Appendix D

Treasury Outturn Report 2018-19

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 treasury management semi-annual and annual reports.

The Authority's treasury management strategy for 2018/19 was approved at a meeting on 20th February 2018. 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 remains central to the Authority's treasury management strategy.

Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 29th January 2019.

External Context

Economic background: After spiking at over $85/barrel in October 2018, oil prices fell back sharply by the end of the year, declining to just over $50 in late December before steadily climbing toward $70 in April 2019. 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.

The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However, a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.

With the 29th March 2019, the original EU 'exit day' now been and gone, having failed to pass a number of meaningful votes in Parliament, including shooting down Theresa May's deal for the third time, MPs voted by a majority of one (313 to 312) to force the prime minister to ask for an extension to the Brexit process beyond 12th April in order to avoid a no-deal scenario. Recent talks between the Conservative and Labour parties to try to reach common ground on a deal which may pass a vote by MPs have yet to yield any positive results. The EU must grant any extension and its leaders have been clear that the terms of the deal are not up for further negotiation. The ongoing uncertainty continues to weigh on sterling and UK markets.

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 Bund 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 in December 2018, the spread on non-ringfenced bank NatWest Markets plc fell back to around 96bps at the end of March, while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 33 and 79bps at the end of the period.

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

There were minimal other credit rating changes during the period. Moody's revised the outlook on Santander UK to positive from stable to reflect the bank's expected issuance plans which will provide additional protection for the its senior unsecured debt and deposits.

Local Context

On 31st March 2018, the Authority had net borrowing of £5.747m 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
General Fund CFR	28.572
Less MRP	-0.204
Total CFR	**28.368**
External borrowing	**21.000**
Internal borrowing	7.368
Less: Usable reserves	**-12.589**
Less: Working capital	-10.032
Net borrowing	-5.747

The Authority 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.

Table 2: Treasury Management Summary

	31.3.18 Balance £m	Movement £m	31.3.19 Balance £m	31.3.19 Rate %
Long-term borrowing	0.0	14.0	14.0	2.38
Short-term borrowing	21.0	-7.0	14.0	0.82
Total borrowing	**21.0**	**7.0**	**28.0**	**1.60**
Long-term investments	2.0	0.0	2.0	1.55
Short-term investments	6.0	10.993	16.993	2.59
Cash and cash equivalents	7.046	-5.935	1.111	0.74
Total investments	**15.046**	**5.058**	**20.104**	**1.73**
Net borrowing	**5.954**	**1.942**	**7.896**	

Borrowing Strategy during the year

At 31st March 2019 the Authority held £28.0m of loans, an increase of £7.0m 31st March 2018, as part of its strategy for funding previous years' capital programmes. Outstanding loans on 31st March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	Net Movement £m	31.3.19 Balance £m
Public Works Loan Board	0.0	14.0	14.0
Banks (LOBO)	0.0	0.0	0.0
Banks (fixed-term)	0.0	0.0	0.0
Local authorities (long-term)	0.0	0.0	0.0
Local authorities (short-term)	21.0	-7.0	14.0
Total borrowing	**21.0**	**7.0**	**28.0**

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.

The Authority has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital. Having considered the appropriate duration and structure of the Authority's borrowing need based on realistic projections, it was decided to take a combination of short-term borrowing and long-term maturity loans. The Authority borrowed £14.0m longer-term fixed rate loans, details of which are below. These loans provide some longer-term certainty and stability to the debt portfolio.

Long-dated Loans borrowed	Amount £m	Rate %	Period (Years)
PWLB Maturity Loan 1	**11.0**	**2.35**	**40**
PWLB Maturity Loan 2	**3.0**	**2.47**	**40**
Total borrowing	**14.0**	**2.38**	

Treasury Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £15.046 and £33.60 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.18 Balance £m	**Net Movement £m**	**31.3.19 Balance £m**	**31.3.19 Income Return %**
Banks & building societies (unsecured)	2.732	1.529	4.261	1.00
Covered bonds (secured)	0.0	0.0	0.0	N/A
Government (incl. local authorities)	5.0	3.0	8.0	0.95
Corporate bonds and loans	3.0	0.0	3.0	1.47
Money Market Funds	0.91	-0.06	0.85	0.79
Other Pooled Funds (CCLA Property Fund)	3.404	0.589	3.993	4.35
Total investments	**15.046**	**5.058**	**20.104**	**1.68**

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 treasury investments before seeking the optimum 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.

Given the increasing risk and low returns from short-term unsecured bank investments, the Authority has further diversified into more secure and/or higher yielding asset classes as shown in table 4 above. £0.589m that is available for longer-term investment was moved from bank and building society deposits into pooled funds. As a result, investment risk was diversified. The average income return was 1.68% as compared with 1.20% in 2017-18.

The progression of risk and return metrics 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 %**	**Weighted Average Maturity (days)**	**Internal Investment Rate of Return %**	**External Investment Rate of Return %**	**Rate of Return %**
31.03.2018	4.67	A+	31	193	0.89	1.27	0.98
31.03.2019	4.65	A+	26	110	1.04	4.61	1.73
Similar LAs	**4.13**	**AA-**	**53**	**86**	**0.86**	**3.85**	**1.80**
All LAs	**4.20**	**AA-**	**55**	**29**	**0.85**	**3.66**	**1.43**

Please note that this table reports Total Rate of Return. Table 4 only shows the Income Return.

£3.99m of the Authority's investments are held in 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 an average total return of £184K (4.61%), comprising a £165K (4.35%) income return which is used to support services in year, and £19K (0.26%) of capital growth.

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. 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 Authority's latest cash flow forecasts, investment in these funds has been increased by £590K

Readiness for Brexit: With little by way of political clarity as to the exact date on whether there would be an agreed deal prior to leaving the EU and to be prepared for the outside chance of a particularly disruptive Brexit (such as last-minute no-deal) on 29th March, the Authority ensured there were enough accounts open at UK-domiciled banks and Money Market Funds to hold sufficient liquidity over the year end and that its account with the Debt Management Account Deposit Facility (DMADF) remained available for use in an emergency.

The Authority's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing was maintained.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority 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 Authority also held £37.4m of such investments in directly owned property as shown in the following table:

Property	Purchase date	Purchase Price	Total Investment	Current Rent	Yield on investment	Sector
Challenge House, Tewkesbury	Dec-16	£8,730,000	£9,083,736	£565,115	6.22%	Office
Challenge House, Tewkesbury	Dec-16	£5,820,000	£6,055,824	£376,743	6.22%	Industrial
Retail units, Clevedon	Jul-06	£2,199,250	£2,299,110	£158,085	6.88%	Retail
The Chase, Hertford	Nov-17	£3,700,000	£3,937,861	£262,058	6.65%	Office
SPL House, Ellesmere Port	Nov-17	£3,490,000	£3,770,482	£242,035	6.42%	Industrial
Wickes, Trowbridge	Dec-17	£5,542,000	£5,929,910	£313,518	5.29%	Retail
Edmund House, Leamington	Aug-18	£3,610,000	£3,851,000	£226,016	5.87%	Office
M&S, Walton on the Naze	Oct-18	£4,335,000	£4,619,280	£231,000	5.00%	Retail
Total		**£37,426,250**	**£39,547,202**	**£2,374,570**	**6.00%**	

These investments generated £2.37m of investment income for the Authority after taking account of direct costs, representing a rate of return of 6%.

Treasury Performance

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 £	Budget £	Over/ Under £	Actual %	Benchmark %	Over/ under
Treasury Investments	356,953	219,600	137,353	1.73%	0.57	1.16%
Borrowing	403,457	336,860	-66,597	1.60%	2.18	-0.58%
GRAND TOTAL	**-46,504**	**-117,260**	**70,756**	**N/A**	**N/A**	**N/A**

Compliance

The Chief Finance Officer reports that all treasury management activities undertaken during the year 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.

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

Table 7: Debt Limits

	2018/19 Maximum	**31.3.19 Actual**	**2018/19 Operational Boundary**	**2018/19 Authorised Limit**	**Complied?** Yes/No
Borrowing	£37.0m	£28.0m	£40.0m	£45.0m	Yes

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.

Table 8: Investment Limits

	2018/19 Maximum	**31.3.19 Actual**	**2018/19 Limit**	**Complied? Yes/No**
Any single organisation, except the UK Government	£2m	£2m	£4m each	Yes
Any group of organisations under the same ownership	£2m	£2m	£2m per group	Yes
Any group of pooled funds under the same management	£3.99m	£3.99m	£4m per manager	Yes
Negotiable instruments held in a broker's nominee account	£0m	£0m	£5m per broker	Yes
Limit per non-UK country	£2m	£2m	£2m per country	Yes
Registered providers	£3m	£3m	£4m in total	Yes
Unsecured investments with building societies	£2m	£0m	£2m in total	Yes
Money Market Funds	£2m	£0.85m	50% of Portfolio Balance	Yes
Non-specified investments	£8.99m	£6.99m	£12m	Yes

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.

	31.3.19 Actual	2018/19 Target	Complied?
Portfolio average credit rating	A+	A+	Yes

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:

	31.3.19 Actual	2018/19 Limit	Complied?
Upper limit on fixed interest rate exposure	£14m	£20m	Yes
Upper limit on variable interest rate exposure	£14m	£40m	Yes

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 all borrowing were:

	31.3.18 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	50%	100%	0%	Yes
12 months and within 24 months	0%	100%	0%	Yes
24 months and within 5 years	0%	100%	0%	Yes
5 years and within 10 years	0%	100%	0%	Yes
10 years and above	50%	100%	0%	Yes

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 365 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:

	2018/19	2019/20	2019/21
Actual principal invested beyond year end	£2m	£0m	£0m
Limit on principal invested beyond year end	£8m	£6m	£4m
Complied?	Yes	Yes	Yes