Non-Executive Report of the: **Audit Committee** **16 November 2017**	TOWER HAMLETS
Report of: Zena Cooke, Corporate Director, Resources	**Classification:** Unrestricted
Treasury Management Mid-Year Report (April 2017 - September 2017)	

Originating Officer(s)	Bola Tobun – Investment & Treasury Manager
Wards affected	All Wards

Summary

This report advises the Committee of the Council's borrowing and investment activities from 1st April 2017 to 30th September 2017. The Treasury Management Strategy Statement and the Treasury Prudential Indicators, for 2017/18 were approved by the Council on 22nd February 2017 as required by the Local Government Act 2003. The Council has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

For this reporting period, the Council earned an average return of 0.53% on its lending, outperforming the actual rolling average 7 day LIBID rate of 0.11%.

Over the reporting period, all treasury management activities have been carried out in accordance with the approved limits and the prudential indicators set out in the Council's Treasury Management Strategy statement. No long-term or short-term borrowing has been raised since the commencement of this financial year 2017/18 to reporting period.

Recommendations:

Members are recommended to:

- note the contents of the treasury management activities and performance against targets for half year ending 30th September 2017;
- note the Council's outstanding investments which amount to £447.1m at 30th September 2017 (appendix 2);
- note the potential impact on the Council of becoming a retail client with effect from 3rd January 2018 as set out at section 3.7; and
- note the protections available to retail clients that the Council will forgo as a result of opting up to professional client (appendix 4).

1. REASONS FOR THE DECISIONS

1.1 The Local Government Act 2003 and the Local Authorities (Capital Financing and Accounting) Regulations 2003 requires that regular reports be submitted to Council/Committee detailing the council's treasury management activities.

1.2 This report updates on both the borrowing and investment decisions made by Corporate Director, Resources under delegated authority in the context of prevailing economic conditions and considers Treasury Management performance measured against the benchmark 7 day LIBID rate.

1.3 Treasury management is defined as "the management of the Council's investments and cash flows; its banking, money market and capital market transaction; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

1.4 The regular reporting of treasury management activities should assist in ensuring that Members are able to scrutinise officer decisions and monitor progress on implementation of investment strategy as approved by Full Council.

1.5 The Council also agreed as part of the Treasury Management Strategy Statement to receive a number of reports. Furthermore, the CIPFA Treasury Management Code of Practice requires that Full Council/Committee should receive a Mid-Year Report reviewing Treasury Management/Investment.

2. ALTERNATIVE OPTIONS

2.1 The Council is bound by legislation to have regard to the Treasury Management (TM) Code. The Code requires that the Council or a sub-committee of the Council (Audit Committee) should receive regular monitoring reports on treasury management activities.

2.2 If the Council were to deviate from those requirements, there would need to be some good reason for doing so. It is not considered that there is any such reason, having regard to the need to ensure that Members are kept informed about treasury management activities and to ensure that these activities are in line with the investment strategy approved by the Council.

2.3 Within reason, the Council can vary its treasury management strategy having regard to its own views about its appetite for risk in relation to the financial returns required.

3. DETAILS OF REPORT

3.1 The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 require local authorities to have regard to the Treasury Management Code. The Treasury Management code requires that the Council or a sub-committee of the Council (Audit Committee) should receive regular monitoring reports on treasury management activities and risks.

3.2 The Treasury Management Strategy, Investment Strategy and Minimum Revenue Provision reports were included in the Budget Pack that was presented to Full Council on 22 February 2017. The 2016/17 Outturn report was approved by Full Council on 21 July 2017.

3.3 This mid - year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- Interest Rate Forecast for the next six months of 2017/18.
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy, which constitutes the following:
  - The Council's borrowing strategy for 2017/18.
  - The Council's investment strategy for 2017/18.
  - The Council's investment portfolio for 2017/18.
  - The Council's capital expenditure (prudential indicators).
  - A review of compliance with Treasury and Prudential Limits for 2017/18.

3.4 **<u>Interest Rate Forecast -</u>** The Council's newly appointed treasury advisor, Arlingclose, has provided the following forecast:

3.4.1 The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Both consumer and business confidence remain subdued. Household consumption growth, the driver of UK GDP growth, has softened following a contraction in real wages. Savings rates are at an all-time low and real earnings growth (i.e. after inflation) struggles in the face of higher inflation.

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

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

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

3.5 Treasury Management Strategy 2017/18

3.5.1 The Council's Treasury Management Strategy was approved on 22nd February 2017 by Full Council. The Strategy comprehensively outlines how the treasury function will operate throughout the financial year 2017/18 including the limits and criteria for selecting institutions to be used for the investment of surplus cash and the Council's policy on long-term borrowing and limits on debt.

3.5.2 All investments made from the start of the year up to 30th September have been with counterparties on the Council's approved lending list.

3.5.3 The Pension Fund cash balances fluctuated between £15m and £140m during the reporting period. This was as a result of the following activities; £50m redeemed in May 2017 and £75m redeemed in August 2017 from the GMO portfolio and £15m in-house working capital. The cash was invested in accordance with the Council's Treasury Management Strategy agreed by Full Council on the 22nd February 2017, under the delegated authority of the Corporate Director, Resources and was managed in-line with the agreed parameters. The cash balance outstanding at 30th September 2017 was £6.5m as a result of £140m being transferred to a fund manager (LCIV) for investments. Pensions Committee is updated on Pension Fund investment activity on a quarterly basis.

3.5.4 On 31st March 2017, the Council had net investments of £361m 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

	31st March 2017 Actual £m
General Fund CFR	206.037
HRA CFR	75.666
Total CFR	**281.703**
Less: Other debt liabilities *	(36.304)
Borrowing CFR	**245.399**
Less: Usable reserves	(478.489)
Less: Working capital	(128.274)
Net (investments)	**(361.364)**

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

3.5.5 The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 30th September 2017 and the change in the quarter is show in table 2 below.

Table 2: Treasury Management Summary

	31.03.17 Balance £m	Mid -Year Movement £m	30.09.17 Balance £m	30.09.17 Rate %
Long-term borrowing	85.936	*(0.000)*	85.936	4.55
Short-term borrowing	00.000	*0.000*	0.000	
Total borrowing	**85.936**	*(0.000)*	**85.936**	**4.55**
Long-term investments	25.000	*(5.000)*	20.000	
Short-term investments	295.500	*(44.500)*	251.000	
Cash and cash equivalents	126.800	*49.300*	176.100	
Total investments	**447.300**	***(0.200)***	**447.100**	**0.53**
Net investments	**361.364**		**361.164**	

Due to unfavourable interest rates offered by Local Authorities, investments that were with other LAs which have matured were reinvested in money market funds (MMF) pending better opportunities in the market.

Borrowing Strategy during the half year

3.5.6 The Council held £85.936m of loans at 30th September 2017 which is the same position as at 31st March 2017. No borrowing has been undertaken and also no debt rescheduling opportunities have arisen during this financial year as the cost of premiums outweighs savings that could be made from the lower PWLB borrowing rates. The borrowing position as at 30th September is show in table 3 below.

Table 3: Borrowing Position

	30.09.17 Balance £m	30.09.17 Rate %	30.09.17 WAM* years
Public Works Loan Board	8.436	6.64	7.7
Banks (LOBO)	60.000	4.32	42.6
Banks (fixed-term)	17.500	4.34	60.1
Total borrowing	**85.936**	**4.55**	**42.7**

*Weighted average maturity

3.5.7 The Council takes a low risk approach to its borrowing strategy. This means that the principal objective when borrowing has been to strike an appropriate balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The secondary objective being to have flexibility to renegotiate loans should the Council's long-term plans change.

3.5.8 Over the first six months of this financial year no new borrowing was undertaken and no maturity of existing loans occurred hence there is no loans replacement. This strategy enabled the Council to reduce its net borrowing costs (despite foregone investment income) and reduce the overall risk.

3.5.9 The "cost of carry" analysis performed by Arlingclose did not indicate any value in borrowing in advance for future years' planned expenditure and therefore no borrowing has been undertaken at this stage of the year.

3.5.10 The Council continues to hold £60m 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. The Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the first six months of this financial year.

Investment Activity

3.5.11 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the first half of 2017/18, the Council's investment balance ranged between £437m to £502 million due to timing differences between income and expenditure. The investment position during the quarter is shown in table 4 below.

Table 4: Investment Position

	31.03.17 Balance £m	Mid-Year Movement £m	30.09.17 Balance £m
Banks & building societies (unsecured)	240.000	(5.000)	235.000
Government (incl. local authorities)	165.500	0.500	166.000
Money Market Funds	41.800	4.300	46.100
Total investments	**447.300**	**(0.200)**	**447.100**

*Weighted average maturity

Performance Report

3.5.12 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 5 below.

3.5.13 As illustrated below in table 5, the Council outperformed the benchmark by **30bps** for reporting period. The Council's budgeted investment return for 2017/18 is **45bps** (0.45%) with average cash balance of £350m**,** the performance for the year to reporting period is **53bps** with average cash balance of £435m, the performance to reporting period is **8bps** (0.08%) ahead of budget. Also the average cash balance is £85m more than budget balance for 2017/18.

Table 5: Investment performance for financial year to 30th September 2017

Period	Benchmark Return	LBTH Performance	Over/(Under) Performance
Full Year 2016/2017	0.30%	0.63%	0.33%
Quarter 1	0.11%	0.42%	0.31%
Quarter 2	0.11%	0.53%	0.42%
2017/18 Year to Period	0.11%	0.53%	0.42%

3.5.14 Investment rates available in the market have been ultra-low since August 2016 when the MPC pegged the Base Rate at 0.25%. The cash balance available for investment purposes during this first six months fluctuated between £430m and £502m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

Investments Outstanding & Maturity Structure

3.5.15 Table 6 below shows the amount of investments outstanding at the end of September 2017, split according to the financial sector.

FINANCIAL SECTOR	£m	%
Banks in the UK	55.00	12.30
Building Societies in the UK	20.00	4.47
Banks in the Rest of the World	160.00	35.79
Government & Local Authorities	166.00	37.13
Money Market Funds	46.10	10.31
Investments Outstanding as at 30/09/2017	**447.10**	**100.00**

3.5.16 The chart 1 below illustrates the maturity structure of deposits at 30th September 2017; we have £46.10m as overnight deposits, and this is predominantly Money Market Funds.

3.5.17 The Weighted Average Maturity for outstanding investment portfolio is 149 days; this is the average number of outstanding days to maturity of each deal from 30th September 2017. This indicates a very low number of investments over 12 months.

Chart 1 – Maturity of Investment Portfolio as at 30th September 2017

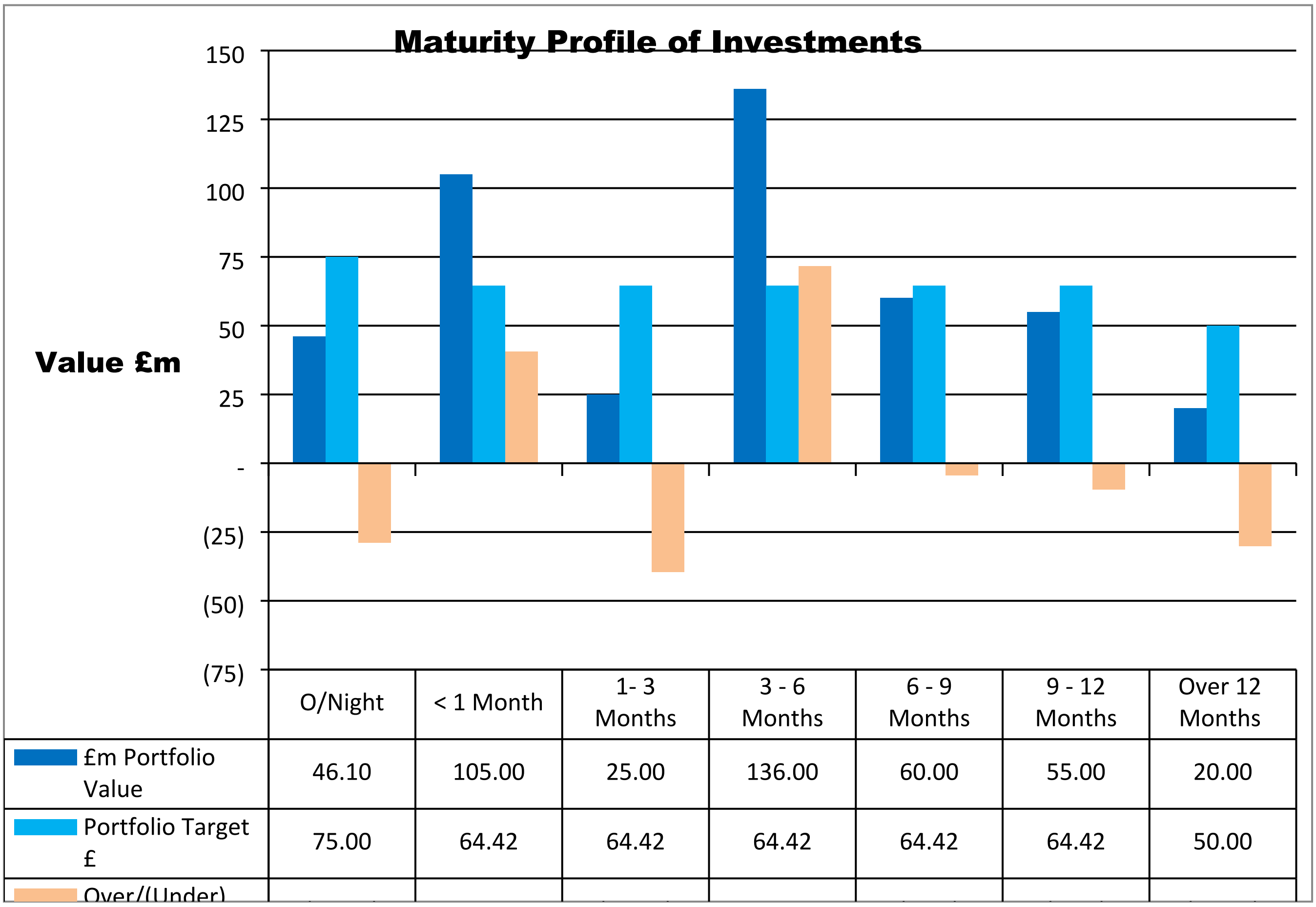
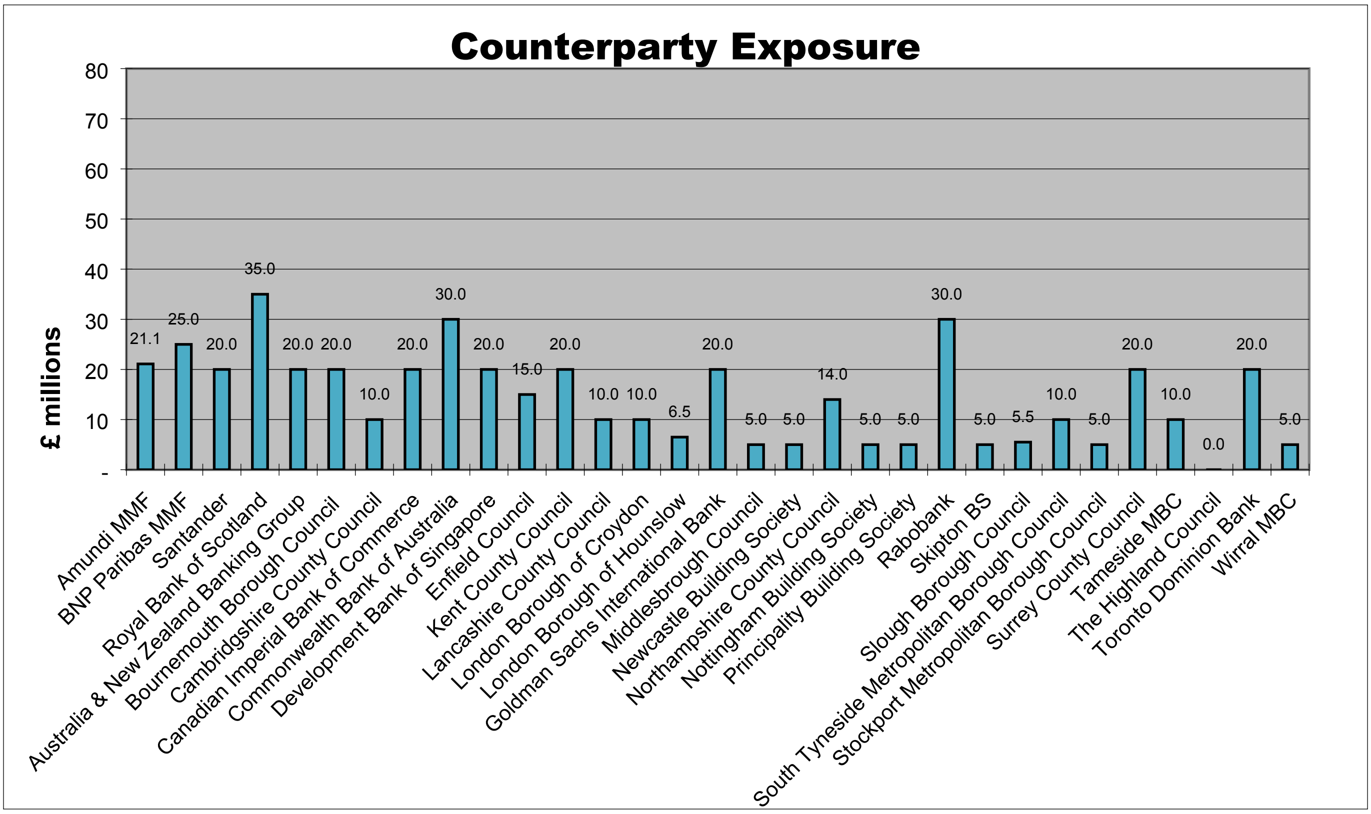


Chart 2 – Counterparty Exposure as at 30th September 2017



3.5.18 The chart 2 above shows the deposits outstanding with authorised counterparties as at 30th September 2017, of which 7.83% (£35m) were with RBS. The deals were executed when this institution was classified as part-nationalised bank. We are currently reviewing the classification of RBS Group as a part nationalised bank and the credit worthiness awarded to this institution under this tag.

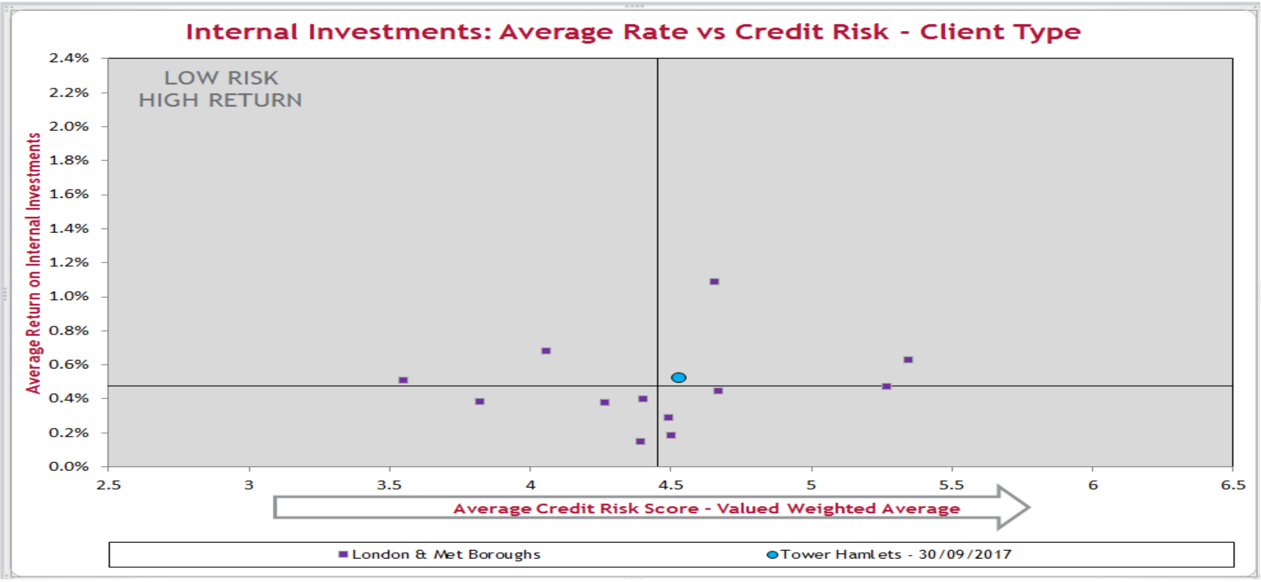
3.5.19 Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

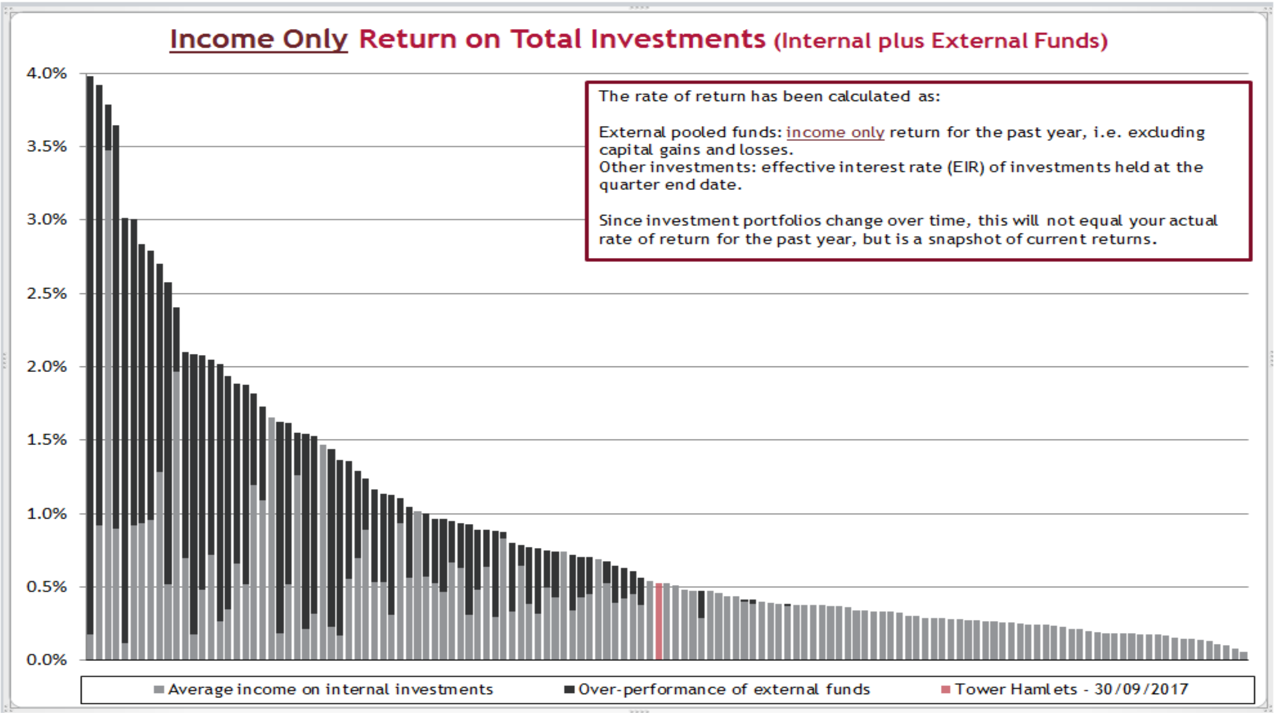
3.5.20 Given the increasing risk and falling returns from short-term unsecured bank investments, the Council is looking to further diversify its investment portfolio into more secure and/or higher yielding asset classes. There is currently £200m that is available for longer-term investment and this will be moved from local authorities, bank and building society deposits into covered bonds, corporate bonds and also into pooled property/bond/equity funds. This action will diversify the investment risk and as a consequence, the average rate of return of investment will increase. The progression of risk and return metrics are shown in table 5 and the charts below, extracts from Arlingclose's quarterly investment benchmarking report.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Internal Investments	Rate of Return

31.03.2017	4.44	A+	46%	91	£447.3m	0.61%
30.06.2017	4.78	A+	72%	79	£501.9m	0.42%
30.09.2017	4.53	A+	38%	149	£447.1m	0.53%
Similar LAs	**4.45**	**AA-**	**63%**	**137**	**£102.9m**	**0.48%**
All LAs	**4.44**	**AA-**	**64%**	**40**	**£63.5m**	**0.48%**





3.6 **<u>Compliance Report</u>**

3.6.1 The Corporate Director, Resources is pleased to report that all treasury management activities undertaken during the first half of 2017/18 complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

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

Table 8: Debt Limits

	2017/18 Forecast	30.9.17 Actual	2017/18 Operational Boundary	2017/18 Authorised Limit	Complied
Borrowing	90.833	85.936	245.299	265.256	✓
PFI & finance leases	34.957	34.957	34.957	35.000	✓
Total debt	**125.790**	**120.893**	**280.256**	**300.256**	✓

3.6.3 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.

3.7 Treasury Management Indicators

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

3.7.2 **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating and 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.

	30.09.17 Actual	2017/18 Target	Complied
Portfolio average credit rating	A+	A-	✓
Portfolio average credit score	4.66	N/A	✓

3.7.3 **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.

	30.09.17 Actual	2017/18 Target	Complied
Total cash available within [3] months	£176.10m	£75m	✓
Total sum borrowed in past [3] months without prior notice	nil	nil	✓

3.7.4 **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 / the proportion] of net [principal borrowed / interest payable] which is:

	2017/18 Maximum	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure		100%	✓
Upper limit on variable interest rate exposure		20%	✓

3.7.5 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.

3.7.6 **Maturity Structure of Borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

	30.09.17 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	£0.970m	10%	0%	✓
12 months and within 24 months	£1.673m	30%	0%	✓
24 months and within 5 years	£3.421m	40%	0%	✓
5 years and within 10 years	£1.163m	80%	0%	✓
10 years and above*	£78.709m	100%	0%	✓

*This includes £60m LOBO with maturity date over 60 years and it could be call for repayment within the next 6 months following the last interest payment date ,but there is a very slim chance of this happening hence it is included in this category

3.7.7 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.

3.7.8 **Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2017/18	2018/19	2019/20
Actual principal invested beyond year end	£20m	£20m	Nil
Limit on principal invested beyond year end	£100m	£100m	£100m
Complied	✓	✓	✓

3.8 Regulatory Update - MiFID

3.8.1 Under the current UK regime, local authorities are automatically categorised as 'per se professional' clients in respect of non Markets in Financial Instrument Directive (MiFID) scope business and are categorised as 'per se professional' clients for MiFID scope business if they satisfy the MiFID Large Undertakings test. Local authorities that do not satisfy the Large Undertakings test may opt up to elective professional client status if they fulfil certain 'opt-up criteria'.

3.8.2 Following the introduction of the Markets in Financial Instrument Directive 2014/65 ("MiFID II") from 3 January 2018, firms will no longer be able to categorise a local public authority or a municipality that (in either case) does not manage public debt ("local authority") as a'per se professional' client or elective eligible counterparty (ECP) for both MiFID and non-MiFID scope business. Instead, all local authorities must be classified as "retail clients" unless they are opted up by firms to an 'elective professional client' status.

3.8.3 Furthermore, the FCA has exercised its discretion to adopt gold-plated opt-up criteria for the purposes of the quantitative opt-up criteria, which local authority clients must satisfy in order for firms to reclassify them as an elective professional client.

Potential impact

3.8.4 A move to retail client status would mean that all financial services firms like banks, brokers, financial institutions, advisers and fund managers will have to treat local authorities the same way they do non-professional individuals and small businesses. That includes a raft of protections ensuring that investment products are suitable for the customer's needs, and that all the risks and features have been fully explained. This provides a higher standard of protection for the client but it also involves more work and potential cost for both the firm and the client, for the purpose of proving to the regulator that all such requirements have been met.

3.8.5 Such protections would come at the price of local authorities not being able to access the wide range of assets needed to implement an effective, diversified investment strategy. Retail status would significantly restrict the range of financial institutions and instruments available to authorities.

3.8.6 Even if the institution secures the ability to deal with retail clients, the range of instruments it can make available to the client will be limited to those defined under Financial Conduct Authority (FCA) rules as 'non-complex'. In many cases managers will no longer be able to even discuss ('promote') certain asset classes and vehicles with the authority as a retail client.

Election for professional client status

3.8.7 MiFID II allows for retail clients that meet certain conditions to elect to be treated as professional clients (to 'opt up'). There are two tests which must be met by the client when being assessed by the financial institution: the quantitative and the qualitative test.

3.8.8 The Local Government Pension Scheme Advisory Board (SAB) and the Local Government Association (LGA) along with the Department of Communities and Local Government (DCLG) and the Investment Association (IA) have successfully lobbied the FCA to make the test better fitted to the unique situation of local authorities.

3.8.9 The election to professional status must be completed with <u>all</u> financial institutions prior to the change of status on 3rd January 2018. Failure to do so by local authorities will result in the financial institution having to take 'appropriate action' which could include a termination of the relationship at a significant financial risk to the authority.

3.8.10 The SAB and the LGA have worked with industry representative bodies including the IA, the British Venture Capital Association (BVCA) and others to develop a standard opt-up process with letter and information templates. This process should enable a consistent approach to assessment and prevent authorities from having to submit a variety of information in different formats.

3.8.11 Applications can be made in respect of either all of the services offered by the institution (even if not already being accessed) or a particular service only. Tower Hamlets Council may wish to do the latter where the institution offers a wide range of complex instruments which the authority does not currently use and there is no intention to use the institution again once the current relationship has come to an end.

3.8.12 Authorities are not required to renew elections on a regular basis but will be required to review the information provided in the opt-up process and notify all institutions of any changes in circumstances which could affect their status.

Next Steps

3.8.13 In order to continue to effectively implement the authority's treasury management strategy after 3rd January 2018, applications for election to be treated as a professional client will be submitted to all financial institutions with whom the Council has an existing or potential relationship in relation to its investments.

3.8.14 Appendix 3 sets out the opt-up process flowchart that the Council has been following. We have started the opting up process with our existing counterparties since September 2017, this is to ensure will obtain the professional client status confirmation from the counterparties in good time so we can continue to operate an effective treasury investment strategy.

4. **COMMENTS OF THE CHIEF FINANCIAL OFFICER**

4.1 The report informs the Committee of the treasury management activities, the financial implications are contained throughout the report.

4.2 The Council held an outstanding internally managed investments portfolio of £447.1m as at 30th September 2017. This portfolio earned an average rate of return of 0.53%. The comparable performance indicator is the average 7-day LIBID rate, which returned 0.11%.

4.3 The investment income budget for 2017/18 is £2.525m and the current forecast is that this will be achieved.

5. **LEGAL COMMENTS**

5.1 The Local Government Act 2003 provides a framework for the capital finance of local authorities. It provides a power to borrow and imposes a duty on local authorities to determine an affordable borrowing limit. It provides a power to invest. Fundamental to the operation of the scheme is an understanding that authorities will have regard to proper accounting practices recommended by the

Chartered Institute of Public Finance and Accountancy (CIPFA) in carrying out capital finance functions.

5.2 The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 require the Council to have regard to the CIPFA publication "Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes" ("the Treasury Management Code") in carrying out capital finance functions under the Local Government Act 2003.

5.3 This noting report of the Corporate Director, Resources advises the Committee of the Council's borrowing and investment activities from 1st April 2017 to 30th September 2017 and is consistent with the key principles expressed in the Treasury Management Code. The Corporate Director Resources has responsibility for overseeing the proper administration of the Council's financial affairs, as required by section 151 of the Local Government Act 1972 and is the appropriate officer to advise in relation to these matters.

5.4 When considering its approach to the treasury management matters set out in the report, the Council must have due regard to the need to eliminate unlawful conduct under the Equality Act 2010, the need to advance equality of opportunity and the need to foster good relations between persons who share a protected characteristic and those who don't (the public sector equality duty).

6 ONE TOWER HAMLETS CONSIDERATIONS

6.1 Capital investment will contribute to achievement of the corporate objectives, including all those relating to equalities and achieving One Tower Hamlets. Establishing the statutory policy statements required facilitates the capital investments and ensures that it is prudent.

7. BEST VALUE (BV) IMPLICATIONS

7.1 The Treasury Management Strategy and Investment Strategy and the arrangements put in place to monitor them should ensure that the Council optimises the use of its monetary resources within the constraints placed on the Council by statute, appropriate management of risk and operational requirements.

7.2 Assessment of value for money is achieved through:

- Monitoring against benchmarks
- Operating within budget

8 SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

8.1 There are no sustainable actions for a greener environment implication.

9 RISK MANAGEMENT IMPLICATIONS

9.1 There is inevitably a degree of risk inherent in all treasury activity.

9.2 The Investment Strategy identifies the risk associated with different classes of investment instruments and sets the parameters within which treasury activities can be undertaken and controls and processes appropriate for that risk.

9.3 Treasury operations are undertaken by nominated officers within the parameters prescribed by the Treasury Management Policy Statement as approved by the Council.

9.4 The Council is ultimately responsible for risk management in relation to its treasury activities. However, in determining the risk and appropriate controls to put in place the Council has obtained independent advice from Capita Treasury Services who specialise in Council treasury issues.

10 <u>CRIME AND DISORDER REDUCTION IMPLICATIONS</u>

10.1 There are no any crime and disorder reduction implications arising from this report.

APPENDICES

Appendix 1 – Economic, Financial and Credit Commentary for the Period

Appendix 2 – Investments Outstanding at 30 September 2017

Appendix 3 – Opt up process flowchart

Appendix 4 – Retail Clients Protections under MiFID II

Appendix 5 – Glossary

Local Government Act, 1972 Section 100D (As amended)

List of “Background Papers” used in the preparation of this report

Arlingclose LTD - Treasury Management Benchmarking Report and Mid-Year 2017/18 Report Template

Brief description of “background papers’	Name and telephone number of holder and address where open to inspection
	Bola Tobun, x4733, Mulberry Place

Appendix 1

ECONOMIC, FINANCIAL AND CREDIT BACKGROUND FOR PERIOD

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

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

3. The Bank of England made no change to monetary policy at its meetings in the first half of the financial year. The vote to keep Bank Rate at 0.25% narrowed to 5-3 in June highlighting that some MPC members were more concerned about rising inflation than the risks to growth. Although at September's meeting the Committee voted 7-2 in favour of keeping Bank Rate unchanged, the MPC changed their rhetoric, implying a rise in Bank Rate in "the coming months". The Council's treasury advisor Arlingclose is not convinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

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

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

6. Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty but the surprise result has led to a minority

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

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

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

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

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

11. There were a few credit rating changes during the quarter. The significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1, placed Lloyds Bank's A1 rating on review for upgrade, revised the outlook of Santander UK plc, and Nationwide and Coventry building societies from negative to stable but downgraded the long-term rating of Leeds BS from A2 to A3. The agency downgraded long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment and the ratings of the large Australian banks on its view of the rising risks from their exposure to the Australian housing market and the elevated proportion of lending to residential property investors.

12. S&P also revised Nordea Bank's outlook to stable from negative, whilst affirming their long-term rating at AA-. The agency also upgraded the long-term rating of ING Bank from A to A+.

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

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

Appendix 2: Investments Outstanding as at 30th September 2017

Time to Maturity	Counterparty	From	Maturity	Amount £m	Rate
Overnight	Amundi MMF		**MMF**	21.10	
	BNP Paribas MMF		**MMF**	25.00	
	SUB TOTAL			**46.10**	
< 1 Month	Surrey County Council	05/07/2017	05/10/2017	20.00	0.25%
	Rabobank	06/07/2017	06/10/2017	20.00	0.26%
	Toronto Dominion Bank	13/10/2016	12/10/2017	10.00	0.59%
	Canadian Imperial Bank of Commerce	17/10/2016	16/10/2017	10.00	0.63%
	Canadian Imperial Bank of Commerce	17/10/2016	16/10/2017	10.00	0.63%
	Toronto Dominion Bank	17/10/2016	16/10/2017	10.00	0.61%
	Goldman Sachs International Bank	24/10/2016	24/10/2017	10.00	0.90%
	Rabobank	26/10/2016	25/10/2017	10.00	0.66%
	Wirral MBC	26/09/2017	25/10/2017	5.00	0.25%
	SUB TOTAL			**105.00**	
1 - 3 Months	Commonwealth Bank of Australia	09/08/2017	09/11/2017	5.00	0.26%
	Goldman Sachs International Bank	14/11/2016	14/11/2017	10.00	0.93%
	Middlesbrough Council	26/09/2017	30/11/2017	5.00	0.32%
	Stockport Metropolitan Borough Council	22/09/2017	15/12/2017	5.00	0.32%
	SUB TOTAL			**25.00**	
3 - 6 Months	London Borough of Croydon	22/09/2017	02/01/2018	10.00	0.35%
	London Borough of Hounslow	26/09/2017	02/01/2018	6.50	0.35%
	South Tyneside Metropolitan Borough Council	29/09/2017	02/01/2018	10.00	0.35%
	Santander		CALL 95	20.00	0.60%
	Tameside MBC	26/09/2017	03/01/2018	10.00	0.35%
	Kent County Council	14/09/2017	22/01/2018	10.00	0.30%
	Royal Bank of Scotland	30/01/2015	30/01/2018	5.00	1.20%
	Slough Borough Council	20/02/2017	19/02/2018	5.50	0.60%
	Kent County Council	14/09/2017	22/02/2018	10.00	0.32%
	Development Bank of Singapore	06/09/2017	06/03/2018	20.00	0.34%
	Skipton BS	23/03/2017	22/03/2018	5.00	0.78%
	Cambridgeshire County Council	28/09/2017	28/03/2018	10.00	0.50%
	Northamptonshire County Council	29/09/2017	29/03/2018	14.00	0.50%
	SUB TOTAL			**136.00**	
6 - 9 Months	Principality Building Society	06/04/2017	06/04/2018	5.00	0.78%
	Newcastle Building Society	28/04/2017	27/04/2018	5.00	0.80%
	Royal Bank of Scotland	28/04/2017	30/04/2018	5.00	1.79%
	Nottingham Building Society	09/05/2017	08/05/2018	5.00	0.77%
	Australia & New Zealand Banking	17/05/2017	16/05/2018	10.00	0.52%
	Commonwealth Bank of Australia	17/05/2017	16/05/2018	15.00	0.53%
	Australia & New Zealand Banking	17/05/2017	16/05/2018	10.00	0.52%
	Royal Bank of Scotland	22/12/2016	22/06/2018	5.00	0.79%
	SUB TOTAL			**60.00**	
9 - 12 Months	Commonwealth Bank of Australia	03/07/2017	03/07/2018	10.00	0.52%
	Royal Bank of Scotland	31/07/2017	31/07/2018	10.00	0.90%
	Royal Bank of Scotland	19/08/2017	19/08/2018	5.00	0.91%
	Royal Bank of Scotland	22/12/2016	24/09/2018	5.00	0.84%
	Enfield Council	26/09/2017	24/09/2018	15.00	0.55%
	Lancashire County Council	26/09/2017	24/09/2018	10.00	0.55%
	SUB TOTAL			**55.00**	
> 12 Months	Bournemouth Borough Council	26/09/2017	25/09/2019	20.00	0.75%
	SUB TOTAL			**20.00**	
	TOTAL			**447.10**	

* This is a structured deal, the terms of which could change during its tenor.

Appendix 3

UK Local Authority Client Opt-Up Process

STAGES	TIMELINE	GUIDANCE
Preparatory Stage Finalise standard opt-up process	End July 2017	(i) Finalise industry standard quantitative and qualitative questionnaire; (ii) Finalise request and consent letter from Local Authority to be opted-up; and (iii) Finalise response letter from investment firms agreeing to the opt-up.
Stage 1 Local authorities to complete letter and questionnaire and send to investment firms	August – September 2017	Local authorities to complete and send investment firms: (i) request and consent letter to be opted-up to professional client status; and (ii) completed quantitative and qualitative questionnaire (to allow investment firms to satisfy themselves that the local authority passes the qualitative test).
Stage 2 Investment Firms to validate the information and run the client status assessment	September – October 2017	Investment firms to validate information received from local authorities to determine information is (i) sufficient; and (ii) appropriate. Assess the information received by the local authority and confirm that it: (i) has provided the request and consent letter to be treated as a professional client; and (ii) passes (i) the quantitative test and (ii) the qualitative test Log and store the local authority information and the results of the internal assessment.
Stage 3 Dispatch the confirmation letter to LA clients confirming professional client status	October 2017	If a local authority has provided the request and consent letter and has satisfied the requirements for both: (i) the quantitative test; and (ii) the qualitative test, send a letter confirming the classification of the client as a professional client.
Stage 4 Client re-categorisation	3 January 2018	Once the steps above are complete, as of 3 January 2018, the firm may continue to treat the local authority as a professional client.

Appendix 4

Warnings - loss of protections as a Professional Client
Professional Clients are entitled to fewer protections under the UK and EU regulatory regimes information purposes only, a summary of the protections that you will lose if you request and agree to be treated as a Professional Client.

1. **Communicating with clients, including financial promotions**
As a Professional Client the simplicity and frequency in which the firm communicates with you may be different to the way in which they would communicate with a Retail Client. They will ensure however that our communication remains fair, clear and not misleading.

2. **Information about the firm, its services and remuneration**
The type of information that the firm provides to Retail Clients about itself, its services and its products and how it is remunerated differs to what the firm provides to Professional Clients. In particular,
(A) The firm is obliged to provide information on these areas to all clients but the granularity, medium and timing of such provision may be less specific for clients that are not Retail Clients; and
(B) there are particular restrictions on the remuneration structure for staff providing services to Retail Clients which may not be applicable in respect of staff providing services to Professional Clients;
(C) the information which the firm provides in relation to costs and charges for its services and/or products may not be as comprehensive for Professional Clients as it would be for Retail Clients, for example, they are required when offering packaged products and services to provide additional information to Retail Clients on the risks and components making up that package; and
(D) when handling orders on behalf of Retail Clients, the firm has an obligation to inform them about any material difficulties in carrying out the orders; this obligation may not apply in respect of Professional Clients.

3. **Suitability**
In the course of providing advice or in the course of providing discretionary management services, when assessing suitability for Professional Clients, the firm is entitled to assume that in relation to the products, transactions and services for which you have been so classified, that you have the necessary level of experience and knowledge to understand the risks involved in the management of your investments. The firm will assess this information separately for Retail Clients and would be required to provide Retail Clients with a suitability report.

4. **Appropriateness**
For transactions where the firm does not provide you with investment advice or discretionary management services (such as an execution-only trade), it may be required to assess whether the transaction is appropriate. In respect of a Retail Client, there is a specified test for ascertaining whether the client has the requisite investment
knowledge and experience to understand the risks associated with the relevant transaction. However, in respect of a Professional Client, the firm is entitled to assume that they have the necessary level of experience, knowledge and expertise to understand the risks involved in a transaction in products and services for which they are classified as a Professional Client.

5. **Dealing**
A range of factors may be considered for Professional Clients in order to achieve best execution (price is an important factor but the relative importance of other different factors, such as speed, costs and fees may vary). In contrast, when undertaking transactions for

Retail Clients, the total consideration, representing the price of the financial instrument and the costs relating to execution, must be the overriding factor in any execution.

6. **Reporting information to clients**
For transactions where the firm does not provide discretionary management services (such as an execution-only transactions), the timeframe for our providing confirmation that an order has been carried out is more rigorous for Retail Clients' orders than Professional Clients' orders.

7. **Client reporting**
Investment firms that hold a retail client account that includes positions in leveraged financial instruments or contingent liability transactions shall inform the Retail Client, where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. These reports do not have to be produced for Professional Clients.

8. **Financial Ombudsman Service**
The services of the Financial Ombudsman Service may not be available to you as a Professional Client.

9. **Investor compensation**
Eligibility for compensation from the Financial Services Compensation Scheme is not contingent on your categorisation but on how your organisation is constituted. Hence, depending on how you are constituted you may not have access to the Financial Services Compensation Scheme.

10. **Exclusion of liability**
The FCA rules restrict the firm's ability to exclude or restrict any duty of liability which the firm owes to Retail Clients more strictly than in respect of Professional Clients.

11. **Trading obligation**
In respect of shares admitted to trading on a regulated market or traded on a trading venue, the firm may, in relation to the investments of Retail Clients, only arrange for such trades to be carried out on a regulated market, a multilateral trading facility, a systematic internaliser or a third-country trading venue. This is a restriction which may not apply in respect of trading carried out for Professional Clients.

12. **Transfer of financial collateral arrangements**
As a Professional Client, the firm may conclude title transfer financial collateral arrangements with you for the purpose of securing or covering your present or future, actual or contingent or prospective obligations, which would not be possible for Retail Clients.

13. **Client money**
The requirements under the client money rules in the FCA Handbook (CASS) are more prescriptive and provide more protection in respect of Retail Clients than in respect of Professional Clients.
It should be noted that at all times you will have the right to request a different client categorisation and that you will be responsible for keeping the firm informed of any change that could affect your categorisation as a Professional Client.

Appendix 5 – Glossary

Asset Life	How long an asset, e.g. a Council building is likely to last.
Borrowing Portfolio	A list of loans held by the Council.
Borrowing Requirements	The principal amount the Council requires to borrow to finance capital expenditure and loan redemptions.
Capitalisation direction or regulations	Approval from central government to fund certain specified types of revenue expenditure from capital resources.
CIPFA Code of Practice on Treasury Management	A professional code of Practice which regulates treasury management activities.
Capital Financing Requirement (CFR)	Capital Financing Requirement- a measure of the Council's underlying need to borrow to fund capital expenditure.
Certificates of Deposits	A certificate of deposit (CD) is a time deposit, a financial product. CDs are similar to savings accounts in that they are insured and thus virtually risk free; they are "money in the bank." They are different from savings accounts in that the CD has a specific, fixed term (often monthly, three months, six months, or one to five years) and, usually, a fixed interest rate. It is intended that the CD be held until maturity, at which time the money may be withdrawn together with the accrued interest.
Commercial paper	Commercial paper is a money-market security issued (sold) by large corporations to obtain funds to meet short-term debt obligations (for example, payroll), and is backed only by an issuing bank or corporation's promise to pay the face amount on the maturity date specified on the note. Since it is not backed by collateral, only firms with excellent credit ratings from a recognized credit rating agency will be able to sell their commercial paper at a reasonable price. Commercial paper is usually sold at a discount from face value, and carries higher interest repayment rates than bonds
Counterparties	Organisations or Institutions the Council lends money to e.g. Banks; Local Authorities and MMF.
Corporate bonds	A corporate bond is a bond issued by a corporation. It is a bond that a corporation issues to raise money effectively in order to expand its business. The term is usually applied to longer-term debt instruments, generally with a maturity date falling at least a year after their issue date.
Covered bonds	A covered bond is a corporate bond with one important enhancement: recourse to a pool of assets that secures or "covers" the bond if the originator (usually a financial institution) becomes insolvent. These assets act as additional credit cover; they do not have any bearing on the contractual cash flow to the investor, as is the case with Securitized assets.
Consumer Prices Index &	The main inflation rate used in the UK is the CPI. The

Retail Prices Index (CPI & RPI)	Chancellor of the Exchequer bases the UK inflation target on the CPI. The CPI inflation target is set at 2%. The CPI differs from the RPI in that CPI excludes housing costs. Also used is RPIX, which is a variation of RPI, one that removes mortgage interest payments.
Credit Default Swap (CDS)	A kind of protection that can be purchased by MMF companies from insurance companies (for their investment) in exchange for a payoff if the organisation they have invested in does not repay the loan i.e. they default.
Credit watch	Variety of special programs offered by credit rating agencies and financial institutions to monitor organisation/individual's (e.g. bank) credit report for any credit related changes. A credit watch allows the organisation/individuals to act on any red flags before they can have a detrimental effect on credit score/history.
Credit Arrangements	Methods of Financing such as finance leasing
Credit Ratings	A scoring system issued by credit rating agencies such as Fitch, Moody's and Standard & Poors that indicate the financial strength and other factors of a bank or similar Institution.
Creditworthiness	How highly rated an institution is according to its credit rating.
Debt Management Office (DMO)	The DMO is an agency of the HM Treasury which is responsible for carrying out the Government's Debt Management Policy.
Debt Rescheduling	The refinancing of loans at different terms and rates to the original loan.
Depreciation Method	The spread of the cost of an asset over its useful life.
Gilt	Gilt-edged securities are bonds issued by certain national governments. The term is of British origin, and originally referred to the debt securities issued by the Bank of England, which had a gilt (or gilded) edge. Hence, they are known as gilt-edged securities, or gilts for short. Today the term is used in the United Kingdom as well as some Commonwealth nations, such as South Africa and India. However, when reference is made to "gilts", what is generally meant is "UK gilts," unless otherwise specified.
Interest Rate exposures	A measure of the proportion of money invested and what impact movements in the financial markets would have on them.
The International Monetary Fund (IMF)	is an intergovernmental organisation which states its aims as to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.
Impaired investment	An investment that has had a reduction in value to reflect changes that could impact significantly on the benefits expected from it.

LIBID	The London Interbank Bid Rate – it is the interest rate at which major banks in London are willing to borrow (bid for) funds from each other.
Market Loans	Loans from banks available from the London Money Market including LOBOS (Lender Option, Borrowing Option) which enable the authority to take advantage of low fixed interest for a number of years before an agreed variable rate comes into force.
Money Market Fund (MMF)	A 'pool' of different types of investments managed by a fund manager that invests in lightly liquid short term financial instruments with high credit rating.
Monetary Policy Committee (MPC)	Committee designated by the Bank of England, whose main role is to regulate interest rates.
Minimum Revenue Provision (MRP)	This is the amount which must be set aside from the revenue budget each year to cover future repayment of loans.
Non Specified Investments	Investments deemed to have a greater element of risk such as investments for longer than one year
Premium	Cost of early repayment of loan to PWLB to compensate for any losses that they may incur
Prudential Indicators	Set of rules providing local authorities borrowing for funding capital projects under a professional code of practice developed by CIPFA and providing measures of affordability and prudence reflecting the Council's Capital Expenditure, Debt and Treasury Management.
PWLB	Public Works Loan Board, a statutory body whose function is to lend money to Local Authorities (LAs) and other prescribed bodies. The PWLB normally are the cheapest source of long term borrowing for LAs.
Specified Investments	Investments that meet the Council's high credit quality criteria and repayable within 12 months.
Supranational bonds	Supranational bonds are issued by institutions that represent a number of countries, not just one. Thus, organisations that issue such bonds tend to be the World Bank or the European Investment Bank. The issuance of these bonds are for the purpose of promoting economic development
Treasury bills (or T-bills)	Treasury bills (or T-bills) mature in one year or less. Like zero-coupon bonds, they do not pay interest prior to maturity; instead they are sold at a discount of the par value to create a positive yield to maturity. Many regard Treasury bills as the least risky investment available.
Unrated institution	An institution that does not possess a credit rating from one of the main credit rating agencies.
Unsupported Borrowing	Borrowing where costs are wholly financed by the Council.