AGENDA ITEM.

REPORT TO AUDIT & GOVERNANCE COMMITTEE

23 SEPTEMBER 2019

REPORT OF DIRECTOR OF FINANCE & BUSINESS SERVICES

TREASURY MANAGEMENT STRATEGY – ANNUAL REPORT 2018/19

SUMMARY

This report informs Members of the performance against the treasury management and prudential indicators set in the Treasury Management Strategy approved by Council in March 2018.

REASONS FOR PRODUCING THIS REPORT

The Council operates under the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Council to approve a treasury management annual report after the end of each financial year.

This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code

Introduction

The Council's treasury management strategy for 2018/19 was approved at Council on the 8th March 2018. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Council's treasury management strategy.

External Context

The Councils Treasury Management Advisors Arlingclose have provided the following commentary on the external context.

Economic background: UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year/year, just above the consensus forecast but broadly in line with the Bank of England's February Inflation Report. The most recent labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

After rising to 0.6% in the third calendar quarter from 0.4% in the second, fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

While the domestic focus has been on Brexit's potential impact on the UK economy, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to be show signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

Financial markets: December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE 100 and FTSE All share indices were both around 10% higher than at the end of 2018.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new year - the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate pushed up money markets rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury yields were lower than US 3 month money market rates) and German 10-year Bond yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling by 1.8% year-on-year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China which despite some moderation in January does suggest that the International Monetary Fund's (IMF) and Organisation for Economic Co-Operation & Development's (OECD) forecasts for global growth in 2019 of 3.5% might need to be revised downwards.

Credit background: Credit Default Swap (CDS) spreads drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms. After hitting around 129 basis points (bps) in December 2018, the spread on non-ring fenced bank NatWest Markets plc fell back to around 96bps at the end of March, while for the ring fenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 40bps. The other main UK banks, as yet not separated into ring fenced and non-ring fenced from a CDS perspective, traded between 33 and 79bps at the end of the period.

The ring fencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS / Natwest Bank plc) transferred their business lines into retail (ring fenced) and investment banking (non-ring fenced) entities.

In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty, following this move with the same treatment for UK banks and a number of government-related entities.

Local Context

On 31st March 2019, the Council had net borrowing of £18.81m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.18 Actual £m	**2018/19 Movement £m**	**31.3.19 Actual £m**
General Fund CFR	113.56	22.54	136.10
Less: Other debt liabilities	(7.01)	0.42	(6.59)
Borrowing CFR	**106.55**	**22.96**	**129.51**
Less: Usable reserves	(98.82)	(9.07)	(107.89)
Less: Working capital	(9.16)	6.34	(2.82)
Net Borrowing / (Investments)	**(1.43)**	**20.24**	**18.81**

The Council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The treasury management position at 31st March 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.18 Balance £m	**2018/19 Movement £m**	**31.3.19 Balance £m**
Long-term borrowing	47.25	(0.06)	47.19
Short-term borrowing	0.16	(0.09)	0.07
Total borrowing	**47.41**	**(0.15)**	**47.26**
Long-term investments	9.59	5.21	14.80
Short-term investments	8.49	(8.49)	0.00
Cash and cash equivalents	30.76	(17.11)	13.65
Total investments	**48.84**	**(20.39)**	**28.45**
Net Borrowing / (Investments)	**(1.43)**	**20.24**	**18.81**

In order to reduce borrowing costs and risk the Council choose to internally borrow to fund its capital programme in year. This has resulted in reduced level of funds available for investment.

Borrowing Strategy during the year

At 31st March 2019 the Council held £47.26m of loans, a decrease of £0.150m from the previous year. The year-end borrowing position and the year-on-year change is shown in Table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	2018/19 Movement £m	31.3.19 Balance £m	Average Rate %	31.3.19 WAM* years
Public Works Loan Board	4.41	(0.15)	4.26	5.90%	9.4
Banks (LOBO)	37.00	0.00	37.00	4.83%	40.9
Banks (fixed-term)	6.00	0.00	6.00	10.24%	3.0
Total borrowing	**47.41**	**(0.15)**	**47.26**	**5.98%**	**33.2**

**Weighted average maturity*

The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

In furtherance of these objectives, **no new borrowing** was undertaken in 2018/19, while existing loans were allowed to mature without replacement. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

The "cost of carry" analysis performed by the Council'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 Council continues to holds £37m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during 2018/19.

Treasury Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Council's investment balances fluctuated due to timing differences between income and expenditure. The year-end investment position is show in Table 4 below.

Table 4: Treasury Investment Position

Counterparty	Amount £	Rate %	Start Date	Maturity Date
Nat West SIBA	1,070,000	0.20%	n/a	Call Account
Blackrock	1,000,000	0.64%	01-Sep-17	Money Market Fund
Aberdeen	3,000,000	0.65%	08-Sep-16	Money Market Fund
Federated	6,000,000	0.65%	08-Sep-16	Money Market Fund
Legal & General	1,000,000	0.64%	10-Oct-16	Money Market Fund
Insight	1,500,000	0.64%	10-Oct-16	Money Market Fund
CCLA Property Fund	15,000,000	4.10%	30-Apr-17	Property Fund
	28,570,000			

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.

In furtherance of these objectives, and given the low returns from short-term unsecured bank investments, the Council invested additional sums into higher yielding asset classes during 2018/19, investing a further £5m into the CCLA Property Fund. The progression of credit risk and return metrics for the Council's investments managed in-house are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2018	4.67	A+	91%	27	1.23%
30.06.2018	4.85	A+	91%	6	1.55%
30.09.2018	5.05	A+	100%	1	1.78%
31.12.2018	4.64	A+	100%	1	2.01%
31.03.2019	4.66	A+	100%	1	2.57%
Similar LAs	4.17	AA-	58%	50	1.59%
All LAs	4.20	AA-	55%	29	1.45%

*Weighted average maturity

£15m of the Council's investments are held in an externally managed strategic pooled property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated a return of £0.608m (4.1%) which is used to support services in year.

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives is regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three to five-year period total returns will exceed cash interest rates. In light of their performance over the medium term and the Council's latest cash flow forecasts, investment in these funds has been increased to £15m.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The Council also held £19.863m of such investments in;

- directly owned property £18.749m
- loans to local businesses £0.110m
- loans to subsidiaries £0.800m
- other £0.204m

These investments generated £0.410m of investment income for the Council after taking account of direct costs in 2018/19 representing a rate of return of 2%.

Compliance

The Director of Finance and Business Services reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in Table 6 below.

Table 6: Debt Limits

	2018/19 Maximum	31.3.19 Actual	2018/19 Operational Boundary £m	2018/19 Authorised Limit £m	Complied
Borrowing	47.4	47.3	157.1	141.3	✓
PFI & finance leases	7.0	6.6	6.0	6.0	✓
Total debt	**54.4**	**53.8**	**163.1**	**147.3**	✓

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. Total debt was above the operational boundary for 0 days during 2018/19.

Compliance with specific investment limits is demonstrated in Table 7 below.

Table 7: Investment Limits

	2018/19 Maximum	31.3.19 Actual	2018/19 Limit	Complied
Any single organisation, except the UK Central Government	£12.9m	£1.07m	£20m each	✓
UK Central Government	£0m	£0m	unlimited	✓
Any group of organisations under the same ownership	£0m	£0m	£20m per group	✓
Any group of pooled funds under the same management	£15m	£15m	£25m per manager	✓
Negotiable instruments held in a broker's nominee account	£0m	£0m	£25m per broker	✓
Foreign countries	£0m	£0m	£10m per country	✓
Registered Providers	£0m	£0m	£25m in total	✓
Unsecured investments with Building Societies	£0m	£0m	£10m in total	✓
Loans to unrated corporates	£0m	£0m	£10m in total	✓
Money Market Funds	£50m	£12.5m	£50m in total	✓

Treasury Management Indicators

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

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 proportion of net principle invested was:

	31.3.19 Actual	31.3.19 Actual	2018/19 Limit	Complied
Upper limit on fixed interest rate exposure	£0m	0%	100%	✓
Upper limit on variable interest rate exposure	£28.57m	100%	100%	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months. All other instruments are classed as variable rate.

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

	31.3.19 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	0.2%	25%	0%	✓
12 months and within 24 months	4.3%	40%	0%	✓
24 months and within 5 years	8.6%	60%	0%	✓
5 years and within 10 years	11.1%	80%	0%	✓
10 years and above	75.9%	100%	0%	✓

Principal Sums Invested for Periods Longer than 365 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:

	2018/19	2019/20	2020/21
Actual principal invested beyond year end	£15m	£15m	£15m
Limit on principal invested beyond year end	£60m	£60m	£60m
Complied	✓	✓	✓

PRUDENTIAL INDICATORS 2018/19

Introduction: The Local Government Act 2003 requires the Council to have regard to the Chartered Institute of Public Finance and Accountancy's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code is to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

This report compares the approved indicators with the outturn position for 2018/19. Actual figures have been taken from or prepared on a basis consistent with, the Council's statement of accounts.

Capital Expenditure: The Council's capital expenditure and financing is summarised as follows.

Capital Expenditure and Financing	2018/19 Estimate £m	2018/19 Actual £m	Difference £m
Total Expenditure	**61.4**	**45.3**	**(16.1)**
Capital Receipts	3.9	0.8	**(3.1)**
Grants & Contributions	21.3	20.5	**(0.8)**
Revenue	0.0	0.0	**0.0**
Borrowing	36.2	24.0	**(12.2)**
Total Financing	**61.4**	**45.3**	**(16.1)**

Capital Financing Requirement: The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31.03.19 Estimate £m	31.03.19 Actual £m	Difference £m
General Fund	145.0	136.1	**(8.9)**
Total CFR	**145.0**	**136.1**	**(8.9)**

There was a difference of £8.9m on the CFR from the original estimate due to slippage on spend within the capital programme.

Actual Debt: The Council's actual debt at 31st March 2019 was as follows:

Debt	31.03.19 Estimate £m	31.03.19 Actual £m	Difference £m
Borrowing	99.9	47.4	**(52.5)**
Finance leases	0.4	1.2	**0.8**
PFI liabilities	5.7	5.8	**0.1**
Total Debt	**106.0**	**54.4**	**(51.6)**

To minimise loan interest payments during 2018/19 the council as part of its treasury management strategy did not take out any external loans instead deciding to use its own available resources to fund the capital programme.

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence. The table below shows the position as at 31st March 2019;

Debt and CFR	31.03.19 Estimate £m	31.03.19 Actual £m	Difference £m
Total debt	106.0	54.4	**(51.6)**
Capital financing requirement	145.0	136.1	**(8.9)**
Headroom / Under Borrowed	**(39.0)**	**(81.7)**	**(42.7)**

Total debt during the year remained below the CFR. At the 31st March the Council was under borrowed by £81.7m.

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the Council's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary and Total Debt	**31.03.19 Boundary £m**	**31.03.19 Actual Debt £m**	**Complied**
Borrowing	157.1	47.4	✓
Other long-term liabilities	6.0	6.6	✓
Total Debt	**163.1**	**54.0**	✓

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the *Local Government Act 2003.* It's the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit and Total Debt	**31.03.19 Limit £m**	**31.03.19 Actual Debt £m**	**Complied**
Borrowing	141.3	47.4	✓
Other long-term liabilities	6.0	6.6	✓
Total Debt	**147.3**	**54.0**	✓

Ratio of Financing Costs to Net Revenue Stream: This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**31.03.19 Estimate %**	**31.03.19 Actual %**	**Difference %**
General Fund	1.0%	1.1%	0.1%

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