

Item: 10

Policy and Resources Committee: 27 November 2018.

Treasury Management – Mid-Year Update.

Report by Head of Finance.

1. Purpose of Report

To provide a mid-year update in respect of the Council's treasury management function for financial year 2018 to 2019.

2. Recommendations

The Committee is invited to note:

2.1.

The mid-year update for financial year 2018 to 2019 as detailed in Appendices 1 to 4 to this report, in respect of the following elements of treasury management:

- Borrowing activity.
- Temporary loans.
- The Strategic Reserve Fund.
- The Pension Fund.

2.2.

The Treasury Adviser's overview of the economy and interest rates for the first half of financial year 2018 to 2019, as detailed in Appendix 5 to this report.

2.3.

That the Treasury Management Practices have operated effectively during financial year 2018 to 2019 to date.

2.4.

That, as at 30 September 2018, the Treasury Management Strategy Statement and Annual Investment Strategy for 2018 to 2019 has been adhered to.

3. Background

3.1.

Section 21 of the Financial Regulations confirms that the Council has adopted the key recommendations of Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Sector Code of Practice (the Code).

3.2.

The revised Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management in the Public Services (2011) further expands the definition of treasury management to include investment activities.

3.3.

The Council's investment priorities can be summarised as maintaining:

- The security of capital.
- The liquidity of its investments.

3.4.

The Council aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments. This is in keeping with the nature of the Strategic Reserve Fund, which is to provide for the benefit of Orkney and its inhabitants, whilst having regard to the Fund's long term obligations in terms of the decline and decommissioning of the Flotta Oil Terminal in the future.

3.5.

The Financial Regulations refer to maintenance of the Treasury Management Policy Statement and Treasury Management Practices as the cornerstone for effective treasury management and the requirement to report annually on the Treasury Management function.

3.6.

Although not covered by the Treasury Management Strategy Statement, the Pension Fund investments form part of the Council's treasury management function and are included for information. The Pension Fund investment arrangements are set out in a separate Statement of Investment Principles as required by the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2016.

4. Treasury Management Performance

4.1.

A detailed analysis of the Treasury Management Performance for financial year 2018 to 2019, as at 30 September 2018, is contained in Appendices 1 to 4 to this report, which refer to the following activities:

- Borrowing activity.
- Temporary loans.
- Strategic Reserve Fund.
- Pension Fund.

4.2.

The conclusion of the analysis of performance is that existing treasury management practices have operated effectively over the first six months of financial year 2018 to 2019.

4.3.

The prime objective for the managed funds remains to maintain or increase their real value over time, while at the same time generating an annual return which meets the targets set by the Council. These objectives normally require to be measured over a number of years while acknowledging that abnormal fluctuations in the short term do create a cause for concern.

4.4.

Appendix 5 to this report presents the Council's Treasury Adviser's overview of the economy and interest rates for the first half of financial year 2018 to 2019.

5. Corporate Governance

This report relates to the Council complying with its governance and financial processes and procedures and therefore does not directly support and contribute to improved outcomes for communities as outlined in the Council Plan and the Local Outcomes Improvement Plan.

6. Financial Implications

6.1.

Recurring slippage continues to be a feature within the approved capital programme. This was partially addressed in financial year 2017 to 2018 when works valued at £10,120,000 were re-profiled into 2018 to 2019 and beyond. Since then further slippage of £1,630,000 has been recognised in the capital programme. Not only does this impact on the cost of delivering the capital programme works, it also delays the timescale over which the capital finance is required.

6.2.

The Council has established an authorised limit for external debt of £75,000,000 for the three-year period 2018 to 2021, together with an operational boundary of £60,000,000, as part of its Treasury Management Strategy for 2018 to 2019.

6.3.

The Council supports its capital financing requirement through a combination of borrowings and use of internal reserves. In determining this combination, the cost of raising additional finance or borrowing is compared against the opportunity cost of using internal reserves and balances, in that these funds could otherwise be generating an investment return for the Council. On the basis the capital financing requirement can be externalised through borrowings, and investment returns generated in excess of the cost of any borrowings to meet the requirements of the

capital programme, the potential exists for a net saving to be realised by the treasury management function over the longer term.

6.4.

As at 30 September 2018, the Council's debt portfolio stood at £30,185,412, with loan maturities ranging over periods from one to 46 years. Overall this represents an average cost of borrowing of 3.82% per annum, with an average duration of 36.6 years.

6.5.

The cost of this debt is managed as part of the loan charges associated with the capital programme and has been offset in the short term with surplus funds placed on deposit for periods of up to one year at an average rate of 0.74% for the first half of financial year 2018 to 2019.

6.6.

The strategic priority for Central Government and the Bank of England during financial year 2018 to 2019 to date has been to maintain monetary and financial stability as the United Kingdom prepares to depart from the European Union.

6.7.

Although there remains much uncertainty over interest rates, with the long-term trend prediction for rates to rise, the Council should be well placed to benefit from savings on loan charges over the longer term.

7. Legal Aspects

7.1.

Treasury Management arrangements help the Council meet its statutory obligation to secure best value.

7.2.

Section 40 of the Local Government in Scotland Act 2003 provides local authorities with the power to invest money. This power may be exercised in accordance with regulations made by Scottish Ministers under this section.

7.3.

Section 95 of the Local Government Act 1973 states that every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that the proper officer has responsibility for the administration of those affairs.

8. Contact Officers

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9. Appendices

Appendix 1: Borrowing (Capital Financing Requirement) – Mid-year update 2018 to 2019.

Appendix 2: Temporary Loans – Mid-year update 2018 to 2019.

Appendix 3: Strategic Reserve Fund – Mid-year update 2018 to 2019.

Appendix 4: Pension Fund – Mid-year update 2018 to 2019.

Appendix 5: Treasury Adviser's economic overview for 2018 to 2019, as at 30 September 2018.

Appendices.

Treasury Management Practices

2018 to 2019 Mid Year Review

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Appendix 1 – Capital Financing Requirement

1.1.

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement. The Capital Financing Requirement arises directly from the capital activity of the Council and the resources applied to fund the capital spend and represents the unfinanced element of capital expenditure.

1.2.

A key part of the Council's treasury management function includes the need to manage the cashflow requirements for all the Council's activities including the capital financing requirements. Depending on the progress of the capital expenditure programme, the treasury service aims to organise the Council's cash position to best effect and ensure that sufficient cashflow is available to meet all planned outlays. For capital purposes, this can be sourced through borrowing from external bodies such as the Public Works Loans Board or alternatively through what is known as internal borrowing i.e. utilising Council reserves held in the form of surplus or temporary cash balances that would otherwise be placed on deposit as temporary loans.

1.3.

The Council's underlying Capital Financing Requirement or need to borrow is not allowed to rise indefinitely, and statutory controls exist to ensure that the cost of financing the acquisition and/or creation of capital assets is charged to revenue accounts over the life of the asset. This reduction in the Capital Financing Requirement is effectively a repayment of the borrowing need and differs from the treasury management arrangements which aim to ensure that sufficient cash is available to meet the Council's capital commitments. The total Capital Financing Requirement can also be reduced by the application of additional capital financing resources or charging accelerated loan repayments.

1.4.

The Council's Capital Financing Requirement for the year ending 31 March 2019, is shown below:

Capital Expenditure and Capital Financing	2018 to 2019 Budget	2018 to 2019 Probable Out-turn
	£000	£000
Opening Capital Financing Requirement	53.5	49.1
Capital Expenditure for Year	29.6	30.7
Sources for Finance:		
Capital Receipts and Grants	(10.2)	(12.5)
Use of Reserves and Revenue	(2.0)	(2.1)
Less: Scheduled Debt Amortisation	(1.7)	(1.6)
Closing Capital Financing Requirement	69.2	63.6
External Long-term Borrowings (PWLB)	45.2	40.2
Under-borrowed Position	(24.0)	(23.4)
Operational Boundary in External Debt	60.0	60.0
Authorised Limit for External Debt	75.0	75.0

1.5.

The underlying need to borrow and the requirement to ensure that sufficient cash resources are available to cash flow all planned capital outlays during the financial year can be impacted by any changes or slippage on the approved capital programme.

1.6.

As a whole the 2018 to 2019 Capital Programme was established on the basis of a programme expenditure limit of £29,618,000, including £27,136,000 of General Fund and £2,482,000 of Non-General Fund Programmes.

1.7.

During financial year 2018 to 2019 a number of changes have been agreed, including the addition and removal of projects and after allowing for slippage and re-profiling in 2017 to 2018 carried forward into 2018 to 2019 and beyond, the resulting Capital Financing Requirement is estimated to be £5,600,000 less than planned by 31 March 2019. This impacts directly on both the capital financing and cash flow requirements of the Council.

1.9.

As at 30 September 2018 the capital debt stands at £30,185,412 as follows:

Body	Borrowed £ million	Term Years	Rate %	Maturity
PWLB	5	9	3.51	26/05/19
PWLB	5	12	3.93	26/05/22
PWLB	10	50	4.28	26/05/60
PWLB	10	50	3.54	10/10/64
Salix Finance Ltd	0.185	8	0.00	01/10/24
Total	30.185			
Average Rate %			3.82	

1.10.

As stated in the Treasury Management Strategy Statement, interest rates were originally anticipated to increase during 2010 and therefore it was considered prudent to borrow for periods longer than one year at that point in time. The cost of borrowing can be compared against the Bank of England base rate which stood at 0.50% as at 30 September 2018, after rising by 0.25% from 0.25% on 2 November 2017.

1.11.

The challenging and uncertain economic outlook has several treasury management implications including the fact that the cost of borrowing continues to be attractive and is likely to remain relatively low over the short term at least.

Appendix 2 – Treasury Loans

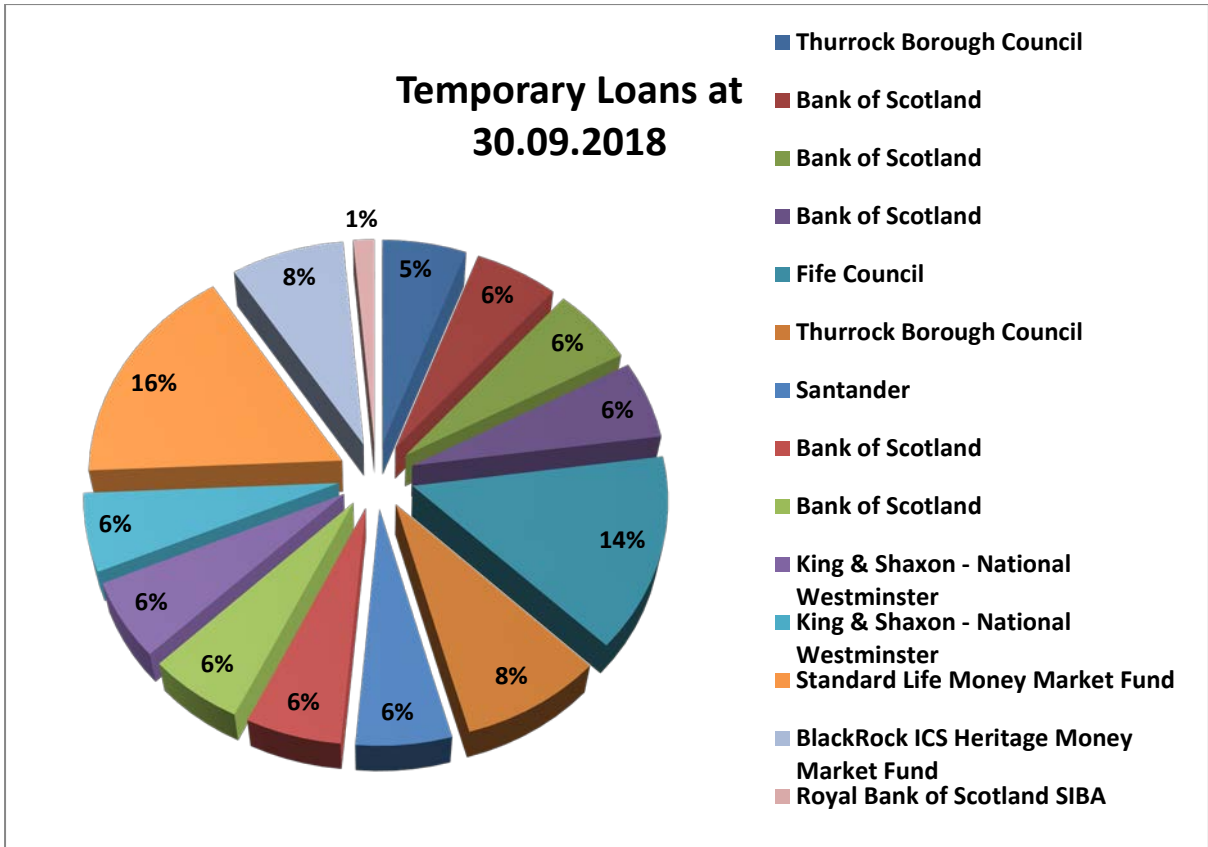
2.1.

The amount of cash and cash equivalent funds that can be deposited with bodies such as banks, building societies and local authorities is governed by the Council's Treasury Management Practices schedule.

2.2.

The following loans amounting to £34,965,993.79 were held as part of the treasury management function as at 30 September 2018:

Body	Lending £m	Term	Rate %	Maturity
Thurrock Borough Council	2.0	1 year	0.74	09/11/2018
Bank of Scotland	2.0	1 year	0.90	23/11/2018
Bank of Scotland	2.0	1 year	0.90	10/12/2018
Bank of Scotland	2.0	1 year	0.85	03/01/2019
Fife Council	5.0	1 year	0.73	04/01/2019
Thurrock Borough Council	3.0	6 months	0.90	25/02/2019
Santander	2.0	6 months	0.95	15/03/2019
Bank of Scotland	2.0	1 year	1.00	13/06/2019
Bank of Scotland	2.0	1 year	1.00	21/06/2019
King and Shaxon – National Westminster	2.0	1 year	1.01	19/07/2019
King and Shaxon – National Westminster	2.0	1 year	1.04	29/07/2019
Standard Life Money Market Fund	5.8	Call	0.67	Call
BlackRock ICS Heritage Money Market Fund	2.7	Call	0.67	Call
Royal Bank of Scotland SIBA	0.5	Call	0.05	Call



2.3.

The temporary loans portfolio has operated within policy during financial year 2018 to 2019 so far and has realised a return of £115,217.53 at a rate of 0.74%, as at 30 September 2018. This is in-line with the weighted average 3 months LIBOR (London Inter-Bank Offered Rate) performance benchmark (0.73%) and is therefore considered to be an acceptable return.

Appendix 3 –Strategic Reserve Fund

3.1.

The performance of the managed funds for the Strategic Reserve Fund is measured on a rolling 3 year average, with the target mandate being to outperform the respective benchmarks as follows:

	Portfolio	Benchmark	Target Mandate
1	Bond Fund	UK Gilts (25%) - FTSE Government All Stocks Index, UK Corporate Bonds (75%) - ML Sterling Non-Gilts All Stocks UNPO Index	+0.75% p.a
2	Equities Fund	UK Equities (40%) - FTSE All Share Index, Global Equities (60%) - MSCI All Country World Index (NDR)	+1.5% p.a
3	UK Property Fund	IPD All Balances Property Fund Index Weighted Average	Out-perform the benchmark
4	Diversified Growth Fund	3 Month LIBOR	+3.0% p.a
5	Global High Yield Credit Strategies Fund	3 Month LIBOR	+5.0% p.a

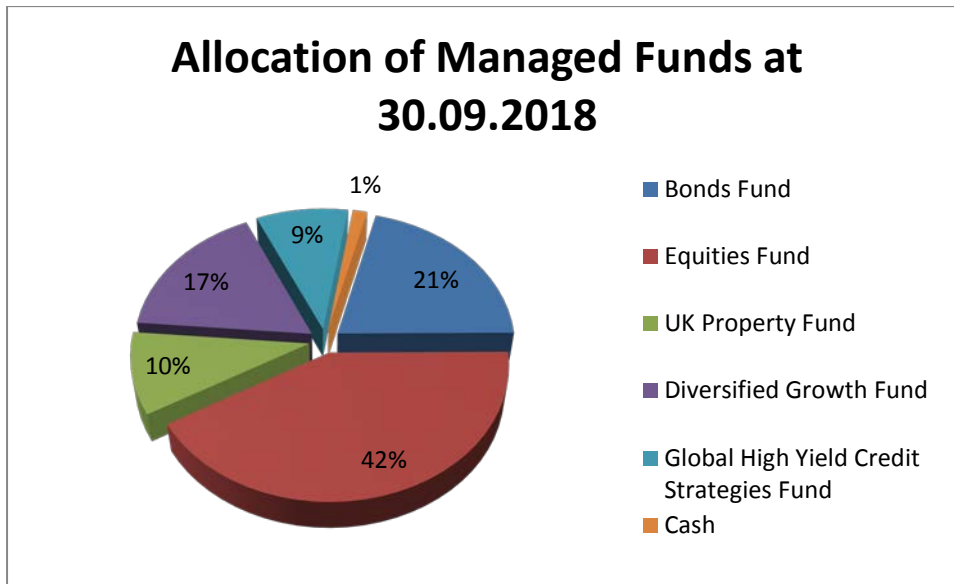
3.2.

The following table summarises those returns relative to benchmark for the four discrete portfolios as at 30 September 2018:

	Portfolio	Market Value £m	Actual 1 Year %	Benchmark 1 Year %	Actual 3 Year %	Benchmark 3 Year %
1	Bond Fund	47.5	-0.1	0.2	4.6	4.1
2	Equities Fund	97.4	9.4	10.2	15.4	15.9
3	UK Property Fund	22.1	9.9	8.8	8.0	7.1
4	Diversified Growth Fund	38.3	4.1	0.6	3.9	0.5
5	Global High Yield Credit Strategies Fund *	20.7	3.6	0.6	n/a	n/a

	Portfolio	Market Value £m	Actual 1 Year %	Benchmark 1 Year %	Actual 3 Year %	Benchmark 3 Year %
	Total	226.0				
*Funds held for less than 3 years – Inception date 2 August 2017.						

3.3.



3.4.

The value of the managed funds for the Strategic Reserve Fund increased from an opening position of £215,400,000 to £226,000,000 or by £10,600,000 for the six months to 30 September 2018.

3.5.

The Bonds portfolio returned a loss of 0.1% p.a., which was 0.3% behind its benchmark of 0.2% for the year. This contributed to a 3-year performance of 4.6% p.a. which was ahead of benchmark by 0.5% but slightly behind the target mandate of +0.75%.

3.6.

The Equities portfolio returned a gain of 9.4% p.a. which is 0.8% behind its benchmark of 10.2% for the year.

3.7.

With an average return of 15.4% p.a. over a rolling 3 year period, the Equities portfolio has fallen well short of the agreed target of benchmark +1.5% which was 17.4%. With equity markets driven largely by a momentum style including technology stocks, our value style bias has not performed well.

3.8.

The UK Property Fund returned a gain of 9.9% p.a. which is 1.1% ahead of its benchmark and ahead of target for the year.

3.9.

The Diversified Growth Fund returned a gain of 4.1% p.a. which is 3.5% ahead of its benchmark for the year. Against a target to outperform 3 month London Inter-bank Offered Rate by 5.0% this, however remains below target.

3.10.

The UK Property Fund and the Diversified Growth Fund allocations were established in 2015, with Global High Yield Credit Strategies more recently in 2017, as part of an agreed investment strategy for the Strategic Reserve Fund, to reduce the risks through a process of diversification away from equities as an asset class. It is perhaps too early to comment overall on the performance of these Funds against the 3 year benchmark period, other than to note that the Funds have delivered positive performance figures over the past year and the 3 year period where applicable. As such these Funds appear to be acting to stabilise the performance of the Strategic Reserve Fund managed funds over time.

3.11.

Following an annual performance review the Investment Sub-Committee agreed to commission a review of the investment strategy for the Strategic Reserve Fund managed funds. The findings of this strategy review will be considered by the Sub-Committee.

Appendix 4 – Pension Fund

4.1.

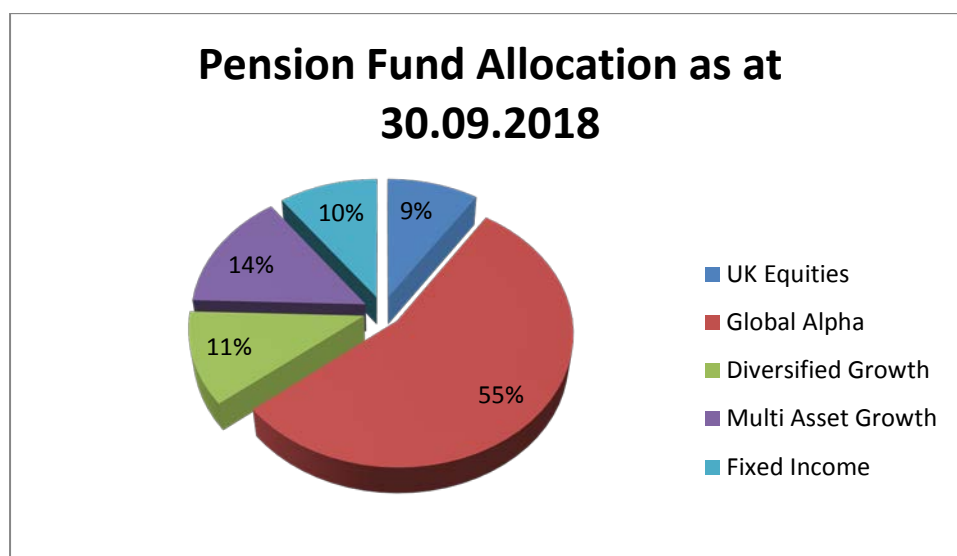
The Pension Fund investments are managed by a single fund manager under a mandate which allows the fund manager to invest in equities, bonds, diversified growth, multi-asset growth fund and cash type investments. The performance of this fund is measured over a longer period with a rolling 5 year average relative to benchmark with the target mandate being to outperform the fund specific benchmark.

4.2.

The following table summarises the performance of the Pension Fund investments as at 30 September 2018:

Portfolio	Market Value £m	Actual 1 Year %	Benchmark 1 Year %	Actual 5 Year %	Benchmark 5 Year %
Balanced Fund	389.2	9.3	8.5	11.7	9.4

4.3.



4.4.

From the table shown at 4.2 above, it can be seen that the Pension Fund investments are performing ahead of the benchmark and target over the rolling 5 year period.

4.5.

The value of the Pension Fund investments increased from an opening position of £365,900,000 to £389,200,000, or by £23,300,000 for the six months ending 30 September 2018.

4.6.

After allowing for capital contributions made during the year of £800,000, the value of Pension Fund investments as at 30 September 2018 increased by £22,500,000 (6.1%). The movement in the value of investments was represented by a gain of £17,000,000, which was realised during the year in the form of investment income, and unrealised profit of £5,500,000 due to the increase in the value of the investments held as at 30 September 2018.

4.7.

Following an annual performance review the Pension Fund Sub-committee agreed to commission a review of the investment strategy for the Pension Fund managed funds. The findings of this strategy review will be considered by the Sub-committee.

Appendix 5 – Treasury Adviser’s Economic Overview

5.1

The Council’s Treasury advisers, Link Asset Services, have provided the following overview of the economy and interest rates:

5.2.

Economics update

“**UK.** The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase Bank Rate on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England’s August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concerns about a build-up of inflationary pressures, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

As for the labour market, unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point was in July 2015.) Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

In the political arena, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May’s government will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential

loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA. President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

EUROZONE. Growth was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

JAPAN - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. The outcome of the EU referendum in June 2016 resulted in a gloomy outlook and economic forecasts from the Bank of England based around an expectation of a major slowdown in UK GDP growth, particularly during the second half of 2016, which was expected to push back the first increase in Bank Rate for at least three years. Consequently, the Bank responded in August 2016 by cutting Bank Rate by 0.25% to 0.25% and making available over £100bn of cheap financing to the banking sector up to February 2018. Both measures were intended to stimulate growth in the economy. This gloom was overdone as the UK economy turned in a G7 leading growth rate of 1.8% in 2016, (actually joint equal with Germany), and followed it up with another 1.8% in 2017, (although this was a comparatively weak result compared to the US and EZ)."

5.3.

Interest rate forecasts

"The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases

would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary or contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast. We do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. We also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.”