

	<b>Cabinet</b> 14 January 2019
	<b>Report from the Chief Finance Officer</b>
<b>2018/19 MID-YEAR TREASURY REPORT</b>	

<b>Wards Affected:</b>	All
<b>Key or Non-Key Decision:</b>	Non-key
<b>Open or Part/Fully Exempt:</b> (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	Open
<b>No. of Appendices:</b>	Three:  Appendix 1: Prudential Indicators Appendix 2: Maturity Structure of Fixed Rate Borrowing Appendix 3: Investment Strategy Options
<b>Background Papers:</b>	None
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## 1.0 Purpose of the Report

1.1 This report updates Members on recent treasury activity.

## 2.0 Recommendation(s)

2.1 Cabinet is asked to note the 2018/19 mid-year Treasury report, which has already been reviewed by the Audit and Standards Advisory Committee and is to be forwarded to the Council.

## 3.0 Detail

### Background

3.1 The Council's Treasury Management Strategy is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for

determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

- 3.2 The Code also recommends that Members are informed of Treasury Management activities at least twice a year. This report therefore ensures this authority is embracing best practice in accordance with CIPFA's recommendations.
- 3.3 Treasury Management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."
- 3.4 In addition to reporting on risk management, the Code requires the Authority to report on any financial instruments entered into to manage treasury risks.

### **Economic Background**

- 3.5 Growth in the UK economy recovered somewhat in Q2 following very low growth in Q1. The most recent estimate for UK GDP growth is 0.4% for Q2. This is the same as the Eurozone however US growth has been strong. Arlingclose have advised that the outlook for the UK economy remains challenging to predict following the vote to leave the European Union. Other risks include potential trade wars which will continue to cause significant volatility in financial markets.
- 3.6 Consumer Price Index (CPI) has increased since the previous update, to 2.7% in August mostly due to increases in transport fares and recreation and culture. Employment is currently at 75.5% of the working age population, marginally down on the quarter prior however the number of people in work increased through the year. Wages excluding bonuses grew by 2.9% therefore wages including inflation only showed a very slight increase.
- 3.7 Gilt yields have fluctuated in response to domestic and international events in the first half of the year. The movement in rates at which local authorities can borrow from the Public Works Loans Board (PWLB) on maturity loans is shown in the table below:

### **PWLB Rates**

<b>Period</b>	<b>Mar-18</b>	<b>Sep-18</b>
1 year	1.7%	1.8%
5 year	2.1%	2.1%
10 year	2.4%	2.5%

- 3.8 The interest rate the Council receives on money market funds has risen since the previous report and 12 month maturities with local authorities have risen from 0.8% to 1.1%.

## Debt Management

- 3.9 The Authority continues to qualify for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate). This is reviewed on an annual basis and has been confirmed as applying until 31 October 2019.
- 3.10 Alternative sources of long term funding to long-dated PWLB borrowing are available, but the Council will continue to adopt a cautious and considered approach to funding from the capital markets. The affordability, simplicity and ease of dealing with the PWLB represents a strong advantage but the Council, due to its prudent policies and strong balance sheet, is in a position to consider alternatives, and will start to do so in order to finance the investment strategy. However, no new long term loans have needed to be raised so far this year as can be seen in the table below:

	Balance on 01/04/2018 £m	Debt repaid* £m	New Borrowing £m	Balance on 30/09/2018 £m
Short Term Borrowing	21	21	0	0
Long Term Borrowing	411	2.2	0	408
<b>TOTAL BORROWING</b>	<b>432</b>	<b>2.2</b>	<b>0</b>	<b>408</b>
Ave Rate of Long Term Borrowing %	4.82	2.58	0	4.83*

*\* £25m of the PWLB loans are referred to as EIP, whereby the Councils pays down the loans in half-yearly equal installments over the lifetime of the loan. The marginal increase in the average interest rate can be attributed to the Council paying back its EIP loans. This is because the EIP loans have a much lower average interest rate of 2.58% compared with the rest of the debt, which is 4.97%.*

*The figures above excludes redemption of the £10m RBS inverse LOBO on 29<sup>th</sup> November. (see para 3.23)*

- 3.11 The use of internal resources in lieu of borrowing has continued to be the most cost effective means of funding capital expenditure. This has lowered overall treasury risk by reducing external debt and temporary investments. However this position will not be sustainable over the medium term and the Council will need to give careful consideration to its future capital programme and how this is financed. Borrowing options, including the potential to agree forward funding and the timing of such borrowing will continue to be assessed in conjunction with the Council's treasury advisor, Arlingclose.
- 3.12 Affordability remains an important influence on the Council's borrowing strategy. Moreover, any borrowing undertaken ahead of need would need to be invested in the money markets at rates of interest significantly lower than the cost of borrowing and involve credit risk. If interest rates seemed likely to rise significantly in the short-term then this approach might need to be reviewed, however forward borrowing which is under consideration largely eliminates this risk. This is because it allows the Council to agree a sum in advance of need, at a fixed rate for delivery on a pre-determined future, thereby hedging against future interest rate exposure whilst avoiding a short term increase in costs, as interest payments do not commence until the loan starts.

- 3.13 The persistence of low interest rates means that it would be uneconomic to reschedule debt, because early retirement of the loan would incur a heavy penalty, to compensate the PWLB for having to lend the money on at lower rates. For example, the Council's most expensive loan is £3.05m at a rate of 8.875%, to repay it would cost £0.781m, a 26% premium on the value of the loan before the cost of re-financing. In short, the cost of re-financing our loans under the Government's approach means is not economical. This analysis might change if interest rates returned to historically normal levels.

### **Investment Activity**

- 3.14 The Council gives priority to security and liquidity and aims to achieve a yield commensurate with these principles.

	<b>Balance on 01/04/2018 £m</b>	<b>Investments Made £m</b>	<b>Investments Repaid £m</b>	<b>Balance on 30/09/2018 £m</b>
Short Term Investments	<b>140</b>	579	594	<b>125</b>

- 3.15 There was a £15m downward movement in short-term investments. This is expected and mainly due to the significant capital investments being applied to new NAIL schemes, loans to I4B and investment in the HRA stock. This downward trend in investment balances is expected to continue in the coming years as the capital programme is progressed. YTD capital spend for 18-19 currently stands at £52m with the forecast for the full year £162m. This is having a significant impact on our cash available for investment and as noted in para 3.11 the use of internal balances to fund capital expenditure will not be sustainable over the medium to long term.
- 3.16 The Council has undertaken a detailed analysis of its cash flows, examining the pace at which we are reducing our cash reserves. The analysis was based on forecast capital commitments, incoming resources and seasonal variations. As reported to Cabinet in September 2018 the prediction is that the council will need to borrow towards the end of 2020, to a certain extent limiting our ability to use financial products that generate higher financial returns, as they would require longer time horizons. The council is reviewing its borrowing options which may include short term loans, PWLB borrowing, forward borrowing and other market loans. At the same meeting Cabinet endorsed an updated borrowing strategy that included a recommendation to commence negotiations to agree a forward funding loan of up to £40m. The council will also consider the advice of our Treasury management advisors, Arlingclose prior to any borrowing decision being made.
- 3.17 Security of capital has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2018/19. New investments were made with the following classes of institutions:
- A- or above rated banks;
  - AAA rated Money Market Funds;

- Other Local Authorities;
- UK Debt Management Office

A short summary of the investment products available to the council is provided in Appendix 3.

- 3.18 Counterparty credit quality was assessed and monitored with reference to Credit Ratings (the Council's minimum long-term counterparty rating of A- (or equivalent) across rating agencies Fitch, Standard & Poor's and Moody's); credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; sovereign support mechanisms; potential support from a well-resourced parent institution; share price. There were two foreign banks on our Lending List, both Swedish (and, therefore, outside the Eurozone), conservatively run and with good ratings and strong financial figures.
- 3.19 All investments in banks and building societies are now undertaken by means of marketable instruments (Certificates of Deposit, CDs). This adds a measure of additional liquidity without sacrificing return, given our maturity limits.

#### **Budgeted Income And Outturn**

- 3.20 The Council's external interest budget for the year is £23.3m, and for investment income is £1.4m. The Council is unlikely to achieve the income figure, but this will be compensated for by lower borrowing costs than budgeted. The average cash balances, representing the Council's reserves and working balances, were £137m during the period to 31 September 2018.
- 3.21 The UK Bank Rate increased to 0.75% from 0.50% on 02 August 2018. Following this decision short-term money market rates have increased in response however rates are very low compared to historic rates. This will lead to an increase on the return of the council's investment portfolio though this will be gradual because existing fixed rate investments will be held to maturity.

#### **Icelandic Bank Investment Update**

- 3.22 £0.2m of the original £10m deposit remains outstanding. It is expected that a further distribution will be made but this depends on the result of litigation currently under way regarding a property investment.

#### **LOBOs (Lender Option Borrower Options) - Update**

- 3.23 The Council has a market loan portfolio comprising a total value of £95.5m. Of this, £80.5m are LOBOs with the remaining £15m made up of fixed rate loans. The majority of the loans were taken out before 2010 meaning that in the current interest rate environment the likelihood of these loans being "called" by the bank, in terms of changing the rate, is low. However, in recent months many banks have been active in seeking to exit these loans for various reasons which relate to either the regulatory rules required in terms of setting aside capital ("Risk Weighted Assets") which restrains the bank from lending further in other areas and more recently the changes in International Financial Reporting

Standard (IFRS) and in particular IFRS9 which impacts the bank with regards to the accounting for these loans.

- 3.24 During the month of October both RBS (£10m Inverse floater LOBO) and KA Finanz (2 x £5m Vanilla LOBOs) approached the Council seeking to enter into negotiations to extinguish our LOBO Loans. The KA Finanz offer was based on a competitive bidding process whilst RBS was based on a negotiated process. The Council submitted a competitive bid to extinguish the both KA Finanz loans, which was not accepted. However we were able to agree terms on the RBS loan at a Pricing Call on the 28<sup>th</sup> Nov and the loan was repaid shortly afterwards.
- 3.25 The Council's position has for some years been that under the current interest rate conditions it would be uneconomic to repay PWLB loans, despite the substantial spread between the highest coupon PWLB loans in its portfolio (8.875%) and current interest rates.
- 3.26 The Council would therefore as a minimum need to demonstrate that the repayment of any LOBO loan would be at a price that generated substantially more benefit than an equivalent (i.e. £5m or £10m) repayment of PWLB debt. The detailed business case proves this to be the case. Furthermore the workings that underpin this transaction show that after taking account of the premium there is an overall discounted (3.5% discounted cash flow based on Green Book) benefit of £4.5m based on the interest saved on the loan (rising to £8.1m if the loan is not replaced).

### **Compliance**

- 3.27 Officers confirm that they have complied with its Prudential Indicators for 2018/19, which were set in February 2018 as part of the Council's Treasury Management Strategy Statement (TMSS). Details can be found in Appendix 1.

### **Summary**

- 3.28 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 the first half of 2018/19. As indicated in this report, none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

### **4.0 Financial Implications**

- 4.1 These are covered throughout the report.

### **5.0 Legal Implications**

- 5.1 There are no direct legal implications.

### **6.0 Equality Implications**

6.1 No direct implications.

**7.0 Consultation with Ward Members and Stakeholders**

7.1 None.

**8.0 Human Resources/Property Implications (if appropriate)**

8.1 No direct implications.

**Related Documents**

Treasury Management Strategy – Report to Full Council as part of the Budget Report  
– February 2018.

**Report sign off:**

**Conrad Hall**  
Chief Finance Officer