AUDIT & ACCOUNTS COMMITTEE
25 JULY 2018

TREASURY MANAGEMENT OUTTURN REPORT 2017/18

1. Purpose of Report

1.1. The purpose of this report is to give Members the opportunity to review the annual Treasury Outturn report which will be presented to Council on 10th October 2018 (copy attached at **Appendix A**).

2. Introduction

2.1. In January 2010 the Council formally adopted the CIPFA Code of Practice on Treasury Management which requires that the Council receives regular reports on its treasury management activities including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close.

2.2. The Council delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Audit and Accounts Committee and for the execution and administration of treasury management decisions to the section 151 officer, who will act in accordance with the Council's policies and practices.

2.3. The Treasury Strategy and Prudential Indicators for 2017/18 were approved by Council on 9th March 2017 and the Outturn report is the last report for the financial year, required by the Code. It has been prepared on the basis of the draft final accounts which appear elsewhere on the agenda. If there are significant changes resulting from the audit of the accounts they will be reported at the next meeting of this Committee.

2.4. The report in section 7.2 details that there was breach of the 'Interest Rate Exposure' prudential indicator. The maximum by which the limit was exceeded was £2.181m for 1 day during February 2018. The timing of receipt of income meant that excess funds were receipted into the bank account, which needed to be invested, as the money would have been at greater risk due to breaching the counterparty investment limit should they not have been. This has arisen as there is a cash limit on this indicator, rather than a percentage basis, as set within the Treasury Management Strategy approved at Council on 9 March 2017.

3. RECOMMENDATION

That the Treasury Outturn position for 2017/18 be considered.

Background Papers

Nil

For further information please contact Tara Beesley on extn. 5328

Nick Wilson
Business Manager Financial Services

APPENDIX A

ANNUAL TREASURY REPORT 2017/18

1. Background

1.1. The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ('the Code') which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year. Scrutiny of treasury policy, strategy and activity is delegated to the Audit and Accounts Committee.

1.2. 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.'

1.3. Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management strategy.

2. Economic Background

2.1. 2017-18 was characterised by the push-pull from expectations of tapering of Quantitative Easing (QE) and the potential for increased policy rates in the US and Europe and from geopolitical tensions, which also had an impact.

2.2. The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in calendar 2017, the same level as in 2016. This was a far better outcome than the majority of forecasts following the EU Referendum in June 2016, but it also reflected the international growth momentum generated by the increasingly buoyant US economy and the re-emergence of the Eurozone economies.

2.3. The inflationary impact of rising import prices, a consequence of the fall in sterling associated with the EU referendum result, resulted in year-on-year CPI rising to 3.1% in November before falling back to 2.7% in February 2018. Consumers felt the squeeze as real average earnings growth, i.e. after inflation, turned negative before slowly recovering. The labour market showed resilience as the unemployment rate fell back to 4.3% in January 2018. The inherent weakness in UK business investment was not helped by political uncertainty following the surprise General Election in June and by the lack of clarity on Brexit, the UK and the EU only reaching an agreement in March 2018 on a transition which will now be span Q2 2019 to Q4 2020. The Withdrawal Treaty is yet to be ratified by the UK parliament and those of the other 27 EU member states and new international trading arrangements are yet to be negotiated and agreed.

2.4. The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 0.25% in November 2017. It was significant in that it was the first rate hike in ten years, although in essence the MPC reversed its August 2016 cut following the referendum result. The February Inflation Report indicated the MPC was keen to return inflation to the 2% target over a more conventional (18-24 month) horizon with 'gradual' and 'limited' policy tightening. Although in March two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates, the minutes of the meeting suggested that an increase in May 2018 was highly likely.

2.5. In contrast, economic activity in the Eurozone gained momentum and although the European Central Bank removed reference to an 'easing bias' in its market communications and had yet to confirm its QE intention when asset purchases end in September 2018, the central bank appeared some way off normalising interest rates. The US economy grew steadily and, with its policy objectives of price stability and maximising employment remaining on track, the Federal Reserve Open Market Committee (FOMC) increased interest rates in December 2017 by 0.25% and again in March, raising the policy rate target range to 1.50% - 1.75%. The Fed is expected to deliver two more increases in 2018 and a further two in 2019. However, the imposition of tariffs on a broadening range of goods initiated by the US, which has led to retaliation by China, could escalate into a deep-rooted trade war having broader economic consequences including inflation rising rapidly, warranting more interest rate hikes.

A more detailed economic and interest rate forecast provided by Arlingclose is attached at ***Appendix B***.

3. <u>Local Authority Regulatory Changes</u>

3.1. Revised CIPFA Codes: CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The required changes from the 2011 Code have been incorporated into Treasury Management Strategies and monitoring reports.

3.2. The 2017 Prudential Code introduces the requirement for a Capital Strategy which provides a high-level overview of the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for future financial sustainability. Where this strategy is produced and approved by full Council, the determination of the Treasury Management Strategy can be delegated to a committee. The Code also expands on the process and governance issues of capital expenditure and investment decisions.

3.3. The Council approved a Capital Strategy on 8th March 2018 alongside the Treasury Management Strategy.

3.4. In the 2017 Treasury Management Code the definition of 'investments' has been widened to include financial assets as well as non-financial assets held primarily for financial returns such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be discussed in the Capital Strategy or Investment Strategy. Additional risks of such investments are to be set out clearly and the impact on financial sustainability is be identified and reported.

3.5. MHCLG Investment Guidance and Minimum Revenue Provision (MRP): In February 2018 the MHCLG (Ministry of Housing, Communities and Local Government) published revised Guidance on Local Government and Investments and Statutory Guidance on Minimum Revenue Provision (MRP).

3.6. Changes to the Investment Guidance include a wider definition of investments to include non-financial assets held primarily for generating income return and a new category called "loans" (e.g. temporary transfer of cash to a third party, joint venture, subsidiary or associate). The Guidance introduces the concept of proportionality, proposes additional disclosure for borrowing solely to invest and also specifies additional indicators. Investment strategies must detail the extent to which service delivery objectives are reliant on investment income and a contingency plan should yields on investments fall.

3.7. The definition of prudent MRP has been changed to "put aside revenue over time to cover the CFR"; it cannot be a negative charge and can only be zero if the CFR is nil or negative. Guidance on asset lives has been updated, applying to any calculation using asset lives. Any change in MRP policy cannot create an overpayment; the new policy must be applied to the outstanding CFR going forward only.

3.8. MiFID II: As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could "opt up" to professional client status, providing certain criteria was met which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a year's relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

3.9. The Authority has met the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. The Authority will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

4. Local Context

4.1. At 31/03/2018 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £122m, while usable reserves and working capital which are the underlying resources available for investment were £42.5m.

4.2. At 31/03/2018, the Council had £89m of borrowing and £24m of investments. The Council's current strategy is to maintain borrowing below the underlying level indicated by the CFR, and to use internal resources to cover the gap. This is referred to as internal borrowing.

4.3. The Council has a reducing CFR over the next 2 years due to the capital programme and there may be a requirement to borrow up to £2m over the forecast period. However, if reserve levels permit, internal borrowing will be considered.

5. Borrowing Strategy

5.1. Borrowing Activity in 2017/18

	Balance 1/4/17 £000	New Borrowing £000	Debt Maturing £000	Balance 31/3/18 £000
CFR	114,489			122,389
Short Term Borrowing	3,917	12,853	13,477	3,293
Long Term Borrowing	87,123	0	1,020	86,103
Total Borrowing	**91,040**	**12,853**	**14,497**	**89,396**
Other Long Term Liabilities	224	0	0	224
Total External Debt	**91,264**	**12,853**	**14,497**	**89,620**

Increase/(Decrease) in Borrowing £000				(1,644)

5.2. 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. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

5.3. Affordability remained an important influence on the Council's borrowing strategy alongside the "cost of carry" - consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained, and are likely to remain lower than long-term rates, at least over the forthcoming two years, the Council determined it was more cost effective in the short-term to use internal resources instead of borrowing.

5.4. The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with this 'cost of carry' and breakeven analysis.

5.5. **LOBOs**: The Council holds £3.5m 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, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. All of the £3.5m of LOBOS had options during the year, none of which were exercised by the lender.

5.6. **Debt Rescheduling**: The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

6. Investment Activity

6.1. Investment Activity in 2017/18

	Balance 1/4/17 £000	**New Investments £000**	**Investments Redeemed £000**	**Balance 31/3/18 £000**
Short Term Investments	27,864	135,611	139,003	24,472
Long Term Investments	0	0	0	0
Total Investments	**27,864**	**135,611**	**139,003**	**24,472**
Increase/(Decrease) in Investments £000				(3,392)

6.2. The Council has held invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2017/18 the Council's investment balances have ranged between £21.1 and £39.5 million. The Guidance on Local Government

Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

6.3. Security of capital remained the Council's main objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2017/18.

6.4. Counterparty credit quality is assessed and monitored by Arlingclose, the Council's treasury advisors, with reference to credit ratings; credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. Arlingclose provide recommendations for suitable counterparties and maximum investment periods.

7. Compliance with Prudential Indicators

7.1. The Council can confirm that it has complied with its Prudential Indicators for 2017/18 which was set on 9th March 2017 as part of the Council's Treasury Management Strategy Statement, except on the 'Interest Rate Exposure, see 7.2 below.

7.2. **Interest Rate Exposure:** These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates for both borrowing and investments. The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments. The figure shown below for the variable rate for investments has exceeded the limit. All our investments are short term and there were no fixed rates that were comparable to variable rates, over the short term.

	Approved Limit for 2017/18 £m	**Maximum during 2017/18 £m**
Fixed Rate		
Borrowing	124.2	87.1
Investments	-5	0
Net Upper Limit for Fixed Rate Exposure	**119.2**	**87.1**
Compliance with Limit		*Yes*
Variable Rate		
Borrowing	31	4.9
Investments	-37.3	-39.5
Net Upper Limit for Variable Rate Exposure	**-6.3**	**-34.6**
Compliance with Limit		*No*

7.3. **Maturity Structure of Fixed Rate Borrowing.** This indicator is to limit large concentrations of fixed rate debt and control the Council's exposure to refinancing risk.

	Upper Limit %	**Fixed Rate Borrowing 31/03/18 £m**	**Fixed Rate Borrowing 31/3/18 %**	**Compliance?**
Under 12 months	15%	4.5	5.3%	Yes
12 months to 2 years	15%	2	2.4%	Yes
2 years to 5 years	30%	13.6	15.8%	Yes

5 years to 10 years	100%	22.7	26.4%	Yes
10 years and above	100%	43.3	50.1%	Yes

7.4. **Principal Sums Invested for over 364 Days.** All investments were made on a short-term basis and there were no investments for more than 364 days.

7.5. **Authorised Limit and Operational Boundary for External Debt.** The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached. The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit. The s151 Officer confirms that there were no breaches to the Authorised Limit and the Operational Boundary during 2017/18; borrowing at its peak was £92.7m.

	Approved Operational Boundary 2017/18 £m	**Authorised Limit 2017/18 £m**	**Actual External Debt 31/03/18 £m**
Borrowing	141.8	155.2	89.4
Other Long Term Liabilities	0.4	0.6	0.2
Total	**142.2**	**155.8**	**89.6**

7.6. In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary of the treasury management activity during 2017/18. A prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

7.7. The Council also confirms that during 2017/18 it complied with its Treasury Management Policy Statement and Treasury Management Practices.

8. RECOMMENDATION

That the Treasury outturn position for 2017/18 be noted.

For further information please contact Tara Beesley, Accountant, on extn 5328.

Nick Wilson
Business Manager Financial Services

APPENDIX B

Financial markets: The increase in Bank Rate resulted in higher money markets rates: 1-month, 3-month and 12-month LIBID rates averaged 0.32%, 0.39% and 0.69% and at 31st March 2018 were 0.43%, 0.72% and 1.12% respectively.

Gilt yields displayed significant volatility over the twelve-month period with the change in sentiment in the Bank of England's outlook for interest rates. The yield on the 5-year gilts which had fallen to 0.35% in mid-June rose to 1.65% by the end of March. 10-year gilt yields also rose from their lows of 0.93% in June to 1.65% by mid-February before falling back to 1.35% at year-end. 20-year gilt yields followed an even more erratic path with lows of 1.62% in June, and highs of 2.03% in February, only to plummet back down to 1.70% by the end of the financial year.

The FTSE 100 had a strong finish to calendar 2017, reaching yet another record high of 7688, before plummeting below 7000 at the beginning of 2018 in the global equity correction and sell-off.

Credit background:

<u>Credit Metrics</u>

In the first quarter of the financial year, UK bank credit default swaps reached three-year lows on the announcement that the Funding for Lending Scheme, which gave banks access to cheaper funding, was being extended to 2018. For the rest of the year, CDS prices remained broadly flat.

The rules for UK banks' ring-fencing were finalised by the Prudential Regulation Authority and banks began the complex implementation process ahead of the statutory deadline of 1st January 2019. As there was some uncertainty surrounding which banking entities the Authority would will be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non-ring-fenced entities would look would actually look like, in May 2017 Arlingclose advised adjusting downwards the maturity limit for unsecured investments to a maximum of 6 months. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non-ring-fenced bank.

Money Market Fund regulation: The new EU regulations for Money Market Funds (MMFs) 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 Net Asset Value (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.

<u>Credit Rating developments</u>

The most 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.

Changes to credit ratings included Moody's downgrade of Standard Chartered Bank's long-term rating to A1 from Aa3 and the placing of UK banks' long-term ratings on review to reflect the impending ring-fencing of retail activity from investment banking (Barclays, HSBC and RBS were on review for downgrade; Lloyds Bank, Bank of Scotland and National Westminster Bank were placed on review for upgrade).

Standard & Poor's (S&P) revised upwards the outlook of various UK banks and building societies to positive or stable and simultaneously affirmed their long and short-term ratings, reflecting the institutions' resilience, progress in meeting regulatory capital requirements and being better positioned to deal with uncertainties and potential turbulence in the run-up to the UK's exit from the EU in March 2019. The agency upgraded Barclays Bank's long-term rating to A from A- after the bank announced its plans for its entities post ring-fencing.

Fitch revised the outlook on Nationwide Building Society to negative and later downgraded the institution's long-term ratings due to its reducing buffer of junior debt. S&P revised the society's outlook from positive to stable.

S&P downgraded Transport for London to AA- from AA following a deterioration in its financial position.

Other developments:

In February, Arlingclose advised against lending to Northamptonshire County Council (NCC). NCC issued a section 114 notice in the light of severe financial challenge and the risk that it would not be in a position to deliver a balanced budget.

In March, following Arlingclose's advice, the Authority removed RBS plc and National Westminster Bank from its counterparty list. This did not reflect any change to the creditworthiness of either bank, but a tightening in Arlingclose's recommended minimum credit rating criteria to A- from BBB+ for FY 2018-19. The current long-term ratings of RBS and NatWest do not meet this minimum criterion, although if following ring-fencing NatWest is upgraded, the bank would be reinstated on the Authority's lending list.