APPENDIX 1

Treasury Management Mid-Year Performance Report 2019/20

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 2019/20 was approved at a meeting of the Isle of Wight Council's Audit Committee on 18 February 2019. The council 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 remains central to the council's treasury management strategy.

The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full council covering capital expenditure and financing, treasury management and non-treasury investments. The council's Capital Strategy, complying with CIPFA's requirement, was approved by full council on 27 February 2019

External Context (Provided by Arlingclose Limited, based on data at 04/10/2019)

Economic background: UK Consumer Price Inflation (CPIH) fell to 1.7 percent year/year in August 2019 from 2.0 percent in July, weaker than the consensus forecast of 1.9 percent and below the Bank of England's target. The most recent labour market data for the three months to July 2019 showed the unemployment rate edged back down to 3.8 percent while the employment rate remained at 76.1 percent, the joint highest since records began in 1971. Nominal annual wage growth measured by the 3-month average excluding bonuses was 3.8 percent and 4.0 percent including bonuses. Adjusting for inflation, real wages were up 1.9 percent excluding bonuses and 2.1 percent including.

The Quarterly National Accounts for Q2 GDP confirmed the UK economy contracted by 0.2 percent following the 0.5 percent gain in Q1 which was distorted by stockpiling ahead of Brexit. Only the services sector registered an increase in growth, a very modest 0.1 percent, with both production and construction falling and the former registering its largest drop since Q4 2012. Business investment fell by 0.4 percent (revised from -0.5 percent in the first estimate) as Brexit uncertainties impacted on business planning and decision-making.

Politics, both home and abroad, continued to be a big driver of financial markets over the last quarter. Boris Johnson won the Conservative Party leadership contest and has committed to leaving the EU on 31 October regardless of whether a deal is reached with the EU. Mr Johnson prorogued Parliament which led some MPs to put forward a bill requiring him to seek a Brexit extension if no deal is in place by 19th October. The move was successful and, having been approved by the House of Lords, was passed into law. The Supreme Court subsequently ruled Mr Johnson's suspension of Parliament unlawful.

Tensions continued between the US and China with no trade agreement in sight and both countries imposing further tariffs on each other's goods. The US Federal Reserve cut its target Federal Funds rates by 0.25 percent in September to a range of 1.75 percent - 2 percent, a pre-emptive move to maintain economic growth amid escalating concerns over the trade war and a weaker economic environment leading to more pronounced global slowdown. The euro area Purchasing Manager Indices (PMIs) pointed to a deepening slowdown in the Eurozone. These elevated concerns have caused key government yield curves to invert, something seen by many commentators as a predictor of a global recession. Market expectations are for further interest rate cuts from the Fed and in September the European Central Bank reduced its deposit rate to -0.5 percent and announced the recommencement of quantitative easing from 1 November.

The Bank of England maintained Bank Rate at 0.75 percent and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction depending on whether or not a deal is ultimately reached by 31 January 2020.

Financial markets: After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April.

Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63 percent at the end of June, the 5-year benchmark gilt yield fell to 0.32 percent by the end of September. There were falls in the 10-year and 20-year gilts over the same period, with the former dropping from 0.83 percent to 0.55 percent and the latter falling from 1.35 percent to 0.88 percent. 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65 percent, 0.75 percent and 1.00 percent respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24 percent in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77 percent.

Credit background: Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ringfenced bank NatWest Markets plc fell back to around 80bps by the end of September, while for the ringfenced entity, National Westminster Bank plc, the spread remained around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 34 and 76bps at the end of the period.

There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.

Local Context

On 31 March 2019, the council had net borrowing of £198.5 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

	31.3.19 Actual £m
Total CFR	**403.5**
Less: Other debt liabilities*	(107.2)
Borrowing CFR	**296.3**
External borrowing**	(261.9)
Internal / (over) borrowing	**34.4**
Less: Usable reserves	(92.6)
Less: Working capital	(5.2)
(Investments) / New Borrowing	**(63.4)**

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt
** shows only loans to which the council is committed and excludes optional refinancing

The council pursued its strategy of keeping 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 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.19 Balance £m	Movement £m	30.9.19 Balance £m	30.9.19 Rate percent
Long-term borrowing	162.9	30.2	193.1	3.36%
Short-term borrowing	99.0	(32.0)	67.0	1.07%
Total borrowing	**261.9**	**(1.8)**	**260.1**	**2.85%**
Short-term investments	63.4	10.3	73.7	0.80%
Total investments	**63.4**	**10.3**	**73.7**	**0.80%**
Net borrowing	**198.5**	**(12.1)**	**186.4**	**3.68%**

The council took advantage of the recent dip in long-term interest rates, and the increase in long-term borrowing has been used to fund the repayment in short term borrowing.

Borrowing Strategy during the period

At 30 September 2019 the council held £260.1 million of loans, (a decrease of £1.8 million on 31 March 2019), 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

	31.3.19 Balance £m	Net Movement £m	30.9.19 Balance £m	30.9.19 Weighted Average Rate percent	30.9.19 Weighted Average Maturity (years)
Public Works Loan Board	157.9	30.2	188.1	3.44%	16.29
Banks (LOBO)	5.0	-	5.0	4.27%	22.17
Local authorities (short-term)	99.0	(32.0)	67.0	1.07%	0.36
Total borrowing	**261.9**	**(1.8)**	**260.1**	**2.85%**	**12.30**

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.

The council has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital. Having considered the appropriate duration and structure of the council's borrowing need based on realistic projections, it was decided to take some longer-term Equal Instalment of Principal (EIP) loans. The council borrowed a total of £35 million longer-term fixed rate loans, details of which are below. These loans provide some longer-term certainty and stability to the debt portfolio.

Table 4: Long-dated Loans borrowed

Long-dated Loans borrowed	Amount £m	Rate percent	Period (Years)
PWLB EIP Loan 1	20.0	1.89%	25.0
PWLB EIP Loan 2	15.0	1.06%	11.5
Total borrowing	**35.0**		

The council's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing was maintained.

LOBO loans: The council continues to hold £5 million 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 so far during the year.

However, on assessment of the LOBO portfolio by the council's treasury advisor, loans from some banks presented restructuring opportunities with substantial value from a negotiated settlement with the bank. The risks and benefits, including restructuring savings, were assessed and it was decided that due to the change in PWLB interest rates, which would have been used to finance the repayment, it was no longer beneficial for the council to proceed.

Other Debt Activity

Although not classed as borrowing, the council also raised £17.2 million of capital finance for Highway Improvements via Private Finance Initiative during the six months to 30 September 2019.

Total debt other than borrowing stood at £123.6 million on 30 September 2019, taking total debt to

£385.5 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 balances ranged between £63.7 and £105.6 million due to timing differences between income and expenditure. The investment position is shown in table 5 below.

Table 5: Treasury Investment Position

	31.3.19 Balance £m	Net Movement £m	30.9.19 Balance £m	30.9.19 Income Return percent	30.9.19 Weighted Average Maturity days
Banks & building societies (unsecured)	4.0	-	4.0	0.60%	1.0
Government (incl. local authorities)	28.8	(8.8)	20.0	0.79%	22.8
Isle of Wight Council Pension Fund	10.4	(0.7)	9.7	1.05%	137.8
Cash plus Funds	-	4.0	4.0	1.22%	90.0
Money Market Funds	20.2	15.8	36.0	0.72%	1.0
Total investments	**63.4**	**10.3**	**73.7**	**0.80%**	**24.8**

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.

Given the increasing risk and low returns from short-term unsecured bank investments, the council has diversified into higher yielding asset classes as shown in table 4 above. As a result, investment risk was diversified while the average rate of return has decreased by 0.5 percent to 0.80 percent. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 6 below.

Table 6: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return percent
31.03.2019	3.98	AA-	38%	53	0.84%
30.06.2019	3.99	AA-	38%	42	0.81%
30.09.2019	4.08	AA-	57%	26	0.78%
Similar LAs	**4.28**	**AA-**	**72%**	**42**	**0.80%**
All LAs	**4.27**	**AA-**	**62%**	**28**	**0.83%**

Readiness for Brexit: The scheduled leave date for the UK to leave the EU has been delayed to 31 January 2020 and there remains little political clarity as to whether a deal will be agreed by this date. As 31 January approaches the council will ensure there are enough accounts open at UK-domiciled banks and Money Market Funds to hold sufficient liquidity required in the near term and that its account with the Debt Management Account Deposit Facility (DMADF) remains available for use in an emergency.

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 held £40.0 million of such investments in

- directly owned property £33.7 million
- shared ownership housing £3.7 million
- loans to local businesses and landlords £2.6 million

A full list of the council's non-treasury investments is available in the audited 2018/19 accounts which can be accessed here: https://www.iow.gov.uk/documentlibrary/view/draft-statement-of-accounts-2018-19

Details of the performance of non-treasury investments for the year ended 31 March 2019 can be found here: https://www.iow.gov.uk/Meetings/committees/Audit%20Committee/30-9-19/PaperG-ProgressReport-PropertyAquisitionsStrategy.pdf and the figures for the half year to 30 September have not yet been published.

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 7 below.

Table 7: Performance

	Actual as at 30 September 2019 £m	Actual as at 30 September 2018 %	Forecast to 31 March 2019 £m	Full year Budget* £m	Over/ Under £m
Total cost of borrowing	(1.9)	2.65%	(8.7)	(9.7)	1.0
PFI and Finance leases	-	-	(9.8)	(9.8)	-
Total debt	**(1.9)**	**-**	**(18.5)**	**(19.5)**	**1.0**
Total treasury investments	**0.2**	**0.79%**	**0.3**	**0.2**	**0.1**
	(1.7)	**-**	**(18.2)**	**(19.3)**	**1.1**

*to be reassessed as part of the 2019/20 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 2019 complied fully with the CIPFA Code of Practice and apart from the specific items indicated below the council also adhered to the approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 8 below.

On three occasions throughout the six months to 30 September 2019 the balance in the council's current account exceeded the limit of £10 million. The amount and duration by which this limit was exceeded were:

- 5 June to 9 June (5 days) and the maximum amount was £2.2 million
- 3 July to 7 July (5 days) and the maximum amount was £1.1 million
- 26 July to 28 July (3 days) and the maximum amount was £1.0 million

The duration and amount were approved in advance by either the Director of Finance and S151 Officer or the Assistant Director of Finance.

With regard to investments in money market funds, when the TMSS was set the limit of £35m was sufficient, but as a result of increased borrowing the amount invested in money market funds was increased. It is recommended that this limit is increased for the remainder of the year to £50m.

Table 8: Investment Limits

	Maximum balance in period to 30.09.19 £m	**30.9.19 Actual £m**	**2019/20 Limit £m**	**Complied**
Any single organisation, except the UK Government	12.2	10.0	10.0	x
Any group of organisations under the same ownership	10.0	10.0	10.0	✓
Money Market Funds	36.0	36.0	35.0	x

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 9 below.

The Authorised Limit for PFI and Finance leases was exceeded by £13.6 million during the six months to 30 September 2019. The reason for non compliance is because the PFI contractor has not achieved the agreed milestones, and therefore the capital contributions have been substantially delayed. It is anticipated that this delay will not be made up before the end of the year. Consequently, it is recommended that the operational limit is increased to £125 million and the authorised limit is increased to £135 million.

However, as the Total Debt limit was not exceeded the council considered itself compliant throughout the year.

Table 9: Debt Limits

	Maximum balance in period to 30.09.19 £m	**30.9.19 Actual £m**	**2019/20 Operational Boundary £m**	**2019/20 Authorised Limit £m**	**Complied?**
Borrowing	293.4	261.9	392.9	430.0	✓
PFI and Finance Leases	123.6	123.6	101.2	110.0	x
Total debt	**417.0**	**385.5**	**494.1**	**540.0**	✓

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.

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.

	30.9.19 Actual	**2019/20 Target***	**Complied**
Portfolio average credit score	4.08	4.28	✓

*based on Arlingclose Investment Benchmarking scores for English Authorities

Liquidity: The council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

	30.9.19 Actual £m	**2019/20 Target £m**	**Complied**
Total cash available within 3 months	66.6	£15.0	✓

Interest Rate Exposures: This indicator is set to control the council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1 percent rise or fall in interests was:

Interest rate risk indicator	**30.9.19 Actual £m**	**2019/20 Limit £m**	**Complied?**
Upper limit on one-year revenue impact of a 1 percent rise in interest rates	-0.2	-0.5	✓
Upper limit on one-year revenue impact of a 1 percent fall in interest rates	+0.2	+0.5	✓

The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

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:

	30.9.19 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	27%	50%	0%	✓
12 months and within 24 months	3%	30%	0%	✓
24 months and within 5 years	7%	30%	0%	✓
5 years and within 10 years	14%	50%	0%	✓
10 years and above	49%	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 a year: 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:

	2019/20	2020/21	2021/22
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	£35m	£40m	£45m
Complied?	✓	✓	✓

Outlook for the remainder of 2019/20

The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity. In response, global and UK interest rate expectations have eased dramatically.

There appears no near-term resolution to the trade dispute between China and the US, a dispute that the US appears comfortable exacerbating further. With the 2020 presidential election a year away, Donald Trump is unlikely to change his stance.

Parliament has frustrated UK Prime Minister Boris Johnson's desire to exit the EU on 31 October, and the EU granted a further extension to 31 January 2020 and a general election has been called for the 12 December.

Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

Our treasury advisor Arlingclose expects Bank Rate to remain at 0.75 percent for the foreseeable future but there remain substantial risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judge the risks to be weighted to the downside and that volatility will continue to offer longer-term borrowing opportunities

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Cas	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Downside risk	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75