Annual Report on the Treasury Management Service and Actual Prudential Indicators for 2018/19

Summary

Report to advise members of the Treasury Management Service performance and to illustrate the compliance with the Prudential Indicators for 2018/19

Portfolio - Finance
Date signed off: 17 September 2019

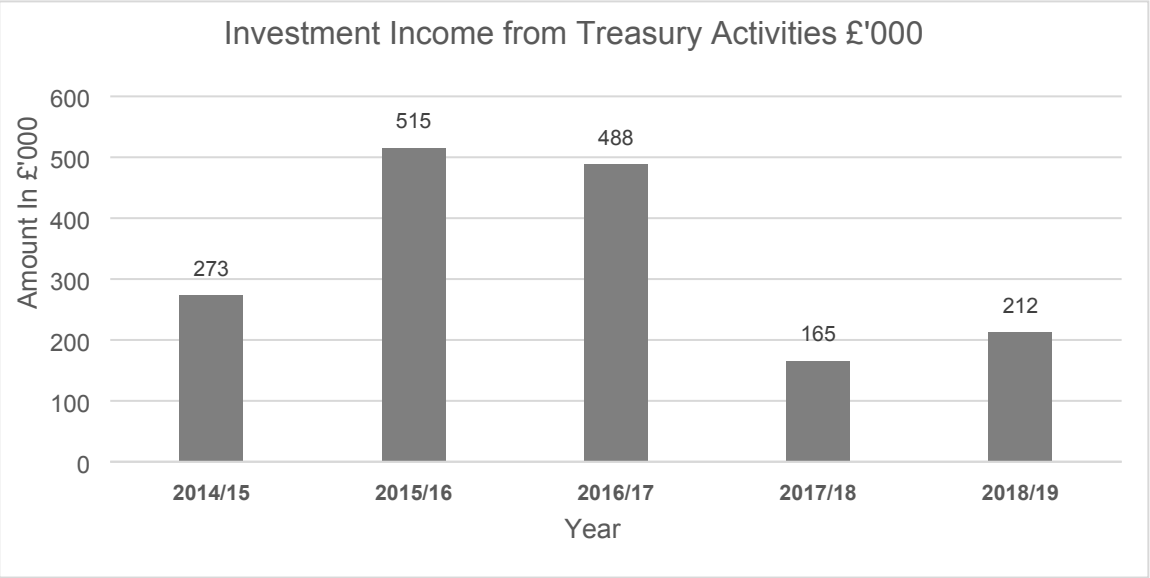
Wards Affected
All

Recommendation

The Performance and Finance Scrutiny Committee is asked to NOTE the report on Treasury Management including compliance with the 2018/19 Prudential Indicators

1. Resource Implications

1.1 None directly as a result of this paper however the management of investments and borrowings does have an impact on the Council's resources. The graph below shows investment income from treasury activities from 2014/15 to 2018/19.



1.2 Treasury income returns increased in 2018/19 due to an increase in the level of investments in 2018/19 coupled with the Bank of England's decision to increase Bank Rate to 0.75% from 0.50% in August 2019. The increased level of investments at the year-end was because the Authority took out a number of PWLB loans just before the end of the financial year to take advantage of low interest rates. These loans were then used to repay short term borrowing that became due in the first part of the financial year 2019/20.

1.3 Borrowing costs have increased over the year as the Council has invested further money in to property.

2. Key Issues

2.1 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 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.

2.2 Treasury management is defined as: "The management of the organisation's borrowing, 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."

2.3 The Authority's treasury management strategy for 2018/19 was approved at a meeting on 21st 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.

2.4 This report is the annual report for the 2018/19 financial year. It includes both a summary of treasury management performance during the year as well demonstrating compliance with the 2018/19 Prudential Indicators.

3. Supporting Information

Treasury Management Strategy 2018/19

3.1 The Authority approved the 2018/19 Treasury Management Strategy, which includes the investment strategy, at its meeting on the 21st February 2018. All treasury management activity undertaken during the year complied with the approved treasury management strategy, the CIPFA Code of Practice and the relevant legislative provisions, except as shown in note 5.26.

Investment Strategy 2018/19

3.2 The approved investment strategy for 2018/19 adopted a view to investment that sought to balance risk against return. It maintained a policy, on the advice of our treasury advisors Arlingclose, of diversifying investments in line with the agreed strategy. The Authority maintained its longer term investment in the CCLA Property Fund.

3.3 The Authority continued to use local authorities, the Government and money markets with investments being placed generally for short periods only.

Approved Counterparties

3.4 The Council's Treasury advisors have advised that the Council may invest its surplus funds with any of the counterparty types in the table below, subject to the cash limits (per counterparty) and the time limits shown.

Table 2: Approved Investment Counterparties and Limits

Credit Rating	Banks Unsecured	Banks Secured	Building Societies	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£2m 5 years	£3m 10 years	£2m 3 years	n/a	£2m 20 years	£2m 20 years
AA+	£2m 5 years	£3m 10 years	£2m 3 years	n/a	£2m 10 years	£2m 10 years
AA	£2m 4 years	£3m 5 years	£2m 3 years	n/a	£2m 5 years	£2m 10 years
AA-	£2m 3 years	£3m 4 years	£2m 3 years	n/a	£2m 4 years	£2m 10 years
A+	£2m 2 years	£3m 3 years	£2m 2 years	n/a	£2m 3 years	£2m 5 years
A	£2m 13 months	£3m 2 years	£2m 12 months	n/a	£1m 2 years	£2m 5 years
A-	£2m 6 months	£3m 13 months	£1m 6 months	n/a	£1m 13 months	£2m 5 years
BBB+	£3m next day only	£3m 6 months	£1m 100 days	n/a	n/a	£1m 2 years
None	£1m 6 months	n/a	£1m 6 months	n/a	n/a	n/a
Pooled funds	£2m per fund					
Supranational Banks	£3m for up to 5 years where rated A or above					
UK Local Authorities	£2m per authority for up to 5 years					

Borrowing Strategy 2018/19

3.5 The Authority's chief objective when borrowing has been to strike a balance between achieving cost certainty and securing low interest costs. This has been achieved by Council borrowings being a mixture of fixed and variable loans. In addition the Council has entered in to a forward loan agreement, on the advice of its treasury advisors, which guarantees a fixed loan rate at a point in the future, thereby fixing the risk of interest rate changes on a portion of the short term variable loans.

Treasury Advisors

3.6 The Authority uses Arlingclose Limited as its treasury management advisors toprovide advice on all aspects of treasury management including interest rate forecasts, counterparty lists, management advice and borrowing strategy. They have provided an Economic Review, counterparty update and market data by way of background information and this is included in Annex C.

Borrowing and Investment Activity in 2018/19

Borrowing Activity 2018/19

3.7 At 31/03/2019 the Authority's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £189.7m, while usable reserves and working capital which are the underlying resources available for investment were £41.0m on an accruals basis.

3.8 The Authority's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). The CFR arises directly from the capital activity of the Authority and the resources applied to fund the capital spend, and represents the unfinanced element of capital expenditure.

3.9 At 31/03/2019, the Authority had £175.7m (£119.7m at 31 March 2018) of actual borrowing and £30.3m (£14.9m at 31 March 2018) of treasury investments. The net of borrowing and investments was £145.4m (£104.8m at 31 March 2018). This is less than the CFR of £189.7m above and working capital as the Authority is able to use “Internal borrowing” to fill this gap subject to holding a minimum short-term investment balance of £5m.

3.10 Working capital is money available to the Authority for its day-to-day operations and is calculates as the current assets less the current liabilities. Internal borrowing is a treasury management practice whereby an authority delays the need to borrow externally by temporarily using cash it holds for other purposes.

3.11 A large proportion of the Authority’s borrowing consisted of short term loans. This enabled the Authority to reduce borrowing costs by taking advantage of low interest rates. However, in order to manage interest rate risk, the Authority arranged in 2017/18, £50million of forward starting loans. Loan 1 which is for the £25m will commence in 2020/21 at a rate of 2.853% and Loan 2 will commence in 2021/22 at a rate of 2.908% Both loans will be repayable over 40 years.

3.12 Based on the current capital programme, the Authority is predicted to have an increasing CFR over the next year.

3.13 During the year the Authority entered in to £41m of new long term borrowing and £15m of new short term borrowing mainly to fund property acquisitions. The details are given in the table below:

	31.03.18 Balance £m	**2018/19 Movement £m**	**31.03.19 Balance £m**	**31.03.19 Rate %**
Public Works Loan Board	(16)	(41)	(57)	2.54%
Local authorities (long term)	(1)	0	(1)	0.00%
Local authorities (short term)	(103)	(15)	(118)	0.90%
Total Borrowing	(120)	(56)	(176)	1.15%

3.14 The outturn for debt interest paid in 2018/19 was £1.6m on an average debt portfolio of £175.7m. The budgeted interest was £3.2m on an average debt portfolio of £120m.

Investment Activity 2018/19

3.15 The Authority held investments which consisted of income received in advance of expenditure, balances and reserves. During 2018/19 the Authority’s average investment balance was £15 million. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority’s aim in its investment strategy is to achieve a yield commensurate with these principles.

3.16 The table below shows a summary of the investment activity for 2018/19:

Investment Counterparty	Balance on 01/04/18	Investments Made	Maturities/ Investments Sold	Balance on 31/03/19	Average Rate at 31st March
	£000s	£000s	£000s	£000s	%
UK Central Government					
- Short Term	**0**	235,860	-208,360	**27,500**	0.50
- Long Term	**0**	0	0	**0**	-
UK Local Authorities					
- Short Term		6,500	-6,500	**0**	0.00
- Long Term	**2,000**	0	-2,000	**0**	0.00
Banks, Building Societies & Other Organisations					
- Short Term	**1,032**	54,575	-54,961	**646**	0.20
- Long Term	**0**	0	0	**0**	-
AAA-rated Money Market Funds					
- Short Term Cash Equivalents	**9,752**	47,370	-57,122	**0**	0.00
- Long Term	**2,151**	33	0	**2,184**	4.40
Total Investments	**14,935**	**344,338**	**-328,943**	**30,330**	**0.91**

3.17 In 2018/19 the Authority increased its investment activity with the UK Government (Debt management Office - DMO), which is considered to be the safest depositor, when compared to the previous year for the following reasons:

- Following guidance from our Treasury Advisors excess funds above a minimum in the Council's bank Natwest were transferred to the DMO due to the poor credit rating of the bank.
- PWLB and short term borrowing taken in advance to secure low interest rates are placed in the DMO for security. This is on average for 10 days until required.

3.18 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.

3.19 Security of capital has remained the Authority's main investment objective. This has been maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy for 2018/19.

3.20 Counterparty credit quality was assessed and monitored by our advisors with reference to credit ratings (the Authority's minimum long-term counterparty rating is A across the 3 main credit rating agencies).

3.21 Investments held during the year included:

- Deposits with the Debt Management Office
- Deposits with Other Local Authorities
- Investments in AAA-rated constant and variable net asset value Money Market Funds
- Call accounts and deposits with Banks and Building Societies in the UK
- Longer Term Property Fund

Credit Risk

Counterparty credit quality as measured by credit ratings is summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/2016	4.26	AA-	2.35	AA
31/03/2017	4.99	A+	3.06	AA
31/03/2018	4.42	AA-	3.65	AA-
31/03/2019	3.01	AA	3.00	AA

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 26
-Aim = A+ or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Budgeted Income and Outturn

3.22 The average cash balance during the year was £15m. The externally managed CCLA Property Fund continued to be the Authority's best performing investment in 2018/19. The Authority maintained its investment of £2m in the fund in 2018/19 generating a total return of £0.14m (5.96%), comprising £0.11m (4.40%) income return used to support services in year, and £0.03m (1.56%) of capital growth. Because this fund has no defined maturity date, but is available for withdrawal after a notice period, its performance and continued stability in meeting the Authority's investment objectives is regularly reviewed. In light of its strong income generation performance, investment in this fund has been maintained for the 2018/19 financial year. 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.

3.23 The Authority's budgeted investment income for the year was £0.30m and the outturn was £0.21m. Although this fell short of the budgeted investment income for 2018/19, the actual income received represented an increase of 28.30% compared to 2017/18. The shortfall was due to the fact that surplus cost was used to reduce borrowing rather than being invested.

Externally Managed Funds

3.24 The Authority maintained its investment in the CCLA Property fund. The property fund which is operated on a variable net asset value (VNAV) basis offers diversification of investment risk, coupled with the services of a professional fund manager; it also offers enhanced returns over the longer term but is more volatile in

the short-term. The Authority's CCLA property fund is in the distributing share class which pays out the income generated.

Readiness for Brexit:

3.25 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 31st October, 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 Office (UK Government) remained available for use in an emergency.

Non-Treasury Investments

3.26 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 performance of the Authority's non-treasury investments are reported separately to members twice a year.

Compliance with Prudential Indicators

3.27 The Authority can confirm that it has complied with its Prudential Indicators for 2018/19 with the exception of the breach noted below. These indicators were approved on 21st February 2018 by Full Council as part of the Authority's Treasury Management Strategy Statement.

3.28 There was only one breach of the Treasury Strategy during the year. On 7th January 2019 £6m was invested with Thurrock Council. The limit on Local Authority investments was assumed to be the same limit as the Debt Management Office i.e. unlimited rather than £2m. The money was repaid on the 7th February 2019 and the Authority suffered no loss. Procedures have being changed to prevent this happening again in the future by the introduction of a treasury management monitoring system to detect any potential breach before a deal is agreed.

4. Corporate Objectives and Key Priorities

4.1 This report demonstrates how treasury management supports Key priority 2.

5. Policy Framework

5.1 The 2018/19 Annual Investment Strategy together with the Treasury Management Strategy was approved by Full Council on 21st February 2018. These set out the parameters under which Treasury Management operates including the Prudential Indicators.

5.2 The Authority fully complies with the requirements of the CIPFA Code of Practice on Treasury Management. The relevant criteria and constraints incorporated into the Treasury Management Policy Statement are:

- New borrowing is contained within the limits approved by the Authority, in accordance with the CIPFA Prudential Code for Capital Finance in Local Authorities, and the Authority's Prudential Indicators.

- Investments are made in accordance with the MHCLG guidance on Local Authority Investments, on the basis of the three main credit ratings agencies and as detailed in the Treasury Management Policy statement and approved schedules and practices.

- Sufficient funds are available to meet the Authority's estimated outgoings for any day.

- Investment objectives are to maximise the return to the Authority, subject to the overriding need to protect the capital sum.

6. Legal Issues

6.1 The Authority is required to comply with the Prudential Code as laid down by the Government.

7. Risk Management

7.1 The Authority regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. The key treasury risks being managed are:

- credit risk,
- liquidity risk,
- interest rate risk,
- refinancing risk, and
- operational risk

The techniques employed to manage these risks are covered in detail in the Authority's Treasury Management Practices, and include:

- robust counterparty monitoring and selection criteria,
- prudent cash flow forecasting,
- a range of exposure limits and indicators, and
- procedures designed to prevent fraud and error.

7.2 The Authority's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds before seeking the best rate of return.

7.3 The limits applied in respect of counterparties and investments are the <u>overall limits</u> approved by Council in the annual Treasury Management Strategy. However from time to time these may be tightened temporarily by the Executive Head of Finance in consultation with the Portfolio Holder for Finance to reflect increased uncertainty and increase in perceived risk in financial institutions and the economy. This will usually be at the cost of lower returns.

7.4 It should be noted that the investments ratings provided by credit ratings agencies are only a guide and do not give 100% security. There is always a risk that an institution may be unable to repay its loans whatever the credit rating.

7.5 The Authority measures its exposures to treasury management risks using a range of indicators as recommended by the CIPFA Code of Practice on Treasury Management.

7.6 The Authority is exposed to interest rate risk on its borrowings. Although steps have been taken to mitigate this risk, through the use of forward starting loans, for example, the risk still remains. However, based on advice from our Treasury Advisors, the risk is considered to be low for the current year.

8. Recommendations

8.1 That the Performance and Finance Scrutiny Committee note the report on Treasury Management including compliance with the 2018/19 Prudential Indicators;

Annexes	Annex A – Investments as at 31st March 2019 Annex B - Compliance with Prudential Indicators Annex C – Economic and other background information from Arlingclose Limited.
Background Papers	CIPFA Code of Practice: Treasury Management in the Public Services – 2018 Edition CIPFA Code of Practice: Treasury Management in the Public Services – 2017 Edition
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Annex A

Treasury Related Investment Balances as at 31st March 2019

Investments	Notes	Maturity Date	Interest Rate %	Principal
				£
Cash and Cash Equivalents				
Banks				
NatWest Business Reserve Account	On call		0.21	101,912
NatWest Central Account			0.10	543,821
Total Cash and Cash Equivalents				**645,732**
Debt Management Office		Apr-2019	0.50	27,500,000
Long Term Investments				
CCLA Property Fund		Long term	5.96	2,184,425
Total Long Term Investments				**2,184,425**
Total Investments				**30,330,157**

Annex B

Compliance with Prudential Indicators

The Authority confirms compliance with its Prudential Indicators for 2018/19 which were set in February 2018.

Treasury Management Indicators

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

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:

	31.3.19 Actual	**2018/19 Limit**
Upper limit on fixed interest rate exposure	£0.8m	£3.2m
Upper limit on variable interest rate exposure	£0.2m	£190m

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.

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**
Portfolio average credit rating	AA	A+

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing. The Authority also has the option to borrow on a daily basis on the open market.

	31.3.19 Actual	**2018/19 Target**
Total cash available within 3 months	£8m	£5m

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:

	31.3.19 Actual	Upper Limit	Lower Limit
Under 12 months	68%	100%	100%
12 months and within 24 months	2%	100%	100%
24 months and within 5 years	2%	100%	100%
5 years and within 10 years	3%	100%	100%
10 years and above	25%	100%	100%

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	2020/21
Actual principal invested beyond year end	£2m	£2m	£2m
Limit on principal invested beyond year end	£15m	£15m	£15m

Annex C

External Context provided by the Authority's Treasury Advisors, Arlingclose Limited

Economic background:
UK Consumer Price Inflation (CPIH) was 2.0% year/year in July 2019, slightly stronger than the consensus of 1.8% but in line with the Bank of England's target. The most recent labour market data for the three months to June 2019 showed the unemployment rate edged up to 3.9% while the employment rate of 76.1% was the joint highest since records began in 1971. Nominal annual wage growth measured by the 3-month average excluding bonuses was 3.9% and 3.6% including bonuses. Adjusting for inflation, real wages were up 1.9% excluding bonuses and 1.8% including.

The first estimate of Q2 GDP growth showed the UK economy contracted by 0.2% following the 0.5% gain in Q1 which was distorted by stockpiling ahead of Brexit. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 2012. Business investment fell by 0.5% as Brexit uncertainties impacted on business planning and decision-making.

Politics, both home and abroad, continued to be a big driver of financial markets over the last quarter. Boris Johnson won the Conservative Party leadership contest and has committed to leaving the EU on 31st October regardless of whether a deal is reached with the EU. Mr Johnson prorogued Parliament which led some MPs to seek to block the UK from leaving without a deal and at the time of writing Number 10 is apparently considering seeking an early general election if such a block is attempted.

Tensions continued between the US and China with no trade agreement in sight and both countries imposing further tariffs on each other's goods. The US Federal Reserve cut interest rates in a pre-emptive move to maintain economic growth amid escalating concerns over the trade war and a weaker economic environment leading to more pronounced a global slowdown. These elevated concerns have caused government yield curves in the US and UK to invert, something seen by many commentators as a predictor of a global recession. Market expectations are for further interest rate cuts from the Fed and the European Central Bank likely to add more monetary stimulus from September.

The Bank of England maintained Bank Rate at 0.75% and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction depending on whether or not a deal is ultimately reached by 31st October.

Financial markets: After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April.

Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. The 5-year benchmark gilt yield fell to 0.28% at the start of September from 0.63% at end of June. There were falls in the 10-year and 20-year gilts over the same period, dropping to 0.43% from 0.83% and to 0.84% from 1.35% respectively. 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65%, 0.75% and 1.00% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker

economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently trading around -0.94% and -0.93% respectively.

Credit background:
Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ringfenced bank NatWest Markets plc fell back to around 82bps at the start of September, while for the ringfenced entity, National Westminster Bank plc, the spread fell from 40bps to 34bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 34 and 66bps at the end of the period.

There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.