ANNEX F

Treasury Management Update
Quarter 3 (October-December), 2017-18

Purpose:

The Chartered Institute of Public Finance and Accountancy (CIPFA) issued the revised Code of Practice for Treasury Management in November 2009; it recommends that members should be updated on treasury management activities at least twice a year, but preferably quarterly. This report therefore ensures this council is implementing best practice in accordance with the Code.

Economic climate:

In brief summary, the fourth quarter of 2017 (calendar year) saw:

- Bank of England policymakers increased Bank Rate from 0.25% to 0.50% - the first movement in base rate since August 2016 and first increase since July 2007. At its December meeting, policymakers kept Bank Rate unchanged with the voting unanimous at 9-0 (the first time the committee have been in full agreement since February 2017). Acknowledgement was made to progress in Brexit discussions and that “further modest increases” may be required in future.
- UK economic growth continues to face a challenging outlook with economic growth slowing as high inflation and low confidence weigh on activity, and business investment is held back due to Brexit concerns;
- The outlook for the global economy appears reasonably steady overall with global inflation remaining low;

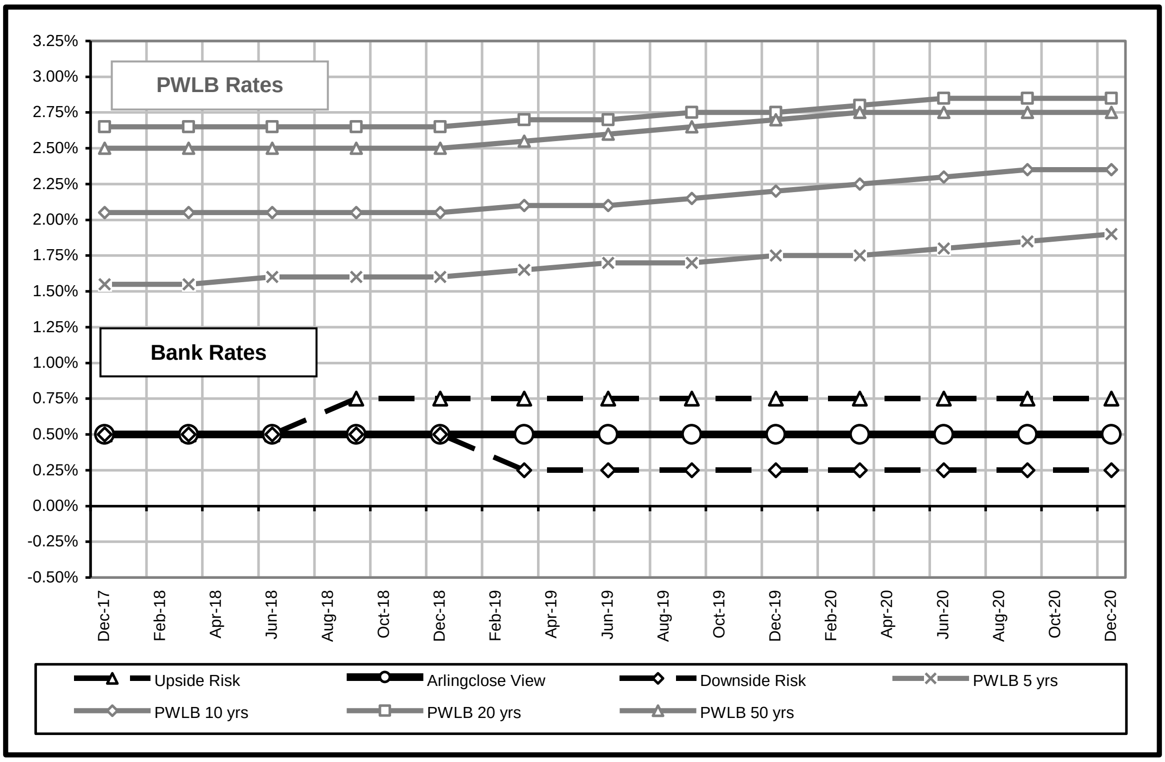
Interest rate forecast:

The latest forecast for interest rates of treasury advisors Arlingclose over the next three years is set out below, along with a sensitivity analysis of potential upside and downside risk to official bank rate.

Table 1: Interest Rate Forecast

	Dec 2017	Mar 2018	Jun 2018	Sept 2018	Dec 2018	Mar 2019	Jun 2019	Sept 2019	Dec 2019	Mar 2020	Jun 2020	Sept 2020	Dec 2020
Official Bank Rate													
Upside Risk				0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%
Arlingclose View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
Downside Risk						(0.25%)	(0.25%)	(0.25%)	(0.25%)	(0.25%)	(0.25%)	(0.25%)	(0.25%)
Public Works Loans Board Implied Rates (Certainty Rate)													
5 years	1.55%	1.55%	1.60%	1.60%	1.60%	1.65%	1.70%	1.70%	1.75%	1.75%	1.80%	1.85%	1.90%
10 years	2.05%	2.05%	2.05%	2.05%	2.05%	2.10%	2.10%	2.15%	2.20%	2.25%	2.30%	2.35%	2.35%
20 years	2.65%	2.65%	2.65%	2.65%	2.65%	2.70%	2.70%	2.75%	2.75%	2.80%	2.85%	2.85%	2.85%
50 years	2.50%	2.50%	2.50%	2.50%	2.50%	2.55%	2.60%	2.65%	2.70%	2.75%	2.75%	2.75%	2.75%

Chart 1: Interest Rate Forecast



There are many risks to the forecast set out above, principally around the timing and pace of rate rises, and a listing of underlying assumptions is attached at Appendix A. Budget estimates prudently include sensitivity analysis of the impact that a slower than forecast economic recovery would have upon the Council.

Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2017/18, which includes the Annual Investment Strategy, was approved by the Council on 15th February 2017. It sets out the Council's investment priorities as being:

1. **S**ecurity of Capital;
2. **L**iquidity; and
3. **Y**ield

The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity.

The table below summarises the forecast investment maturity position at 31st December 2017.

Table 2: Forecast Investment Maturity Position

Period	Product type / Maturity	Amount	
		£	**%**
Instant Access	Banks	£15,027	0.0
	Money Market Funds	£135,000,000	39.4
		£135,000,027	**39.4**
Fixed Term - Local Authorities	0-3 months to maturity	£30,000,000	8.8
	9-12 months to maturity	£10,000,000	2.8
	>12 months to maturity	£8,500,000	2.4
		£48,500,000	**14.0**
Fixed Term – Central Government	0-3 months to maturity	£70,000,000	20.3
		£70,000,000	**20.3**
Certificates of Deposit – Banks	0-3 months to maturity	£15,000,000	4.4
	3-6 months to maturity	£40,000,000	11.7
	6-9 months to maturity	£5,000,000	1.5
		£60,000,000	**17.6**
Covered Bonds – Fixed Rate	6-9 months to maturity	**£5,179,868**	**1.5**
Covered Bonds – Floating Rate	3-6 months to maturity	£5,000,375	1.5
	>12 months to maturity	£4,002,656	1.2
		£9,003,031	**2.7**
Property Fund	4-5 years to maturity*	**£14,856,448**	**4.4**
YourMK LLP	Capital injection	£100	0.0
	4-5 years to maturity	£301,772	0.1
		£301,882	**0.1**
Total Investment Portfolio		**£342,841,256**	**100.0**

* In order to recoup initial BID/OFFER pricing spread. Monthly valuation dates for purchase/sale of units - redemptions may be delayed should the fund be required to raise cash meet this commitment.

Financial markets trade on confidence and certainty – and although the Bank of England forward guidance is aimed at providing this, markets remain sceptical. Investment rates have increased from historical lows following the base rate rise, but remain relatively low in short to medium-term durations, with limited pickup in value for longer durations.

Investment balances at the 31st March 2017 were £274.550m. Due to the front-loaded nature of various government funding streams the average level of funds available for investment purposes during this quarter is forecast at £335.6m.

Balances are forecast to fall to circa £150.0m by 31st March 2018 as internal resources are applied to fund capital expenditure demands in lieu of further borrowing (significantly the circa £130m (ex VAT) Residual Waste Treatment Facility payment, now due in January 2018, subject to sign-off), effectively reducing the cost of carrying debt at higher cost than income generated through investment of balances.

Table 3: Forecast Benchmark Performance – Q3

Benchmark	Benchmark Return	Council Performance
3 month LIBID	0.32%	0.63%

As illustrated, the authority outperformed the benchmark by 31 basis points. Latest projections for the financial year are reported through the Budget Monitoring process.

New Borrowing

No new borrowing for capital purposes was undertaken during the quarter.

Below is a table setting out the profile of existing borrowing as at 31st December 2017.

Table 4: Borrowing Profile as at 31st December 2017

	Borrowing	
	£m	**%**
Under 12 months	1.296	0.3
1-2 years	9.166	1.9
2-5 years	31.027	6.3
5-10 years	66.710	13.6
Over 10 years	381.929	77.9
	490.128	**100.0**

Debt Restructuring

Debt rescheduling opportunities have been limited due to the current economic climate and consequent structure of interest rates following increases in PWLB new borrowing rates in October 2010. Officers continue to monitor the position regularly.

No debt rescheduling was undertaken during the quarter.

Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) were approved alongside the TMSS on 15th February 2017.

During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Statement.

The Prudential and Treasury Indicators are shown in Appendix B.

Residual Waste Treatment Facility

Delays in completion and therefore payment of the capital sum of £130m (ex VAT) for the Residual Waste Treatment Facility have impacted upon investment activity. Table 2 above demonstrates that the Council has sufficient cash balances in hand to service the outlay that continue to be held in secure liquid instruments at the sacrifice of yield. Latest information estimates capital outlay will occur in January 2018 pending satisfactory facility testing and sign-off.

The Councils has engaged external consultants to review the VAT treatment of the capital sum to ensure recovery can take place swiftly through normal channels.

MiFID II – Elective Professional Status

European legislation governs and harmonises Financial Markets across the EU. It focuses on strengthening transparency and investor protection across financial markets via wide reaching changes to market structure, investor protection, organisational structure, and pre and post trade reporting.

New legislation for Markets in Financial Instruments Directive (2014/65/EU) and the Markets in Financial Instruments Regulation (600/2014) collectively referred to as MiFID II herein, becomes effective from 3rd January 2018.

The UK financial regulator, The Financial Conduct Authority (FCA), has clarified that irrespective of the potential impact of Brexit, MiFID II will become UK law in 2018.

Local authorities are currently treated by regulated financial services firms (defined in next paragraph) as professional clients who can "opt down" to be treated as retail clients instead. But as a result of MiFID II and from 3rd January 2018, local authorities will instead be treated as retail clients by default 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 certain designated investments. In order to opt up to professional status, this Council satisfies the criteria of investment balances of at least £10 million, a minimum of 10 trades per quarter, and persons authorised to make investment decisions on behalf of the Council have at least one year's relevant professional experience. In addition, each counterparty themselves must then assess that the Councils treasury personnel have the expertise, experience and knowledge to make investment decisions and understand the risks involved and then confirm acceptance.

The main additional protection for retail clients is an enforced duty on the investment counterparty to ensure that investments are “suitable” for their clients. 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. Many investment counterparts have already warned that the increased costs related to added due-diligence requirements for retail clients will be passed on to the investor, and potentially they may restrict access to certain products including money market funds, pooled funds, treasury bills, bonds, shares and limit financial advice provided.

This Council meets the conditions to opt up to professional status and intends to do so in order to maintain their current MiFID status and continue to have access to the full range of products and trading platforms when moving cash between money market funds currently employed. Officers have returned questionnaires to all investment counterparties and brokers, and have applied for an “LEI” (Legal Entity Identifier) which will allow the Council to continue to purchase, hold and potentially sell (for liquidity or credit risk reasons) instruments tradeable in secondary markets.

Regulatory Developments

CIPFA Codes of Practice

In February 2017 CIPFA sought views on the relevance, adoption and practical application of the Treasury Management and Prudential Codes and after reviewing responses launched a further consultation on proposed changes to the codes in August 2017. Officers made representation on behalf of the Council offering broad support but citing challenges in the implementation of some of the new requirements.

The proposed changes to the Prudential Code include the requirement to produce 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. The Council already has an approved Capital Strategy, so these requirements will have minimal impact.

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 any subsidiaries of the Council.

Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties 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 and need 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.

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, which will incorporate the Treasury Management Strategy report presented to Council for approval in February as part of the budget setting process.

The Department of Communities and Local Government (DCLG) guidance

DCLG and CIPFA wish to have a more rigorous framework in place for the treatment of commercial type investments as soon as is practical. DCLG are consulting on revising its Investment Guidance and Minimum Revenue Provision (MRP) Guidance for local authorities in England.

In terms of Treasury Management, proposals include disclosure of the contributions that non-core service investments make towards core functions and the introduction of measures of transparency for financial and non-financial investments with quantitative indicators that will allow assessment of exposure to risk. In addition is the proposed introduction of a concept of proportionality – stating dependence on commercial income to deliver statutory services and the amount of borrowing that has been committed to generate that income.

For MRP, there is a proposed change the definition of ‘prudent provision’ to one that requires MRP to be set to cover the gap between the Capital Financing Requirement and amount of that requirement funded by income, grants and receipts – effectively meaning that MRP must be provided for on all unsupported borrowing regardless of underlying security or collateral. Furthermore, DCLG propose to set maximum useful economic lives for MRP calculations based on asset life - 50 years for freehold land and 40 years for other assets.

Officers intend to highlight to DCLG that many of these proposals enforce limitation on local authorities without considering local circumstances.

DCLG also propose to ensure changes to future MRP methodology does not generate an overpayment of MRP so therefore precludes the backdating of approach changes – this Council has already and will continue to benefited from past methodology changes.

IFRS 9 Accounting Standard

Local authorities will adopt new International Financial Reporting Standard (IFRS) 9 accounting standard for financial instruments in 2018/19. CIPFA has yet to publish the final 2018/19 Accounting Code of Practice, but has announced that it will adopt IFRS 9 in full and will provide additional guidance at a later date. Although the content of this guidance is unknown, it is likely that the change to IFRS 9 will result in additional costs to local authorities’ General Funds.

Under existing standards, unrealised movements (gains or losses) in the underlying fair value assessment of investment holdings at 31st March are reversed in the Statement of Accounts to negate any impact on the General Fund, instead held in reserve until such time as the investment is realised / liquidised. Under IFRS 9, those movements would not be reversed, subjecting the General Fund to a financial risk at financial year end.

The actual impact of IFRS 9 on the Council's 2018/19 accounts will depend on many variables that are currently unknown, including CIPFA guidance, the mix of our investment portfolio on 29/03/19, market conditions on that date, etc. As an indication; a £10m investment in a property-type fund subject to underlying asset movements, based on actual changes observed in recent market events, could be subject to a 30% price devaluation equating to a £3m charge (loss) against the General Fund.

At a CIPFA meeting earlier this month, representatives from DCLG and the devolved administrations stated they would be willing to consider representations from local authorities for a statutory override to reverse these costs, providing they receive enough evidence from local authorities on the need for one.

Given the substantial lead time required for legislative change, the Council intends to make representation to DCLG ahead of the release of CIPFA's guidance to press for a statutory override of this potential impact.

Amendment to Minimum Revenue Provision – Homelessness Fund

On 26th January 2015 Cabinet approved that £5m funded by Prudential Borrowing is used to fund investment in the Real Lettings Property Fund to provide up to 70 self-contained flats to address the urgent need for suitable temporary accommodation.

Cabinet approved that although the Council expects its investment to be returned in full, and with participation in surpluses accruing from capital growth, the risk of the investment not being returned in full will be provided for through making an MRP charge over the expected life of the underlying property assets. The values of the fund and the underlying assets will be kept under review.

Officers now believe that given the investment is secured against real assets, for a defined period of time, and with expectation & proven track record of asset value increases, MRP charges are not required. However as noted above, the DCLG guidance consultation on MRP may force the Council to reinstate these MRP charges if implemented.

In the meantime and under existing powers - similar to financing extended to Milton Keynes Development Partnership for assets with future development potential - no MRP charge will be levied. Instead an annual review will be undertaken to assess the collateral against outstanding finance. Should this review show collateral to have fallen below the level of finance outstanding, MRP will be re-introduced as a prudent provision.