

Overview and Scrutiny Committee

09 July 2019



Title	Treasury Management Annual Report 2018-19		
Purpose of the report	To note		
Report Author	Anna Russell, Deputy Chief Accountant		
Cabinet Member	Councillor Tony Harman	Confidential	No
Corporate Priority	Financial Sustainability		
Recommendations	Overview and Scrutiny Committee is asked to note the treasury outturn position for 2018-19 and the financial environment in global markets.		
Reason for Recommendation	Not applicable.		

1. Key issues

- 1.1 The Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA TM Code, edition 2017) 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 TM Code.
- 1.2 The Council's Treasury Management Strategy for 2018-19 was approved by Cabinet on 21 January 2018 and then by full Council on 22 February 2018.
- 1.3 This report is an outturn statement of treasury management activities for the financial year 2018-19. 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.
- 1.4 CIPFA's 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 Council's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 21 February 2019.

2. External Context provided by Arlingclose

- 2.1 The narrative for external context is provided by the Council's treasury advisers, Arlingclose, with minor revisions by council officers reflecting for example the timing of this report compared to the Arlingclose draft.

Economic background

- 2.2 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 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%.
- 2.3 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 2018, no changes to monetary policy have been made since.
- 2.4 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.
- 2.5 With the 29 March 2019, the original EU 'exit day' now been and gone, having failed to pass a number of meaningful votes in Parliament, including rejecting 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 12 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 failed to yield any positive results. The EU has granted an extension to 31 October 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.
- 2.6 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

- 2.7 December saw poor 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.
- 2.8 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. One-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.
- 2.9 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

- 2.10 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.
- 2.11 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.
- 2.12 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.
- 2.13 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.

3. Local Context

Overview

- 3.1 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 borrowing secured on fixed rates to fund property acquisitions.
- 3.2 The Council's 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.
- 3.3 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 2019

	Actual 31/03/2018 £m	Movement 2018-19 £m	Actual 31/03/2019 £m
Opening Capital Financing Requirement	416	265	681
Capital investment	273	109	382
<i>Less:</i>			
Capital Receipts, Grants & Contributions	(2)	1	(1)
Revenue Contributions	(1)	0	(1)
Minimum Revenue Provision	(5)	(2)	(7)
Closing Capital Financing Requirement	681	373	1,054

- 3.4 On 31 March 2019, the Council had net borrowing of £970m arising from its revenue and capital income and expenditure, an increase on 2017-18 of £333m (shown at Table 2). 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).
- 3.5 The Council's current strategy is to maintain borrowing below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The Council also continues to consider alternative funding to assess availability of funders at rates cheaper than the PWLB. The treasury management position as at 31 March 2019 and the change over the period is show in Table 2 below.

Table 2: Treasury Management Summary

	Balance 31/03/2018 £m	Movement £m	Balance 31/03/2019 £m	Rate 31/03/2019 %
Long-term borrowing	(651)	(389)	(1,039)	2.41%
Short-term borrowing *	(14)	3	(11)	0.79%
Total borrowing	(665)	(386)	(1,050)	
Long-term investments #	21	15	36	4.23%
Short-term investments	1	29	30	0.98%
Cash and cash equivalents	5	9	14	0.77%
Total investments	27	53	80	
Net borrowing	(638)	(333)	(970)	

Notes:

* Short term borrowing includes £5m relating to PWLB.

For long-term investments, the annualised rate of return excludes funds added to the portfolio during February 2019 where dividends had not been allocated for 2019/20.

- 3.6 The changes in long-term and short-term funds was significant during 2018-19. In summary, increased borrowing is mainly due to property acquisitions made during 2018-19, with a smaller element of financing of affordable housing developments. However, it should be noted that there is no requirement to link such borrowing to specific spend.
- 3.7 The Council increased long-term investments by £15m after consultation with our treasury management advisers, Arlingclose, who provided sensitivity analyses in the context of existing pooled funds. This enabled treasury managers to assess various options, and to diversify the pooled fund portfolio, balancing risk and returns.
- 3.8 Considering reasons for the changes in more detail, the following issues during 2018-19 contributed to changes in cash and short-term investments.
- 3.9 For the Brockton portfolio acquisition, the Council borrowed funds based on the implied value of the properties which reflected expected rental flows as well as the value of the assets. The purchase price was adjusted to account for example for vacant tenancies and outstanding contractual obligations. This reduction provided funds for cover items such as £12m for guaranteed rental sums where tenants had not been in place on acquisition and £26m for sums retained for contractual obligations including those which would only be required if specific tenants were placed.
- 3.10 A prospective and imminent £15m acquisition at the end of 2018-19 was aborted within days of completion. Funds of £20m had been borrowed a month earlier, to take advantage of low PWLB rates as well as to cover two acquisitions, the other of which was successful.
- 3.11 In terms of financing, the borrowing does help offset the capital financing requirement, which increased during 2018-19 because of acquisitions (mainly) and development projects.
- 3.12 In terms of cash, borrowing during 2018-19 has increased cash and short term investments. Increasing longer term investments is a deliberate process that takes time to action, including confirming availability of funds long term.

Borrowing Activity

- 3.13 At 31 March 2019, the Council held £1,050m of loans, an increase of £385m from 31 March 2018, including £1,027m long-term PWLB borrowing as part of the strategy for funding major acquisitions and developments. The 31 March 2019 borrowing position is show in Table 3 below.

Table 3: Borrowing Position

	Balance 31/03/2018 £m	Movement £m	Balance 31/03/2019 £m	Rate 31/03/2019 %	Maturity (wtd av) 31/03/2019 years
Public Works Loan Board	648	379	1,027	2.41%	49
Local authorities (long-term)	3	14	17	0.74%	2
Local authorities (short-term)	14	(8)	6	0.79%	<1
Total Borrowing	665	385	1,050		

- 3.14 At 31 March 2019, the Council's short-term borrowing totalled £6m. This reflected the impact of the Council's cashflow, including costs associated with acquisitions such as VAT which is reclaimed from Government. Short-term funding for acquisitions were borrowed from other local authorities because of the affordable rates on offer.
- 3.15 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.
- 3.16 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.
- 3.17 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 2019

- 3.18 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.
- 3.19 As at 31 March 2019, the Council's investment portfolio was a total of £80.6m, with £14.3m of this in short-term cashflow funds. A breakdown of the investments is given in **Appendix A**.
- 3.20 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. The Council has no funds placed with the ‘challenger’ bank, Metro Bank.

- 3.21 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

- 3.22 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 2018-19.
- 3.23 Table 4 shows the performance of the Council’s investments compared to budget.

Table 4: Performance of investments

Investment Income 2018-19	Budget	Actual	Variance from budget
	£'000	£'000	£'000
Pooled Fund - Dividends	(800)	(752)	48
Fixed Term Deposits - Interest	(50)	(72)	(22)
Money Market Funds - Dividends	(50)	(193)	(143)
Total Investment Income	(900)	(1,017)	(117)

- 3.24 The Council seeks professional advice from Arlingclose and closely adheres to the advice set out in the Ministry for Housing, Communities and Local Government (MHCLG) 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.
- 3.25 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.

Non-Treasury Investments

- 3.26 The definition of investments in CIPFA’s revised Treasury Management Code now covers all the financial assets of an authority as well as other non-financial assets that an 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.
- 3.27 The Authority also held £1bn of such investments in:
- directly owned property £1bn;
 - subsidiary £7m.

3.28 These investments generated £38m of investment income for the Council after taking account of direct costs, representing a rate of return of 3.8%.

4. Financial implications

4.1 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. Our aim is to continue to maintain flexibility commensurate with the high level of security and liquidity and minimal risk when making investment decisions.

5. Other considerations

5.1 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, now MHCLG) 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.

5.2 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.

6. Timetable for implementation

6.1 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