Rother District Council

Report to	-	Audit and Standards Committee
Date	-	31 July 2019
Report of the	-	Executive Director
Subject	-	Treasury Management Report – Quarter 1

Recommendation: It be **RESOLVED:** That the report be noted.

Corporate Transformation Finance Manager – Catherine Jobling
Assistant Director Resources – Robin Vennard

Introduction

1. Council approved the Council's 2019/20 Investment Strategy in February 2019 (Minute CB18/66 refers). The investment strategy requires regular reports to be presented to this Committee on the Council's treasury management activities. Members are also reminded that investment activity is also reported through the Members' Bulletin. In managing its treasury management activities, the Council follows the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

2. Treasury Management covers two main areas:-

   i. The management of day to day cash flows by way of short term investing and borrowing. Longer term investment opportunities may arise depending on cashflow requirements.
   ii. Management of the Council's long term debt portfolio which is used to finance capital expenditure that cannot be immediately funded by internal resources (e.g. by Capital Receipts).

Economic Update

3. Appendix A is our treasury advisors, Link Asset Services', view on the current economic environment and their outlook for the remainder of 2019/20. It details the impact this is likely to have on the Council's investment performance.

4. The expectation for interest rates within the treasury management strategy for 2019/20 was that rates would rise to 1% in June. The latest forecast from Link Asset services suggests a rise in March 2020.

Investments review

5. The Council currently makes most of its investments through the use of call and deposit accounts with the major financial UK institutions.

6. In addition to this the Council has invested £5 million in the Churches, Charities, Local Authorities' (CCLA) Property Investment Fund and £3 million in the HERMES Property Investment Fund.

7. As at 31 May 2019 the Council's total investments were £25,366,860. There was £12.045m borrowing at 31 May 2019 and the Capital Financing requirement was £17.284m.

8. The Council's investment policy is governed by Ministry of Housing, Communities and Local Governance investment guidance, which has been implemented in the annual investment strategy approved by the Council in February 2019. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

9. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

10. The total income from investments is estimated at £85,270 compared to a profiled budget of £85,000.

11. The average rate of return on investments was 1.67%.

12. The investment portfolio as at 31 May 2019:

Deposit with	**Type of account**	**Maturity Date**	**Amount £**	**Deposit**	**%**
Lloyds (RFB)	Call Account		5,364,120	0.65%	21.15%
Bank of Scotland (RFB)	32 Days notice		1,000,000	0.80%	3.94%
Bank of Scotland (RFB)	Call Account		35	0.65%	0.00%
Barclays (RFB)	Call Account		1,060	0.50%	0.00%
Santander	Call Account		1,647	0.55%	0.01%
Lloyds (RFB)	Deposit	02/07/2019	1,500,000	1.00%	5.91%
Lloyds (RFB)	Deposit	05/07/2019	1,000,000	1.00%	3.94%
Lloyds (RFB)	Deposit	16/08/2019	1,000,000	1.05%	3.94%
Lloyds (RFB)	Deposit	24/04/2020	2,000,000	1.25%	7.88%
Lloyds (RFB)	Deposit	08/05/2020	1,000,000	1.25%	3.94%
Bank of Scotland (RFB)	Deposit	18/09/2019	3,000,000	1.05%	11.83%
Bank of Scotland (RFB)	Deposit	03/02/2020	1,500,000	1.05%	5.91%
HERMES Property Fund	Long Term		2,999,998	3.52%	11.83%
CCLA Local Authority Property Fund	Long Term		5,000,000	4.28%	19.71%
Total			**25,366,860**		100%
Total managed in-house			17,366,862		
Total managed externally			7,999,998		
Total Treasury Investments			**25,366,860**		

Prudential Indicators

13. During the period to 31 May 2019, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities to the period ended 31 May 2019, with comparators, are as follows:

Rother District Council
Capital Expenditure in £ millions

	2019/20 Budget £ (000)	2019/20 Estimated Outturn £'000
General Fund Services	8,967	8,967
Property Investment Strategy	12,238	12,238
Total	21,205	21,205

Capital financing requirement in £ millions

	2019/20 Budget £ (000)	2019/20 Estimated Outturn £'000
CFR	3,650	17,484
Gross borrowing (a)	2,512	12,046
Internal borrowing	1,138	5,438
Investments > 1year	5,000	7,935
Investments under 1 year	17,000	17,432
Total (b)	22,000	25,367
Net Borrowing (a-b)	(19,488)	(13,321)

14. Other prudential and treasury indicators are to be found in the main body of this report. The Chief Finance Officer also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit, the authorised limit, was not breached.

15. The financial year 2019/20 continued the challenging investment environment of previous years, namely low investment returns.

16. The Council undertakes capital expenditure on long-term assets. These activities may either be:

(a) financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or

(b) if insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

17. The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

Capital Expenditure and Financing 2019/20

	2019/20 Budget £ (000)	(Apr - May) Actual £'000
Capital Expenditure	21,205	21,205
Financing		
Capital Receipts	1,930	1,930
Grants and contributions	3,847	3,847
Borrowing	13,758	13,758
Capital Expenditure Charged to Revenue	1,670	1,670
Total Funding	21,205	21,205

Borrowing

18. The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). The figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2019/20 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not been paid for by revenue or other resources.

19. Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, such as the Government, through the Public Works Loan Board (PWLB), or the money markets, or utilising temporary cash resources within the Council.

20. The Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP) to reduce the CFR. This is effectively a repayment of the borrowing need. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

21. The total CFR can also be reduced by:

    - the application of additional capital financing resources, (such as unapplied capital receipts);or
    - charging more than the statutory revenue charge (MRP) each year through Voluntary Revenue Provision (VRP).

22. The Council's 2019/20 MRP Policy, (as required by MHCLG Guidance), was approved as part of the Treasury Management Strategy Report for 2019/20 in February 2019.

23. The Council's CFR for the year is shown below:

CFR

	2019/20 Budget £ (000)	2019/20 Estimated Outturn £'000
Opening balance	3,650	3,756
Add unfinanced capital expenditure	16,136	13,758
Less MRP/VRP	(156)	(30)
Closing balance	19,630	17,484

24. Borrowing activity is constrained by prudential indicators for gross borrowing and the CFR, and by the authorised limit.

25. The authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2019/20 the Council plans to maintain gross borrowing within its authorised limit.

Treasury Indicators	2019/20 Budget £'000	(Apr - May)* Actual £'000
Authorised limit for external debt	20,000	57,400
Operational boundary for external debt	10,000	52,000
Gross external debt	12,488	12,046
Investments		25,367
Net borrowing		(13,321)

26. The operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the authorised limit not being breached.

27. The actual financing costs as a proportion of net revenue stream identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream.

Prudential indicators	2019/20 Budget £'000	2019/20 Estimated Outturn £'000
Capital expenditure charged to the general fund	1,670	1,670
Capital Financing Requirement (CFR)	19,630	17,484
Annual change in CFR	15,980	13,728
In year borrowing requirements	12,488	12,046
Ratio of financing costs to net revenue stream %	2.50%	2.59%

28. During 2018/19, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

29. The Council's treasury management debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting, detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the 31 May 2019 the Council's treasury borrowing position was as follows:

Borrowing position as at 31 May 2019					
PWLB Ref:	**Amount o/s**	**Interest rate**	**Term**	**Type**	**Repayments**
507499	447,776.00	2.59%	50	Annuity	16102.16
507503	447,770.00	2.58%	50	Annuity	16070.34
509130	1,650,000.00	2.39%	50	Annuity	56729.24
509131	1,000,000.00	2.24%	50	Maturity	22,400.00
509165	8,500,000.00	2.48%	50	Annuity	297571.66
Total Borrowing	12,045,546.00	2.46%			408,873.40

30. The maturity structure of the debt portfolio was as follows:

Maturity structure of fixed rate borrowing		**(Apr - May)* Actual £'000**
Under 12 months		66
12 months to 2 years		234
2 years to 5 years		373
5 years to 10 years		686
10 years to 20 years *1		1,653
20 years to 30 years *1		2,114
30 years to 40 years *1		2,704
40 years to 50 years *1		4,215
Upper limit of fixed interest rates based on net debt		100%
Upper limit of variable interest rates based on net debt		50%
Upper limit for principal sums invested over 364 days	10,000	10,000

Non Treasury Investments

31. The Council has invested in regeneration of Rother through its Property Investment Strategy and the expected income from these non Treasury Investments is estimated as follows.

Property	2019/20 Estimated Property Investment Income Income Property Investment Strategy	MRP & interest	Net Income
14 Terminus Road*	106,000	(32,091)	73,909
18-40 Beeching Road*	87,684	(48,435)	39,249
16 Beeching Road*	97,000	(48,435)	48,565
Glovers House	389,583	(190,133)	199,450
Total	680,267	(319,094)	361,173

* Ground rent included in rental income

Conclusion

32. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Malcolm Johnston
Executive Director

Dr Anthony Leonard
Executive Director

Risk Assessment Statement
There are no direct risks arising from this report. Failure to follow the Council's investment strategy could increase the risk of financial loss

Investment Strategy for 2019/20

Interest Rate Forecasts								
Bank Rate	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Link	0.75%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.25%
Cap Econ	0.75%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	-
5Y PWLB RATE								
Link	1.80%	1.80%	1.90%	2.00%	2.10%	2.20%	2.20%	2.30%
Cap Econ	1.50%	1.60%	1.60%	1.70%	1.80%	2.00%	2.10%	-
10Y PWLB RATE								
Link	2.10%	2.20%	2.30%	2.40%	2.50%	2.50%	2.60%	2.70%
Cap Econ	1.80%	1.80%	1.80%	2.00%	2.10%	2.20%	2.30%	-
25Y PWLB RATE								
Link	2.60%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%
Cap Econ	2.20%	2.20%	2.20%	2.40%	2.50%	2.60%	2.60%	-
50Y PWLB RATE								
Link	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.10%
Cap Econ	2.20%	2.20%	2.20%	2.40%	2.50%	2.60%	2.70%	-

The expectation for interest rates within the treasury management strategy for 2019/20 was that rates would rise to 1% in June. The latest forecast from Link Asset services suggests a rise in March 2020.

Borrowing Strategy for 2019/20

During 2019/20, the Council is expecting to maintain an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Chief Finance Officer therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks.

After taking advice from our Treasury advisors, the Council took advantage of low long term interest rates and locked into 50 year fixed rate borrowing to fund the property investment strategy purchases.

Interest rate forecasts expected only gradual rises in medium and longer term fixed borrowing rates during 2019/20 and the two subsequent financial years. Variable or short-term rates were expected to be the cheaper form of borrowing over the period.

<u>The Economy and Interest Rates</u>

The Economy and Interest Rates

UK. After weak **economic growth** of only 0.2% in quarter one of 2018, growth picked up to 0.4% in quarter two and to a particularly strong 0.7% in quarter three, before cooling off to 0.2% in the final quarter. Given all the uncertainties over Brexit, this weak growth in the final quarter was as to be expected. Subsequently, the date for the UK leaving the EU has been put back to 31 October 2019 and although quarter one growth in 2019 came in at 0.5%, this performance was due in many areas to stockpiling ahead of the original 31 March 2019 exit day, and the economy is therefore expected to cool in quarter two 2019.

The annual growth in quarter one 2019 came in at 1.8% year on year, generally in line with the Bank of England's estimate of trend growth for the UK.

After the Monetary Policy Committee (MPC) raised **Bank Rate** from 0.5% to 0.75% in August 2018, it is little surprise that they have abstained from any further increases since then. We are unlikely to see any further action from the MPC until the uncertainties over Brexit clear. If there were a disorderly exit, it is likely that Bank Rate would be cut to support growth. Nevertheless, the MPC has been having increasing concerns over the trend in **wage inflation** which peaked at a new post financial crisis high of 3.5%, (excluding bonuses), in the three months to December before falling only marginally to 3.4% in the three months to January. British employers ramped up their hiring at the fastest pace in more than three years in the three months to January, as the country's labour market defied the broader weakness in the overall economy as Brexit approached. The number of people in work surged by 222,000, helping to push down the unemployment rate to 3.9 percent, its lowest rate since 1975. Correspondingly, the total level of vacancies has risen to new highs.

As for **Consumer Price Index** (**CPI) inflation** itself, this has been on a falling trend since peaking at 3.1% in November 2017, reaching a new low of 1.8% in January 2019 before rising marginally to 1.9% in February. However, in the February and May 2019 Bank of England Inflation Reports, the forecast for inflation over both the two and three year time horizons remained marginally above the MPC's target of 2%.

The rise in wage inflation and fall in CPI inflation is good news for consumers as their spending power is improving in this scenario as the difference between the two figures is now around 1.5%, i.e. a real terms increase, albeit the distribution of wage increases is broadly spread with those changing jobs enjoying significantly higher wage increases than the norm. 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.

Brexit. The Conservative minority government was unable to muster a majority in the Commons over its Brexit deal and the Prime Minister, Theresa May, subsequently resigned in June 2019. The EU continues to wait for the House of Commons to propose what form of Brexit it would support. At the time of writing, a Conservative leadership election process has been initiated and this will directly impact future Brexit negotiations throughout 2019/20. However, it still appears unlikely that there would be a Commons majority which would support a disorderly Brexit or revoking Article 50, (cancelling Brexit). There would also need to be a long delay if there is no majority for any form of Brexit. If that were to happen, then it increases the chances of a general election in 2019; this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a (temporary) boost in consumption which generated an upturn in the strong rate of growth; this rose from 2.2%, (annualised rate) in quarter one of 2018 to 4.2% in quarter two, 3.5% in quarter three and then back to 2.2% in quarter four. The annual rate came in at 2.9% for 2018, just below President Trump's target of 3% growth. The strong growth in employment numbers has fed through to an upturn in wage inflation which hit 3.4% in February, a decade high point. However, CPI inflation overall fell to 1.5% in February, a two and a half year low, and looks to be likely to stay around that number in 2019, i.e. below the Fed's target of 2%. The Fed increased rates another 0.25% in December to between 2.25% and 2.50%, this being the fourth increase in 2018 and the ninth in the upward swing cycle. However, the Fed now appears to be heading towards a change of direction and admitting there may be a need to switch to taking action to cut rates over the next two years.

EUROZONE (EZ). The European Central Bank (ECB) provided massive monetary stimulus in 2016 and 2017 to encourage growth in the EZ and that produced strong annual growth in 2017 of 2.3%. However, since then the ECB has been reducing its monetary stimulus measures and growth has been weakening - to 0.4% in quarters one and two of 2018, and then slowed further to 0.2% in quarters three and four; it is likely to remain weak in 2019. The annual rate of growth for 2018 was 1.8% but is expected to fall to possibly around half that rate in 2019. The ECB completely ended its programme of quantitative easing purchases of debt in December 2018, which means that the central banks in the US, UK and EU have all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in growth, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), prompted the ECB to take new measures to stimulate growth. With its refinancing rate already at 0.0% and the deposit rate at -0.4%, it has probably reached the limit of cutting rates. At its March 2019 meeting it said that it expects to leave interest rates at their present levels "at least through the end of 2019" (subsequently increased to June 2020), but that is of little help to boosting growth in the near term. Consequently, it also announced a third round of targeted longer-tern refinancing operations (TLTRO); this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank is making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank's eligible loans.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

JAPAN - has been struggling to stimulate consistent significant gross domestic product growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

WORLD GROWTH. Equity markets are currently concerned about the synchronised general weakening of growth in the major economies of the world: they fear there could even be a recession looming up in the US, though this fear is probably overdone. It is evident that monetary policy in all the developed economies is going to remain loose for the time being and that any uplift in UK rates will be very much constrained by what is happening in the global economy, as well as domestic factors.