Appendix A

Treasury Management Outturn Report 2017/18

Introduction

In December 2011 the Council 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 Council to approve a treasury management annual report after the end of each financial year.

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

The Council's treasury management strategy for 2017/18 was approved at a meeting on 22 February 2017. The Council 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 Council'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 at the March meeting of the MPC indications were that policy rates would increase in May 2018, at its meeting of 9 May the Committee voted to maintain Bank Rate at 0.5%.

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:

<u>Credit Metrics</u>

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 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.

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.

<u>Credit Rating developments</u>

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 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 Arlingclose advised that RBS plc and National Westminster Bank were removed from its client's counterparty lists; this reflected a tightening of Arlingclose recommended minimum credit rating to A- from BBB+ for the 2018-19 financial year. The Council's Treasury Management Strategy Statement for 2017-2018 and 2018-2019 had minimum credit rating criteria of A- and therefore this change in advice has no impact on the Council's investment policy.

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.

The Council has not prepared a Capital Strategy; the Council will pay heed to the requirements of the 2017 Prudential Code in its reporting on the 2018-2019 Treasury Management Strategy throughout the coming financial year, and will produce its first formal Capital Strategy as a part of the process of developing its 2019-2020 Treasury Management Strategy.

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.

Amendments to Capital Finance Legislation: The Welsh Government published the Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2018 in March 2018. It amends and clarifies erstwhile regulations so that investments in corporate bonds and shares in FCA (Financial Conduct Authority) approved UCITS (Undertakings for the Collective Investment of Transferable Securities) funds, Real Estate Investment Trusts (REITs) and investment schemes approved by HM Treasury are no longer treated as capital expenditure. This legislation came into effect in the 2017/18 financial year. It enables the Council to invest in these instruments, if appropriate for the Council's circumstance and objectives, without the potential revenue cost of MRP (Minimum Revenue Provision) and without the proceeds from sale being considered a capital receipt.

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 were 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 Council 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 Council has not, and does not plan to opt up to professional status because it does not consider a £10 million investment portfolio as a part of daily treasury activity as reasonable assumption for the foreseeable future. This has led to some increased costs and restrictions in accessing financial products since 3rd January 2018, to this point there has been no significant impact on the Council's treasury activity as a result of not opting up. The main protection in being a retail client is a duty on the firm to ensure that the investment is "suitable" for the Council. It should be noted that local authorities' investments are not protected by the Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service regardless of whether they are retail or professional clients.

Local Context

On 31st March 2018, the Council had £364.4m of borrowing (an increase of £44.3m from March 2017) and £13.9m of investments (an increase of £5.2m from 31 March 2017). 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	156.19	1.12	157.31
HRA CFR	230.91	22.52	253.43
Total CFR	**387.10**	**23.64**	**410.74**
Less: Other debt liabilities *	(28.47)	0.79	(27.68)
Borrowing CFR	**358.63**	**24.43**	**383.06**
Less: Usable reserves	(43.55)	(0.99)	(44.54)
Net borrowing	**315.08**	**23.44**	**338.52**

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

The Council'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. The treasury management position as at 31st March 2018 and the year-on-year change in show in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Rate %
Long-term borrowing Short-term borrowing	299.37 20.69	(2.03) 46.35	297.34 67.04	3.95
Total borrowing	**320.06**	**44.32**	**364.38**	
Long-term investments Short-term investments Cash and cash equivalents	0.00 2.00 6.71	0.00 (2.00) 7.23	0.00 0.00 13.94	0.35
Total investments	**8.71**	**5.23**	**13.94**	
Net borrowing	**311.35**	**39.09**	**350.44**	

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

Borrowing Activity

At 31st March 2018, the Council held £364.38m of loans, an increase of £44.32m 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 New £m	2017/18 Maturing £m	31.3.18 Balance £m	31.3.18 Rate %
Public Works Loan Board	273.93	0.00	(0.34)	273.59	4.68
Banks (LOBO)	15.30	0.00	0.00	15.30	4.84
Banks (fixed-term)	8.50	0.00	0.00	8.50	5.00
Local authorities (long-term)	0.00	0.00	0.00	0.00	
Local authorities (short-term)	20.00	123.00	(78.00)	65.00	0.66
Other	2.33	0.00	(0.34)	1.99	
Total borrowing	**320.06**	**123.00**	**(78.68)**	**364.38**	

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, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

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

The Council continues to hold £15.3m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during 2017/18. The Council will continue to monitor its position in respect of rescheduling this element of its debt portfolio in the event that a cost neutral opportunity arises.

Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2017/18, the Council's investment balance ranged between £1.4m and £22m 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 New £m	2017/18 Maturing £m	31.3.18 Balance £m	31.3.18 Rate %
Banks & building societies (unsecured)	8.71	155.09	(149.86)	13.94	
Government (incl. local authorities)	0.00	8.5	(8.5)	0.00	
Money Market Funds	0.00	87.85	(87.85)	0.00	
Total investments	**8.71**	**251.44**	**(246.21)**	**13.94**	

Both the CIPFA Code and government guidance require the Council 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 Council'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 the Council continues to monitor daily its investment position in order that it is able to maximise the return on its portfolio, whilst ensuring that risks of default are managed through the rigorous application of a number of counterparty suitability checks, including the monitoring of credit rating in line with the Council's Treasury Management Strategy Statement.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	Rate of Return
31.03.2017	4.24	AA-	100%	0.23
30.06.2017	3.72	AA-	100%	0.21
30.09.2017	4.94	A+	100%	0.24
31.12.2017	4.00	AA-	37%	0.43
31.03.2018	4.87	A+	100%	0.35

Other Non-Treasury Holdings and Activity

Although not classed as treasury management activities, the 2017 CIPFA Code now requires the Council 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. Currently whilst the Council has examples of loans to local businesses and for service purposes these are not considered for investment. Such loans and investments will be subject to the Council's normal approval processes for revenue and capital expenditure and need not comply with this treasury management strategy.

Compliance Report

The Head of Finance is pleased to report that all treasury management activities undertaken during 2017/18 complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management. 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 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-including PFI and Finance Leases	392	392	430	445	✓
Total debt	**392**	**392**	**430**	**445**	✓

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

	2017/18 Maximum	31.3.18 Actual	2017/18 Limit	Complied
Any single organisation, except the UK Central Government	£5m	£4.8m	£5m	✓
Any group of pooled funds under the same management	-	-	£5m	✓
Negotiable instruments held in a broker's nominee account	-	-	£20m	✓
Foreign countries	£5m	£3m	£10m	✓
Registered Providers	-	-	£5m	✓
Unsecured investments with Building Societies	£1m	-	£2m	✓
Money Market Funds	£9.6m	-	£20m	✓

Treasury Management Indicators

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

Security: The Council 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 Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed and interest payable was:

	Approved Limits for 2017/18 %
Upper Limit for Fixed Interest Rate Exposure on Debt	100
Upper Limit for Fixed Interest Rate Exposure on Investments	(100)
Upper Limit for Fixed Rate Exposure	**0**
Compliance with Limits:	Yes
Upper Limit for Variable Interest Rate Exposure on Debt	30
Upper Limit for Variable Interest Rate Exposure on Investments	(100)
Upper Limit for Variable Rate Exposure	**(70)**
Compliance with Limits:	**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.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Council'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 £m	**2018/19 £m**	**2019/20 £m**
Actual principal invested beyond year end	0	-	-
Limit on principal invested beyond year end	5	10	5
Complied	✓	✓	✓

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

Maturity Structure of Fixed Rate Borrowing	**Upper Limit** %	**Lower Limit** %	**Actual Fixed Rate Borrowing at 31/03/2018** **£m**	**% Fixed Rate Borrowing at 31/03/2108**	**Compliance with Set Limits?**
under 12 months	30	0	82.34	22.60	Yes
12 months and within 24 months	20	0	1.86	0.51	Yes
24 months and within 5 years	20	0	6.72	1.85	Yes
5 years and within 10 years	80	0	24.33	6.51	Yes
10 years and within 20 years	80	0	167.75	46.20	Yes
20 years and within 30 years	80	0	22.35	6.13	Yes
30 years and within 40 years	80	0	52.13	14.31	Yes
40 years and within 50 years	80	0	6.90	1.89	Yes
50 years and above	90	0	0.0	0.00	Yes
Total			364.38	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.