Report

Council

Part 1

Date: 30 January 2018

Subject **Mid- Year Treasury Management Update**

Purpose This report is to inform the Council of treasury activities undertaken during the period to 30 September, 2017. To provide details of the proposal to change the Minimum Revenue Provision (MRP) policy for supported borrowing and to 'opt-up' to professional status in relation to the introduction of the 'Second Markets in Financial Instruments Directive (MiFID II)

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Summary In line with the agreed Treasury Management Strategy, the Council continues to be both a short term investor of cash and borrower to manage day-to-day cash flows. Current forecasts indicate that in the future, temporary borrowing will continue to be required to fund normal day to day cash flow activities.

The first half of the year saw the successful sale of the Friars Walk development which allowed borrowing which had been undertaken in relation to the loan provided to Queensberry Newport Ltd to be repaid. All borrowing in relation to this development are now fully repaid, and this has meant that net borrowing has fallen from £209.2m to £149.1m during the year.

All borrowing and investments undertaken during the first half of the year was expected and within the Council's agreed limits for 2017/18.

The Council currently charges MRP for supported borrowing at 4% reducing balance, it is proposed that this is changed to a 2.5% straight line charge, which will reduce the revenue charge for the provision by c£2.4m.

All Councils have been historically classed as 'professional bodies' when it comes to managing their investments / borrowings. Under the 'Second Markets in Financial Instruments Directive (MiFID II), they are now required to confirm this by 'opting – up' to this level or elect to drop down to 'private investor status. It is proposed that this Council, in line with nearly all UK Councils, confirm and maintain their current 'professional status'

Proposal That Council:

(1) To note the treasury management activities for the period to 30 September 2017, which are in line with the agreed 17/18 Treasury Strategies, including the repayment of the Councils own borrowings in relation to the Friar's Walk Development Loan.

(2) Approve the recommendation that the Council 'opt-up' (and therefore maintain current status) to professional status in relation to the introduction of the 'Second Markets in Financial Instruments Directive (MiFID II), applicable to the UK in January 2018.
(3) Approve the proposed change to the Minimum Revenue Provision (MRP) policy for supported borrowing to the asset life basis, on a straight line basis, noting the Audit Committee's comments.

Action by Head of Finance / Assistant Head of Finance

Timetable Immediate

This report was prepared after consultation with:

- Audit Committee – all aspects
- Treasury Advisers – MRP Policy changes
- Welsh Audit Office – MRP Policy changes
- Head of Law & Standards
- Head of People & Business Change

Signed

Background

1. The Council's Treasury Management Strategy and Prudential Indicators were approved by Council in March 2017 alongside the Medium Term Financial Plan and the 2017/18 Budget.

2. The Treasury Management Strategy for 2017/18 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year. The Code also recommends that members are informed of Treasury Management activities at least twice a year. This report therefore ensures this authority is embracing best practice in accordance with CIPFA's recommendations.

3. Treasury management is defined as: "The management of the local authority's 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."

4. The report has been prepared in accordance with the CIPFA Treasury Management Code and the Prudential Code, and reviews and reports on:

- Borrowing Strategy / Activity
- Investment Strategy / Activity
- Economic Background
- Compliance with Prudential Indicators approved by Council

BORROWING STRATEGY / ACTIVITY

Short and Long Term Borrowing

5. Whilst the Council has significant long term borrowing requirements, the Council's current strategy of funding capital expenditure is through reducing investments ('internal borrowing') rather than undertaking new borrowing i.e. we defer taking out new long term borrowing and fund capital expenditure from 'day to day positive cash-flows / cash represented by reserves' for as long as we can.

   By using this strategy the Council can also minimise cash holding at a time when counterparty risk remains relatively high. The interest rates achievable on the Council's investments are also significantly lower than the current rates payable on long term borrowing and this remains the main reason for our current 'internally borrowed' strategy.

6. Whilst the strategy minimises investment counterparty risk, the risk of interest rate exposure is increased as the current low longer term borrowing rates may rise in the future. The market position is being constantly monitored in order to minimise this risk.

7. As anticipated, during the first half of the year the amount of borrowing has reduced by £60.075m, this relates mainly to the Council's own borrowing associated with the making of loans to develop Friar's Walk. This reduction in borrowing followed the sale of the Friars Walk development and all borrowing in relation to this was able to be fully repaid in July 2017. The borrowing associated with this loan was always kept separate from the Council's other borrowing requirements shown in Appendix B.

8. No further long term loans have been taken out in the first half of the financial year. However, it is anticipated that the Council will need to undertake additional borrowing on a short term basis for the remainder of the year in order to cover normal day to day cash flow activity. With current estimates it is not expected that any additional long-term borrowing would be required in this financial year.

9. Appendix B summarises the Council's debt position as at 30 September 2017. The changes in debt outstanding relate to the raising and repaying of temporary loans.

10. In regards to LOBOs, no loans were called during the period. All £30m outstanding is subject to potential change of interest rates by the lender (which would automatically trigger a right to the Council to repay these loans) prior to the end of this financial year. Should a change of interest rate be requested, then it will be considered in detail and a decision on how we proceed will be made in conjunction with our treasury advisors.

INVESTMENTS ACTIVITY / POSITION

11. The Council's strategies in this area of Treasury Management are (i) to be a short term and relatively low value investor and (ii) investment priorities should follow the priorities of security, liquidity and yield, in that order.

    The Council's strategy of being a s/t and relatively low value investor has been maintained, though the repayment of the Friar's Walk loans has increased cash holdings temporarily. In line with our borrowing strategy, this will be allowed to reduce over the next year or so.. As at 30 September 2017, there was a £33.3m balance of short-term investments outstanding.

12. This was anticipated and reported in the 2017/18 TM strategy report at March 2017. All investments are placed on a temporary basis and are placed in high security institutions, in line with our other strategy in this area, dealing with our investing priorities of (i) security (ii) liquidity and (iii) yield, in that order. At the 30 September 2017 £32.5m was placed with various local authorities and £800k with Santander Call Account with the maximum maturity date of 22 March 2018.

13. January 2018 will see the implementation in the UK of the second Markets in Financial Instruments Directive (MiFID II), where firms will be obliged to treat all local authorities as retail clients unless they opt up to professional client status and meet certain criteria. All Councils have historically been 'professional clients' but this directive now requires a formal decision to 'opt – up' to this status, even though it just maintains the current status. The Directive is therefore an opportunity to re-assess this status and to make a deliberate and conscious decision to maintain (by 'opting-up') or change the historically existing professional status and ensure certain updated criteria are met. These criteria include holding a minimum of £10m investment balance and employing knowledgeable and experienced staff to carry out investment transactions. If the Council do not opt up to professional client service it is likely to severely limit the scope of services that financial institutions including advisers and brokers can provide to the Council and increase the costs of financial advice. Therefore it is recommended that the Council will 'opt up' to professional status and therefore would be required in the future to maintain investment balances of at least £10m. This is still a relatively small balance within the context of the Council's finances and cash-flows and still allows us to pursue current strategies on borrowing and investments. This is further discussed in Appendix A.

14. It is anticipated that our investment balances will remain well above the minimum £10m, until the start of 2019/20, when the stock issue of £40m will be due, at this point the Council will need re-finance and undertake new long-term borrowing.

15. The Council does not hold any long-term (more than 364 days) investments as at 30 September 2017.

OTHER MID YEAR TREASURY MATTERS

Economic background and Counter Party Update

16. Appendix A outlines the underlying economic environment during the first half of the financial year, as provided by the Council's Treasury Management Advisors 'Arlingclose'.

17. As discussed previously in this report the Council does not have any long-term investments, and the investments that it currently undertakes is mainly with other local authorities which are deemed very secure, therefore the risk is currently limited. There were no significant changes in credit ratings advised in the first half of the financial year that had implications for the approved lending list. The long term rating of Santander UK, the Council's bankers, remains at A; above the Council's minimum level of A-.

Regulatory Updates

18. The implementation of MiFID II in January 2018 is further detailed in Appendix A.

19. In February 2017 CIPFA canvassed views on the relevance, adoption and practical application of the Treasury Management and Prudential Codes and after reviewing responses launched a further consultation on changes to the codes in August with a deadline for responses of 30th September 2017. Details of the proposed changes are outlined in Appendix A to this report, with the main proposed changes including, the production of a new high-level Capital Strategy report to full council, plans to drop certain indicators and for the treasury management code to include reference to non-treasury investments such as commercial investments in properties in the term "investments".

20. CIPFA have published two revised Codes at the end of 2017 for implementation in 2018/19, although CIPFA plans to put transitional arrangements in place for reports that are required to be approved before the start of the 2018/19 financial year. This will be updated in the Treasury Management Strategy report in February 2018.

Compliance with Prudential Indicators approved by Council

21. The Authority measures and manages its exposures to treasury management risks using various indicators which can be found in Appendix B. The Authority has complied with the Prudential Indicators for 2017/18, set in March 2017 as part of the Treasury Management Strategy. Details of treasury-related Prudential Indicators can be found in Appendix B.

MINIMUM REVENUE PROVISION – CHANGE OF METHOD

Minimum Revenue Provision (MRP) Policy

22. MRP is the method by which Local Authorities charge their revenue accounts over time with the cost of their capital expenditure that was originally funded by debt.

23. From 2007/08 onwards, Local Authorities have been free to set their own policy on calculating MRP, with the sole legislative proviso being that the amount calculated must be one that the Council considers to be "prudent". Detailed guidance then exists as to methods of setting MRP which are deemed acceptable / prudent.

24. Council's agree their policy for charging MRP on an annual basis and can change it from year to year. In practice, Councils tend to stick with a consistent methodology and carry out a periodic review every few years to confirm or change their existing policies / methodologies.

Reason for the review

25. Following significant financial restraints that face local authorities, a number of Councils across the UK; in undertaking their periodic review of their MRP policy, have assessed that it is prudent to

change the existing MRP policy from a 4% reducing balance, to a policy which aligns the MRP charge to the actual average asset lives of the Council. This is because the 4% reducing balance is based on the Capital Financing Requirement method, with the opening balance reducing by 4% each year until the amount is fully extinguished. This begins with a higher charge which reduces each year and takes a significant amount of time to fully repay (c 150 years). In Wales, such reviews have already been undertaken by Torfaen, Merthyr Tydfil, Conwy, Denbighshire, Flintshire, Rhondda Cynon Taff, Caerphilly and Monmouthshire Councils.

26. Newport City Council updated their policy in relation to *unsupported* borrowing last year which resulted in a saving on the MRP charged for that, whilst still being prudent. This was reviewed by the Audit Committee and subsequently approved by Council. In this current year, officers, alongside Treasury Advisers, have undertaken a review of their policy in relation to *supported* borrowing to assess whether there was scope to change the charge which remained prudent but also achieved savings to support the finances of the Council.

27. As noted above, the Council's Treasury Management Advisor, Arlingclose, was commissioned to objectively review the Council's current MRP policy and our findings, including confirming the recommendations as being prudent and within guidelines. This gives an objective and independent review to the Audit Committee and Council.

Current supported borrowing MRP Policy

28. The Council's MRP policy is set on an annual basis in accordance with the 2008 Regulations and approved by Full Council as part of the Treasury Management Strategy and the Revenue Budget prior to the commencement of each financial year.

29. The Council's 2017/18 MRP policy was approved by Council in March 2017 and comprises of the following method to determine the annual MRP charge: -

    - Historic debt liability as at the 31st March 2007 and subsequent capital expenditure funded from supported borrowings to be charged to revenue at 4% in accordance with the CFR Method on a reducing balance basis.

30. Based on the current policy the supported borrowing MRP charge/budget to the revenue account for the 2017/18 financial year is £6,451k.

Alternative approaches

31. The amended Local Authorities (Capital Finance and Accounting) (Wales) regulations require that the Authority make a 'prudent' amount of MRP each year. The regulations also require that the Authority "have regard" to the MRP guidance issued by the WAG. The guidance suggests four options for the calculation of MRP. They are shown in the following table, together with a high level analysis of which one was chosen to review further:

METHODOLOGY	MAIN ATTRIBUTES / ISSUES	CONCLUSION
'Regulatory Method'	(i) Used for pre-2008 borrowing / capital expenditure but regulation allows it to be still used (ii) based on superseded regulations (iii) a complex methodology	**Not reviewed as a viable options:** -Not used by virtually all Councils at this point. -Overly complex and outdated

'CFR method'	(i) Easier to use than above method (ii) Charge based on the Capital Financing Requirement (iii) Charge reduces over time and therefore is a longer term charge for creating 'cash' funds to repay debt	**Current methodology / policy**
'Asset Life'	(i) Charge based on average asset life's (ii) Different options as to how to implement (iii) Potentially provides a simpler and straightforward method for planning and monitoring purposes (iv) Consistent charge which creates 'cash' funds much quicker than the above methods	**Recommended for review** -should provide a lower charge whilst still prudent as based on asset life -Easier to use for planning and monitoring purposes -Writes down loan amount / CFR on a consistent and therefore quicker basis
'Depreciation method'	(i) More suitable for unsupported borrowing (ii) Charge based on asset life (iii) More complicated than asset life methodology above as need to take account of revaluations / impairments etc and previous charges made (iii) Produces a higher charge than the above options (iv) Provides a simpler and straightforward method for planning and monitoring purposes	**Not reviewed as a viable option** -significantly more complicated and time consuming to implement than straight line method, without adding benefit. - would cause large variations in MRP which make it hard to plan -requires implementation on an asset by asset basis and no data on which assets funded by unsupported borrowing and have o/s loans attached to them.

32. The Asset Life method was deemed a viable option for further review. This is entirely consistent with reviews undertaken by other Local Authorities when they have reviewed their supported borrowing MRP policy / methodology – it is *the* obvious alternative for supported borrowing CFR. This links the supported MRP charge to average asset lives, is allowable within the MRP guidance and links the annual MRP charge to a more realistic assessment of the lives of assets funded through debt.

33. Moving to this method requires an assessment of the average asset life's on the Councils Balance Sheet. These assets have a range of estimated asset lives but it is difficult to establish which are unfinanced and included in the supported element of the CFR and therefore this is calculated using all assets currently on the balance sheet and calculating an average, weighted asset life. This was completed, has been shared with the Council's external auditors and indicated an average weighted life of 40 years.

34. Having established an asset life approach based on 40 years, there are 2 alternative options available for charging the MRP on this basis:

    Straight Line Method – Under this approach the MRP charge on the supported borrowing CFR would be applied equally over the 40 year period meaning that the year-on-year charge remains constant.

    Annuity Method – This is more commonly used as a method of establishing loan repayments, and works in a similar way. In this context, , it produces a profile of MRP payments that starts low and increases each year. which makes forward planning more difficult.

35. Appendix C shows the different MRP charges each methodology would produce

    - Option 1 - 40 year (2.5%) Straight line method
    - Option 2 - 40 year (2.5%) Annuity method

    The differences mainly relate to timing / value of the charges, as follows:

    - Straight line method makes a consistent charge over the 40 year period, therefore easier to use for planning / monitoring purposes
    - Straight line is a relatively easier methodology
    - Straight line produces a saving of c£2.4m compared to the current budget level and this is then a fixed saving from that point – no future pressures on the budget. Appendix C shows this.
    - Annuity method produces a higher saving in the first year at c£4.2m but then increases each year and produces a pressure on the budget in each year. Appendix C shows this.
    - By taking a higher saving in first few years, the dis-benefits of moving to the asset life method shown below are very significantly greater with the annuity basis
    - All methods charge the same MRP over the total lifespan of each policy / methodology but timings / values are different. The suggested 'asset life' method reduce the annual MRP charge compared to the current policy / method in the short to medium term but that is then reversed over the medium to long term. This however, under the straight line method would not create any budget problem as the saving is taken in the year of implementation and the charge is then fixed.

    On balance, the Head of Finance recommends the straight line method given the significant increase in the dis-benefits shown above that the annuity method would create the ease of use and easier planning / monitoring. Implementation is recommended for 2017/18.

Revised policy

36. Due to current austerity and the pressure on revenue budgets, it is deemed necessary to assess the above alternative approaches to assess whether a change in the MRP policy could release savings while maintaining a prudent charge which meets Welsh Government guidance.

37. From the above alternative approaches, moving to an 'asset life' approach based on the 40 years asset life calculated from a review of the balance sheet would provide the Authority with an ongoing

saving of £2.4m. If this was brought in from 2017/18 financial year, this saving could be moved to an earmarked reserve, which could be utilised to further support future budget pressures.

38. While creating a significant saving from day one of implementation, the revised policy also:

- Meets Welsh Government guidance of charging MRP
- Provides a straight line charge to the revenue account, which will assist in future planning, and does not cause increased budget pressure in future years unlike with the annuity method.
- Provides a number of positives which would be beneficial to the Wellbeing and Future Generations Act, such as:
  - Linking the MRP charge to the useful life of the asset, therefore applying the charge to the taxpayers who have use of the asset
  - From this, there is a reduction in the time to extinguish the "repayment" of the borrowing undertaken to fund capital expenditure will be reduced from c.150 years to 40 years.
  - Protects front line services from being cut for future generations to use, while funding is being cut.
  - Asset life being used is well inside the maximum allowable in guidance of 50 years.

39. However it is recognised there are a number of consequences of reducing the MRP charge from the current policy, these include:
- The current method would see, with all other factors remaining equal, a reducing charge in each year. As per table 1 in year 13, the revised method would actually cost more than the reduced charge. However, in reality the reduced Capital Financing Requirement would be replaced by further supported capital expenditure, therefore it is unlikely that this reduced charge would be realised as future savings.
- Reduced MRP charge will reduce cash-flow over the short to medium term, which will mean that borrowing may need to be brought forward.
- Reduces headroom for new borrowing without increasing the current 'borrowing requirement' compared to current methodology. This is exemplified by Chart 2 in Appendix C.

Audit Committee review and conclusions

40. The revised policy and this report were reviewed by the Councils Audit Committee in their November and January meeting. The following views were made and require to be shared with Council:

- The proposed new policy is consistent with WG guidelines
- The move to an asset life based policy is more consistent with the principles of the 'Well Being & Future Generation' framework than the current policy
- The proposed new policy generates 'cash' which repays borrowing / reduce CFR at a faster rate than the current policy
- There are dis-benefits which the Council needs to be aware of – the increased cost on a like for like basis after year 13, pressure on cash-flow and the reduced headroom for capital expenditure whilst keeping borrowing requirements at current levels, compared to the existing policy.

Financial Summary

41. The decrease in the charge to revenue resulting from changing to the various options is shown in Appendix C, Table 1.

42. If the Council were to implement the proposed Option 1 from 2017/18, this would create an underspend of c. £2.4m in this financial year. This underspend will continue, until a saving is taken in relation to this.

    Although Option 1 gives revenue savings, due to the fact that MRP could be looked at as a provision for the repayment of debt, this saving in turn leads to less cash being left in the authority to repay existing borrowing or delaying taking out new borrowing. Therefore there is going to be £2.4m less cash each financial year, in order to repay this debt over the short to medium term.

43. Another impact of reducing the MRP charge is that it reduces the speed in which the CFR is falling. We are currently developing the capital programme for 2018/19 to 2022/23, and if the current assumption was to fund capital expenditure through borrowing at the same rate as the MRP is "falling-off", then as MRP is declining at a lower rate if we implement the new proposal, this impacts on the level of capital expenditure the Council can undertake without causing a pressure on revenue budgets i.e. it reduces the headroom the capital programme has to play with. The impact of this over the life of the programme is estimated to be a reduction in capital expenditure of c.£10m. Chart 2 in Appendix C, shows the reduction in headroom due to change in MRP policy.

44. From Table 1 in Appendix C, you can see that all other things remaining equal, the MRP charge on the current policy would reduce incrementally each year as the CFR reduces. However, in option 1 this would remain a steady charge until the CFR was extinguished. Therefore in the first year there would be a variance of a lower charge, which would incrementally reduce until year 13 where the charge that would be made under Option 1 is actually higher than that made under the current method, and this difference would increase as the years go on.

45. However, from the perspective of future revenue implications, the straight line method gives a level of certainty over the charge as it is more stable than the reducing balance method, and although the comparative values show a higher amount in year 13 onwards, this will not be an actual pressure on the medium term financial plan as the straight line charge is fixed. The implication is that the capital programme would need to be restricted to fit within the new funding envelope of the lower charge which is illustrated in Chart 2 of the appendix.

46. Wales Audit Office have been consulted on the proposed change to Option 1 and have reviewed the basis of the charge and are content that this is in line with current guidance and that it is prudent. The Council's Treasury Advisors have also advised that all methods reviewed comply with WG guidance, it is however the responsibility of the Section 151 Officer to assess its prudence..

Summary of change to Option 1

47. The table below shows the main differences and implications of change to a 2% straight line MRP charge in comparison to the current MRP policy of charging at 4% reducing balance.

Impact	**Current Policy 4% Reducing Balance**	**Option 1 – 2.5% Straight Line**
Supported borrowing MRP Charge (no new capital exp)	£6.4m reducing each year	£4m straight line
Revenue saving achieved	N/A	£2.4m
CFR balance after 40 years	£31.5m	£0
Asset lives	Not based on asset lives therefore span to pay off is longer than realistic asset life	Based on 40 year asset life which is felt realistic
Future Generations Act	Higher MRP charge today but would like for like be lower for	Lower MRP charge, but it could be argued that the current policy

	taxpayers in the future (after year 13 for comparative purposes)	is placing a subsidy on current taxpayers for assets that will not have the expected life in future. This policy addresses that issue.
WG Guidance	Follows the CFR Method of WG Guidance	Follows the Asset Life Method of WG guidance which is still deemed acceptable and prudent by both the Head of Finance and Treasury Advisors.

Risks

Risk	Impact of Risk if it occurs* (H/M/L)	Probability of risk occurring (H/M/L)	What is the Council doing or what has it done to avoid the risk or reduce its effect	Who is responsible for dealing with the risk?
Investment counterparty not repaying investments	High but depending on investment value	Low	The Council only invests with Institutions with very high credit scores. It employs advisors to monitor money market movements and changes to credit scores and acts immediately should things change adversely. The lower levels of funds available for investment will also alleviate the risk.	Members, Head of Finance, Treasury staff, based on advice from treasury advisors
Interest Rates moving adversely against expectations	Low	Low	Despite recent increase in the bank rate to 0.5%, future expectations for higher short term rates are subdued. The Treasury strategy approved allows for the use of short term borrowing once investment funds are exhausted to take advantage of these low rates.	Head of Finance, Treasury staff, treasury advisors
Due to change in MRP policy, pressure on cash resources increases so that external borrowing required	Medium	Medium	When re-financing of the stock issue comes in to place, thought will be given to the impact on the reduction of cash in the organisation to repay borrowing and the revenue implication of this.	Head of Finance, Treasury staff, treasury advisors

* Taking account of proposed mitigation measures

Links to Council Policies and Priorities

It is the Council's policy to ensure that the security of the capital sums invested is fully recognised and has absolute priority. The Council follows the advice of the Welsh Governments that any investment decisions take account of security, liquidity and yield in that order.

Options Available and considered

The Prudential Code and statute requires that, during and at the end of each financial year, reports on these matters are presented to Council for approval. Thus the only option available is consider the report and provide comments to the Council.

The Council could decide to not change its MRP policy and maintain existing policy

The Council could decide not to 'opt-up' and maintain current professional client status in relation to Treasury activities

Preferred Option and Why

Note the contents of the report in relation to Treasury activities and all Treasury Indicators met.

To change MRP policy to asset life basis from 2017/18 based on straight line basis in line with HoF recommendation and reviewed by external Advisers and the Audit Committee

To maintain current status of professional client and 'opt-up'.

Comments of Chief Financial Officer
Decisions made on treasury matters will be made with a view the Treasury Management Strategy, Treasury Advisors and Prudential Indicators.

The change of the MRP policy will create an immediate saving as highlighted in the report. These will be built into the Medium Term Financial Plan as part of the budget strategy.

Comments of Monitoring Officer
There are no legal implications. The in year and annual treasury management report is consistent with relevant Chartered Institute of Public Finance and Accountancy Guidance, Treasury Management principles and the Council's investment Strategy.

Comments of Head of People and Business Change
There are no staffing implications within the report. As the proposed changes to the MRP policy now look to charge this over the life of the asset it is in keeping with the sustainability principles within the Well-being of Future Generations Act and helps support better medium to long term planning.

Comments of Cabinet Member
The Leader of the Council, as lead member for strategic finance confirms she has been consulted on the report, including the proposals to change the MRP policy and maintain our current professional client status in relation to Treasury activities.

Local issues
N/A

Scrutiny Committees
N/A

Equalities Impact Assessment and the Equalities Act 2010
No issues

Children and Families (Wales) Measure
No issues

Wellbeing of Future Generations (Wales) Act 2015

As noted in paragraph 38, the change to the MRP policy brings improvements compared to the existing policy in relation to this Act.

Crime and Disorder Act 1998
No issues

Consultation
As noted in the report – the report was reviewed by the Audit Committee. Their comments are summarised in paragraph 40 above

Background Papers
Treasury Management Strategy report to Audit Committee January 2017.
Report to Council February 2017: 2017/18 Budget and Medium Term Financial Plan
Report to Audit Committee January 23rd

Dated: 24 January 2018

APPENDIX A

External Context

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%.

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.

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.

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.

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.

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.

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.

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%.

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.

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.

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.

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+.

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.

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.

Regulatory Updates

MiFID II: Local authorities are currently treated by regulated financial services firms as professional clients who can "opt down" to be treated as retail clients instead. But from 3rd January 2018, as a result of the second Markets in Financial Instruments Directive (MiFID II), local authorities will be treated as retail clients who can "opt up" to be professional clients, providing that they meet certain criteria.

Regulated financial services firms include banks, brokers, advisers, fund managers and custodians, but only where they are selling, arranging, advising or managing designated investments. In order to opt up to professional, the authority must have an investment balance of at least £10 million and the person authorised to make investment decisions on behalf of the authority must have at least one year's relevant professional experience. In addition, the firm must assess that that person has the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The main additional protection for retail clients is a duty on the firm to ensure that the investment is "suitable" for the client. However, local authorities are not protected by the Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service whether they are retail or professional clients. It is also likely that retail clients will face an increased cost and potentially restricted access to certain products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice. The Authority has declined to opt down to retail client status in the past as the costs were thought to outweigh the benefits.

The Authority meets the conditions to opt up to professional status and intends to do so in order to maintain their current MiFID status.

CIPFA Consultation on Prudential and Treasury Management Codes: In February 2017 CIPFA canvassed views on the relevance, adoption and practical application of the Treasury Management and Prudential Codes and after reviewing responses launched a further consultation on changes to the codes in August with a deadline for responses of 30th September 2017. The Authority responded to this consultation with its feedback.

The proposed changes to the Prudential Code include the production of a new high-level Capital Strategy report to full council which will cover the basics of the capital programme and treasury management. The prudential indicators for capital expenditure and the authorised borrowing limit would be included in this report but other indicators may be delegated to another committee. There are plans to drop certain prudential indicators, however local indicators are recommended for ring fenced funds (including the HRA) and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties in the definition of "investments" as well as loans made or shares brought for service purposes. Another proposed change is the inclusion of financial guarantees as instruments requiring risk management and addressed within the Treasury Management Strategy. Approval of the technical detail of the Treasury Management Strategy may be delegated to a committee rather than needing approval of full Council. There are also plans to drop or alter some of the current treasury management indicators.

CIPFA intends to publish the two revised Codes towards the end of 2017 for implementation in 2018/19, although CIPFA plans to put transitional arrangements in place for reports that are required to be approved before the start of the 2018/19 financial year. The Department of Communities and Local Government (DCLG) and CIPFA wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. It is understood that DCLG will be revising its Investment Guidance (and its MRP guidance) for local authorities in England; however there have been no discussions with the devolved administrations yet.

Outlook for the remainder of 2017/18

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.

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.

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.

APPENDIX B

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.17 Actual £m
General Fund CFR	276.1
Less: Other debt liabilities *	-47.4
Borrowing CFR	**228.7**
Less: Usable reserves	-107.2
Less: Working capital	88.0
Net borrowing	**209.5**

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

The Authority'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 30 September 2017 and the change over the period is show in table 2 below.

Table 2: Treasury Management Summary

Newport City Council Debt	**Outstanding as at 31/03/17 £m**	**Debt Raised £m**	**Debt Repaid £m**	**Outstanding as at 30/09/2017 £m**
Public Works Loans Board	71.1	0	0	71.1
Market Loans	35.0	0	0	35.0
Stock Issue	40.0	0	0	40.0
Total Long Term Loans	**146.1**	0	0	**146.1**
Temporary Debt	63.1	44.3	104.4	3.0
Total Long Term and Temporary Debt	**209.2**	**44.3**	**104.4**	**149.1**

Borrowing Strategy during the half year

At 30/9/2017 the Authority held £149.1m of loans, (a decrease of £60.1m on 31/3/2017), as part of its strategy for funding previous years' capital programmes. The 30th September 2017 borrowing position is show in table 3 below.

Table 3: Borrowing Position

	31.3.17 Balance £m	Movement £m	30.9.17 Balance £m	30.9.17 Weighted average rate %	30.9.17 Weighted average maturity years
Public Works Loan Board	71.1	0	71.1	4.45	16.6
Banks (LOBO)	30.0	0	30.0	4.302	36.8
Banks (fixed-term)	5.0	0	5.0	3.77	60.5
Stock Issue	40.0	0	40.0	8.875	1.5
Local authorities (long-term)	0	0	0	-	-
Local authorities (short-term)	63.1	(60.1)	3.0	0.35%	0
Total borrowing	**209.2**	**(60.1)**	**149.1**	**5.52%**	**17.7**

The "cost of carry" analysis performed by the Authority's treasury management advisor Arlingclose did not indicate any value in borrowing in advance for future years' planned expenditure and therefore none was taken.

The Authority continues to hold £30m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority 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 half of 2017/18.

Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the first half of 2017/18 the Authority's investment balance ranged between £0.6m and £96 million (due to sale of Friars Walk receipt) due to timing differences between income and expenditure. The investment position during the half year is shown in table 4 below.

Table 4: Investment Position

	31.3.17 Balance £m	Movement £m	30.9.17 Balance £m	30.9.17 Weighted average rate %	30.9.17 Weighted average maturity Years
Banks & building societies (unsecured)	2.3	(1.5)	0.8	0.15	0
Government (incl. local authorities)	0	32.5	32.5	0.23	0.27
Total investments	**2.3**	**31.0**	**33.3**	**0.22**	**0.26**

Both the CIPFA Code and government guidance require the Authority 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 Authority'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.

Compliance Report

The Head of Finance 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 Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	30.9.17 Actual (£m)	2017/18 Limit (£m)	Complied
Banks Unsecured	**0.8**	**£5m**	✓
Banks Secured	**0**	**£10m**	✓
Government	**32.5**	**Unlimited**	✓
Corporates	**0**	**£5m**	
Registered Providers	**0**	**£5m**	✓
Unsecured investments with Building Societies	**0**	**£5m**	✓

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

Table 8: Debt Limits

	H1 Maximum (£m)	30.9.17 Actual (£m)	2017/18 Operational Boundary (£m)	2017/18 Authorised Limit (£m)	Complied
Borrowing	209	149	288	308	✓
PFI & finance leases	46	46	46	46	✓
Total debt	**255**	**195**	**334**	**354**	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Treasury Management Indicators

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

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed was:

	30.9.17 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure	100%	100%	✓
Upper limit on variable interest rate exposure	0	50%	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

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

	30.9.17 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	22%	80%	0%	✓
12 months and within 24 months	27%	70%	0%	✓
24 months and within 5 years	3%	70%	0%	✓
5 years and within 10 years	25%	50%	0%	✓
10 years and within 20 years	8%	30%	0%	✓
20 years and within 30 years	0%	20%	0%	✓
30 years and within 40 years	9%	20%	0%	✓
40 years and within 50 years	3%	20%	0%	✓
50 years and above	3%	20%	0%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Authority'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	0	0	0
Limit on principal invested beyond year end	5	5	5
Complied	✓	✓	✓

In the next TM Strategy report we may need to adjust these limits taking into consideration the introduction of MiFID II.

APPENDIX C – MRP POLICY OPTION APPRAISAL

Table 1

		Current MRP		Option 1			Option 2		
Period	Year	CFR 4% Reducing Balance (£'000)	MRP Charge 4% RB (£'000)	CFR 2.5% Straight Line (£'000)	MRP Charge 2.5% SL (£'000)	Difference (£'000)	CFR 2.5% Annuity Method (£'000)	MRP Charge 2.5% AM (£'000)	Difference (£'000)
1	2017	161,278	6,451	161,278	4,032	**(2,419)**	161,278	2,253	**(4,198)**
2	2018	154,827	6,193	157,246	4,032	**(2,161)**	159,025	2,315	**(3,878)**
3	2019	148,634	5,945	153,214	4,032	**(1,913)**	156,710	2,379	**(3,566)**
4	2020	142,688	5,708	149,182	4,032	**(1,676)**	154,331	2,445	**(3,262)**
5	2021	136,981	5,479	145,150	4,032	**(1,447)**	151,885	2,513	**(2,966)**
6	2022	131,502	5,260	141,118	4,032	**(1,228)**	149,372	2,583	**(2,677)**
7	2023	126,242	5,050	137,086	4,032	**(1,018)**	146,790	2,654	**(2,395)**
8	2024	121,192	4,848	133,054	4,032	**(816)**	144,135	2,728	**(2,120)**
9	2025	116,344	4,654	129,022	4,032	**(622)**	141,408	2,803	**(1,851)**
10	2026	111,690	4,468	124,990	4,032	**(436)**	138,604	2,881	**(1,587)**
11	2027	107,223	4,289	120,959	4,032	**(257)**	135,724	2,961	**(1,328)**
12	2028	102,934	4,117	116,927	4,032	**(85)**	132,763	3,043	**(1,075)**
13	2029	98,817	3,953	112,895	4,032	**79**	129,720	3,127	**(826)**
14	2030	94,864	3,795	108,863	4,032	**237**	126,593	3,214	**(581)**
15	2031	91,069	3,643	104,831	4,032	**389**	123,380	3,303	**(340)**
16	2032	87,427	3,497	100,799	4,032	**535**	120,077	3,394	**(103)**
17	2033	83,930	3,357	96,767	4,032	**675**	116,683	3,488	**131**
18	2034	80,572	3,223	92,735	4,032	**809**	113,195	3,585	**362**
19	2035	77,349	3,094	88,703	4,032	**938**	109,610	3,684	**590**
20	2036	74,255	2,970	84,671	4,032	**1,062**	105,926	3,786	**816**
21	2037	71,285	2,851	80,639	4,032	**1,181**	102,140	3,891	**1,040**
22	2038	68,434	2,737	76,607	4,032	**1,295**	98,249	3,999	**1,261**
23	2039	65,697	2,628	72,575	4,032	**1,404**	94,250	4,110	**1,482**
24	2040	63,069	2,523	68,543	4,032	**1,509**	90,141	4,223	**1,701**
25	2041	60,546	2,422	64,511	4,032	**1,610**	85,917	4,340	**1,918**
26	2042	58,124	2,325	60,479	4,032	**1,707**	81,577	4,461	**2,136**
27	2043	55,799	2,232	56,447	4,032	**1,800**	77,116	4,584	**2,352**
28	2044	53,567	2,143	52,415	4,032	**1,889**	72,532	4,711	**2,568**
29	2045	51,424	2,057	48,383	4,032	**1,975**	67,821	4,842	**2,785**
30	2046	49,367	1,975	44,351	4,032	**2,057**	62,980	4,976	**3,001**
31	2047	47,393	1,896	40,320	4,032	**2,136**	58,004	5,114	**3,218**
32	2048	45,497	1,820	36,288	4,032	**2,212**	52,890	5,255	**3,435**
33	2049	43,677	1,747	32,256	4,032	**2,285**	47,635	5,401	**3,654**
34	2050	41,930	1,677	28,224	4,032	**2,355**	42,234	5,550	**3,873**
35	2051	40,253	1,610	24,192	4,032	**2,422**	36,684	5,704	**4,094**
36	2052	38,643	1,546	20,160	4,032	**2,486**	30,980	5,862	**4,316**
37	2053	37,097	1,484	16,128	4,032	**2,548**	25,118	6,024	**4,541**
38	2054	35,613	1,425	12,096	4,032	**2,607**	19,093	6,191	**4,767**
39	2055	34,189	1,368	8,064	4,032	**2,664**	12,902	6,363	**4,995**
40	2056	32,821	1,313	4,032	4,032	**2,719**	6,539	6,539	**5,226**
41	2057	31,508	1,260	- 0			0		

Chart 1

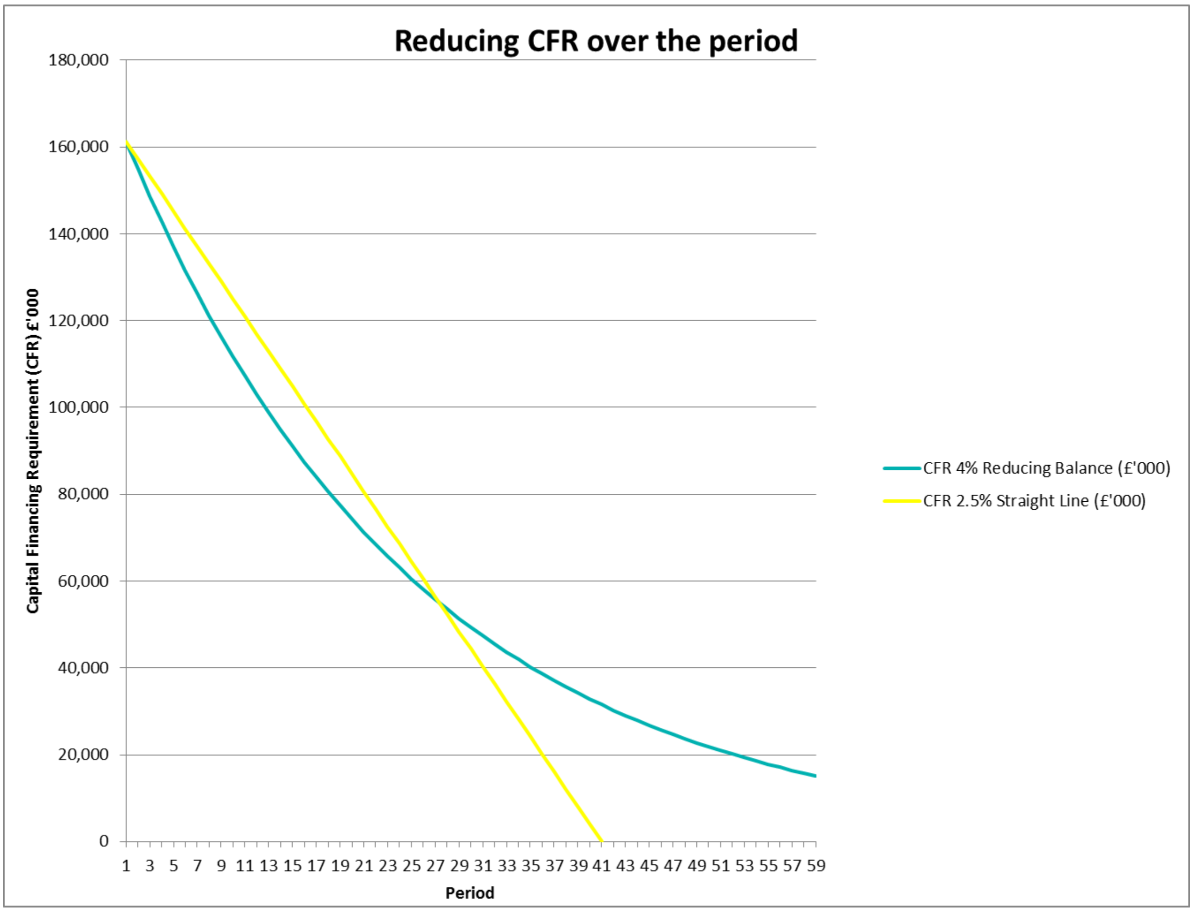
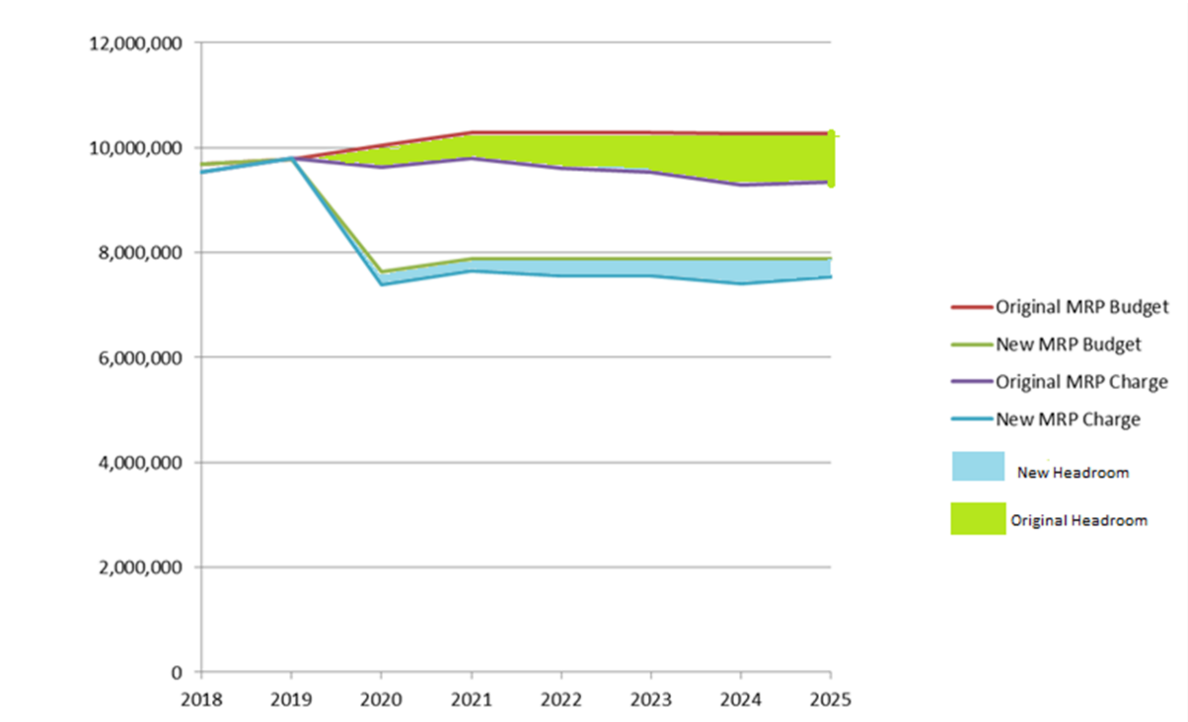


Chart 2



The difference in the shaded area between the current MRP policy and the proposed policy is reduced “headroom” which relays to capital expenditure of c£10m over the programme to 2023/24.