APPENDIX A

Treasury Management Mid-Year Report 2018/19

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* (the CIPFA Code) which requires the Council to approve treasury management semi-annual and annual reports.

The council's treasury management strategy for 2018/19 was approved at the full council meeting of the Isle of Wight Council on 28 February 2018. The council has borrowed 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 is therefore central to the council's treasury management strategy.

Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Treasury Management Code of Practice but has yet to publish the local council specific Guidance Notes to the latter. In England the Ministry for Housing, Communities and Local Government (MHCLG) published its revised Investment Guidance which came into effect from April 2018.

The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full council covering capital expenditure and financing, treasury management and non-treasury investments. The Council will be producing its Capital Strategy later in 2018-19 for approval by full Council.

External Context

Economic background: Oil prices rose by 23 percent over the six months to around $82/barrel. UK Consumer Price Inflation (CPI) for August rose to 2.7 percent year/year, above the consensus forecast and that of the Bank of England's in its August *Inflation Report*, as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4 percent, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9 percent providing some evidence that a shortage of workers is providing support to wages. However real wages (i.e. adjusted for inflation) grew only by 0.2 percent, a marginal increase unlikely to have had much effect on households.

The rebound in quarterly GDP growth in Q2 to 0.4 percent appeared to overturn the weakness in Q1 which was largely due to weather-related factors. However, the detail showed much of Q2 GDP growth was attributed to an increase in inventories. Year/year GDP growth at 1.2 percent also remains below trend. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25 percent in August, taking Bank Rate to 0.75 percent.

Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in each of June and September by 0.25 percent to the current 2 percent-2.25 percent. Markets now expect one further rise in 2018.

The escalating trade war between the US and China as tariffs announced by the Trump administration appeared to become an entrenched dispute, damaging not just to China but also other Asian economies in the supply chain. The fallout, combined with tighter monetary policy, risks contributing to a slowdown in global economic activity and growth in 2019.

The EU Withdrawal Bill, which repeals the European Communities Act 1972 that took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament. With just six months to go when Article 50 expires on 29th March 2019, neither the Withdrawal Agreement between the UK and the EU which will be legally binding on separation issues and the financial settlement, nor its annex which will outline the shape of their future relationship, have been finalised, extending the period of economic uncertainty.

Financial markets: Gilt yields displayed marked volatility during the period, particularly following Italy's political crisis in late May when government bond yields saw sharp moves akin to those at the height of the European financial crisis with falls in yield in safe-haven UK, German and US government bonds. Over the period, despite the volatility, the bet change in gilt yields was small. The 5-year benchmark gilt only rose marginally from 1.13 percent to 1.16 percent. There was a larger increase in 10-year gilt yields from 1.37 percent to 1.57 percent and in the 20-year gilt yield from 1.74 percent to 1.89 percent. The increase in Bank Rate resulted in higher money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.56 percent, 0.70 percent and 0.95 percent respectively over the period.

Credit background: Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ringfenced bank NatWest Markets plc rose relatively sharply over the period to around 96bps. The CDS for the ringfenced entity, National Westminster Bank plc, has held steady below 40bps. Although the CDS of other UK banks rose marginally over the period, they continue to remain low compared to historic averages.

The ringfencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/NatWest Bank plc – is complete, the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.

There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ringfencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody's and to A- from BBB+ by both Fitch and Standard & Poor's (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody's.

Our treasury advisor Arlingclose will henceforth provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities' flexibility during bail-in. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs but not senior unsecured bonds issued by commercial banks.

Local Context

On 30 September 2018, the council had net borrowing of £165.1 million 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

	31.3.18 Actual £m
Total CFR	360.7
Less: Other debt liabilities	(102.2)
Borrowing CFR	**258.5**
Less: Usable reserves	(102.3)
Less: Working capital	(5.3)
Net borrowing	**150.9**

* 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 at 30 September 2018 and the change during the period is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.18 Balance £m	Movement £m	30.9.18 Balance £m	30.9.18 Rate %
Long-term borrowing	128.1	(2.1)	126.0	4.26%
Short-term borrowing	41.0	22.0	63.0	0.85%
Total borrowing	**169.1**	**19.9**	**189.0**	**3.24%**
Short-term investments	18.2	5.7	23.9	0.7%
Total investments	**18.2**	**5.7**	**23.9**	**0.7%**
Net borrowing	**150.9**	**14.2**	**165.1**	**3.6%**

Due to the continued low interest rates the Isle of Wight Council has continued to use short term borrowing rather than PWLB borrowing, where the rates are higher. The level of short-term investments has increased due to the additional investment in the Isle of Wight Pension Fund.

Borrowing Strategy during the half year

At 30 September 2018 the council held £189.0 million of loans, (an increase of £19.9 million on 31 March 2018), as part of its strategy for funding previous years' capital programmes. Outstanding loans on 30 September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	Net Movement £m	30.9.18 Balance £m	30.9.18 Weighted Average Rate %	30.9.18 Weighted Average Maturity (years)
Public Works Loan Board	123.1	(2.1)	121.0	4.43%	11.44
Banks (LOBO)	5.0	-	5.0	4.27%	23.17
Banks (fixed-term)	-	-	-	-	-
Local authorities (long-term)	-	-	-	-	-
Local authorities (short-term)	41.0	22.0	63.0	0.85%	0.53
Total borrowing	**169.1**	**19.9**	**189.0**	**3.24%**	**8.12**

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 keeping with these objectives, new borrowings were taken out to fund both capital expenditure and also to replace existing loans as they fall due. This strategy enabled the council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

With short-term interest rates remaining much lower than long-term rates, the council considered it to be more cost effective in the near term to use short-term loans instead. The net movement in temporary loans is shown in table 3 above.

To enable certainty of cost to be achieved without suffering a cost of carry in the intervening period, the council arranged two forward starting loans, both of £5 million, with fixed interest rates of 1.1 percent and 0.95 percent for the delivery of cash in 2 and 3 months' time from the 30 September 2018, details of which are below.

Forward Starting Loans	Amount £m	Rate %	Loan Period	Forward Period Months
London Borough of Islington	5.0	1.1%	364 days	2 months
St Helens	5.0	0.95%	6 months	2.5 months
Total future borrowing	**10.0**			

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 at 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 period.

Other Debt Activity

Although not classed as borrowing, the council also raised £11.7 million of capital finance for Highway Improvements via Private Finance Initiative during the six months to 30 September 2018.

Total debt other than borrowing stood at £113.8 million on 30 September 2018, taking total debt to £302.8 million.

Treasury Investment Activity

The council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six-month period, the council's investment balance ranged between £9.7 million and £43.1 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.18 Balance £m	Net Movement £m	30.9.18 Balance £m	30.9.18 Rate of Return %	30.9.18 Weighted Average Maturity days
Banks an building societies (unsecured)	-	-	-	-	-
Covered bonds (secured)	-	-	-	-	-
Government (incl. local authorities)	7.2	0.7	7.9	0.87%	164
Money Market Funds	11.0	5.0	16.0	0.62%	1
Total investments	**18.2**	**5.7**	**23.9**	**0.70%**	**55**

**Weighted average maturity will apply to the first five categories above and to cash plus and bond funds*.

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 treasury investments before seeking the optimum 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 reduced the value of investments in total. As a result, investment risk was diversified while the average rate of return has increased by 0.2 percent to 0.7 percent. 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 – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2018	2.04	AA+	0%	98	0.53%
30.06.2018	4.21	AA-	51%	83	0.61%
30.09.2018	4.31	AA-	56%	73	0.75%
Similar LAs	**4.53**	**A+**	**66%**	**52**	**0.75%**
All LAs	**4.38**	**AA-**	**60%**	**37**	**0.76%**

*Weighted average maturity

MHCLG consulted on statutory overrides relating to the IFRS 9 Financial Instruments accounting standard from 2018/19. The consultation recognised that the requirement in IFRS 9 for certain investments to be accounted for as fair value through profit and loss may introduce “more income statement volatility” which may impact on budget calculations. The consultation proposed a time-limited statutory override and sought views whether it should be applied only to pooled property funds.

Non-Treasury Investments

The definition of investments in CIPFA’s revised Treasury Management Code now covers all the financial assets of the council as well as other non-financial assets which the council holds primarily for financial return. This is replicated in MHCLG’s Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The council also holds £21.2 million of such investments in directly owned property

A full list of the council’s non-treasury investments is available in the accounting system.

These investments are expected to generate £0.8 million of investment income for the council for the year after taking account of direct costs, representing a rate of return of 3.31 percent.

Treasury Performance

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 benchmark interest rates, as shown in table 6 below.

The council has identified savings of approximately £0.8 million in external interest costs to the end of September, which is due to the council not undertaking as much borrowing as originally budgeted. The final level of budget savings will be assessed as part of the 2018-19 budget review when the amount in the full year budget will be reduced.

Table 6: Performance

	Actual as at 30 September 2018 £m	Actual as at 30 September 2018 %	Forecast to 31 March 2018 £m	Full year Budget £m *	Over/ under
Total cost of borrowing	(1.7)	3.24%	(6.4)	(8.6)	2.2
PFI and Finance leases	-	-	(9.3)	(9.3)	-
Total debt	(1.7)	-	(15.7)	(17.9)	2.2
Total treasury investments income	0.1	0.70%	0.1	0.2	(0.1)
	(1.6)	n/a	(15.6)	(17.7)	2.1

*to be reassessed as part of the 2018/19 budget review

Compliance

The Director of Finance and S151 Officer is pleased to report that all treasury management activities undertaken during the six months to 30 September 2018 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.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7: Debt Limits

	Maximum balance in period to 30.9.18	**30.9.18 Actual**	**2018/19 Operational Boundary**	**2018/19 Authorised Limit**	**Complied**
Borrowing	194.2	169.1	324.8	357.3	✓
PFI and Finance Leases	**105.4**	**105.4**	**107.0**	**107.0**	✓
Total debt	**299.6**	**274.5**	**431.8**	**464.3**	✓

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.

Table 8: Investment Limits

	H1 Maximum	**30.9.18 Actual**	**2018/19 Limit**	**Complied**
Any single organisation, except the UK Government	8.0	8.0	8.0	✓
Any group of organisations under the same ownership	8.0	8.0	8.0	✓
Any group of pooled funds under the same management	-	-	8.0	✓
Limit per non-UK country	-	-	8.0	✓
Registered providers	-	-	20.0	✓
Unsecured investments with building societies	-	-	10.0	✓
Loans to unrated corporates	-	-	10.0	✓
Money Market Funds	16.0	10.0	25.0	✓

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.

	30.9.18 Actual	**2018/19 Target***	**Complied**
Portfolio average credit score	4.31	4.53	✓

***** Based on Arlingclose Investment Benchmarking scores for English unitary authorities

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:

	30.9.18 Actual	2018/19 Limit	Complied?
Upper limit on fixed interest rate exposure	126.0	357.3	✓
Upper limit on variable interest rate exposure	39.1	201.9	✓

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 all borrowing were:

	30.9.18 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	35%	30%	0%	x
12 months and within 24 months	3%	30%	0%	✓
24 months and within 5 years	10%	30%	0%	✓
5 years and within 10 years	22%	50%	0%	✓
10 years and above	29%	95%	0%	✓

The proportion of debt with less than 12 months to maturity was higher than anticipated due to the decision to use short-term borrowing for an investment property purchase rather than PWLB as had been included in the forecast upon which the Treasury Management Strategy limits were set. This decision was actively taken, and it is acknowledged that there is an increased level of refinancing risk. This position will be reassessed as part of the future treasury management strategy setting.

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 365 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:

	2018/19	2019/20	2019/21
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	35	40	45
Complied?	✓	✓	✓

Outlook for the remainder of 2018/19

Having raised policy rates in August 2018 to 0.75 percent, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon.

The MPC has a definite bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that (a) ultra-low interest rates result in other economic problems, and that (b) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise, and cuts are required.

Arlingclose's central case is for Bank Rate to rise twice in 2019. The risks are weighted to the downside. The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2 percent remains well below the long-term average

	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Ca	0.75	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Downside risk	0.00	0.00	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75

The view is that the UK economy still faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Central bank actions and geopolitical risks, such as prospective trade wars, have and will continue to produce significant volatility in financial markets, including bond markets.