Appendix A

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 Council, on 13th February 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

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017) primary requirements 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 the Corporate 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

*note the commentary below are views of LINK Treasury Services in their capacity of treasury management advisors to Melton Borough Council

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.

With regard to **Brexit**, there is a risk that the Government could lose a Brexit vote. . Although a general election is not anticipated, if, as a result, the UK faces a general election in the next 12 months, this could lead to 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.

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. We do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. We 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.

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 7th February 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 shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget. The figures shown are the latest estimates and have/will be approved at the relevant policy committee during November 2018.

Capital Expenditure by Service	**2018/19 Original Estimate £m**	**2018/19 Revised Estimate £m**
Non HRA	0.386	1.017
HRA	5.948	7.354
Total capital expenditure	**6.334**	**8.371**

The increase in the non HRA capital expenditure from £0.386m to £1.017m is as a result of carry forwards of £0.533m from 2017/18 and an increase to the number of the budgets including DFGs, new Play Area equipment and Telephony £0.098m.

In terms of the HRA, the movement from the original estimate of £5.948m to the revised estimate of £7.534m is a result of carry forwards from 2017-18 being included into the 2018-19 capital programme of £1.282m and, additional costs of £0.124m primarily relating to Beckmill Court.

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.

Capital Expenditure	**2018/19 Original Estimate £m**	**2018/19 Revised Estimate £m**
Total capital expenditure	**6.334**	**8.371**
Financed by:		
Capital receipts	-	0.003
Capital grants	0.237	0.418
Reserves	5.948	7.758
Renewals and Repairs fund	0.149	0.192
Third party contribution	-	-
Total financing	**6.334**	**8.371**
Borrowing requirement	**0**	**0**

Due to changes outlined in para 5.1 there have been associated changes in the financing requirements and sources of funding which are highlighted above.

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement (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

We are on target to achieve the original forecast Capital Financing Requirement

Prudential Indicator – the Operational Boundary for external debt

	2018/19 Original Estimate £m	**2018/19 Revised Estimate £m**
CFR – non housing	0.101	0.101
CFR – housing	31.484	31.484
Total CFR	**31.585**	**31.585**
Net movement in CFR	**0**	**0**
Borrowing	31.413	31.413
*Other Long term Liabilities	0.096	0.096
Total debt (year end position)	**31.509**	**31.509**

** Long term credit arrangement with Registrars*

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.

	2018/19 Original Estimate £m	**2018/19 Revised Estimate £m**
Total debt	**31.509**	**31.509**
CFR* (year end position)	**31.585**	**31.585**

The Director for Corporate Services 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 £m**	**2018/19 Revised Indicator £m**
Total Borrowing	46.000	46.000

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 £22.7m of investments as at 30 September 2018 (£20.1m at 31 March 2018) and the investment portfolio yield for the first six months of the year is 1.19% against the seven day money market rate of 0.71%.

The Director for Corporate Services confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2018/19.

The Council's gross budgeted investment return for 2018/19 is £181,800, and performance for the year is currently anticipated to be £70k above budget. This is due to both level of balances held and interest rate achieved being higher than budgeted.

Investment Counterparty criteria

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

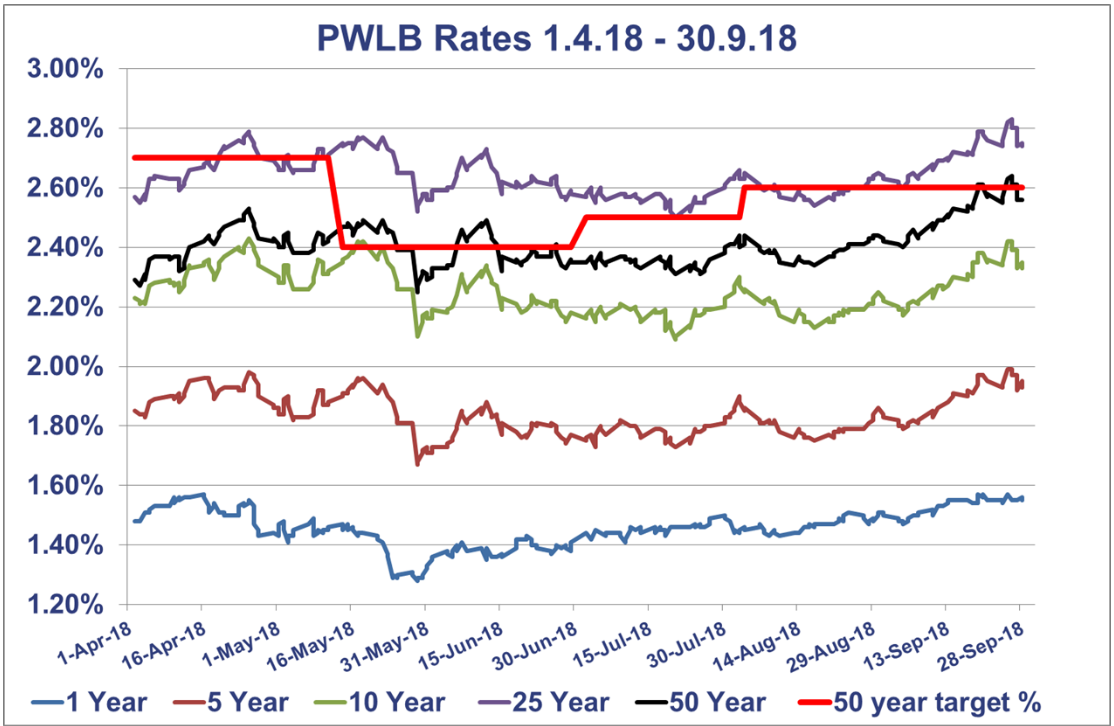
7 Borrowing

The Council's capital financing requirement (CFR) for 2018/19 is £31.585m. 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. Table 5.4 shows the Council has borrowings of £31.413m. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

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

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates 1 April 2018 to 28 September 2018



	1 Year	5 Year	10 Year	25 Year	50 Year
3.4.18	**1.48%**	**1.84%**	**2.22%**	**2.55%**	**2.27%**
30.9.18	**1.55%**	**1.93%**	**2.33%**	**2.74%**	**2.56%**
Low	**1.28%**	**1.67%**	**2.09%**	**2.50%**	**2.25%**
Date	**01/06/2018**	**29/05/2018**	**20/07/2018**	**20/07/2018**	**29/05/2018**
High	**1.57%**	**1.99%**	**2.43%**	**2.83%**	**2.64%**
Date	**17/04/2018**	**25/09/2018**	**25/04/2018**	**25/09/2018**	**25/09/2018**
Average	**1.46%**	**1.84%**	**2.25%**	**2.64%**	**2.41%**

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.

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. IFRS9 accounting standard
This accounting standard came into effect from 1st April 2018. It means that the category of investments valued under the available for sale category will be removed and any potential fluctuations in market valuations may impact onto the Surplus or Deficit on the Provision of Services, rather than being held on the balance sheet. This change is unlikely to materially affect the commonly used types of treasury management investments but more specialist types of investments, (e.g. pooled funds, third party loans, commercial investments), are likely to be impacted. The Council currently holds £2m in a pooled property fund which would be affected by this change. However this investment will be subject to the override described below.

The Ministry of Housing, Communities and Local Government (MHCLG), conducted a consultation for a temporary override to allow English local authorities time to adjust their portfolio of investments. The consultation ended on 28 September 2018 and the MHCLG have subsequently published their intentions as follows:

“Having considered the consultation responses the Government intends to:

- *Require local authorities to account for fair value movements in financial instruments in accordance with proper practices as set out in the Code on Local Authority Accounting published by CIPFA.*
- *Introduce a mandatory statutory override requiring local authorities to reverse out all unrealised fair value movements resulting from pooled investment funds. This will be effective from financial year commencing 1 April 2018*
- *Extend the proposed period for which the statutory override applies to five years. The Government will keep use of the override under review.*

- *Require Local Authorities to disclose the net impact of the unrealised fair value movements in a separate unusable reserve throughout the duration of the override*
- *Introduce a 2 year extension of the unequal pay regulation. 9.*

There will be no override for the expected loss model or for the extra disclosures that the new standard requires."