Chichester District Council

CORPORATE GOVERNANCE & AUDIT COMMITTEE 23 November 2017

Treasury Management – 2017-18 Mid-year update

1. Contacts

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2. Recommendation

2.1. That the committee considers this 2017-18 mid-year review of treasury management activity and performance and provides comments to the Cabinet as necessary.

3. Background

3.1. 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 yearly (mid-year and at year end). This report provides a summary of the Council's Treasury Management Activities for the half year to 31 September 2017.

3.2. The Authority's Treasury Management Strategy for 2017/18 was approved by full Council on 7 March 2017 and is available on the Council's internet site.

3.3. The Authority has continued to invest substantial sums of money and manage financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk. It also highlights to Members relevant regulatory changes that will impact on the Council's next Treasury Management Strategy.

4. Outcomes to be achieved

4.1. This report demonstrates treasury management activities conducted to date during 2017-18 were in accordance with the Council's Treasury Management Strategy and achieved an appropriate return given the Council's expressed risk appetite.

4.2. The Committee are asked to consider this report and raise any concerns or comments for consideration by the Cabinet on 5 December.

5. Treasury Management

5.1. The Council continues to manage significant resources as part of its treasury management function as shown in Exhibit 1, below.

Exhibit 1: Movement in treasury funds

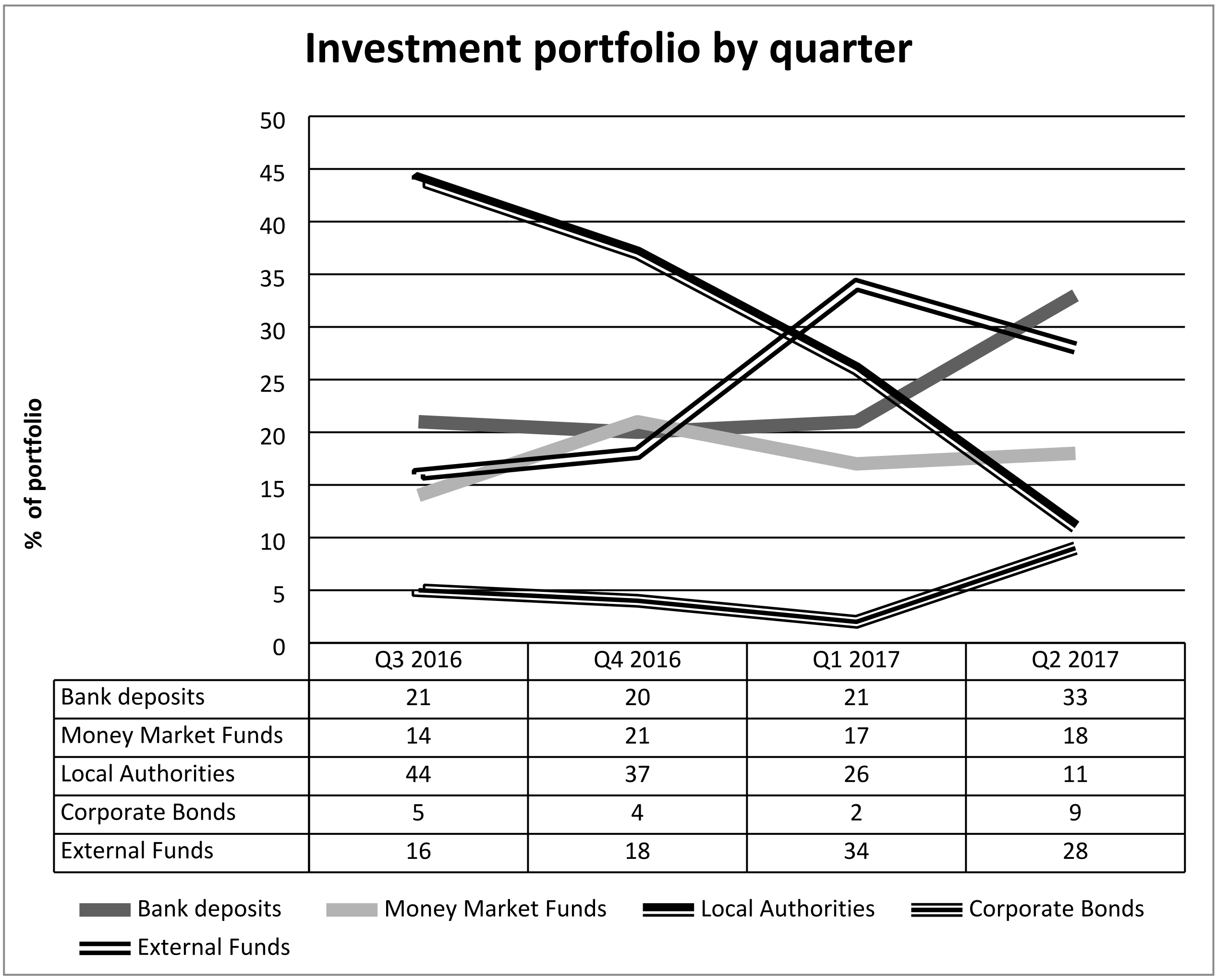
Investments £000	Balance 01/04/2017	Movement	Balance 30/06/2017	Movement	Balance 30/09/17
Short term Investments	24,305	(5,805)	18,500	3,500	22,000
Money Market Funds	11,000	(2,550)	8,450	2,800	11,250
Corporate Bonds	2,020	(1,020)	1,000	4,460	5,460
Total liquid investments	**37,325**	**(9,375)**	**27,950**	**10,760**	**38,710**
Long term Investments	5,000	-	5,000	-	5,000
Local Authority Property fund	10,000	-	10,000	-	10,000
Pooled funds:					
- Columbia		2,650	2,650	-	2,650
- M&G Securities		1,650	1,650	-	1,650
- Investec		3,650	3,650	-	3,650
TOTAL INVESTMENTS	**52,325**	**7,950**	**50,900**	**10,760**	**61,660**

Short term investments include any investments that had an original period over greater than 1 year, but which will mature during 2017-18.

5.2. The movement in investments is as a result of:

- Investments in short-term corporate bonds where returns exceeded available money market rates and where they meet our counterparty lending criteria
- New long-term investments in three external pooled funds made during the first half-year.

5.3. The graph below shows the movement in various asset classes over the past year. The main drivers of change being the investments in the Local Authority property Fund and other external funds starting February 2016, and a corresponding reduction in funds deposited with other Local Authorities over that same period.



	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Bank deposits	21	20	21	33
Money Market Funds	14	21	17	18
Local Authorities	44	37	26	11
Corporate Bonds	5	4	2	9
External Funds	16	18	34	28

6. Borrowing

6.1. The Authority does not expect to undertake any borrowing in 2017/18.

6.2. The Council is not currently approved for the reduced ‘certainty’ rate available from the Public Works Loan Board as it requires a three year forecast of expected borrowing.

6.3. Officers, will as part of the budget process, consider the Council’s capital programme and the options to finance this expenditure. If the Council decides to borrow, and successfully applies for the PWLB certainty rate. This will be available for PWLB borrowing from November 2018.

7. Investment Activity Benchmarking

6.4. The data below is presented in terms of the key objectives of public sector treasury management, Security, Liquidity and Yield for the previous four quarters.

Security

Measure	Qtr3 16-17	Qtr4 16-17	Qtr 1 17-18	Qtr 2 17-18	Non-met District average	Rating
Average Credit Score (time-weighted)	4.01	4.07	4.18	4.27	4.28	AMBER
Average Credit Rating (time weighted)	AA-	AA-	AA-	AA-	AA-	GREEN
Proportion Exposed to Bail-in (%)	40	48	54	60	65	GREEN

6.5. The increase in average time weighted credit score over the period (4.18 to 4.28) since 31 June 2017 is driven by three investments in Corporate Bonds during Q2. Risk associated with these investments is managed by restricting the maximum amount and duration that investments can be made for.

6.6. Whilst this is as a result of active management of the portfolio within the Treasury Strategy, the indicator has been re-categorised as 'Amber' (from Green) to reflect the importance of security in our approach to Treasury Management.

Liquidity

Measure	Qtr3 16-17	Qtr4 16-17	Qtr 1 17-18	Qtr 2 17-18	Non-met districts (average)	Rating
Proportion available within 7 days (%)	21	24	17	18	38	GREEN
Proportion available within 100 days (%)	52	47	48	38	61	GREEN
Average days to maturity	176	174	177	161	108	GREEN

6.7. The relatively low proportion of funds available within 7 days reflects the Council's active management of its investments to limit its exposure to bank bail-in, the majority of short term deposits being for periods of 1 to 6 months with Local Authorities or Bonds issued by large corporates.

6.8. The relatively high average days to maturity figure reflects a number of longer term investments which generate additional returns for the Council's general fund. The Council's ability to commit funds to such long-term investments reflects both the size of funds available for treasury management and also the integration of this with medium and long term financial forecasting undertaken by the Council.

6.9. As this position results from an active decision by the Council, the overall risk has been re-categorised as Green (from Amber).

Return

Measure	Qtr3 16-17	Qtr4 16-17	Qtr 1 17-18	Qtr2 17-18	Non-met districts (average)	Rating
Internal investment return %	0.73	0.68	0.65	0.52	0.51	GREEN
External funds – income return %	4.31	4.50	4.35	4.38	3.56	GREEN
External funds – capital gains/losses %	(8.00)	(3.77)	(0.81)	2.19	0.99	GREEN
Total treasury Investments – income return %	1.29	1.37	1.93	1.62	1.12	GREEN
Property – income return % (1)	9.09	9.09	9.09	9.09		

[1] *Note: This relates to properties managed directly by the Council's Estates Service.*

6.10. The overall internal investment return on internal treasury investments continues to exceed the benchmark measure. This quarter showed the first overall capital growth in the Council's pooled and property funds and as a result the indicator has been re-categorised as Green (from Red)

6.11. The overall internal investment return on treasury investments has exceed the target return for the year (0.55%), until the effects of last summer's base rate cut worked its way through into returns from September onwards.

6.12. The return for the previous four quarters on our investment in the Local Authority Property Fund is shown below

	Dividend £	Dividend % (p.a.)
October – December 2017	105,239	4.2
January 2017 – March 2017	105,216	4.2
April - June 2017	109,243	4.4
July - September 2017	123,123	4.8
Total for 12 months to September	442,821	4.5

6.13. The return on our investments with external pooled funds is as follows

	Balance £	Return % (p.a.)
Investec	3,650,000	4.55
Columbia Threadneedle	2,650,000	3.55
M&G	1,650,000	No data yet*

*M&G dividends are paid half-yearly

8. Treasury management activity

6.14. The following exceptions have been recorded between April and September. Each was reported as soon as identified to the Council's S.151 officer.

July 2017

- £2m was invested with National Counties Building Society. This amount exceeded the limit for unsecured building society deposits (£1m). The Council's Treasury system alerted officers to this exception but unfortunately the deal had already been confirmed with the broker and the Council was committed to honour it. The deposit was repaid in full on 13 October 2017.

- The Council's bank account was overdrawn by £54,000 overnight as a redemption requested from Standard Life did not arrive until the following day.

September 2017

- The limit on unsecured investments (£20m) was exceeded by £1m for 7 days. It is not possible to monitor this via the Council's Treasury management system and a reminder has been given to officers to conduct a manual check on this limit going forward.

7. Other Treasury Management Indicators

7.1. The Authority also measures and manages its exposures to treasury management risks using the following indicators.

7.2. **Interest Rate Exposure**: This indicator is set to control the authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount and proportion of net principal invested during the year were:

	2017-18	**2018-19**	**2019-20**
Upper limit on fixed interest rate exposure	£28m/40%	£24m/40%	£22m/40%
Actual (30 September 2017)	£5m/8%		
Upper limit on variable interest rate exposure	£70m/100%	£60m/100%	£55m/100%
Actual	£38.7m/63%*		

**The residual amount is invested in asset classes where returns are based on dividend distributions rather than interest rates*

7.3. Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. Instruments that mature during the financial year are classed as variable rate.

7.4. **Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The actual principal sum expected to be invested to final maturities beyond 31 March 2018 is shown below.

	2017-18	2018-19	2019-20
Limit on principal invested beyond year end	£35m	£30m	£25m
Actual (30 September 2017)	£23.9m	£20.9m	£23m

8. Investment Briefings

8.1. A workshop to help Members exercise proper oversight of Treasury Management activities is offered each year to all members. Members of the Corporate Governance and Audit Committee and the Cabinet are required to attend the next training session which is scheduled for 8 December.

9. Regulatory update

The second Markets in Financial Instruments Directive (MiFID II)

9.1. Local authorities are currently treated by regulated financial services firms as professional clients who can “opt down” to be treated as retail clients instead. But from 3rd January 2018, as a result of the second Markets in Financial Instruments Directive (MiFID II), local authorities will be treated as retail clients 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 designated investments.

9.2. To opt up to professional status, the authority must have an investment balance of at least £10 million, and the person authorised to make investment decisions on behalf of the authority must have at least one year’s relevant professional experience. In addition, the firm must assess that that person has the expertise, experience and knowledge to make investment decisions and understand the risks involved.

9.3. The main additional protection for retail clients is a duty on the firm to ensure that the investment is “suitable” for the client. 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. It is also likely that retail clients will face an increased cost and potentially restricted access to certain products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice. The Council has declined to opt down to retail client status in the past as the costs were thought to outweigh the benefits.

9.4. The authority meets the conditions to opt up to professional status and intends to do so in order to maintain their current MiFID status.

CIPFA Prudential and Treasury Management Codes

9.5. The proposed changes to the Prudential Code 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.

9.6. Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties, to come into the definition of "investments" as well as loans made or shares brought for service purposes.

9.7. 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.

9.8. There are also plans to drop or alter some of the current treasury management indicators.

European Money Market Reform

9.9. The EU has been concerned about aspects of the present money market for some time and has recently issued regulations that will be implemented over the next 18 months until January 2019.

9.10. In short, the regulations mean that the majority of available Money Market Funds (MMF) will elect to become Low Volatility NAV during 2018. In 'normal' market circumstances, LVNAV should operate in the same way as our present funds, but under very stressed market conditions, it is possible that the value of funds invested in MMF will change.

9.11. At present the Council uses MMF for liquidity management. There are limited (and narrowing) options for other liquidity deposits other than the DMO or overnight deposits with banks and LVNAV funds will still offer benefits of diversification, security and liquidity.

10. Resource and legal implications

10.1. The Council has complied with all the relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management, means that, its capital expenditure is prudent, affordable and sustainable, and demonstrates a low risk approach.

11. Other Implications

Crime & Disorder	None
Climate Change	None
Human Rights and Equality Impact	None
Safeguarding and Early Help	None

12. Appendices

Appendix 1 – Economic and credit commentary prepared by Arlingclose
Appendix 2 - Benchmarking definitions

Appendix 1: Economic and credit commentary prepared by Arlingclose

Provided by Arlingclose

Economic background: The major external influence on the Authority's treasury management going forward will be the UK's progress in negotiating its exit from the European Union and agreeing future trading arrangements. The domestic economy has remains relatively robust since the surprise outcome of the 2016 referendum, but there are indications that uncertainty over the future is now weighing on growth. Transitional arrangements may prevent a cliff-edge, but will also extend the period of uncertainty for several years. Economic growth is therefore forecast to remain sluggish throughout 2018/19.

Consumer price inflation reached 3.0% in September 2017 as the post-referendum devaluation of sterling continued to feed through to imports. However, this effect is expected to fall out of year-on-year inflation measures during 2018, removing pressure on the Bank of England to raise interest rates.

In contrast, the US economy is performing well and the Federal Reserve is raising interest rates in regular steps to remove some of the emergency monetary stimulus it has provided for the past decade. The European Central Bank is yet to raise rates, but has started to taper its quantitative easing programme, signalling some confidence in the Eurozone economy.

Credit outlook: High profile bank failures in Italy and Portugal have reinforced concerns over the health of the European banking sector. Sluggish economies and fines for pre-crisis behaviour continue to weigh on bank profits, and any future economic slowdown will exacerbate concerns in this regard.

Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the European Union, Switzerland and USA, while Australia and Canada are progressing with their own plans. In addition, the largest UK banks will ringfence their retail banking functions into separate legal entities during 2018. There remains some uncertainty over how these changes will impact upon the credit strength of the residual legal entities.

The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however remain very low.

Interest rate forecast: Following the Bank of England's decision on 2 November 2017 to increase Bank Rate by 0.25 percentage points to 0.5%, Arlingclose's updated central forecast is for the base rate to remain at this level until December 2020, with equal upside and downside risk.

Appendix 2 – Benchmarking definitions

The benchmarking compares various measures of risk and return, which are calculated as follows:

Investment Value
For internal investments, the value is the sum initially invested. For external funds, the value is the fund's bid price on the quarter end date multiplied by the number of units held.

Rate of Return
For internal investments, the return is the effective interest rate, which is also the yield to maturity for bonds. For external funds (LAPF) this is measured on an offer-bid basis less transaction fees. For external funds the income only return excludes capital gains and losses.

Average returns are calculated by weighting the return of each investment by its value. All interest rates are quoted per annum.

Duration
This measure applies to internal investments only. This is the number of days to final maturity. For instant access money market funds, the number of days to final maturity is one.

Average duration is calculated by weighting the duration of each investment by its value. Higher numbers indicate higher risk.

Credit Risk
Each investment is assigned a credit score, based where possible on its average long-term credit rating from Fitch, Moody's and Standard & Poor's. This is converted to a number, so that AAA=1, AA+=2, etc. Higher numbers therefore indicate higher risk. Unrated local authorities are assigned a score equal to the average score of all rated local authorities.

Average credit risk is measured in two ways. The value-weighted average is calculated by weighting the credit score of each investment by its value. The time-weighted average is calculated by weighting the credit score of each investment by both its value and it's time to final maturity. Higher numbers indicate higher risk.