider using the MBA as a source of financing if the pricing meets the Council’s expectations. In practice once a need to borrow arises, officers will make a decision on the source of that borrowing based on the options available and the full details of those options.

MiFID II

4.20 The Markets in Financial Instruments Directive (MiFID) refers to EU legislation that regulates firms who provide services to clients linked to financial instruments, and the venues where those instruments are traded. MiFID was applied in the UK from November 2007, but is now being revised to improve the functioning of financial markets in light of the 2008-2011 financial crisis and to strengthen investor protection. The changes are set to take effect from 3 January 2018, with the new legislation being known as MiFID II.

4.21 The implementation of MiFID II will result in all Local Authorities being classed as “retail” counterparties with the option to request to opt up to ”professional” status subject to meeting qualitative and quantitative criteria.

4.22 The qualitative criteria will be set by the counterparty that the Council is looking to trade with and the expectation is that this will be tailored to the product(s) the Council is looking to use.

4.23 The quantitative criteria is made up as follows:

- a Local Authority has to have an investment portfolio of at least £10m. It is understood that this is at the point of requesting to opt up rather than, at say, balance sheet date, and either;
- 10 transactions per quarter in a relevant market in past 4 quarters;
- Or; at least 1yr experience in professional position in financial markets which requires knowledge of transactions or services envisaged.

4.24 As at the end of September the Council had £15m in term deposits and £20.7m in Money Market Funds.

4.25 Term deposits are not covered by MiFID II. Therefore, out of the current investment portfolio, Money Market Funds would be the main financial instruments used by the authority which would require it to opt up to "professional" status to continue to have access to the selection of funds it has now.

4.26 The 2017/18 Treasury Management Strategy also permits use of investment in Certificates of Deposit and Bond Funds which would also require the Authority to opt up to "professional" status to use such instruments.

4.27 Over the past few months the Council has been completing the required documentation to be able to make opt-up applications with its treasury management advisor and all of the money market funds and brokers it uses. All completed applications were submitted by the end of the first week in December.

<u>Treasury Management Advisor</u>

4.28 At the start of November the Council's current treasury management advisor, Capita Asset Services, announced that it had changed its name to Link Asset Services following the acquisition of Capita Asset Services, formerly part of Capita plc, by Link Group.

4.29 The Council's contract with Link Asset Services ends on 31 March 2018. A joint procurement exercise will be carried out by the new Sutton and Kingston shared finance service over the next few months to establish a new joint contract for treasury management advice, which will take effect from the start of April 2018.

<u>Treasury Management Strategy</u>

4.30 The Council receives regular briefings from Link Asset Services on the economic outlook for the UK and other key economies. These are used to inform treasury management decisions relating to future investment and borrowing strategies.

4.31 Growth in 2017 has been weak, largely due to a sharp increase in inflation, caused by the devaluation of sterling after the EU referendum. A reduction in consumer disposable income also caused weak growth in the services sector. However, more recently the manufacturing sector is seeing stronger growth, mainly as a result of increased demand for exports. Inflation came in at 3.0% in both September and October 2017.

4.32 At its 2 November meeting, the Monetary Policy Committee (MPC) delivered a 0.25% increase in the bank rate. They expect to increase the rate only twice more in the next three years to reach 1.0% by 2020. Previous statements indicated the rate would only go up very gradually and to a limited extent. However, some forecasters are now expecting growth to accelerate into 2018, primarily due to the coming fall in inflation.

4.33 Economic growth in the eurozone had been lacklustre for several years after the financial crisis, however, growth picked up in 2016 and has now gathered strength. Despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in October inflation was 1.4%. Growth in the American economy has continued to be erratic during 2017 and inflationary pressures in general have been building. The Fed has has increased its central rate three times since December 2016.

4.34 The overall balance of risks to economic recovery in the UK is currently to the downside but huge variables over the coming few years include what final form Brexit will take, when finally agreed with the EU, and when. The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit. When the Chancellor of the Exchequer, delivered his second budget speech of 2017 on 22nd November, GDP growth forecasts were revised downwards, partly due to lower productivity growth. CPI inflation is now expected to peak at just over 3%, before falling back to near its target rate of 2% by the end of 2018.

4.35 Volatility in bond yields is likely to endure, as investor fears and confidence ebb and flow between favouring relatively more “risky” assets i.e. equities, or the “safe haven” of government bonds. The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. A world economic recovery will likely see investors switching from the safe haven of bonds to equities.

4.36 The Council continues to utilise Link Asset Services’ creditworthiness methodology, with the following individual investment limits assigned to individual counterparties according to a colour coding system.

- Yellow (AAA rated Government debt or its equivalent) up to 5 years;
- Purple £20m, up to 2 years;
- Blue £20m, up to 1 year (only applies to nationalised or semi nationalised UK banks);
- Orange £17.5m, up to 1 year;
- Red £15m, up to 6 months;
- Green £12.5m up to 100 days;
- No colour - not to be used.

Interest rates

4.37 The bank base rate at the start of the year was 0.25% and it remained unchanged until 2 November 2017 when the Monetary Policy Committee increased it to 0.50%. The MPC also gave forward guidance that they expect to increase the bank rate twice more in the next three years to reach 1.0% by 2020. Link Asset Services' forecast is that the increase will be 0.25% in December 2018, 0.25% in December 2019 and a further increase of 0.25% in September 2020.

Heritable Bank

4.38 In August 2015 the Council received the fifteenth instalment of the recovery of the £5.5m funds invested with Heritable Bank. Total funds recovered stands at just over £5.4m, representing around 98p in the pound. It is still not clear whether this is a final dividend. The administrators have retained a reserve to provide for legal costs and expenses until the conclusion of the administration. They do not intend to make further distributions to unsecured creditors until all outcomes are fully known.The Council has initiated a claim against Landisbanki, the parent company of Heritable Bank. The claim is dependant on the conclusion of the administration of Heritable, after which no further dividend payments will be made to creditors. If the Council receives any further amounts from Heritable, these will be offset against the subsequent claim against Landisbanki.

5. Options Considered

5.1 Investment and borrowing options are considered as and when appropriate. These are referenced within the main body of the report.

6. Impacts and Implications

Financial

6.1 The financial implications are addressed within the report.

Legal

6.2 There are no legal issues arising from this report.

7. Appendices and Background Documents

Appendix letter	Title
A	Quarter 2 - Performance against Prudential Indicators
B	Council cash available for investment

Background documents
Ernst and Young Progress Report on the Administration of Heritable Bank
Municipal Bond Agency Framework Agreement

Audit Trail		
Version	Final	Date: 22 December 2017
Consultation with other officers		
Finance	Yes	Lyndsey Gamble
Legal	No	N/A
Equality Impact Assessment required?	No	Completed / N/A

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