Performance and Finance Select Committee

22 November 2018

Treasury Management Mid-Year Review 2018/19

Report by Director of Finance, Performance and Procurement

Executive Summary

County Council is required by the Chartered Institute of Public Finance and Accountancy (CIPFA) to receive as a minimum each year:

- An annual strategy statement for the forthcoming year
- A mid-year review
- An annual report at year end

In accordance with governance arrangements approved in February 2014, the Performance and Finance Select Committee will receive all of the above reports for scrutiny. In addition effective governance is maintained through the submission of quarterly compliance reports to the Regulation, Audit and Accounts Committee.

The Council's overall risk management procedures focus on the unpredictability of financial markets, and implementing restrictions to minimise these risks. The procedures for risk management are set out through a legal framework in the Local Government Act 2003 and the associated regulations (including CIPFA Codes of Practice). Financial risks are minimised through compliance with the annual Treasury Management Strategy Statement (TMSS) which incorporates the Prudential and Treasury Indicators, approved for 2018/19 by County Council in December 2017. During the first half of 2018/19 the Council has complied with all of the statutory and regulatory requirements which require the Council to identify and where possible quantify the levels of risk associated with its treasury management activities. Additionally the Council confirms that:

- Given the differential between the cost of new Public Works Loan Board (PWLB) borrowing against the return generated on the Council's investments, the use of internal resources in lieu of borrowing continued to be considered the most cost effective means of funding 2018/19 capital expenditure. As a consequence no new external borrowing was taken relating to the Council's capital programme during the first half of 2018/19. £3.5m (plus interest) was however repaid to the PWLB as per the terms and conditions of the £70m borrowing taken during April 2011 *(Paragraph 5.3).*

- At 30 September 2018 the Council's external borrowing for capital purposes, excluding PFI schemes and finance leases, was £392.4m (£395.9m at 31 March 2018); all loans sourced from the PWLB *(Paragraph 5.4).*

- In accordance with 2018/19 capital expenditure plans, the Council's internal borrowing (in lieu of external borrowing) is expected to increase to £95.2m by 31 March 2019 *(Paragraph 5.5)*.

- Total interest payable to the PWLB during the first half of 2018/19 was £8.9m at an average rate of 4.56%; the total revenue (interest) cost of servicing the Council's PWLB debt in 2018/19 is forecast to be £17.8m *(Paragraph 5.6).*

- Security of capital remains a primary investment objective. This continues to be maintained by following the Council's counterparty policy as set out in its Annual Investment Strategy for 2018/19 (contained within the approved TMSS). At 30 September 2018 the Council's investments totalled £266.8m (£253.9m at 31 March 2018). Gross investment interest received during the first half of 2018/19 was £1.4m, representing an investment return of 0.92% on an average investment portfolio of £308.6m *(Paragraph 6.10).*

- At 30 September 2018, the Council forecasts that interest receipts during 2018/19 will be in line with the approved investment income revenue budget (£1.9m); achieved by increasing the Council's exposure to higher yielding (long-term) investments through the use of approved externally managed property and multi-asset income funds *(Paragraphs 6.8 and 6.11).*

- In December 2017, revised CIPFA Codes of Practice and Ministry of Housing, Communities and Local Government's (MHCLG) Investment Guidance required additional reporting on an authority's non-treasury (commercial) activities. Whilst a report setting out the Council's Capital Strategy (as required by the CIPFA Prudential Code) is currently being prepared for approval by County Council in February 2019; a schedule listing the Council's current Income Generating Initiatives is included in the Mid-Year Review to meet the 2018/19 reporting requirements of the Code *(Section 7)*.

Focus for Scrutiny

The Committee is asked to review and comment on the treasury management mid-year position.

Treasury Management Mid-Year Review (2018/19)

1. Introduction

1.1 The Council operates a balanced budget which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operation is to ensure that cash flow is adequately planned, with surplus monies being invested in accordance with the approved Treasury Management Strategy Statement (TMSS).

1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. The management of longer term cash may involve the arrangement of long and/or short term loans (external borrowing) or may use longer term cash flow surpluses in lieu of external borrowing (internal borrowing). On occasion any external debt previously drawn may be repaid and/or restructured to meet the Council's risk or cost objectives.

1.3 Accordingly, treasury management is defined as:

> *"The management of the Council's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."*

1.4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017) includes the requirement to produce a mid-year review covering treasury management activities and performance in the year to-date. In accordance with the revised Code and governance arrangements approved by County Council in February 2014, scrutiny of the mid-year review is delegated to the Performance and Finance Select Committee.

1.5 The attached report has been prepared in compliance with CIPFA's Code of Practice and covers the following:

- An economic, interest rate and counterparty update for the first half of the 2018/19 financial year *[Section 2]*;
- An overview of the Council's 2018/19 Treasury Management Strategy Statement *[Section 3]*;
- The Council's 2018/19 Capital Programme and associated Prudential Indicators *[Section 4]*;
- A review of the Council's borrowing strategy for 2018/19 *[Section 5]*;
- A review of the Council's investment portfolio during the first six months of 2018/19 *[Section 6]*; and
- A schedule of the Council's non-treasury activities *[Section 7]*.

2. External Context

2.1 **Economic Background**: During the first half of 2018/19 UK economic growth posted a modest performance, but sufficiently robust for the Bank of England's Monetary Policy Committee (MPC) to unanimously vote to increase the Bank Rate in August 2018 from 0.5% to 0.75%. Although UK growth looks as if it will only be modest at around 1.5% throughout 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019 subject to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

2.2 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% (June 2018) to 2.7% in August, but is forecast to fall back to the Bank's 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 with its two year forecast. As a consequence financial markets are currently pricing the next increase in Bank Rate during 2019 (after the March deadline for Brexit).

2.3 Regarding the UK labour market, unemployment continued at a 43-year low of 4% on the Independent Labour Organisation (ILO) measure. For the three months to July 2018 average weekly earnings increased by 2.9% excluding bonuses (including a one month figure of 3.1% in July). With wage rates higher than CPI inflation this meant that in real terms earnings grew by about 0.4% during the period, 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 will likely feed through into providing some support to the overall rate of economic growth in the coming months. This supports the MPC decision to start increasing the Bank Rate in August; the MPC regards wage inflation in excess of 3% as increasing overall inflationary pressures within the UK economy. However, given all the uncertainties around Brexit the MPC will likely take a cautious approach before increasing the Bank Rate again.

2.4 <u>United States (US)</u>: Whilst resulting in an upturn in inflationary pressures, President Trump's massive easing of fiscal policy is fuelling a temporary boost in consumption which has generated an upturn in the rate of US growth from 2.2% (annualised) in Q1 2018 to 4.2% in by the end of June 2018. With inflation moving towards 3% the US Federal Reserve (the Fed) increased rates by another 0.25% in September to between 2.00% and 2.25%; this being the fourth increase in 2018. Furthermore the Fed indicated they expect to increase rates four more times by the end of 2019. The dilemma remains however as to 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 at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

2.5 <u>The Eurozone</u>: Growth was unchanged at 0.4% in the second quarter of 2018, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and could be negatively impacted by US tariffs on a significant part of its manufacturing exports (including cars). Although Eurozone growth is still expected to be in the region of 2% throughout 2018, the horizon is less clear than it seemed just a short while ago.

2.6 **Interest Rate Forecasts**: The Council's treasury management advisor (Link Asset Services) has updated their forecasts in August 2018 *(PWLB rates based on the "Certainty Rate" which has been accessible to local authorities since November 2012)* as shown below:

Link Asset Services Interest Rate View	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.80%	0.90%	1.00%	1.10%	1.20%	1.30%	1.40%	1.50%	1.50%	1.60%
6 Month LIBID	0.90%	1.00%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%
12 Month LIBID	1.10%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
5yr PWLB Rate	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%
25yr PWLB Rate	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%
50yr PWLB Rate	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%

2.7 Following the August 2018 Bank Rate increase the MPC emphasised again that future increases would be gradual and would rise to a much lower equilibrium rate (where monetary policy is neither expansionary of contractionary) than pre-2008; indicating a figure of around 2.5% in ten years' time. In line with financial market expectations (paragraph 2.2) Link Asset Services do not believe the MPC will increase the Bank Rate again ahead of the March 2019 deadline for Brexit. Depending on a reasonably orderly Brexit, Link Asset Services consider that the next increase in Bank Rate will be in May 2019, followed by increases in February and November 2020 bringing the Bank Rate to 1.5% by the end of the forecast period.

2.8 Currently the overall balance of risks to economic recovery in the UK is probably neutral. Furthermore, the balance of risks to increases in Bank Rate and shorter term PWLB rates are probably also even and broadly dependent on how strong UK GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively. Risks to current forecasts for UK gilt yields and PWLB borrowing rates include:

Downside Risks	Upside Risks
• UK Bank Rate rises undertaken too quickly over the next three years; causing UK economic growth and increases in CPI inflation to be weaker than currently anticipated.	• UK Bank Rate rises undertaken too slowly over the next three years; allowing inflation pressures to build up too strongly within the UK economy which then necessitates a later rapid series of increases in Bank Rate faster than currently anticipated.

• Weak capitalisation of some European banks and a resurgence of the Eurozone sovereign debt crisis; possibly Italy given its high level of government debt, low rate of economic growth, vulnerable banking system and the recent election of an anti-austerity government. • Various political challenges (other than Italy) from within the EU that could put considerable pressure on the cohesion of the Union and consequently spill over into impacting the Euro, EU financial policy and financial markets. • The imposition of US trade tariffs by President Trump which could negatively impact world growth. Specific actions against Turkey pose a particular risk to its economy which in turn could negatively impact Spanish and French banks which have significant exposures to loans to Turkey. • Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens (including UK gilts). • Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows from equities to bonds.	• UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields. • US fiscal plans to stimulate economic expansion causing a significant increase to US inflation; causing further sell-offs of government bonds in all major western countries. • The US Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE; leading to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in US bond yields which could then spill over into impacting bond yields around the world.

2.9 **Counterparty Update**: During the first half of 2018/19 rating changes to counterparties approved for Council investment (as announced by Fitch, Moody's and Standard & Poor's) have been reported to the Treasury Management Panel (via Panel meetings and update reports) and the Regulation, Audit and Accounts Committee (through quarterly treasury management compliance reports). With the exception of Lloyds and NatWest Bank (see paragraphs 2.10 and 2.11) no changes have been made to the Council's lending list, as approved by County Council in December 2017, as a consequence of rating actions taken during the period.

2.10 Lloyds Bank (UK): Following a credit rating upgrade for Lloyds Bank plc (Lloyds ring-fenced bank) the maximum duration limit for unsecured deposits increased to one year from six months. No changes were made to either the maximum duration period for deposits with Lloyds Bank Corporate Markets plc (Lloyds non ring-fenced bank; six months) or the maximum monetary limit for total investments held within the Lloyds Banking Group on an unsecured basis (£15m). The Council's investment with Lloyds totalled £14.7m at 30 September 2018 (see Appendix 1).

2.11 NatWest Bank (UK): Following a credit rating downgrade to NatWest Markets plc (RBS non ring-fenced bank) no new deposits to be arranged with this name. Unsecured investments with National Westminster Bank plc (RBS ring-fenced bank) however continue to be approved up to a maximum monetary limit of £15m for up to a maximum investment duration of one year. The Council held no investments with National Westminster Bank during the first half of 2018/19.

3. Treasury Management Strategy Statement (2018/19)

3.1 Throughout the first half of 2018/19 the Council complied with the relevant statutory and regulatory requirements which require officers to identify and where possible quantify the levels of risk associated with its treasury management activities. In particular, credit risk is managed through the Council's "Annual Investment Strategy" as contained within the 2018/19 Treasury Management Strategy Statement (TMSS) which approves that investments are only placed with counterparties that meet identified minimum credit criteria (including credit ratings, credit default swap prices, share prices, corporate developments and general media alerts).

3.2 The Council defines 'high credit quality' as institutions and securities having a long-term credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher (non-UK banks must hold a credit rating of A+ or higher). The 2018/19 Annual Investment Strategy further approves investments in BBB+ rated institutions including non-financial organisations (corporates). The total level of internally managed investments with organisations rated below A- is limited to a maximum of £30m; such investments being classified as 'non-specified' in accordance with DCLG "Investment Guidance".

3.3 The Director of Finance, Performance and Procurement confirms that on one occasion a monetary exposure limit as approved within the 2018/19 Annual Investment Strategy was exceeded; details reported below:

(i) The maximum approved limit for total investments held in short-term Money Market Funds (£115m) was exceeded for one day (£132.5m on 17 May 2018) due to actual payments and receipts differing from the cash flow forecast; with corrective action being taken on the next working day. Money Market Funds are used to cover the Council's daily liquidity requirements (as opposed to short-term borrowing from other institutions). The maximum monetary limit approved for all such funds is maintained to ensure that the Council is not over exposed to lower yielding investment products; and is therefore not reflective of any additional credit risk. This was fully discussed by the Treasury Management Panel and the Regulation, Audit and Accounts Committee.

Internal controls continue to be reviewed to ensure that this limit is not exceeded in the future.

3.4 In accordance with limits set out within the 2018/19 TMSS, the Director of Finance, Performance and Procurement approved increasing the Council's exposure to longer-term externally managed pooled investment (property and multi-asset income) funds during the period (see paragraphs 6.13 to 6.17).

4. The Council's Capital Position

4.1 Capital Programme: In accordance with CIPFA's "Prudential Code" and the Council's ambitions and priorities as set out within the Future West Sussex Plan, the Council approves annually its capital programme setting out the investment required to meet the Council's capital objectives.

4.2 Capital expenditure as contained within the approved programme may be financed from a range of internal and external sources including:

- Government grants
- External contributions (such as s106 developer contributions)
- Capital receipts
- Revenue contributions
- Transfers from reserves held for capital purpose

4.3 Borrowing is required to meet the cost of any capital expenditure not financed by these internal and external funding sources. The Council is therefore required to approve a strategy that sets-out the borrowing required to meet the cost of any unfinanced expenditure as contained within its capital programme; whilst ensuring that such borrowing remains within prudent, affordable and sustainable limits.

4.4 Capital Expenditure: In December 2017, County Council approved a capital programme that set out total planned investment of £800.5m across the period 2018/19 to 2022/23; including £228m for income generating initiatives over the life of the programme. The table below details the original estimates for 2018/19 capital expenditure and the current forecast spend for the year:

Capital Expenditure by Service	2018/19 Original Estimate £'m	2018/19 Forecast Spend £'m
Adults and Health	0.7	1.1
Education & Skills / Children and Young People	46.4	33.0
Environment	4.6	1.0
Finance and Resources	4.4	5.8
Highways and Infrastructure	34.6	33.0
Leader	8.8	6.8
Safer, Stronger Communities	4.9	4.8
Core Programme	**104.4**	**85.5**
Income Generating Initiatives	31.6	26.7
Total Capital Expenditure	**136.0**	**112.2**

4.5 In line with the above, the revised forecast of 2018/19 capital financing includes £84.0m by way of government grants, external contributions, capital receipts and revenue funding; and £28.2m by way of internal and/or external borrowing (of which £22.7m relates to borrowing for Income Generating Initiatives).

4.6 *Limits to Borrowing Activity*: Key indicators of prudence for the Council's treasury activity are the Prudential Indicators that ensure that over the medium-term borrowing will only be for a capital purpose (including on Balance Sheet PFI schemes and finance leases) including:

- The Council's expected external debt position over the period; termed the "Operational Boundary";
- Gross external debt should not, except in the short-term, exceed the Council's total borrowing requirement in the preceding year plus estimates of any additional borrowing in 2018/19 and over the next two financial years;
- The Council's "Authorised Borrowing Limit" is a statutory limit determined under Section 3(1) of the Local Government Act 2003 representing the limit beyond which all external debt (including overdrawn bank balances and short-term borrowing) is prohibited. The limit is approved annually by County Council and reflects the level of borrowing which could be afforded in the short-term (including borrowing in advance of capital need) but not sustainable in the longer-term. It is therefore the Council's expected maximum borrowing need over a three year period (as approved in the capital programme) with additional headroom for unexpected cash flow movements.

4.7 The Director of Finance, Performance and Procurement confirms that no difficulties are envisaged for the current (as shown below) or future years in complying with these Prudential Indicators as a consequence of the recommended capital programme for the period 2018/19 to 2022/23:

Operational Boundary	2018/19 Original Estimate £'m	2018/19 Latest Forecast £'m
External Borrowing - Capital *(i)*	388.8	388.8
External Borrowing - Chichester Harbour	4.5	5.0
PFI Schemes and Finance Leases	105.6	103.2
Operational Boundary Limit	**498.9**	**497.0**

(i) Assuming the continuation of an internal borrowing strategy throughout 2018/19 (no new external borrowing being arranged during the year).

Authorised Borrowing Limit	2018/19 Original Estimate £'m	2018/19 Latest Forecast £'m
Gross Borrowing	517.0	393.7
PFI Schemes and Finance Leases	105.6	103.2
Authorised Borrowing Limit	**622.6**	**497.0**

4.8 The latest forecast of the Authorised Borrowing Limit is less than that originally approved and assumes that no external borrowing is planned in 2018/19. The approved Authorised Borrowing Limit however remains unchanged at £622.6m allowing for the arrangement of new external debt if current borrowing plans relating to the Council's capital programme change during the remainder of 2018/19.

5. Borrowing

5.1 The Council's main objective when approving new external borrowing is to strike an appropriately low risk balance between securing low interest costs and achieving a cost certainty over the period for which funds are required; flexibility to renegotiate loans should the Council's long-term capital plans change being a secondary objective.

5.2 Affordability remains an important influence on the Council's borrowing strategy. Any borrowing in advance of need continues to introduce a 'cost of carry' where proceeds are temporarily reinvested at interest rates lower than the cost of borrowing. Prevailing Public Works Loan Board (PWLB) borrowing rates for maturity loans (including the "Certainty Rate" discount available to UK local authorities) during the first six months of 2018/19 are shown below:

Change Date	**Notice No**	**1 year**	**4½-5 years**	**9½-10 years**	**19½-20 years**	**29½-30 years**	**39½-40 years**	**49½-50 years**
03/4/2018	128/18	1.48	1.84	2.22	2.53	2.51	2.34	2.27
30/4/2018	167/18	1.43	1.86	2.31	2.66	2.66	2.49	2.43
31/5/2018	209/18	1.30	1.71	2.16	2.54	2.52	2.36	2.29
30/6/2018	251/18	1.40	1.77	2.18	2.55	2.54	2.40	2.35
31/7/2018	295/18	1.46	1.84	2.24	2.60	2.60	2.46	2.41
31/8/2018	339/18	1.49	1.83	2.22	2.60	2.60	2.47	2.42
30/9/2018	380/18	1.55	1.93	2.33	2.71	2.71	2.60	2.56
	Low	1.28	1.67	2.09	2.47	2.47	2.32	2.25
	Average	**1.46**	**1.84**	**2.25**	**2.62**	**2.61**	**2.47**	**2.41**
	High	1.57	1.99	2.43	2.80	2.81	2.69	2.64

5.3 Whilst PWLB borrowing rates have increased across all loan periods since the beginning of the year (as shown above) an internal borrowing strategy whereby the Council is using its own cash resources in lieu of external borrowing continues to be considered the most prudent and cost effective policy in the current economic climate. As a consequence no new external borrowing for capital purposes was arranged during the first half of 2018/19. £3.5m (plus interest) was however repaid to the PWLB as per the terms and conditions of the £70m borrowing taken during April 2011.

5.4 At 30 September 2018 the Council's PWLB long-term borrowing totalled £392.4m (£395.9m at 31 March 2018) with the following maturity profile:

	Maximum Approved Limit	31.03.18 £'m	30.09.18 £'m	30.09.18 %
Less than 1 year	25%	7.0	7.0	1.8
Between 1 and 5 years	35%	27.6	24.1	6.1
Over 5 years to 10 years	40%	74.9	74.9	19.1
Over 10 years to 15 years	70%	194.2	214.2	54.6
Over 15 years to 20 years	30%	52.2	32.2	8.2
Over 20 years to 25 years	30%	0.0	15.0	3.8
Over 25 years to 30 years	30%	15.0	0.0	0.0
More than 30 years	30%	25.0	25.0	6.4
TOTAL		**395.9**	**392.4**	**100.0**

5.5 Cash flow forecasts up to 31 March 2019 show that the Council will have external borrowings of £393.8m and PFI schemes and finance lease liabilities of £103.2m (paragraph 4.8) against an underlying borrowing need of £592.2m; implying total internal borrowing of £95.2m at 31 March 2019 (£69.8m as at 31 March 2018). Based on current capital plans, the forecast movement in the Council's 2018/19 internal borrowing is shown below:

	£'m
Internal Borrowing (actual at 31 March 2018)	**69.8**
2018/19 Capital expenditure *(to be funded through borrowing)*	28.2
Repayment of PWLB Debt (EIP Loans)	7.0
Change (increased) Short-Term Debt – *Chichester Harbour*	-0.4
Revenue Provision for Repayment of Debt	-9.4
Internal Borrowing (forecast at 31 March 2019)	**95.2**

5.6 The revenue (interest) cost of servicing the Council's PWLB debt in 2018/19 is forecast to be **£17.8m**, representing an average rate of **4.56%**. If the Council had externalised its total internal borrowing (£95.2m) on 1 April 2018 it is estimated that the additional revenue cost in 2018/19 relating to interest payments would have been £2.2m (based on a 50 year PWLB maturity loan at 2.27%). The Director of Finance, Performance and Procurement will continue to monitor the benefits of an internal borrowing strategy against the risks of a significant upturn in UK gilt yields.

5.7 Debt Rescheduling: Rescheduling opportunities have remained very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted new PWLB borrowing rates since October 2010. The resulting premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Council's portfolio; therefore no debt rescheduling was undertaken during the first half of 2018/19.

5.8 Borrowing for cash flow purposes: Excluding money held on behalf of the Chichester Harbour Conservancy (and its associated charities) no short-term borrowing was undertaken during the first half of 2018/19. All daily cash flow shortages were funded by withdrawals from the Council's instant access accounts (including Money Market Funds).

6. Investment Activity

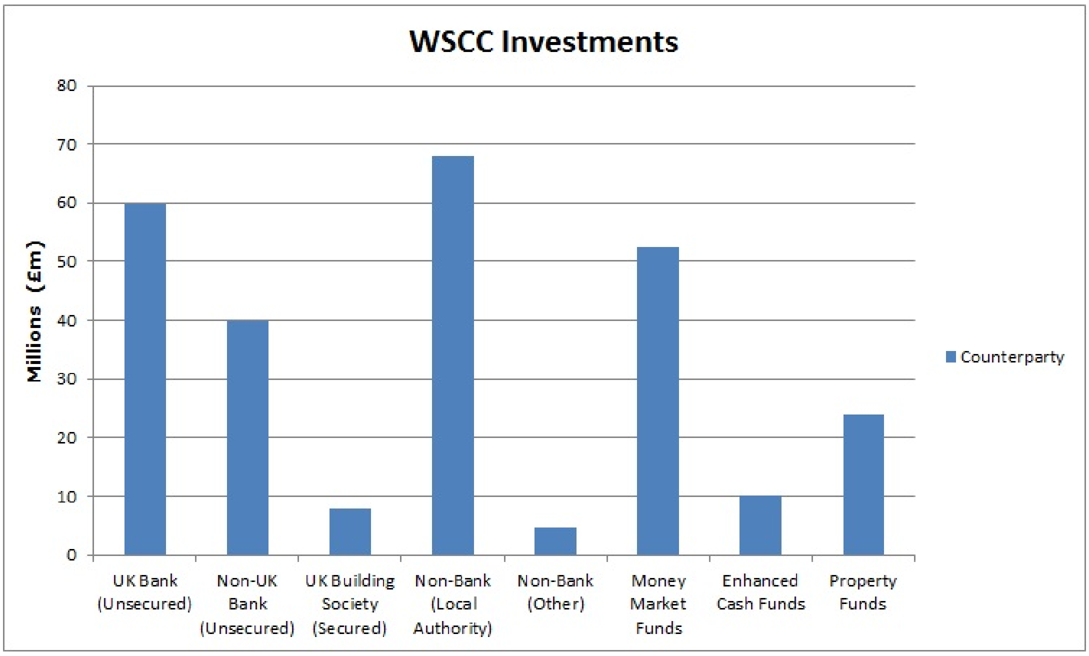
6.1 The Council has substantial amounts of investments and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. In accordance with CIPFA's Treasury Management Code of Practice it is the Council's objective to ensure security of capital and liquidity, before seeking to obtain an appropriate level of investment return consistent with the Council's risk appetite. However, as demonstrated by the prevailing London Interbank Bid Rates (LIBID) detailed below, short-term investments rates (periods up to one year) have remained very low during the first six months of 2018/19 (in line with the current 0.75% Bank Rate).

Date	**Bank Rate**		**O/N LIBID**	**7-day LIBID**	**1-month LIBID**	**3-month LIBID**	**6-month LIBID**	**12-month LIBID**
01/4/2018	0.50		0.35	0.36	0.39	0.59	0.70	0.88
30/4/2018	0.50		0.35	0.37	0.39	0.59	0.68	0.85
31/5/2018	0.50		0.35	0.36	0.37	0.49	0.59	0.76
30/6/2018	0.50		0.34	0.36	0.38	0.55	0.66	0.84
31/7/2018	0.50		0.33	0.50	0.56	0.67	0.78	0.93
31/8/2018	0.75		0.58	0.58	0.60	0.68	0.77	0.92
30/9/2018	0.75		0.57	0.59	0.60	0.67	0.78	0.94
Minimum	0.50		0.33	0.35	0.37	0.48	0.59	0.75
Average	**0.58**		**0.42**	**0.43**	**0.47**	**0.61**	**0.71**	**0.87**
Maximum	0.75		0.58	0.59	0.60	0.68	0.78	0.94

6.2 The average level of funds available for Council investment during the first half of 2018/19 was £308.6m, including Local Enterprise Partnership (LEP) grant monies. Investment levels continue to be dependent on the timing of precept payments from West Sussex Boroughs and Districts, receipt of Government grants ahead of expenditure and the progress on the Council's capital programme.

6.3 At 30 September 2018 the Council's investments amounted to £266.8m (including £48.9m LEP monies) as compared with £253.9m as at 31 March 2018. Within the Council's total invested balances (and having regard to the current environment of low short-term investment returns) approval is given for up to a maximum of £75m to be made available for long-term strategic investment based on forecast levels of PFI/MRMC reserves (£58.1m actual long-term investments as at 30 September 2018).

6.4 The full list of investments held at 30 September 2018 is shown in **Appendix 1**. Additionally a breakdown of the Council's investments by counterparty type at this point in time is shown below:



6.5 Included within the Council's investment portfolio (as shown above) is £68m deposited with other UK local authorities; of which £15m is invested with Northamptonshire County Council (NCC) over a 12 month period. This short-term investment was arranged in December 2017 before NCC's issuance of a S114 Notice in February 2018 on concerns that the authority would be unable to produce a balanced 2018/19 revenue budget.

6.6 Investments arranged with other UK local authorities are protected by statutory provisions set out in the Local Government Act 2003 that prevent default; due to these statutory provisions local authorities are viewed as similar to the UK Government. The issuance of a S114 Notice should not affect either the statutory provisions as set out in legislation or an authority's ability to raise funds from the Public Works Loan Board (PWLB), therefore the Northamptonshire investment (and all other local authority investments) continue to be held to the agreed maturity dates.

6.7 The movement in the Council's internally managed investments during the first half of 2018/19 is shown below:

	Balance on 31st March £'m	Invest-ments Made £'m	Invest-ments Sold £'m	Balance on 30th Sept £'m
UK Banks: Unsecured Deposits	59.7	72.5	-72.5	59.7
Non-UK Banks: Unsecured	59.2	77.5	-96.7	40.0
UK Banks: Secured Deposits	18.3	0.0	-10.4	7.9
UK Local Authority	53.0	15.0	0.0	68.0
Non-Bank Corporates	0.2	4.5	0.0	4.7
Money Market Funds	38.8	480.2	-466.5	52.5
TOTAL (Internally Managed)	**229.2**	**649.7**	**-646.1**	**232.8**
Enhanced Cash Funds	15.0			10.0
Property Funds	9.7			24.0
TOTAL INVESTMENTS	**253.9**			**266.8**

6.8 Investment Performance: The Council's budgeted investment income as approved in the 2018/19 Revenue Budget amounted to £1.9m; increased from £1.6m in 2017/18. The increased revenue budget reflected the move to higher interest rates following the Bank Rate rise in November 2017 and the approval to increase the Council's exposure to higher yielding (long-term) investments during 2018/19 through the use of additional externally managed property and multi-asset income pooled funds (paragraph 3.4).

6.9 The original estimate of 2018/19 gross investment income (before any adjustments for internal interest transfers) was £2.7m, based on the assumption that the Council would achieve an average interest rate of 0.99% on an assumed investment portfolio of £270m. Additionally, the investment income budget as originally reported included an estimated £0.8m in respect of interest transfers to internal and external reserve balances held by the Council, including Local Enterprise Partnership monies, school accumulating funds, PFI/MRMC reserves and cash held on behalf of the Chichester Harbour Conservancy.

6.10 Gross investment interest received during the first half of 2018/19 was **£1.4m**, representing an investment return of **0.92%** on an average investment portfolio of £308.6m. In accordance with the approved Treasury Management Strategy performance can be shown by three separate investment types representing liquidity, short-term investments (up to one year duration) and long-term investments (greater than one year). In accordance with these investment types the Council's investment performance during the first half of 2018/19 is shown below:

Investment Type	Average £'m	Interest £'m	Rate of Return
Liquidity	70.0	0.2	0.53%
Short-Term Investments	192.3	0.7	0.77%
Long-Term Investments	46.3	0.5	2.12%
Total	**308.6**	**1.4**	**0.92%**

6.11 Updated forecasts for the remainder of 2018/19 (based on performance during the first six months of 2018/19 together with updated interest estimates for the remainder of the year) show that for an expected average investment portfolio of £270m (reflecting the pay-over of all LEP monies on 9 November 2018 to the new accountable body) the resulting interest will be in line with the approved £1.9m revenue budget:

Interest earned to 30 September 2018	0.92%	£1.4m
Interest due from existing investments	1.40%	£0.9m
Forecast interest – Future investments	0.75%	£0.4m
Gross Investment Income (2018/19)	**1.01%**	**£2.7m**
Interest payable to internal/external funds held	Variable	-£0.8m
Investment Income (2018/19)		**£1.9m**

6.12 Officers will continue to closely monitor investment income performance throughout the remainder 2018/19. Any changes to the above projections will be reported to the Panel and included within Total Performance Monitors (TPM's).

6.13 Externally Managed Pooled Funds: An overview of the investment activity in the Council's externally managed pooled funds during the first half of 2018/19 is shown below:

(a) Ultra-Short Dated Bond Funds (Enhanced Cash)

Fund	Market Valuation 31-Mar-18	Payments in/out(-)	Market Gain	Dividends Received	Effective Rate of Return
Federated	£0.0m	£10.0m	£33,314	-	0.74%
Payden	£15.0m	-£15.0m	£9,058	£29,549	0.69%

(b) Property Fund (Long-Term Investments):

Fund	Market Valuation 31-Mar-18	Payments in/out(-)	Market Gain/Loss(-)	Dividends Received	Dividend Return
CCLA	£9.7m	£0m	£0.0m	£210,210	4.19%
Hermes	£0.0m	£10.0m	-£0.5m	£27,945	3.00%
Lothbury	£0.0m	£5.0m	-£0.2m	£30,664	2.83%

Note: Estimated dividend amount for Hermes in Q2 2018/19; awaiting final confirmation from the fund manager (to be received 15 November 2018).

6.14 During August 2018 the Director of Finance, Performance and Procurement approved the purchase of Hermes and Lothbury units via secondary markets; prices based on the respective fund's Net Asset Valuation (NAV) at the end of July 2018. As shown below, both secondary market trades resulted in a saving against the primary investor price (NAV+6%) if units had been purchased direct from the fund manager:

- Purchase of £10m Hermes Property Unit Trust (HPUT) units at NAV+5.5% (plus 0.25% brokerage payable to Tullett Prebon Ltd); and
- Purchase of £5m Lothbury Property Trust (LPT) units at NAV+3.0% (plus 0.25% brokerage payable to CBRE Ltd)

6.15 The approval of Hermes and Lothbury (in addition to CCLA) as appropriate funds for long-term investment followed a selection process and appraisal of the related risks undertaken by officers with support of the Council's treasury management advisor (Link Asset Services). The level of cash being available for investment is based on longer-term forecasts of PFI, MRMC and other earmarked reserves being held by the Council. Details of the approved funds were reported to the Treasury Management Panel at their April 2018 meeting.

6.16 The new accounting standard (International Financial Reporting Standard/ IFRS9) that came into effect on 1 April 2018 requires that fluctuations in market valuations of more specialist types of investment (including pooled investment funds, third party loans and commercial investments) will impact the surplus or deficit of the Revenue Budget, rather being held on the Balance Sheet as per the previous accounting standard.

6.17 The Ministry of Housing, Communities and Local Government (MHCLG) consulted in the summer for a statutory accounting override relating to pooled investment funds, allowing market fluctuations (gains and/or losses) to be held on an authority's balance sheet in an unusable reserve until the investment is sold. The outcome of this was announced in early November, with a statutory override for a period of five years. The Government have confirmed they will keep use of the override under review. The Council will be required to disclose the net impact of the unrealised fair value movements in a separate unusable reserve throughout the duration of the override.

7. Non-Treasury (Commercial) Activity

7.1 A schedule of the Council's current income generating initiatives (non-treasury) activities is attached below:

Non-Treasury (Commercial) Activity	Capital Expenditure £'m
Pre-April 2018	
Historic Investment Property *(i)*	31.4
Horsham Enterprise Park *(ii)*	17.4
Assets Under Construction *(iii)*	10.9
Total (Pre-April 2018)	59.7
2018/19 Forecast (at 30 September 2018)	
Horsham Enterprise Park	0.5
Commercial Property Initiatives	20.0
West Sussex Gigabit	5.3
Your Energy Sussex	8.0
Other Income Generating Initiatives	1.0
Total (2018/19)	34.8
Total	**94.5**

(i) As per the Council's 2017/18 Balance Sheet and includes smallholdings, Tangmere solar farm, various land and properties held for investment return

(ii) No return to-date as the business case to develop the Horsham Enterprise Park is yet to be submitted

(iii) Includes £10.5m for Westhampnett Solar Farm which opened in October 2018

8. Resource and Value for Money Implications

Covered in main body of report.

9. Risk Management Implications

Covered in main body of report.

10. Human Rights Act Implications

Not applicable.

11. Crime and Disorder Act Implications

Not applicable

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Appendix 1 – Counterparty Investments

Background Papers
None