Appendix D

Treasury Management Outturn Report 2017/18

Introduction

In February 2012 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve a treasury management annual report after the end of each financial year.

This report fulfils the Authority's legal obligation to have regard to the CIPFA Code.

The Authority's treasury management strategy for 2017/18 was approved at a meeting on 21st February 2017. The Authority 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 are therefore central to the Authority's treasury management strategy.

External Context

Economic commentary

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.

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.

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.

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.

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.

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:

Credit Metrics

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.

Credit Rating developments

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.

Local Authority Regulatory Changes

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

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.

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.

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).

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.

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.

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.

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.

Local Context

On 31st March 2018, the Authority had net borrowing of £5.95m arising from its revenue and capital income and expenditure, an increase on 2017 of £7.85m. 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 and the year-on-year change are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.17 Actual £m	**2017/18 Movement £m**	**31.3.18 Actual £m**
General Fund CFR	14.919	13.653	28.572
Total CFR	**14.919**	**13.653**	**28.572**
Less: Other debt liabilities *	0.0	0.0	0.0
Borrowing CFR	**14.919**	**13.653**	**28.572**
Less: Usable reserves	-11.322	-1.267	-12.589
Less: Working capital	-5.496	-4.536	-10.032
Net Investments/Borrowing	**1.899**	**-7.85**	**-5.951**

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

Net borrowing has increased due to a rise in the CFR as new capital expenditure was higher than the financing applied including minimum revenue provision.

The Authority’s strategy was to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. *(Change if this is not the case for your authority)* The treasury management position as at 31st March 2018 and the year-on-year change in show in table 2 below.

<u>Table 2: Treasury Management Summary</u>

	31.3.17 Balance £m	**2017/18 Movement £m**	**31.3.18 Balance £m**	**31.03.18 Rate of Return %**
Long-term borrowing	0.0	0.0	0.0	0.0
Short-term borrowing	15.0	6.0	21.0	0.42%
Total borrowing	15.0	6.0	21.0	**0.42%**
Long-term investments	0.0	2.0	2.0	1.55%
Short-term investments	6.0	0.0	6.0	1.96%
Cash and cash equivalents	10.9	(3.854)	7.046	0.49%
Total investments	**16.9**	**(1.854)**	**15.046**	**1.75%**
Net borrowing / investments	**1.9**	**(7.854)**	**(5.954)**	

Note: the figures in the table are from the balance sheet in the Authority’s statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments

The increase in net borrowing in table 1 has translated into a fall in investment balances due to the Authority’s internal borrowing policy.

<u>Borrowing Activity</u>

At 31st March 2018, the Authority held £21m of loans, an increase of £6m on the previous year, as part of its strategy for funding previous years’ capital programmes. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position

	31.3.17 Balance £m	**2017/18 Movement £m**	**31.3.18 Balance £m**	**31.3.18 Rate %**
Public Works Loan Board	0.0	0.0	0.0	N/A
Banks (LOBO)	0.0	0.0	0.0	N/A
Banks (fixed-term)	0.0	0.0	0.0	N/A
Local authorities (long-term)	0.0	0.0	0.0	N/A
Local authorities (short-term)	15.0	6.0	21.0	0.42
Total borrowing	**15.0**	**6.0**	**21.0**	**0.42**

The Authority'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 Authority's long-term plans change being a secondary objective.

Given the significant cuts to public expenditure and in particular to local government funding, the Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it has proved to be more cost effective in the past year to borrow short-term loans instead.

The Authority has kept net borrowing costs to a minimum (despite foregone investment income) and reduced overall treasury risk. The benefits of short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly.

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

Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2017/18, the Authority's investment balance ranged between £11.985 and £21.918 million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change in show in table 4 below.

Table 4: Investment Position (Treasury Investments)

	31.3.17 Balance £m	**2017/18 Movement £m**	**31.3.18 Balance £m**	**31.3.18 Rate of Return (Income only) %**
Banks & building societies (unsecured)	6.02	(3.29)	2.73	0.79
Covered bonds (secured)	0.00	0.0	0.0	N/A
Government (incl. local authorities)	0.00	5.0	5.0	0.70
Corporate bonds and loans	2.00	1.0	3.0	1.43
Money Market Funds	4.88	(3.97)	0.91	0.51
Other Pooled Funds	4.00	(0.60)	3.40	4.67
Total investments	**16.90**	**(1.86)**	**15.04**	**1.75**

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.

In furtherance of these objectives, and given the increasing risk and low returns from short-term unsecured bank investments, the Authority further diversified into more secure and higher yielding asset classes during 2017/18. £3.4m that is available for longer-term investment was moved from bank and building society deposits into property funds. As a result, investment risk was lowered, while the average rate of return has increased by 0.23% to 0.98%. The progression of credit risk and return metrics for the Authority's investments managed in-house are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 5 below.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	5.25	A+	84%	77	0.75%
30.06.2017	5.62	A	77%	72	0.48%
30.09.2017	5.41	A+	93%	68	0.46%
31.12.2017	5.15	A+	74%	70	0.76%
31.03.2018	4.67	A+	31%	193	0.98%
Similar LAs	**4.22**	**AA-**	**53%**	**109**	**1.32%**
All LAs	**4.24**	**AA-**	**55%**	**35**	**1.08%**

*Weighted average maturity

The £3.4m portfolio (only £2m until 31.12.17) of externally managed property funds generated an income return of £94,000 (4.67%) 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 Authority's investment objectives is regularly reviewed. In light of their strong income generation performance and the Authority's latest cash flow forecasts, investment in these funds has been increased for the 2018/19 financial year.

Financial Implications

The outturn for debt interest paid in 2017/18 was £0.060 million on an average debt portfolio of £13.83 million against a budgeted £0.084 million.

The outturn for investment income received in 2017/18 was £0.192 million on an average investment portfolio of £16.958 million against a budgeted £0.027 million.

Other Non-Treasury Holdings and Activity

Although not classed as treasury management activities, the 2017 CIPFA Code now requires the Authority to report on investments for policy reasons outside of normal treasury management. This includes service investments for operational and/or regeneration as well as commercial investments which are made mainly for financial reasons. The Authority also holds £32.489m of investments in directly owned property. This represents an increase of £12.937m on the previous year due to new investment in three properties; The Chase, SPL House, and Wickes in Trowbridge.

These non-treasury investments generated £1.374m of investment income for the Authority after taking account of direct costs, representing a rate of return of 6.25%. This is higher than the return earned on treasury investments but reflects the additional risks to the Authority of holding such investments.

Performance Report

The Authority measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below.

Table 6: Performance

	Actual £m	Budget £m	Over/ Under £m
Treasury Investments	0.192	0.027	0.165
Property Investments	1.374	1.199	0.175
Total investments	**1.566**	**1.226**	**0.340**
Borrowing	0.060	0.084	0.024
Total debt	0.060	0.084	0.024
GRAND TOTAL	**1.56**	**1.186**	**0.364**

Compliance Report

The Head of Finance & Asset Management is pleased to report that all treasury management activities undertaken during 2017/18 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy with the exception of the limits detailed below. Compliance with specific investment limits is demonstrated in table 7 and 8 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7: Debt Limits

	2017/18 Maximum £m	31.3.18 Actual £m	2017/18 Operational Boundary £m	2017/18 Authorised Limit £m	Complied
Borrowing	21.0	21.0	33.0	51.0	✓
Total debt	**21.0**	**21.0**	**33.0**	**51.0**	✓

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 2017/18.

Table 8: Investment Limits

	2017/18 Maximum	31.3.18 Actual	2017/18 Limit	Complied
Any single organisation, except the UK Central Government	£2.0m	£2.0m	£2m each	✓
Any group of organisations under the same ownership	£2.0m	£2.0m	£2m per group	✓
Any group of pooled funds under the same management	£3.4m	£3.4m	£2m per manager	x
Negotiable instruments held in a broker's nominee account	£0m	£0m	£4m per broker	✓
Foreign countries	£0m	£0m	£2m per country	✓
Registered Providers	£3m	£3m	£4m in total	✓
Unsecured investments with Building Societies	£2m	£1m	£2m in total	✓
Loans to unrated corporates	£0m	£0m	£1m in total	✓
Money Market Funds	£7.3m	£0.91m	£6m in total	x

The pooled fund limit was breached in December 2017 following an investment opportunity to purchase units in the CCLA Property Fund at a discounted rate. This decision was undertaken under the statutory powers designated to the Section 151 Officer in consultation with lead members and senior management.

The Money Market Fund limit was breached as money was borrowed in advance of an Investment Property purchase. It was prudent to place the funds with the various Money Market Funds at the Council's disposal as opposed to leaving one lump sum in the current account. Arlingclose recommend a maximum of 50% of the total portfolio invested at any one time in Money Market Funds, and £7.3m invested at the end of November represented approximately 33%.

Treasury Management Indicators

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

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.3.18 Actual	2017/18 Target	Complied
Portfolio average credit rating	A+	A	✓

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 amount of net principal borrowed was:

	31.3.18 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure	£21.0m	£51.0m	✓
Upper limit on variable interest rate exposure	£0m	£0m	✓

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:

	31.3.18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	100%	100%	0%	✓
12 months and within 24 months	0%	100%	0%	✓
24 months and within 5 years	0%	100%	0%	✓
5 years and within 10 years	0%	100%	0%	✓
10 years and above	0%	100%	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	£2m	£2m	£1m
Limit on principal invested beyond year end	£2m	£2m	£0m
Complied	✓	✓	✓