SURREY
COUNTY COUNCIL

AUDIT & GOVERNANCE COMMITTEE
4 December 2017

TREASURY MANAGEMENT MID YEAR REPORT

SUMMARY AND PURPOSE:

This report summarises the council's treasury management activity during the first half of 2017/18, as required to ensure compliance with CIPFA's Code of Practice for Treasury Management. The report also covers the council's Prudential and Performance Indicators for the first half of 2017/18, in accordance with the requirements of the CIPFA Prudential Code.

RECOMMENDATIONS:

The Audit and Governance Committee is asked to note the content of the Treasury Management Half Year Report for 2017/18.

BACKGROUND:

1. The Authority has adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

2. The Authority's treasury management strategy for 2017/18 was approved at the County Council meeting on 7 February 2017. The investment and borrowing of cash exposes the Council to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

EXTERNAL CONTEXT:

3. The Bank of England made no change to monetary policy at its meetings in the first half of the financial year. The vote to keep Bank Rate at 0.25% narrowed to 5-3 in June, highlighting that some MPC members were more concerned about rising inflation than the risks to growth. At September's meeting the Committee voted 7-2 in favour of keeping Bank Rate unchanged, although the MPC changed their rhetoric, implying a rise in Bank Rate in "the coming months". This was later realised at the November meeting, when the MPC voted to raise the Bank Rate to 0.5% by a majority of 7-2. The minutes re-emphasised that any further future increases in the Bank Rate would be expected to be at a gradual pace and to a limited extent.

4. Annex 1 contains further commentary on the economic backdrop and provides the external context for the first half of the financial year, including the performance of the financial markets over the period and relevant credit rating changes. The most significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities.

REGULATORY UPDATES:

5. **MiFID II:** 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 3 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. In order to opt up to professional, 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.

6. 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 Authority has declined to opt down to retail client status in the past as the costs were thought to outweigh the benefits.

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

8. **CIPFA Consultation on Prudential and Treasury Management Codes:** In February 2017 CIPFA canvassed views on the relevance, adoption and practical application of the Treasury Management and Prudential Codes and after reviewing responses launched a further consultation on changes to the codes in August with a deadline for responses of 30 September 2017. The Council responded to the consultation in line with these deadlines.

9. 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. 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. There are plans to remove certain prudential indicators, however local indicators are recommended for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

10. 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 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. There are also plans to remove or alter some of the current treasury management indicators.

11. 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. The Department of Communities and Local Government (DCLG) and CIPFA wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. It is understood that DCLG will be revising its Investment Guidance (and its MRP guidance) for local authorities in England; however there have been no discussions with the devolved administrations yet.

MID YEAR REPORT:

12. On 31 March 2017, the Authority had net borrowing of £539m. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment.

13. The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. Internal borrowing allows the Council to utilise its internal cash balances (ie working capital and usable reserves) which are not required in the short to medium term in order to reduce risk and keep interest costs low. These factors are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.17 Actual £m
General Fund CFR	1,063
Less: Other debt liabilities *	-154
Borrowing Requirement	**909**
Less: Internal borrowing (utilisation of working capital reserves & balances)	-372
Net external borrowing	**537**

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

14. The treasury management position as at 30 September 2017 and the change over the period is show in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £m	**Movement £m**	**30.9.17 Balance £m**	**30.9.17 Rate %**
Long-term borrowing	397	0	397	4.1%
Short-term borrowing	115	30	145	0.3%
Surrey Police & Crime Commissioner	25	7	32	
Total borrowing	537	37	574	

Short-term investments	-22	15	-7	0.2%
Net borrowing	**515**	**52**	**567**	

Borrowing Strategy during the half year

15. At 30/9/2017 the Authority held £574m of loans, (an increase of £37m in short term borrowing on 31/3/2017). The 30 September 2017 borrowing position is show in table 3 below.

Table 3: Borrowing Position

	31.3.17 Balance £m	**Movement £m**	**30.9.17 Balance £m**	**30.9.17 Weighted average rate %**	**30.9.17 Weighted average maturity years**
Public Works Loan Board	387		387	4.0%	35 years
Long term commercial loan	10		10	5.0%	36 years
Local authorities (short-term)	115	30	145	0.3%	< 3 months
Surrey Police & Crime Commissioner	25	7	32	0.2%	0 days
Total borrowing*	**537**	**37**	**574**		

16. The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

17. In furtherance of these objectives, no new long term borrowing was undertaken, internal borrowing was maximised and short term borrowing was utilised to manage cash flow. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

18. The "cost of carry" analysis performed by the Authority's treasury management advisor Arlingclose did not indicate any value in borrowing in advance for future years' planned expenditure and therefore none was taken.

Investment Activity

19. The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the first half of 2017/18 the Authority's average daily level of investments was £72.3m.

20. The Council deposits cash on the money market through brokers, directly with counterparties through the use of call accounts, money market funds or direct deal facilities, or with the Debt Management Office (DMO). No new fixed term deposits have been agreed during 2017/18, all investments have been made in call accounts or money market funds.

21. The weighted average return on all investments the council received in the quarter to 30 September 2017 is 0.18%. This compares to the 0.11% average 7-day London Interbank Bid Rate (LIBID) for the same period.

Table 5: Investment Benchmarking

	Average 7-day LIBID	Weighted return on investments
2017/18 quarter 2	0.11%	0.18%
2017/18 quarter 1	0.11%	0.21%
2016/17 total	0.20%	0.38%
2015/16 total	0.36%	0.54%

22. Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Council's strategy of maximising internal borrowing has reduced the cash available for investment.

Other Investment Activity

23. Although not currently classed as treasury management activities and therefore not covered by the CIPFA Code, the Authority also holds £77m of investments in directly owned investment property (excluding assets under construction) and £246m in loans to and shareholdings in its subsidiaries.

24. It is projected that these non-treasury investments will generate £3.7m net investment income for the Authority in 2017/18 after taking account of direct costs and MRP.

Performance Report

25. The Authority measures the financial performance of its treasury management activities in terms of its impact on the revenue budget.

Table 6: Performance

	2017/18 Budget £m	**2017/18 Full year projection £m**	**Projected Over/ Under(-) £m**
Minimum Revenue Provision	21.4	19.9	-1.5
Interest Payable	11.5	11.5	0
Interest Receivable	0.4	0.4	0

26. The amount required to be set aside for the future repayment of external borrowing is known as the Minimum Revenue Provision. This amount is calculated with reference to the Council's balance sheet as at the end of the previous financial year. The Council's audited accounts have now been signed off and the amount required to be set aside is £1.4m less than expected when the budget was set. This is mainly due to underspends in the general capital programme for 2016/17.

Compliance Report

27. The Director of Finance is pleased to report that all treasury management activities undertaken during the first half of 2017/18 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below. All investment made in the first half of the year were made in Money Market Funds.

Table 7: Investment Limits

Type	Rating	Limit	Maximum During the Year	Value at 30/9/17	Complied
Aberdeen – MMF	AAA	£25m	£25m	0	✓
Insight – MMF	AAA	£25m	£25m	0	✓
JP Morgan – MMF	AAA	£25m	£25m	0	✓
Morgan Stanley – MMF	AAA	£25m	£25m	0	✓
Goldman Sachs – MMF	AAA	£25m	£25m	£7m	✓
Money Market Funds	**AAA**			**£7m**	✓

28. Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 8: Debt Limits

	External Debt 30.9.17 Actual	**2017/18 Operational Boundary**	**2017/18 Authorised Limit**	**Complied**
Borrowing	574	694	1,274	✓

29. Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Treasury Management Indicators

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

31. **Security:** The Council analyses the investment portfolio at year end against historic default rates to estimate the maximum exposure to default, as shown in the table below:

	Amount	Historical experience of default	Adjustment for market conditions	**Estimated maximum exposure to default**
	£000s 30/09/2017	% 30/09/2017	% 30/09/2017	**£000s** 30/09/2017
Deposits with banks and financial institutions	(a)	(b)	(c)	**(a x c)**

Local Authorities	0	0.00%	0.00%	**0**
AAA rated counterparties	7,000	0.00%	0.00%	**0**
AA rated counterparties	0	0.03%	0.03%	**0**
A rated counterparties	0	0.08%	0.08%	**0**
Other counterparties				
Total	7,000			**0**

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32. **Liquidity:** The Council currently restricts termed deposits to less than one year. In respect of liquidity, the Council also seeks to maintain the following:

- Bank overdraft of £100,000
- No minimum target relating to liquid short term deposits
- Weighted average life benchmark is expected to be less than 3 months.

33. **Interest Rate Exposures**: 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 proportion of net principal borrowed was:

	30.9.17 Actual	**2017/18 Limit**	**Complied**
Upper limit on fixed interest rate exposure	100%	100%	✓
Upper limit on variable interest rate exposure	0%	25%	✓

34. 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. All other instruments are classed as variable rate.

35. **Maturity Structure of Borrowing:** This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

	30.9.17 Actual	**Upper Limit**	**Lower Limit**	**Complied**
Under 12 months	26.7%	50%	0%	✓
12 months and within 24 months	0%	50%	0%	✓
24 months and within 5 years	1.8%	50%	0%	✓
5 years and within 10 years	0%	75%	0%	✓
10 years and above	71.5%	100%	25%	✓

36. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

37. **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 limits on the long-term principal sum invested to final maturities beyond the period end were:

	30.9.17 Actual	**2017/18 Limit**

Principal invested for more than 365 days	0%	35% of value of investments held
Complied	✓	✓

OUTLOOK FOR THE REMAINDER OF 2017/18:

38. The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Both consumer and business confidence remain subdued. Household consumption growth, the driver of UK GDP growth, has softened following a contraction in real wages. Savings rates are at an all-time low and real earnings growth (i.e after inflation) struggles in the face of higher inflation.

39. The Bank of England's Monetary Policy Committee raised the Bank Rate to 0.5% in November in line with market expectations. Further potential movement in Bank Rate is reliant on economic data and the likely outcome of the EU negotiations. Arlingclose's central case is for Bank Rate to remain at 0.5% over the medium term. Arlingclose's central case is for gilt yields to remain broadly stable across the medium term, but there may be near term volatility due to shifts in interest rate expectations.

IMPLICATIONS:

Financial

40. There are no direct financial implications of this report.

Equalities

41. There are no direct equalities implications of this report.

Risk management

42. See paragraphs 30-37.

WHAT HAPPENS NEXT:

a. The Treasury Team will monitor the UK and overseas banking sector and will continue to update this Committee as appropriate.

b. In line with the requirements of CIPFA's Code of Practice for Treasury Management, a full-year report for 2017/18 will be brought to this Committee after financial year end.

c. The Treasury Team will prepare the annual Treasury Management Strategy, which will be presented to this Committee on 22 January 2018 and County Council in February 2018.

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Sources/background papers:

Capital Budget and Treasury Management Strategy 2017/18
Prudential Indicators 2017/18 to 2019/20
CIPFA Code of Practice for Treasury Management in the Public Services 2011

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