# East Herts District Council Treasury Management Strategy Statement and Annual Investment Strategy

**Mid-Year Review Report 2018/19**

# 1. Background

## 1.1 Capital Strategy

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities will be required to prepare a Capital Strategy which is intended to provide the following:

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability

A report setting out our Capital Strategy will be taken to the full council on 5th March 2019.

## 1.2 Treasury management

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly, treasury management is defined as:

> "The management of the local authority's borrowing, 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."

## 2. Introduction

This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report, (stewardship report), covering activities during the previous year.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Performance, Audit and Governance Scrutiny Committee.

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2018/19 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
- A review of the Council's investment portfolio for 2018/19;
- A review of the Council's borrowing strategy for 2018/19;
- A review of any debt rescheduling undertaken during 2018/19;
- A review of compliance with Treasury and Prudential Limits for 2018/19.

# 3. Economics and interest rates

## 3.1 Economics update

**UK.** The first half of 2018/19 has seen UK **economic growth** post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase **Bank Rate** on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concerns about a build-up of **inflationary pressures**, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

As for the **labour market,** unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009 (The previous high point was in July 2015). Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.
In the **political arena**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

**USA.** President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

**EUROZONE.** Growth was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.

**CHINA.** Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

**JAPAN** has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

### 3.2 Interest rate forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast:

| Link Asset Services Interest Rate View | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank Rate View | 0.75% | 0.75% | 0.75% | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.50% | 1.50% |
| 3 Month LIBID | 0.75% | 0.80% | 0.80% | 0.90% | 1.10% | 1.10% | 1.20% | 1.40% | 1.50% | 1.60% | 1.60% |
| 6 Month LIBID | 0.85% | 0.90% | 0.90% | 1.00% | 1.20% | 1.20% | 1.30% | 1.50% | 1.60% | 1.70% | 1.70% |
| 12 Month LIBID | 1.00% | 1.00% | 1.00% | 1.10% | 1.30% | 1.30% | 1.40% | 1.60% | 1.70% | 1.80% | 1.80% |
| 5yr PWLB Rate | 2.00% | 2.00% | 2.10% | 2.20% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% |
| 10yr PWLB Rate | 2.40% | 2.50% | 2.50% | 2.60% | 2.70% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% |
| 25yr PWLB Rate | 2.80% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.50% | 3.50% |
| 50yr PWLB Rate | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% |

The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast. They do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. They also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

**The balance of risks to the UK**

- The overall balance of risks to economic growth in the UK is probably neutral.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

**Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:**

- Bank of England monetary policy takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. This is likely to lead to friction with the EU when setting the target for the fiscal deficit in the national budget. Unsurprisingly, investors have taken a dim view of this and so Italian bond yields have been rising.
- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position as a result of the rise of the anti-immigration AfD party. To compound this, the result of the Swedish general election in September 2018 has left an anti-immigration party potentially holding the balance of power in forming a coalition government. The challenges from these political developments could put considerable pressure on the cohesion of the EU and could spill over into impacting the euro, EU financial policy and financial markets.
- The imposition of trade tariffs by President Trump could negatively impact world growth. President Trump's specific actions against Turkey pose a particular risk to its economy which could, in turn,

negatively impact Spanish and French banks which have significant exposures to loans to Turkey.

- Weak capitalisation of some European banks.
- Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens e.g. UK gilts.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

**Upside risks to current forecasts for UK gilt yields and PWLB rates**

- President Trump's fiscal plans to stimulate economic expansion causing a significant increase in inflation in the US and causing further sell offs of government bonds in major western countries.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

## 4. Treasury Management Strategy Statement and Annual Investment Strategy Update

The Treasury Management Strategy Statement (TMSS) for 2018/19, was approved by this Council on 1st March 2018.

There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

## 5. The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

### 5.1 Prudential Indicator for Capital Expenditure

This table below shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

| Capital Expenditure | 2018/19 Original Estimate £m | Current Position £m | 2018/19 Revised Estimate £m |
|---|---|---|---|
| **Total capital expenditure** | 1.9 | 0.3 | 6.1 |

The variation between original and revised estimate is detailed as follows:

- A number of major new capital projects have been agreed since the budget was set, including the new leisure centre projects and Hertford Theatre builds with consultancy spend in 2018/19. (£1.5m)
- Herts and Essex loan. (£1m)
- Slippage from 2017/18 plus other minor variations (£1.7m).
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### 5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

| Capital Expenditure | 2018/19 Original Estimate £m | Current Position £m | 2018/19 Revised Estimate £m |
|---|---|---|---|
| **Total capital expenditure** | **1.9** | **0.3** | **6.1** |
| ***Financed by:*** | | | |
| **Capital receipts** | **1.0** | **0.3** | **1.0** |
| **Capital grants** | **-** | **-** | **0.1** |
| **Capital reserves** | **-** | **-** | **-** |
| **Revenue** | **-** | **-** | **-** |
| **Total financing** | **1.0** | **0.3** | **1.1** |
| **Borrowing requirement** | **0.9** | **-** | **5.0** |

### 5.3 (CFR), External Debt and the Operational Boundary

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

### Prudential Indicator – Capital Financing Requirement

The original forecast Capital Financing Requirement is expected to increase by £5m due to additional capital expenditure approved by members since the 2018/19 budget was set.

### Prudential Indicator – the Operational Boundary for external debt

| | 2018/19 Original Estimate £m | Current Position £m | 2018/19 Revised Estimate £m |
|---|---|---|---|
| **Prudential Indicator – Capital Financing Requirement** | | | |
| **Total CFR** | (21.1) | (23.1) | (18.1) |
| | | | |
| **Prudential Indicator – the Operational Boundary for external debt** | | | |
| Borrowing | 7.5 | 7.5 | 7.5 |
| Other long term liabilities* | - | - | - |
| **Total debt (year end position)** | **7.5** | **7.5** | **7.5** |

** On balance sheet PFI schemes and finance leases etc.*

### 5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose*. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2018/19 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

** The management of transferred debt should be excluded from net borrowing.*

| | 2018/19 Original | Current Position | 2018/19 Revised |
|---|---|---|---|

| | Estimate £m | £m | Estimate £m |
|---|---|---|---|
| Borrowing | 7.5 | 7.5 | 7.5 |
| Other long term liabilities* | - | - | - |
| **Total debt** | 7.5 | 7.5 | 7.5 |
| **CFR* (year end position)** | (21.1) | (23.1) | (18.1) |

* *Includes on balance sheet PFI schemes and finance leases etc.*

The Director of Finance reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

| **Authorised limit for external debt** | **2018/19 Original Indicator** | **Current Position** | **2018/19 Revised Indicator** |
|---|---|---|---|
| Borrowing | 11.5 | 7.5 | 11.5 |
| Other long term liabilities* | 1.0 | - | 1.0 |
| Total | 12.5 | 7.5 | 12.5 |

* *Includes on balance sheet PFI schemes and finance leases etc.*

## 6. Investment Portfolio 2018/19

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As shown by forecasts in section 3.2, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.75% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

The Council held £67m of investments as at 30th September 2018 (£66m at 31 March 2017), £20m of which is held in property funds and £47m in short term investments. The investment portfolio yield for the first 6 months of the year is 3.58% (property funds) 0.77% (short term) against an average 6mth benchmark return of 0.71%. (See Appendix 2)

The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2018/19.

The Council's budgeted investment return for 2018/19 is £1.090m, and performance for the year to date is in line with the budget.

**Investment Counterparty criteria**

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

## 7. Borrowing

The Council's capital financing requirement (CFR) for 2018/19 is (£18.1m), negative. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The Council has a negative CFR position and external borrowings of £7.5m.

It is anticipated that further borrowing will not be undertaken during this financial year.

## 8. Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

£6m of the Council's £7.5m external borrowings mature in May 2020.

## 9. Other

### 1. UK banks – ring fencing

The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as "ring-fencing". Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

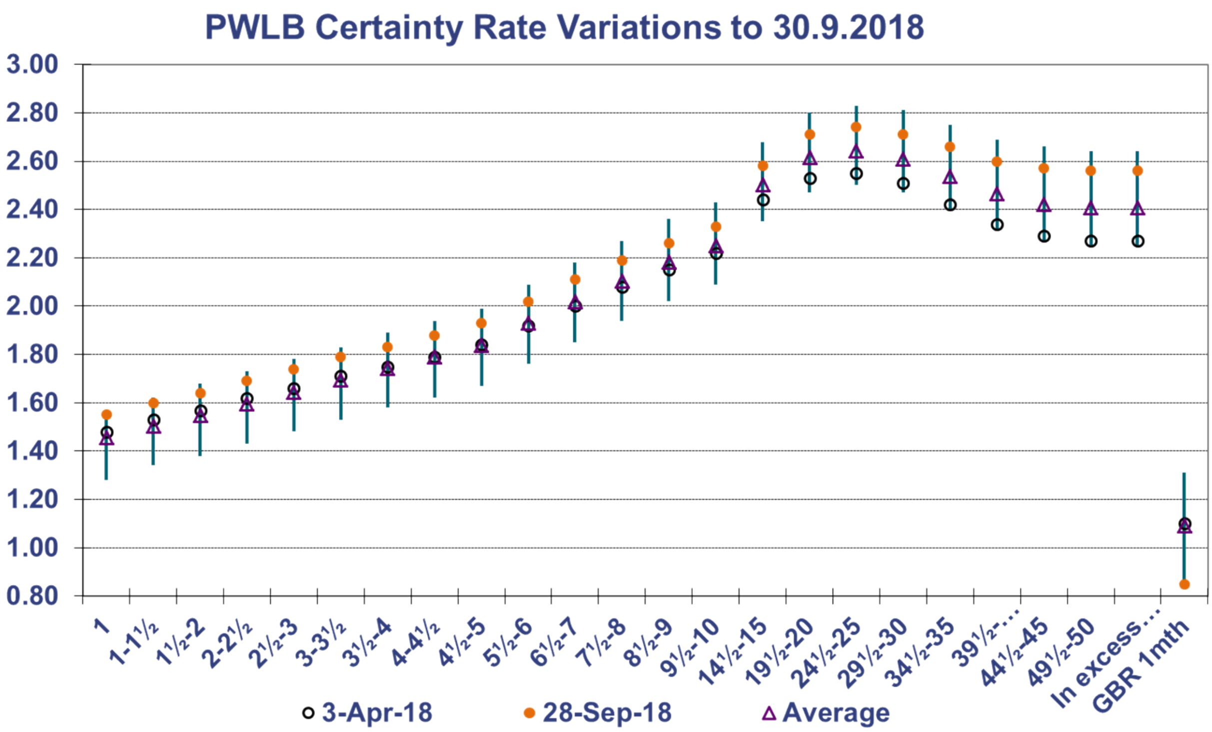
Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank, (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and "riskier" activities are required to be housed in a separate entity, a non-ring-fenced bank, (NRFB). This is intended to ensure that an entity's core activities are not adversely affected by the acts or omissions of other members of its group.

While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

## 2. Changes in risk appetite

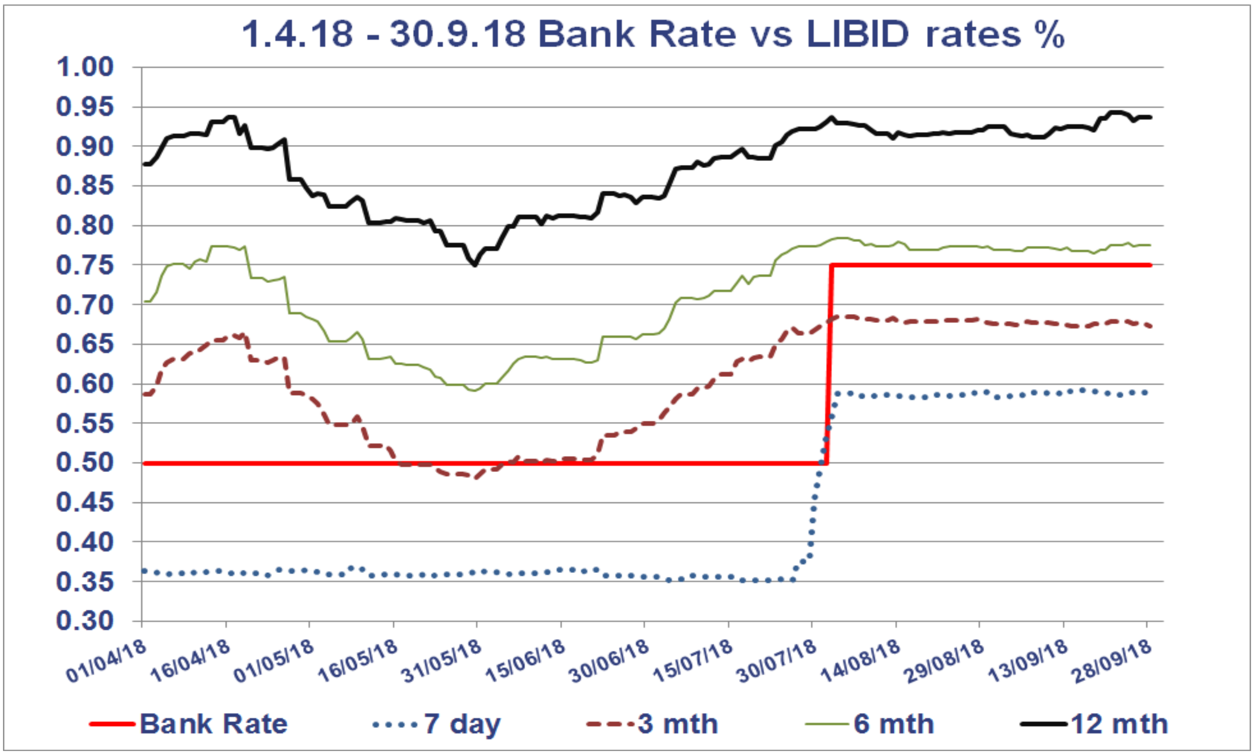
The 2018 CIPFA Codes and guidance notes have placed enhanced importance on risk management. Where an authority changes its risk appetite e.g. for moving surplus cash into or out of certain types of investment funds or other types of investment instruments, this change in risk appetite and policy should be brought to members’ attention in treasury management update reports.

# APPENDIX 1: Borrowing



# APPENDIX 2: Investing

| | Bank Rate | 7 day | 1 mth | 3 mth | 6 mth | 12 mth |
|---|---|---|---|---|---|---|
| High | 0.75 | 0.59 | 0.60 | 0.68 | 0.78 | 0.94 |
| High Date | 02/08/2018 | 14/09/2018 | 18/09/2018 | 06/08/2018 | 03/08/2018 | 21/09/2018 |
| Low | 0.50 | 0.35 | 0.37 | 0.48 | 0.59 | 0.75 |
| Low Date | 01/04/2018 | 19/07/2018 | 30/05/2018 | 30/05/2018 | 30/05/2018 | 30/05/2018 |
| Average | 0.58 | 0.43 | 0.47 | 0.61 | 0.71 | 0.87 |
| Spread | 0.25 | 0.24 | 0.23 | 0.21 | 0.19 | 0.19 |



## APPENDIX 3: Approved Countries for investments

***Based on lowest available rating***

AAA

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France
- Hong Kong
- U.K.

AA-

- Belgium
- Qatar

# N.B. This list is as at 30.09.18