Item 3 (ii)

Ethics, Transparency and Audit Panel Report
10 December 2018

TREASURY MANAGEMENT REPORT FOR THE HALF YEAR ENDED 30 SEPTEMBER 2018

Report of the Director of Finance, Assets and Resources

Summary

1. This report reviews the treasury management activities for the Staffordshire Commissioner Fire and Rescue Authority only; a separate report has been prepared for Staffordshire Police. Therefore, reference is made only to Staffordshire Commissioner Fire and Rescue Authority ('the Authority') as part of this report.

2. This report reviews the treasury management activities for the half-year ended 30 September 2018, including the Prudential Indicators for treasury management and the Authority's approved counterparty lending list.

3. During the first 6 months of the year the Authority continued to invest cautiously. No long-term loans were taken out and the Authority will be repaying a £1.5m Public Works Loan Board (PWLB) loan in February 2019. The total amount of loans outstanding as at 30 September 2018 was £19.550m.

Recommendations

4. That the treasury management activities for the half-year ended 30 September 2018 are reviewed, and the Prudential Indicators for treasury management shown at **Appendix 2** be noted.

Revised CIPFA Code and MHCLG Guidance

5. In late December 2017, CIPFA published both its revised *Treasury Management in the Public Services Code of Practice* and its revised *Prudential Code for Capital Finance in Local Authorities*. In addition, the Ministry of Housing, Communities and Local Government (MHCLG) published revised *Guidance on Local Government Investments* and *Statutory Guidance on Minimum Revenue Provision* in February 2018.

6. As part of the Treasury Management Strategy for 2018/19, it was agreed that amendments required by the new CIPFA Codes and MHCLG Guidance would take place in later reports, now in place for the 2019/20 financial year.

7. In addition CIPFA have only recently published their *Treasury Management in the Public Services Guidance Notes for Local Authorities including Police and Fire Bodies*, originally scheduled for July 2018. The guidance notes would provide more direction for local authorities when setting treasury management indicators.

8. According to the revised CIPFA Code and MHCLG Guidance, the Authority will need to produce the following for the 2019/20 financial year:
    - a new Capital Strategy report
    - a Minimum Revenue Provision (MRP) statement
    - a revised Treasury Management Strategy report

Economic Background

9. In June 2018, the EU Withdrawal Bill narrowly made it through Parliament after a number of defeats. The new Act would repeal the 1972 European Communities Act, which took the UK into Europe, and also allow EU law to be transferred into UK law. With less than 6 months to go until Article 50 expires on 29 March 2019, the extended period of economic uncertainty continues, as the UK and the EU undergo increasing complications in their negotiations to agree a financial settlement and a future trading relationship.

10. The FTSE 100 reached record highs of over 7,800 at the start of the financial year, as markets perceived global trade conflicts as neither pressing or as threatening as previously thought. However those concerns returned as the FTSE 100 finished the half year at around 7,500(at the time of writing in October, the FTSE has fallen further, trading below 7,000). UK gilt yields also showed increased volatility during the period, reflecting investor anxiety over the growing political uncertainty in the UK, as the deadline for Brexit draws near.

11. The Bank of England’s Monetary Policy Committee (MPC) deferred raising interest rates until August, despite earlier statements that monetary policy would need to be tightened in order to bring inflation to target. It then raised rates to 0.75% indicating any further rate rises would be gradual and to a limited extent. Some commentators believe Brexit to be a greater challenge to the UK economy than inflation and that an MPC policy of cutting Bank Rate from a higher level would be more effective if some of the Brexit risks transpire.

12. European markets retreated in June 2018, affected by fears over the rise of populist parties with Eurosceptic policies following the political crisis in Italy. However the European Central Bank (ECB) gave an upbeat assessment of economic conditions in September and confirmed its intention to end quantitative easing by the end of the year.

13. The US economy continued to expand over the period and the Federal Reserve (the Fed) maintained its policy of moving from a quantitative easing

to a monetary tightening position. The Fed raised rates in June and in September by 0.25% to the current 2%-2.25% range. Improvements to the US economy were tempered by an escalating trade war with China, initiated by tariffs announced by the Trump administration. The damage to China and other Asian economies in the supply chain risk contributing to a slowdown in global economic growth in 2019.

Longer-Term Borrowing 1 April 2018 to 30 September 2018

14. The Treasury Management Strategy Report for 2018/19, approved on 1 March 2018, outlined the long-term borrowing strategy for the year and a number of Prudential Indicators as set out in **Appendix 2**. The strategy was;

    "…to use cash as far as possible with the option to borrow up to £3m long-term where the Director of Finance, Assets and Resources considers this appropriate in 2018/19."

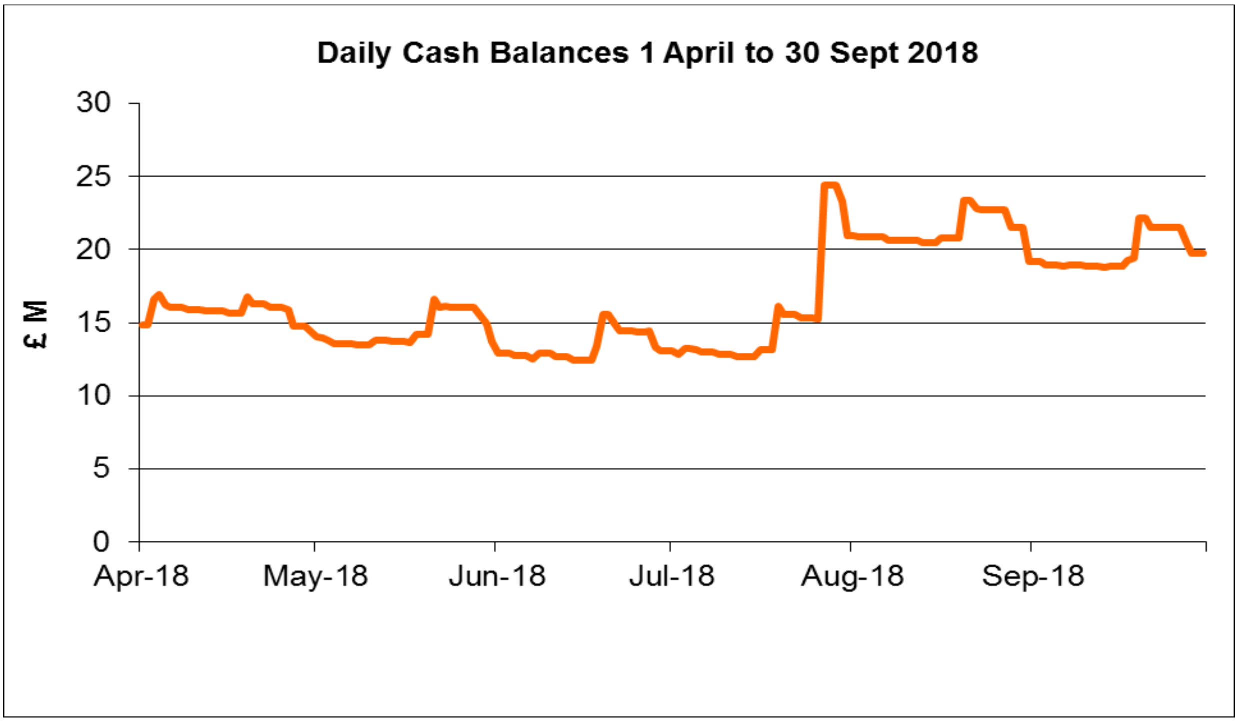
15. In accordance with this, cash was used in lieu of borrowing and no new loans were taken in the first half of the financial year. The implementation of this strategy relied upon two main factors:
    - The Bank of England 'Bank rate' remaining low; and
    - Cash balances being sufficient to allow the Authority's daily cash flow needs to be met.

16. In August 2018, the MPC raised Bank Rate by 0.25% to 0.75%, the second time it had raised rates in the past year. The MPC felt the rise was justified in the face of rising inflation, low unemployment and stronger global economic growth. However the MPC has maintained expectations of a slow rise in interest rates over their forecast horizon, due to the ongoing challenges to the UK economy.

17. In terms of the future, the County Council provide a Bank Rate forecast, based on advice from their treasury advisor. The Council expect Bank Rate to rise twice in 2019 although they maintain significant downside risks to the interest rate forecast, as the UK finds its way through the EU negotiations and the initial post EU period.

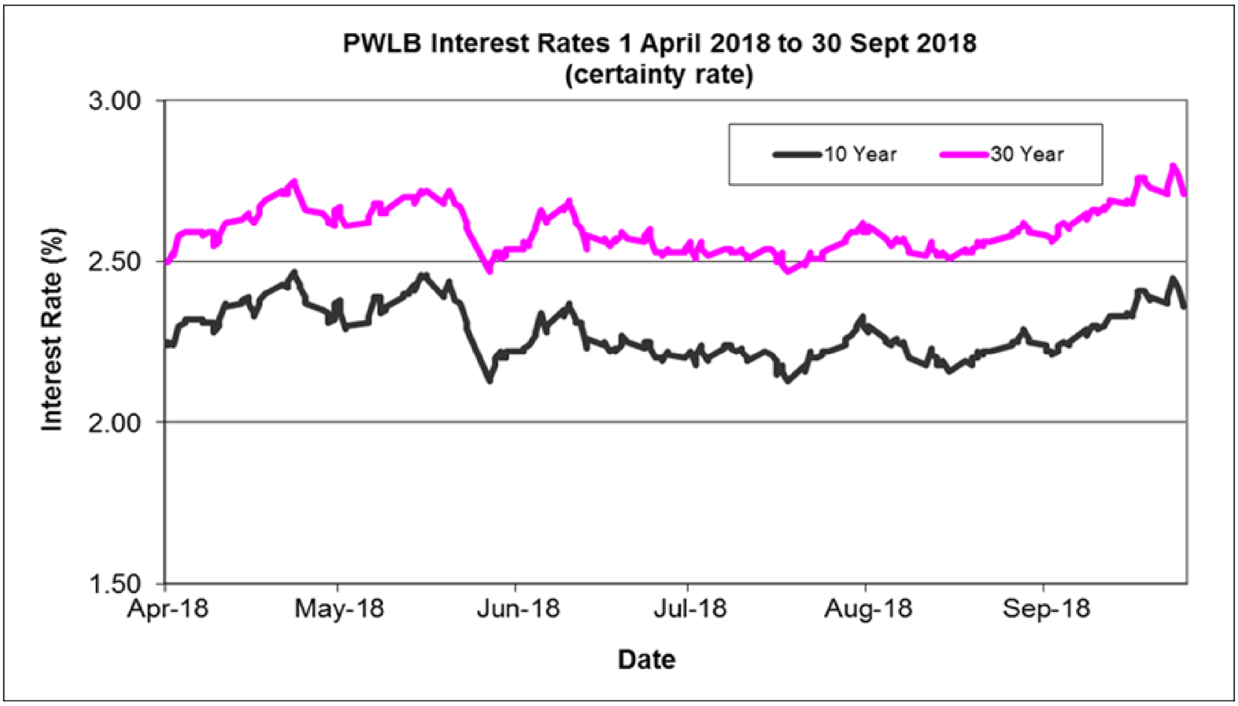
18. Although interest rates have risen, they still remain just above historic lows. Low rates means that the strategy of using cash is still important, as it represents a cheap way of financing the capital programme. Overall, the short-term interest rate environment now and the forecast continue to support the borrowing strategy adopted in 2018/19.

19. Secondly, cash balances have been sufficient to allow day to day cash management in the first half of the year as shown in the following graph.



20. The graph shows a sharp increase in cash balances following the receipt of the pension "top-up" grant of around £9m at the end of July. Cash balances are also around £9m lower than they would be without the strategy of using cash in lieu of borrowing.

21. When loans are taken-up these are mainly sourced from the Public Works Loan Board (PWLB) whose loan interest rates reflect changes in Gilt yields in the UK Government bond market - Gilt yields are effectively longer-term interest rates. The following chart shows two typical loan periods where rates have been adjusted to reflect the "certainty-rate" reduction of 0.20% that is available to all local authorities (including Fire authorities) who register with the Government.



22. Gilt yields are very sensitive to the risk appetite of international investors and currently yields are still relatively low reflecting the uncertain global financial environment. Although the UK is still perceived as a safe-haven for domestic and international investors, gilt yields have increased from the end of August due to concerns over Brexit. This has been reflected in an upturn in PWLB interest rates. At the time of writing in October, gilt yields have fallen back meaning PWLB rates will have also decreased.

23. The following table shows the interest rates incurred on the Authority's debt portfolio for 2017/18 and for this half year, including an adjustment reflecting the use of cash.

	2017/18 Full Year %	**2018/19 Half Year %**
Weighted average rate of interest for external loans *	4.33	4.35
* adjusted for the use of cash	3.57	3.46

24. The weighted average rate of interest has increased slightly in 2018/19 as the Authority had repaid a PWLB loan for £0.5 million in 2017/18, originally taken out at a lower rate than the average. Once the use of cash is taken into account the rate falls considerably. Furthermore the adjusted rate decreased from that in 2017/18 because of an increase in the use of cash available. This illustrates the policy of using cash instead of borrowing continues to generate significant savings, helping reduce the average interest the Authority pays on its debt.

25. A graph illustrating the maturity profile of the long-term debt at 30 September 2018 is provided at **Appendix 3**.

26. As an indication and on average, internally funding from cash in lieu of borrowing has saved the Authority £0.117 million in interest payments so far this financial year. A full year figure will be reported in the 2018/19 outturn report but is expected to be a saving of £0.234 million.

Annual Investment Strategy

27. The Annual Investment Strategy (AIS) sets out those parties the Authority will lend its money to. The general criteria for determining the institutions that should be included on the counterparty list are set out in detail most recently within the Treasury Management Strategy 2018/19.

28. The strategy for 2018/19 set out the requirements of government regulations and the CIPFA Code. Both of these documents set out two prime risk issues:
- The security of capital
- The liquidity of investments.

29. In summary, investments are currently being placed with the following:
- UK Government Debt Management Account Deposit Facility (DMADF) – £ Unlimited (6 months is the maximum period permitted).
- Local Authorities / Parish Councils (per regulations) – £ Unlimited (12 months).
- 3 x "AAA" rated Money Market Funds (MMF) – Up to £2.5m (same day liquidity).
- "AAA" rated Enhanced MMF – Up to £1.5m (3 day notice)

30. As shown in **paragraph 21**, cash balances at the Authority have been relatively high, especially from the point the pensions top up grant was received in July. Once MMF limits are reached, it can be difficult to invest the higher cash balances when there is insufficient demand for local Authority borrowing and with returns from DMADF deposits being relatively low.

31. As part of the Treasury Management Strategy for 2018/19, a hard MMF investment limit of £2.5m was set with a soft limit of £1.5m, in order to maintain flexibility within the investment strategy. In addition the amendment of the AIS has been delegated to the Director of Finance, Assets and Resources, with the outcome reported in the regular treasury management reports.

Short-term money-market transactions

32. Approved investments at 30 September 2018, stood at £19.781 million. They can be analysed by counterparty, amount, term and credit rating as follows.

Regulation Investments	**£m**	**Term**	**Credit rating**
Glasgow City Council	3.000	3 months	Unrated
London Borough of Barking & Dagenham	2.000	3 months	Unrated
Slough Borough Council	5.000	3 months	Unrated
Telford & Wrekin Borough Council	3.000	3 months	Unrated
Banks and building societies			
Lloyds Bank Plc	(0.106)	Instant	A+
Money Market Funds			
Federated	2.000	Instant	AAA
Morgan Stanley	1.500	Instant	AAA
Standard Life*	1.600	Instant	AAA
Collective Investment Scheme			
Royal London Cash Plus Fund	1.500	3 day notice	AAA
TOTAL	**19.494**		

**merged with Aberdeen Asset Management in October 2018*

33. Whilst most local authorities are unrated by credit agencies, both regulations (which list local authorities as acceptable bodies to invest in) and their status

as tax raising bodies make them highly creditworthy. In addition all local Authority deposits were relatively short-term with durations of three months.

34. The table below shows the return in 2017/18 and 2018/19 to date.

	2017/18 Full Year	**2018/19 Half Year**
Average return on investments	0.33%	0.58%
7 day LIBID* benchmark	0.21%	0.43%

** The 7 Day LIBID is the average rate of interest for a period of time at which banks are prepared to lend to each other for up to a week.*

35. The average return on investments so far this year (and in 2017/18) has been higher than the benchmark, reflecting the higher returns from investments made with local authorities and MMFs. In addition the interest rate rises made in November 2017 and August 2018 has meant that the average return this year has been considerably higher than last year.

Second Markets in Financial Instruments Directive (MiFID II)

36. During the first half of the financial year, the Authority remained as a professional client under the second Markets in Financial Instruments Directive (MiFID II), mainly because they continued to meet the required criteria of holding an investment balance of at least £10m.

37. If the Authority were to be treated as a retail client, financial firms would need to provide a raft of protections to ensure suitability of investment products and evidence that all risks and product features have been fully explained. These enhanced protections would ultimately mean the Authority would likely face increased costs and potentially restricted access to certain products including money market funds, pooled funds, and treasury advice.

38. Although the Authority has effectively foregone the protections afforded to retail clients, it should be noted such protections are not currently enjoyed by the Authority anyway and the associated risks are mitigated through a range of different controls, including;

- the CIPFA Code of Practice for Treasury Management in the Public Services, which the Authority has adopted;
- the County Council's Constitution, Scheme of Delegation and Service Level Agreement with the Authority;
- the County Council's access and membership of professional networks; and
- an experienced and well qualified officer team at the County Council.

39. Whether local authorities are retail or professional clients, they are not protected by the Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service.

40. For the reasons above the Authority will continue to be elected up as a professional client.

Money Markets Funds (MMF) reform

41. New EU regulations for MMFs were approved in July 2017 meaning existing funds will need to be compliant by January 2019. As part of the regulations, it is expected that most short term MMFs will convert from a Constant Net Asset Value (CNAV) to a Low Volatility Net Asset Value (LVNAV) structure.

42. The assets of LVNAV MMFs are predominantly marked to market meaning the dealing NAV (unit price) may fluctuate. However the new regulations confirm they will be allowed to maintain a constant dealing NAV provided they meet strict new criteria and minimum liquidity requirements. Public debt CNAV MMFs will still be available where 99.5% of assets are invested in government debt instruments.

43. A number of MMF providers have started to inform clients over their plans to become compliant to the new regulations. The Council's treasury staff will monitor individual MMFs and update the Authority with any developments. The Authority will continue to consider MMFs for investment in accordance with the criteria laid out in the 2018/19 Treasury Management Strategy. The MMF reforms should not lead to any operational change for the Authority.

Bank Ring-fencing

44. Ring-fencing legislation adopted by UK financial regulators requires that the larger UK banks separate their core retail banking activity from the rest of their business, ahead of the statutory deadline of 1 January 2019. The aim is to protect retail banking activity from unrelated risks elsewhere in the banking group, as became evident after the global financial crisis.

45. The Authority's banker Lloyds has created Lloyds Bank Corporate Markets as a new investment bank to hold its relatively small investment banking operation. This means 97% of the bank's assets are expected to remain within the ring-fence bank. The Authority's business with the bank will take place within the ring-fence and not form part of their investment banking operations.

Compliance with CIPFA Code of Practice

46. It can be certified that for the half-year ended 30 September 2018:

(i) All transactions were undertaken by authorised officers and within the limits approved by the Authority;

(ii) All investments were to counterparties on the approved lending list current at the time, and fully met the requirements of relevant legislation;

(iii) During the financial year the Authority operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Practices and Annual Treasury Strategy Statement. The half year position against the Prudential Indicators is shown in **Appendix 2**.

David Greensmith
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<u>Background Documents</u>

1. Treasury Management in the Public Services: Code of Practice (CIPFA) (2011)
2. Prudential Code for Capital Finance in Local Authorities (CIPFA) (2011)
3. Local Authorities (Capital Finance and Accounting) Regulations 2013
4. Local Government Investments - Guidance under Section 15(1) of the Local Government Act 2003 issued by the Secretary of State (2010)

Appendix 1

Financial Implications

All resource implications are covered in the body of this report.

Legal Implications

There are no legal implications.

Equality & Diversity Implications

There are no equalities implications.

Risk Implications

Treasury management operations by their very nature are subject to interest rate risk, credit, counterparty and refinancing risk and these are discussed throughout the report.

Consultation and Engagement undertaken

The County Council's treasury advisors, Arlingclose, have provided some of the information for the report.

Procurement and Social Value Implications

The daily treasury management function is carried out on behalf of the Authority by Staffordshire County Council, under an annually updated Service Level Agreement (SLA). The SLA for 2018/19 has been approved as part of the Treasury Management Strategy in March 2018.

Protective Security Considerations

Data protection and protective security policies are implemented within Staffordshire County Council and all departments within the Council. Treasury management activities are undertaken in line with these policies and the agreed SLA.

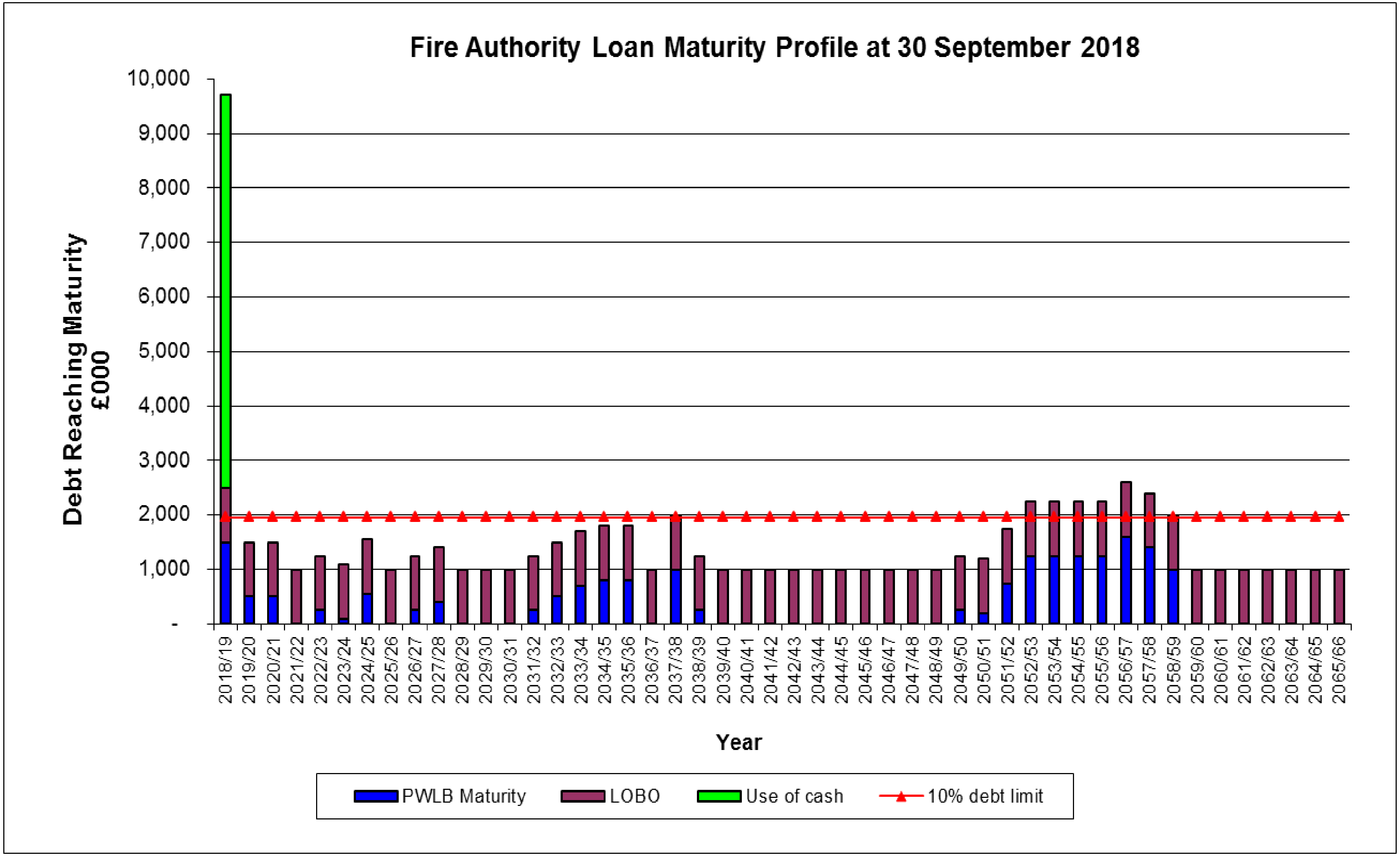
Appendix 2

Staffordshire Commissioner Fire and Rescue Authority

Strategy and Resources Committee – 9 November 2018

Prudential Indicators for Treasury Management

Indicator	Original 2018/19		Position at 30/09/18
1. CIPFA Code of Practice for Treasury Management in the Public Services	The Authority adopted the Code at its meeting on 22 March 2012.		
This indicator identifies whether CIPFA's Code of Practice for Treasury Management in the Public Services has been adopted.			
2. External Debt			
Authorised Limit	£34.9m		£19.6m
Authorised Limit for other liabilities	£80.9m		£79.5m
TOTAL	£115.8m		£99.1m
Operational Boundary	£30.0m		£19.6m
Operational Boundary for other liabilities	£80.9m		£79.5m
TOTAL	£110.9m		£99.1m
External Loans	£19.6m		£19.6m
The Authorised Limit is the maximum level of external borrowing which should not be exceeded. It is linked to the estimated level of borrowing assumed in the capital programme. *The Operational Boundary represents the Directors estimate of the day to day limit for treasury management activity based on the most likely i.e. prudent but not worst case scenario.* *Other liabilities relate to PFI schemes on the balance sheet.*			
3. Interest Rate Exposures			
a. Upper Limit (Fixed)	£28.4m		£19.6m
b. Upper Limit (Variable)	(£25.0m)		(£19.8m)
Upper limits of fixed and variable borrowing and investments are required to be set. This limits the Authority's exposure to both fixed and variable interest rate movements as part of the overall risk management strategy for Treasury Management activities. Negative figures are shown in brackets; these relate to investments at a variable rate which are not offset by variable borrowings.			
4. Maturity Structure of Borrowing	Upper Limit	Lower Limit	
Under 12 months	10%	0%	7.7%
12 months and within 24 months	10%	0%	2.6%
24 months and within 5 years	30%	0%	3.8%
5 years and within 10 years	50%	0%	6.6%
10 years and above	100%	25%	79.3%
This indicator identifies the amount of loans maturing in specified periods. The overarching principle is that steps should be taken from a risk management point of view to limit exposure to significant refinancing risk in any short period of time. *The Authority currently applies the prudent practice of ensuring that no more than 10% of its total gross fixed rate loans mature in any one financial year.*			
5. Upper limit for total principal sums invested for over 364 days (per maturity date)	£		£
Any investments made for over 364 days will be in accordance with the Authority's limits on non-specified investments.	Nil		Nil
6. Borrowing in advance of need (maximum debt)	100%		100%
This is a new indicator; it sets the maximum loans as a proportion of the borrowing need. In 2018/19 the strategy is not to borrow in advance, hence the indicator is set at 100%.			



Fire Authority Loan Maturity Profile at 30 September 2018
Debt Reaching Maturity £000
10,000
9,000
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
-
2018/19
2019/20
2020/21
2021/22
2022/23
2023/24
2024/25
2025/26
2026/27
2027/28
2028/29
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2056/57
2057/58
2058/59
2059/60
2060/61
2061/62
2062/63
2063/64
2064/65
2065/66
Year
PWLB Maturity
LOBO
Use of cash
10% debt limit