Overview and Scrutiny Committee

11 September 2018

Title	Treasury Management Annual Report 2017-18		
Purpose of the report	To note		
Report Author	Anna Russell, Deputy Chief Accountant		
Cabinet Member	Councillor Howard Williams	**Confidential**	No
Corporate Priority	Financial Sustainability		
Recommendations	**Overview and Scrutiny Committee is asked to note the treasury outturn position for 2017-18 and the financial environment in global markets.**		
Reason for Recommendation	**Not applicable**		

1. Key issues

Background

1.1 The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (the CIPFA TM Code) requires that authorities report on the performance of the treasury management function at least twice a year (mid-year and at year end). This report fulfils the Council's legal obligation to have regard to the CIPFA Code

1.2 The Council's Treasury Management Strategy for 2017-18 was approved by Cabinet on 25 January 2017 and then by full Council in February 2017.

1.3 This report is an outturn statement of treasury management activities for the financial year 2017-18. The Council has invested and borrowed 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 Council's treasury management strategy.

External Context – Economic commentary

1.4 The financial year 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.

1.5 The UK economy showed signs of slowing with latest estimates showing Gross Domestic Product (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.

1.6 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 exacerbated by political uncertainty following the surprise General Election in June 2017 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 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.

1.7 The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 0.25% to 0.50% 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.

1.8 In contrast, economic activity in the Eurozone gained momentum. In June, the European Central Bank (ECB) confirmed end of Quantitative Easing at the end of December 2018 with interest rates to remain on hold through summer 2019. 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.

External Context – Financial markets

1.9 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.

1.10 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. Twenty-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.

1.11 The FTSE 100 had a strong finish to calendar year 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.

External Context – Credit background

1.12 In the first quarter of the financial year, UK bank credit default swaps (CDS) 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.

1.13 The rules for ring-fencing UK banks 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 Council 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.

1.14 Barclays was the first to complete its ring-fenced 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.

1.15 **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.

External Context – Credit Rating developments

1.16 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.

1.17 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).

1.18 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.

1.19 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.

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

External Context – Other developments

1.21 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.

1.22 In March, following advice from Arlingclose, the Council 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 Council's lending list.

Local Authority Regulatory Changes

1.23 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 and are being incorporated into Treasury Management Strategies and monitoring reports.

1.24 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.

1.25 The Council aim to produce a Capital Strategy to be reported to Council by October 2018.

1.26 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. In accordance with the new Guidance, the officers will produce a Capital Strategy for approval by Council. Additional risks of such investments are to be set out clearly and the impact on financial sustainability is to be identified and reported.

1.27 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).

1.28 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.

1.29 The definition of prudent MRP has been changed to "put aside revenue over time to cover the CFR". MRP 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

1.30 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 were met which include having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority having 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 the person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

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

Local Context

1.32 With the purchase of commercial properties generating sustainable income streams starting with the BP international campus site in Sunbury during 2016/17, the Council now has significant levels of long-term fixed-rate borrowing, secured to fund property acquisitions.

1.33 The Council's current strategy when making strategic asset acquisitions is to take advantage of the cheap borrowing rates available and fix at those rates to provide long-term funding certainty, whilst maintaining and supplementing when possible the investment portfolio that has been built up.

1.34 On 31 March 2018, the Council had net borrowing of £682m arising from its revenue and capital income and expenditure, an increase on 2017 of £266m. 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. The CFR and resources applied are summarised in Table 1 below.

Table 1: Balance Sheet Summary as at 31 March 2018

	Actual 31/03/2017 £m	Movement 2017/18 £m	Actual 31/03/2018 £m
Opening Capital Financing Requirement	0	416	416
Capital investment	422	(149)	273
Less:			
Capital Receipts, Grants & Contributions	(3)	1	(2)
Revenue Contributions	(3)	2	(1)
Repayment of debt (MRP)	0	(5)	(5)
Closing Capital Financing Requirement	**416**	**265**	**681**

1.35 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 (MRP).

1.36 The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The Council also undertook an alternative funding exercise to assess availability of alternative funders at rates cheaper than the PWLB. The treasury management position as at 31 March 2018 and the change over the period is show in Table 2 below.

Table 2: Treasury Management Summary

	Balance 31/03/2017 £m	Movement £m	Balance 31/03/2018 £m	Rate 31/03/2018 %
Long-term borrowing	(406)	(245)	(651)	2.45%
Short-term borrowing	(8)	(6)	(14)	0.98%
Total borrowing	**(414)**	**(251)**	**(665)**	
Long-term investments	22	(1)	21	4.90%
Short-term investments	0	1	1	
Cash and cash equivalents	7	(2)	5	0.15%-0.45%
Total investments	**29**	**(2)**	**27**	
Net borrowing	**(385)**	**(253)**	**(638)**	

Note: these figures are from the balance sheet in the Council's draft statement of accounts

1.37 Increased borrowing is due to property acquisitions made during 2017-18.

2. Borrowing Activity

2.1 At 31 March 2018, the Council held £665m of loans, an increase of £251m from 31 March 2017, including £648m long-term PWLB borrowing as part of its strategy for funding major acquisitions and developments. The 31 March 2018 borrowing position is show in Table 3 below.

Table 3: Borrowing Position

	Balance 31/03/2017 £m	Movement £m	Balance 31/03/2018 £m	Rate 31/03/2018 %	Maturity (weighted av) 31/03/2018 years
Public Works Loan Board	406	242	648	2.45%	49
Local authorities (long-term)	0	3	3	0.74%	4
Local authorities (short-term)	8	6	14	1.12%	<1
Total Borrowing	**414**	**251**	**665**		

2.2 At 31 March 2018, the Council had short-term borrowing totalling £14m. This reflected the impact of the Council's cashflow, including costs associated with acquisitions such as VAT which is reimbursed by Government. Short-term funding relating to acquisitions were borrowed from other local authorities due to the short-term nature of the requirement and the affordable rates on offer.

2.3 The Council will need to borrow additional funds on both long- and short-term bases for any further acquisition purchases that occur in the future. Work is ongoing with Arlingclose and the portfolio holder to ensure that the cheapest and most appropriate duration and source are secured.

2.4 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. Flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

2.5 Affordability and the "cost of carrying" remained important influences on the Council's borrowing strategy alongside the 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.

Investment Activity to 31 March 2018

2.6 The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield consistent with these principles. However, the ability to maximise interest returns within these guidelines is paramount to generating sufficient funds to support the Council's revenue budget.

2.7 As at 31 March 2018, the Council's investment portfolio was a total of £43.29m, with £2.2m of this in short-term cashflow funds. A breakdown of the investments is given in **Appendix A**.

2.8 Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the Council's aim to further diversify into more secure or higher yielding asset classes. The availability of funds for investment is dependent upon the timing of precept payments, receipt of grants and progress on the capital programme.

2.9 The pooled fund investments form a key part of the portfolio and a full list of these and their current performance is detailed in **Appendix B**.

Investment Performance Monitoring

2.10 Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2017-18.

2.11 Table 4 shows the performance of the Council's investments compared to budget.

Table 4: Performance of investments

Investment Income 2017/18	**Budget £'000**	**Actual £'000**	**Variance from budget £'000**
Pooled Fund - Dividends	(800)	(869)	(69)
Fixed Term Deposits - Interest	(50)	(72)	(22)
Money Market Funds - Dividends	(50)	(74)	(24)
Total Investment Income	**(900)**	**(1,015)**	**(115)**

2.12 The Council seeks professional advice from Arlingclose and closely adheres to the advice set out in the Department for Communities and Local

Government (DCLG) guidance. Given Spelthorne's dependency on investment returns to balance the budget, the Council's investment strategy is also kept under constant review and regular quarterly review meetings are held with Arlingclose, the Council's treasury advisors. All investment and borrowing decisions are made in consultation with our advisors.

2.13 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

3. Financial implications

3.1 The financial implications are as set out in this report. The ability to maximise interest returns is paramount to generate sufficient funds to support the General Fund and even a small decline in interest rates can mean a significant reduction in cash returns. Therefore, our aim is to continue to maintain flexibility commensurate with the high level of security and liquidity and minimal risk when making investment decisions.

4. Other considerations

4.1 The Council fully complies with best practice as set out in the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code for Capital Finance in Local Authorities, the Department for Communities and Local Government (DCLG) Guidance on Investments issued in March 2004 and the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in the Public Sector 2009 and Cross Sectional Guidance Notes.

4.2 Nothing in the Council's current strategy is intended to preclude or inhibit capital investment in local projects deemed beneficial to the local community and which have been approved by the Council.

5. Timetable for implementation

5.1 Treasury management is an ongoing activity and normally there is no specific timetable for implementation.

Background papers: There are none

Appendices: Appendices A – B are attached