Hackney

Treasury Management Update Report

AUDIT COMMITTEE MEETING DATE 2018/19 **15 October 2018**	**CLASSIFICATION:** **Open**
WARD(S) AFFECTED **All Wards**	
Ian Williams, Group Director Finance and Corporate Resources	

1. INTRODUCTION AND PURPOSE

1.1 This report, at Appendix 1, introduces the treasury management outturn report and the actual prudential indicators for 2017/18 for the Audit Committee setting out the background for treasury management activity over the year and confirming compliance with treasury limits and prudential indicators.

1.2 It goes on in Appendix 2 to provide an update on treasury management activity for period June 18 to September 18 of 2018/19.

2. RECOMMENDATION(S)

The Audit Committee is recommended to:

- Note the report

3. BACKGROUND

3.1 Policy Context

Treasury management and ensuring that the function is governed effectively means that it is essential for those charged with governance to review the operations of treasury management on a regular basis. This report sets out the prior year's outturn and forms part of the regular reporting cycle for Audit Committee along with the second of the in-year updates for the current financial year covering period from June 18 to September 18.

3.2 Equality Impact Assessment

There are no equality impact issues arising from this report.

3.3 Sustainability

There are no sustainability issues arising from this report.

3.4 Consultations

No consultations are required in respect of this report.

3.5 Risk Assessment

There are no risks arising from this report as it reports on past events. Clearly though the treasury management function is a significant area of potential risk for the Council if the function were not properly carried out and monitored by those charged with responsibility for oversight. Regular reporting on treasury management ensures that the Committee is kept informed.

4. COMMENTS OF THE GROUP DIRECTOR OF FINANCE AND CORPORATE RESOURCES

There are no direct financial consequences arising from this report as it reflects past performance through 2017/18 and for period from June 18 to September 18. The information contained in this report will assist Members of this Committee in monitoring the treasury management activities and enable better understanding of such operations.

5. COMMENTS OF THE DIRECTOR OF LEGAL

5.1 The Accounts and Audit Regulations 2015 place obligations on the Council to ensure that its financial management is adequate and effective and that it has a sound system of internal control which includes arrangements for management of risk. In addition, the Council within its Annual Treasury Management Strategy has agreed to comply with the CIPFA Code of Practice on Treasury Management. This report demonstrates that Treasury Management is meeting these requirements and adapting to changes as they arise.

5.2 There are no immediate legal implications arising from the report.

6. BACKGROUND PAPERS

6.1 The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that authorities report on the performance of the treasury management function at least twice a year (mid-year and at year end).

6.2 The Authority's Treasury Management Strategy for 2017/18 was approved by full Council on 1st March 2017 which can be accessed on the Council website:

http://mginternet.hackney.gov.uk/documents/s53578/Appendix4201718%2027022017%20Cabinet.pdf

6.3 The Authority's Treasury Management Strategy for 2018/19 was approved by full Council on 21st February 2018 which can be accessed on the Council website:

http://mginternet.hackney.gov.uk/documents/s59421/Appendix3TreasurymanagementStrategy.pdf

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APPENDIX 1: Annual Treasury Management Outturn Report 2017/18

1. External Context

1.1 **Economic background:** 2017-18 was characterised by the push-pull from expectations of tapering of Quantitative Easing (QE) and the potential for increased policy rates in the US and Europe and from geopolitical tensions, which also had an impact.

The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in calendar 2017, the same level as in 2016. This was a far better outcome than the majority of forecasts following the EU Referendum in June 2016, but it also reflected the international growth momentum generated by the increasingly buoyant US economy and the re-emergence of the Eurozone economies.

The inflationary impact of rising import prices, a consequence of the fall in sterling associated with the EU referendum result, resulted in year-on-year CPI rising to 3.1% in November 2017 before falling back to 2.7% in February 2018. Consumers felt the squeeze as real average earnings growth, i.e. after inflation, turned negative before slowly recovering. The labour market showed resilience as the unemployment rate fell back to 4.3% in January 2018.

The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 0.25% in November 2017. It was significant in that it was the first rate hike in ten years, although in essence the MPC reversed its August 2016 cut following the referendum result. The February Inflation Report indicated the MPC was keen to return inflation to the 2% target over a more conventional (18-24 month) horizon with 'gradual' and 'limited' policy tightening. Although in March two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates, the minutes of the meeting suggested that an increase in May 2018 was highly likely.

In contrast, economic activity in the Eurozone gained momentum and although the European Central Bank removed reference to an 'easing bias' in its market communications and had yet to confirm its QE intention when asset purchases end in September 2018, the central bank appeared some way off normalising interest rates. The US economy grew steadily and, with its policy objectives of price stability and maximising employment remaining on track, the Federal Reserve Open Market Committee (FOMC) increased interest rates in December 2017 by 0.25% and again in March, raising the policy rate target range to 1.50% - 1.75%. The Fed is expected to deliver two more increases in 2018 and a further two in 2019. However, the imposition of tariffs on a broadening range of goods initiated by the US, which has led to retaliation by China, could escalate into a deep-rooted trade war having broader economic consequences including inflation rising rapidly, warranting more interest rate hikes.

1.2 **Financial markets:** The increase in Bank Rate resulted in higher money markets rates: 1-month, 3-month and 12-month LIBID rates averaged 0.32%, 0.39% and 0.69% and at 31st March 2018 were 0.43%, 0.72% and 1.12% respectively.

Gilt yields displayed significant volatility over the twelve-month period with the change in sentiment in the Bank of England's outlook for interest rates. The yield on the 5-year gilts which had fallen to 0.35% in mid-June rose to 1.65% by the end of March. 10-year gilt yields also rose from their lows of 0.93% in June to 1.65% by mid-February before falling back to 1.35% at year-end. 20-year gilt yields followed an even more erratic path with lows of 1.62% in June, and highs of 2.03% in February, only to plummet back down to 1.70% by the end of the financial year.

The FTSE 100 had a strong finish to calendar 2017, reaching yet another record high of 7688, before plummeting below 7000 at the beginning of 2018 in the global equity correction and sell-off.

1.3 **Credit background:** In the first quarter of the financial year, UK bank credit default swaps reached three-year lows on the announcement that the Funding for Lending Scheme, which gave banks access to cheaper funding, was being extended to 2018. For the rest of the year, CDS prices remained broadly flat.

The rules for UK banks' ring-fencing were finalised by the Prudential Regulation Authority and banks began the complex implementation process ahead of the statutory deadline of 1st January 2019. As there was some uncertainty surrounding which banking entities the Authority would still be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non-ring-fenced entities would actually look like, in May 2017 Arlingclose , treasury management advisors, advised adjusting downwards the maturity limit for unsecured investments to a maximum of 6 months. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non-ring-fenced bank.

2 The Borrowing Requirement and Debt Management

2.1 The Council currently had one £3.2m LEEF (London Energy Efficient Fund) loan from the European Investment Bank to fund housing regeneration. This loan is below market rate and was taken out in July 2014.

2.2 The LEEF loan is an EIP (Equal Instalment of Principle) loan where each payment includes an equal amount in respect of loan principle throughout the duration of the loan. Therefore the interest due with each payment reduces as the principle is eroded, and so the total amount reduces with each instalment. Consequently, part of the loan is short term in duration, the amount which will be paid via instalments within one year with the remainder of loan maturing beyond 1 year (long term).

2.3 In addition, the Council borrowed £30m as short term borrowing from local authorities for day to day cash management.

Table 1: Capital Financing Requirement (CFR) & Total External Debt

	Balance as at 31/03/17 £'000	**New Borrowing £'000**	**Debt Maturing £'000**	**Debt Repaid £'000**	**Balance as at 31/03/18 £'000**	**Average Rate %**
CFR	328,968				398,854	
Short Term Borrowing *	85,400	30,000		85,000	30,400	0.85%
Long Term Borrowing	3,200	-	400	-	2,800	1.9%
TOTAL BORROWING	**88,600**	**30,000**	**400**	**85,000**	**33,200**	
Other Long Term Liabilities	15,188	-	-	-	14,822	
TOTAL EXTERNAL DEBT	**103,788**	-	-	0	**48,022**	

2.4 The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31/03/2018 was £398.854m.

2.5 Internal Borrowing - Given the significant cuts to local government funding putting pressure on Council finances, the strategy followed was to minimise debt interest payments without compromising the longer-term stability of the portfolio. The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding capital expenditure where other resources are not available. This has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. Whilst this net position is expected to continue in 2018/19, it is not likely to be sustainable over the medium to longer term as demands from the capital programme continues to grow.

3. Investment Activity

3.1 MHCLG's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield.

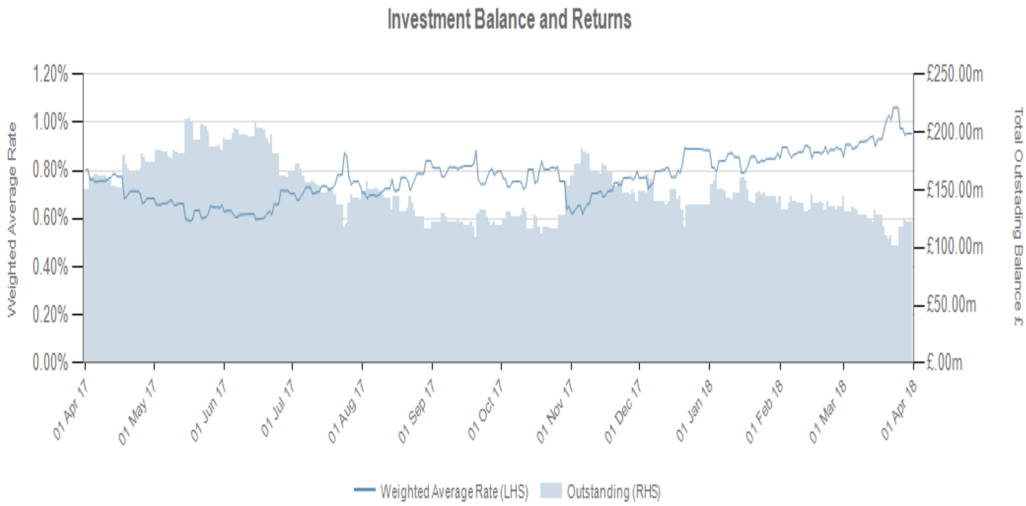
3.2 Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2017/18 Investments during the year included:

- Deposits with other Local Authorities
- Investments in AAA-rated Constant Net Asset Value Money Market Funds
- Investments in AAA-rated Variable Net Asset Value Cash Enhanced Money Market Funds
- Call accounts, deposits, Certificate of Deposits and Covered Bonds with Banks and Housing Associations.
- High quality Bank, Corporate and Covered bonds.

Table 2: Investment Balances

Investments	**Balance as at 31/03/17 £'000**	**Average Rate %**	**Balance as at 31/03/18 £'000**	**Average Rate %**
Short Term Investments	43,104		51,211	
Long Term Investments	31,500		6,500	
Covered Bonds	7,874		0	
Corporate Bonds	12,125		10,563	
Housing Associations	15,000		25,000	
Investments in VNAV MMF's (Money Market Funds)	3,000		3,000	
Investments in CNAV MMF's (Money Market Funds)	36,660		25,350	
TOTAL INVESTMENTS	**149,263**	**0.81**	**121,624**	**0.95**

3.3 The Council's investment balance reduced by £28m to £121,624m at the end of the financial year with weighted average rate (investment return) of 0.95%. The Council is forecasting a further downward trend in cash balances as the Council progresses a number of major capital schemes requiring forward funding. The movement of cash balances (thick grey block) and yield (thin blue line) throughout the year is represented in the graph below:



3.4 Credit Risk- Counterparty credit quality was assessed and monitored with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for the 2017/18 treasury strategy was BBB-across rating agencies Fitch, S&P and Moody's.

Table 3: Credit Score Analysis

Date	Value Weighted Average Credit Risk Score	Value Weighted Average Credit Rating	Time Weighted Average Credit Risk Score	Time Weighted Average Credit Rating
31/03/2017	4.05	AA-	3.64	AA-
30/06/2017	4.30	AA-	3.6	AA-
30/09/2017	4.55	A+	4.11	AA-
31/12/2017	4.69	A+	4.47	AA-
31/03/2018	4.77	A+	4.49	AA-

Scoring: - Aim = AA- or higher credit rating, with a score of 4 or lower, to reflect current investment approach with main focus on security
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 15

3.5 Liquidity - In keeping with the MHCLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds/overnight deposits/call accounts.

3.6 Yield - The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate changed from 0.25% to 0.50% in November 2017.

4. Compliance

4.1 The Council can confirm that it has complied with its Prudential Indicators for 2017/18, which were approved on 1st March 2017 as part of the Council's Treasury Management Strategy Statement.

4.2 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2017/18. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

4.3 The Authority can confirm that during 2017/18 it complied with its Treasury Management Policy Statement and Treasury Management Practices.

5. Prudential Indicators

5.1 Capital Financing Requirement (CFR)

The Council's cumulative maximum external borrowing requirement for 2015/16 to 2017/18 are shown in the table below. The estimates for the 2018/19 are currently being reworked, in conjunction with the first review of the authority's capital programme and financing.

	31/03/16 Actual £'000	**31/03/17 Actual £'000**	**31/03/18 Actual £'000**	**31/03/19 Estimated £'000**
Gross CFR	227,688	328,968	398,854	543,217
Less: Other Long Term Liabilities	16,850	15,188	14,822	14,112
Borrowing CFR	**210,838**	**313,780**	**384,032**	**529,105**
Less: Existing Profile of Borrowing	9,000	88,600	33,086	30,000
Gross Borrowing Requirement/Internal Borrowing	**201,838**	**225,180**	**350,946**	**499,105**
Usable Reserves	294,841	255,474	295,064	240,000
Net Borrowing Requirement/(Investment Capacity)	**(93,003)**	**(30,294)**	**55,882**	**259,105**

In the Prudential Code Amendment (November 2012), it states that the Chief Finance Officer should make arrangements for monitoring with respect to gross debt and the capital financing requirement such that any deviation is reported to him/her, since any such deviation may be significant and should lead to further investigation and action as appropriate.

	2015/16 Actual £'000	2016/17 Actual £'000	2017/18 Actual £'000	2018/19 Estimate £'000
Gross Debt	25,850	103,788	47,908	44,112
CFR	227,688	328,968	398,854	543,217
Borrowed in excess of CFR? (Y/N)	N	N	N	N

5.2 Prudential Indicator Compliance

(a) Authorised Limit and Operational Boundary for External Debt

- The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached.

- The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit.

- The Group Director of Finance and Corporate Resources confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year.

	Operational Boundary (Approved) as at 31/03/18 £'000	Authorised Limit (Approved) as at 31/03/18 £'000	Actual External Debt as at 31/03/18 £'000
Borrowing	459,873	489,873	33,086
Other Long-term Liabilities	18,000	17,000	14,822
Total	**477,873**	**506,873**	**47,908**

(b) Capital Expenditure

This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits, and, in particular, to consider the impact on Council tax and in the case of the HRA, housing rent levels. The three year capital programme is being re-profiled and reviewed at the time of this report being prepared. An aggregate annual capital spend of £300m is a sensible benchmark based on the last two years of spend, and known plans.

	2016/17 Actual £000	2017/18 Actual £000	2018/19 Estimate £000	2019/20 Estimate £000	2020/21 Estimate £000
Capital Expenditure					
Housing	107,990	144,109	170,000	170,000	170,000
Non-Housing	160,009	127,006	130,000	130,000	130,000
Total spend	**267,999**	**271,115**	**300,000**	**300,000**	**300,000**

Capital expenditure has been and will be financed or funded as follows:

Capital Financing	2016/17 Actual £000	2017/18 Actual £000	2018/19 Estimate £000	2019/20 Estimate £000	2020/21 Estimate £000
Prudential Borrowing	107,518	69,794	147,000	87,000	87,000
S106/CIL	3,620	23,746	20,000	20,000	20,000
Capital receipts	80,212	92,952	40,000	100,000	100,000
Grants	25,388	26,033	30,000	30,000	30,000
Reserves	15,415	5,726	10,000	10,000	30,000
RCCO	35,846	52,864	53,000	53,000	53,000
Total Financing	**267,999**	**271,115**	**300,00**	**300,000**	**300,000**

The table shows that the capital expenditure plans of the Authority could not be funded entirely from sources other than borrowing.

(c) Ratio of Financing Costs to Net Revenue Stream

- This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs.
- The ratio is based on costs net of investment income.
- As mentioned above there is a reworking of the capital financing requirement in train currently, which also drives this indicator and hence 2018/19 and 2019/20 figures will be updated at a point after the date this report is being discussed.

Ratio of Financing Costs to Net Revenue Stream	2016/17 Actual	2017/18 Actual	2018/19 Estimate	2019/20 Estimate
Non-HRA	1.7%	1.2%	1.8%	2.4%
HRA	2.3%	2.1%	2.7%	3.5%

(d) **Adoption of the CIPFA Treasury Management Code**

This indicator demonstrates that the Authority adopted the principles of best practice via approval of the CIPFA Treasury Management Code

(e) **HRA Limit on Indebtedness**

HRA Limit on Indebtedness	2016/17 Approved £m	2016/17 Actual £m	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m
HRA CFR	106.118	100.080	100.080	160.080	202.000
HRA Debt Cap (as prescribed by CLG)	178.353	178.353	178.353	178.353	178.353
Difference - Additional Borrowing Capacity for the HRA	72.235	78.273	78.273	18.273	(23.65)

The Group Director, Finance and Corporate Resources confirms that the Council's HRA Capital Financing Requirement did not exceed the HRA Debt Cap in 2017/18 and measures will be taken to ensure that the projected breach in 2019/20 is rectified through financing decisions or a restriction on the overall HRA related capital programme. At the time of writing this report, the Government announced its intention to scrap the HRA debt cap although details of when this will take effect are awaited.

Appendix 2 – Quarterly Treasury Management Update Report

Treasury Management Activities from July to September 2018

1. Economic Highlights

1.1 **Growth:** According to the third estimate of Q2 GDP released by the ONS, the UK economy expanded by 0.4% over the quarter unrevised from the first quarterly estimate of GDP and 1.2% year-on-year.

1.2 **Inflation:** The Consumer Price Index including owner occupiers housing costs (CPIH) 12-month rate was 2.4% in August 2018, an increase from 2.3% July 2018. The Consumer Prices Index (CPI) 12-month rate was 2.7% in June 2018, up from 2.5% in July 2018.

1.3 **Labour Market:** The latest statistics released by the ONS for the three months to July 2018 show that the number of people in work was little changed, the number of unemployed people decreased, and the number of people aged from 16 to 64 not working and not seeking or available to work has increased across the period. The unemployment rate was 4.0%, it has not been lower since 1975. The employment rate was 75.6%, marginally lower than for February to April 2018, but higher than for a year earlier 75.3%. Nominal wages including bonuses increased by 2.6% and wages excluding bonuses increased by 2.9%. Real wages excluding bonuses increased by 0.5% and including bonuses increased by 0.2% compared to a year earlier.

1.4 **Monetary Policy Committee:** The Bank of England’s Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending on 12 September 2018, the MPC voted unanimously to maintain Bank Rate at 0.75%. The Committee voted unanimously to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion. The Committee also voted unanimously to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion.

2. Borrowing & Debt Activity

2.1 The Authority currently has £43m in external borrowing. This is made up as a single LEEF loan of £3m from the European Investment Bank to fund housing regeneration and £40m short-term borrowing from Local Authorities for day to day cash management purposes.

3. Investment Policy and Activity

3.1 The Council held average cash balances of £110 million during the reported period, compared to an average £135 million for the same period last financial year.

Movement in Investment Balances 01/06/18 to 30/09/18

	Balance as at 01/06/2018 £'000	**Average Rate of Interest %**	**Balance as at 30/09/2018 £'000**	**Average Rate of Interest %**
Short Term Investments	44,226	-	46,303	-
Long Term Investments	6,500	-	6,500	-
Covered Bonds	0	-	0	-
Corporate Bonds	6,853	-	6,853	-
Housing Associations	25,000	-	25,000	-
Investments in VNAV MMF's (Money Market Funds)	3,000	-	3,000	-
Investments in CNAV MMF's (Money Market Funds)	60,350	-	14,274	-
	145,929	**0.87**	**101,930**	**1.10**

3.2 Due to the volatility of available creditworthy counterparties, longer and short term investments have been placed in highly rated UK Government institutions, thus ensuring creditworthiness of investments.

4. Counterparty Update

4.1 S&P placed Transport for London on CreditWatch Negative. Arlingclose, the Council's treasury management advisor, remains comfortable with their clients purchasing senior bonds issued by Transport for London for periods up to 10 years subject to investment strategies.

4.2 Most UK banks have their financial year end on 31st December and publish interim results in early August. Based on the results Arlingclose is comfortable with their clients making senior unsecured investments in Barclays Bank UK Plc, National Westminster Bank Plc, Royal Bank of Scotland Plc and Ulster Bank Ltd for periods up to 100 days, and in HSBC UK Bank Plc and Standard Chartered Bank for periods up to 6 months, where in line with strategies.

4.3 Arlingclose remains comfortable with their clients making secured investments only in Lloyds Bank Corporate Market plc to the limits as approved by the strategies.

4.4 Whilst the ongoing investment strategy remained cautious counterparty credit quality remains strong, as can be demonstrated by the Credit Score Analysis summarised below:

5. Credit Score Analysis

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating Score	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating Score
30/06/2018	A+	5.0	A+	5.0
31/07/2018	A+	5.0	A+	5.1
31/08/2018	A+	5.0	A+	5.1
30/09/2018	A+	5.0	A+	4.9

Scoring:

-Value weighted average reflects the credit quality of investments according to the size of the deposit

-Time weighted average reflects the credit quality of investments according to the maturity of the deposit

-AAA = highest credit quality = 1

- D = lowest credit quality = 27

-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

5.1 The Council continues to utilise AAAmmf/Aaa/AAAm rated Money Market Funds for its very short, liquidity-related surplus balances. This type of investment vehicle has continued to provide very good security and liquidity, although yield suffers as a result.

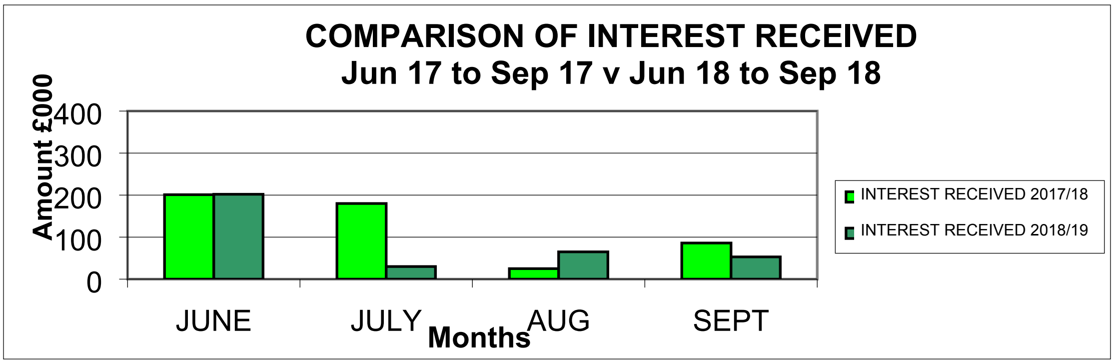
5.2 In light of legislative changes and bail-in risk for unsecured bank deposits, as set out in previous monitoring reports, the Council continues to invest in high quality corporate bonds and highly rated UK Government institutions. This investment vehicle offers good level of security and increases diversification for the Council’s portfolio whilst achieving a reasonable yield.

6. Comparison of Interest Earnings

6.1 The Council continues to adopt a fairly cautious strategy in terms of investment counterparties and periods. Due to the volatility of available creditworthy counterparties, longer term and short term investments have been placed in highly rated UK Government institutions or Corporate Bonds, thus ensuring creditworthiness whilst increasing yield's through the duration of the deposits.

6.2 The graph below provides a comparison of interest earnings for June 18 and September 18 against the same period for 2017/18.

6.3 Average interest received for the period June 18 to Sep 18 was £88k compared to £123k for the same period last financial year.



7. Movement in Investment Portfolio

7.1 Investment levels have decreased to £102 million at the end of Sep 18 in comparison to the end of Sep 17 last year of £119 million. The decrease in the investment balance year on year is the result of the continued approach of maintaining borrowing and investments below their underlying levels i.e. use of internal borrowing to finance the Council's capital programme.