Appendix 1

Treasury Management Mid-Year Report 2017/18

Introduction

In February 2011 the council 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 council to approve treasury management semi-annual and annual reports.

The council's treasury management strategy for 2017/18 was approved at the full council meeting of the Isle of Wight Council on 15 March 2017. The Authority has borrowed and invested substantial sums of money and is therefore exposed 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 at 30 September 2017

Economic backdrop: Commodity prices fluctuated over the period with oil falling below $45 a barrel before inching back up to $58 a barrel. UK Consumer Price Inflation (CPI) index rose with the data print for August showing CPI at 2.9%, its highest since June 2013 as the fall in the value of sterling following the June 2016 referendum result continued to feed through into higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.7%.

The unemployment rate fell to 4.3%, its lowest since May 1975, but the squeeze on consumers intensified as average earnings grew at 2.5%, below the rate of inflation. Economic activity expanded at a much slower pace as evidenced by Q1 and Q2 GDP growth of 0.2% and 0.3% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings falling and real wage growth negative, there are concerns that these will be a constraint on economic activity in the second half of calendar 2017.

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. Although at September's meeting the Committee voted 7-2 in favour of keeping Bank Rate unchanged, the MPC changed their rhetoric, implying a rise in Bank Rate in "the coming months". The Council's treasury advisor Arlingclose is not convinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

In contrast, near-term global growth prospects improved. The US Federal Reserve increased its target range of official interest rates in June for the second time in 2017 by 25bps (basis points) to between 1% and 1.25% and, despite US inflation hitting a soft patch with core CPI at 1.7%, a further similar increase is expected in its December 2017 meeting. The Fed also announced confirmed that it would be starting a reversal of its vast Quantitative Easing programme and reduce the $4.2 trillion of bonds it acquired by initially cutting the amount it reinvests by $10bn a month.

Geopolitical tensions escalated in August as the US and North Korea exchanged escalating verbal threats over reports about enhancements in North Korea's missile programme. The provocation from both sides helped wipe off nearly $1 trillion from global equity markets but benefited safehaven assets such as gold, the US dollar and the Japanese yen. Tensions remained high, with North Korea's threat to fire missiles towards the US naval base in Guam, its recent missile tests over Japan and a further testing of its latent nuclear capabilities.

Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty but the surprise result has led to a minority Conservative government in coalition with the Democratic Unionist Party. This clearly results in an enhanced level of political uncertainty. Although the potential for a so-called hard Brexit is diminished, lack of clarity over future trading partnerships, in particular future customs agreements with the rest of the EU block, is denting business sentiment and investment. The reaction from the markets on the UK election's outcome was fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations, the ultimate 'divorce bill' for the exit and whether new trade treaties and customs arrangements are successfully concluded to the UK's benefit.

In the face of a struggling economy and Brexit-related uncertainty, Arlingclose expects the Bank of England to take only a very measured approach to any monetary policy tightening; any increase will be gradual and limited as the interest rate backdrop will have to provide substantial support to the UK economy through the Brexit transition.

Financial markets: Gilt yields displayed significant volatility over the six-month period with the appearing change in sentiment in the Bank of England's outlook for interest rates, the push-pull from expectations of tapering of Quantitative Easing (QE) in the US and Europe and from geopolitical tensions, which also had an impact. The yield on the 5-year gilts fell to 0.35% in mid-June, but then rose to 0.80% by the end of September. The 10-year gilts similarly rose from their lows of 0.93% to 1.38% at the end of the quarter, and those on 20-year gilts from 1.62% to 1.94%.

The FTSE 100 nevertheless powered away reaching a record high of 7548 in May but dropped back to 7377 at the end of September. Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.30% and 0.65% over the period from January to 21 September 2017.

Credit background: UK bank credit default swaps continued their downward trend, reaching three-year lows by the end of June. Bank share prices have not moved in any particular pattern.

There were a few credit rating changes during the quarter. The 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. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1, placed Lloyds Bank's A1 rating on review for upgrade and revised the outlook of Santander UK plc

Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May, following Arlingclose's advice, the Authority reduced the maximum duration of unsecured investments with Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as until banks' new structures are finally determined and published, the different credit risks of the 'retail' and 'investment' banks cannot be known for certain.

The new EU regulations for Money Market Funds were finally approved and published in July and existing funds will have to be compliant by no later than 21 January 2019. The key features include Low Volatility NAV (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

Regulatory Updates

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.

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.

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

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 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 drop certain prudential indicators, however local indicators are recommended for ring fenced funds (including the HRA) and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

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 drop or alter some of the current treasury management indicators.

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.

Local Context

On 31 March 2017, the council had net borrowing of £127.3m arising from its revenue and capital income and expenditure. 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. These factors are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.17 Actual £m
General Fund CFR	300.5
Less: Other debt liabilities *	(97.9)
Borrowing CFR	**202.6**
Less: Usable reserves	(90.9)
Less: Working capital	15.6
Net borrowing	**127.3**

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

The council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. 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	137.3	(6.1)	131.2	4.29%
Short-term borrowing	22.5	(2.5)	20.0	0.54%
Total borrowing	**159.8**	**(8.6)**	**151.2**	**3.94%**
Short-term investments	32.5	(19.8)	12.7	0.34%
Total investments	**32.5**	**(19.8)**	**12.7**	**0.34%**
Net borrowing	**127.3**	**11.2**	**138.5**	**4.27%**

During the half year it has been decided to utilise the short-term investments, which are mainly money market fund and instant access balances, rather than increase borrowing as this reduces the amount of interest incurred.

Borrowing Strategy during the half year

At 30 September 2017 the council held £151.2m of loans, (a decrease of £8.6m on 31 March 2017), as part of its strategy for funding previous years' capital programmes. 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 Rate %	30.9.17 Weighted Average Maturity years
Public Works Loan Board	132.3	(6.1)	126.2	4.46%	12.2
Banks (LOBO)	5.0	-	5.0	4.27%	24.2
Banks (fixed-term)	-	-	-	-	-
Local authorities (long-term)	-	-	-	-	-
Local authorities (short-term)	22.5	(2.5)	20.0	0.54%	0.4
Total borrowing	**159.8**	**(8.6)**	**151.2**	**3.94%**	**11.02**

The council'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 council's long-term plans change being a secondary objective.

In furtherance of these objectives, no new borrowing was undertaken, while existing loans were allowed to mature without replacement. This strategy enabled the council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

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

However, to enable certainty of cost to be achieved without suffering a cost of carry in the intervening period, the council arranged £10m of forward starting loans with fixed interest rates of 0.65% for the delivery of cash in 1 years' time.

The council continues to hold £5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the first half of 2017/18.

Other Debt Activity

Although not classed as borrowing, the council also raised £20m of capital finance for Highway Improvements via Private Finance Initiative during the first half of the 2017/18 financial year. Total debt other than borrowing stood at £106m on 30 September 2017, taking total debt to £257m.

Investment Activity

The council holds invested funds, representing income received in advance of expenditure plus balances and reserves held and money borrowed in advance of need. During the first half of 2017/18 the council's investment balance ranged between £9.7 and £49.5 million due to timing differences between income and expenditure. The investment position during the half year is shown in table 4 below.

Table 4: Investment 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 days
Banks & building societies (unsecured)	4	(4)	-	0.48%	1
Covered bonds (secured)	-	-	-	-	-
Government (incl. local authorities)	16.5	(10.2)	6.3	0.48%	204
Corporate bonds and loans	-	-	-	-	-
Money Market Funds	12	(5.6)	6.4	0.20%	1
Other Pooled Funds	-	-	-	-	-
Total investments	**32.5**	**14.2**	**12.7**	**0.34%**	**102**

Both the CIPFA Code and government guidance require the council 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 council'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 has continued to utilise their instant access account and money market funds rather than investing externally. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 5 below.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	3.93	AA-	49%	75	0.34%
30.06.2017	4.11	AA-	51%	50	0.43%
30.09.2017	4.21	AA-	50%	102	0.34%
Similar LAs	**4.80**	**A+**	**70%**	**100**	**0.54%**
All LAs	**4.44**	**AA-**	**64%**	**40**	**0.48%**

*Weighted average maturity

Other Investment Activity

Performance Report

The council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to forecast interest rates, as shown in table 6 below.

Table 6: Performance

	Actual £m	Budget £m	Over/ under	Actual %	Forecast %	Over/ under
Total investment income	0.1	0.1	-	0.34	0.41	0.09
Total cost of borrowing	(1.6)	(4.2)	(2.6)	3.96	4.40	0.44
GRAND TOTAL	**(1.5)**	**(4.1)**	**(2.6)**	n/a	n/a	n/a

Compliance Report

The Director of Finance & S151 Officer 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 council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	H1 Maximum £m	30.9.17 Actual £m	2017/18 Limit £m	Complied
Any single organisation, except UK Government	5.0	-	**10.0**	✓
Any group of organisations under the same ownership per group	**-**	**-**	**8.0**	✓
Any group of pooled funds under the same management – per manager	**-**	**-**	**8.0**	✓
Foreign countries per region	**-**	**-**	**8.0**	✓
Registered Providers	**-**	**-**	**20.0**	✓
Unsecured investments with Building Societies	**-**	**-**	**20.0**	✓
Money Market Funds	**16.0**	**6.4**	**25.0**	✓

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

Table 8: Debt Limits

	H1 Maximum	30.9.17 Actual	2017/18 Operational Boundary	2017/18 Authorised Limit	Complied
Borrowing	159.8	151.2	314.2	344.2	✓
PFI & finance leases	105.4	105.4	101.8	101.8	x
Total debt	**265.2**	**256.6**	**416.0**	**446.0**	✓

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. Although the authorised limit for PFI & finance leases has been exceeded, the total debt authorised limit has not been breached. By the end of the year the level of the PFI & Finance leases will have reduced to £101.9m which exceeds the operational Boundary and the authorised limit by £0.1m.

Treasury Management Indicators

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

Security: The council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	30.9.17 Actual	2017/18 Limit	Complied
Portfolio average credit score	4.21	6.0	✓

Liquidity: The council addresses liquidity issues by restricting a significant proportion of its investment opportunities to short term and instant access deposits

Interest Rate Exposures: This indicator is set to control the council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed was:

	30.9.17 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure	143.8	372.7	✓
Upper limit on variable interest rate exposure	7.3	249.8	✓

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.

Maturity Structure of Borrowing: This indicator is set to control the council'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	16%	30%	0%	✓
12 months and within 24 months	3%	30%	0%	✓
24 months and within 5 years	13%	30%	0%	✓
5 years and within 10 years	27%	50%	0%	✓
10 years and above	42%	95%	0%	✓

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.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the council'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:

	2017/18	2018/19	2019/20
Actual principal invested beyond year end	-	-	-
Limit on principal invested beyond year end	28m	44m	72m
Complied	✓	✓	✓

<u>Outlook for the remainder of 2017/18 as at 30 September 2017</u>

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.

The Bank of England's Monetary Policy Committee has changed its rhetoric, implying a rise in Bank Rate in "the coming months". Arlingclose is not convinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

This decision is still very data dependant and Arlingclose is, for now, maintaining its central case for Bank Rate at 0.25% whilst introducing near-term upside risks to the forecast as shown below. Arlingclose's central case is for gilt yields to remain broadly stable in the across the medium term, but there may be near term volatility due to shifts in interest rate expectations.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Official Bank Rate													
Upside risk	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Downside risk	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25