Cherwell District Council

Accounts, Audit & Risk Committee

25 July 2018

2017/18 Treasury Management Annual Report

Report of the Executive Director of Finance and Governance (Interim)

This report is public

Purpose of report

This report presents information on treasury management performance and compliance with treasury management policy during 2017/18 as required by the Treasury Management Code of Practice.

1.0 Recommendations

The meeting is recommended:

To note the contents of this report in line with the Treasury Management Strategy.

2.0 Introduction

In 2012 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve a treasury management annual report after the end of each financial year.

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

The Authority's revised treasury management strategy for 2017/18 was approved by Council on 27 February 2017 and was revised by full Council on 18 December 2017. The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

3.0 External Context *(report by Arlingclose as at 9/4/18)*

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 in March two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates, the minutes of the meeting suggested that an increase in May 2018 was highly likely.

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:

Credit Metrics

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 Authority 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.

Credit Rating developments

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 a deterioration in its financial position.

Moody's downgraded Rabobank's long-term rating due to its view on the bank's profitability and the long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment and the ratings of the large Australian banks on its view of the rising risks from their exposure to the Australian housing market and the elevated proportion of lending to residential property investors. S&P also upgraded the long-term rating of ING Bank to A+.

Moody's upgraded the baseline credit assessment and the long-term rating of Clydesdale Bank to baa2 and Baa1 respectively and revised the bank's outlook to positive reflecting the agency's view that the bank's return to profitability.

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 Authority expects to produce it's Capital Strategy during 2018/19.

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.

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).

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.

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

4.0 Local Context

On 31st March 2018, the Authority had net borrowing of £92.7m arising from its revenue and capital income and expenditure, a decrease in treasury funds on 2017 of £110.7m. 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	5.5	125.5	131.0
Prior year adjustment	32.2	-32.2	0
Borrowing CFR	**37.7**	**93.3**	**131.0**
Less: Usable reserves	-22.8	5.7	-17.1
Less: Working capital	-32.9	11.7	-21.2
Net borrowing / (investments)	**-18.0**	**110.7**	**92.7**

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; offset by an increase in usable reserves, and a rise in working capital due to the timing of receipts and payments.

The Authority'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 shown 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	0	21.2	21.2	1.84
Short-term borrowing	0	90.6	90.6	0.71
Total borrowing	**0**	**111.8**	**111.8**	**0.92**
Long-term investments	0	0	0	-
Short-term investments	11.5	-4.5	7.0	0.25
Cash and cash equivalents	6.5	5.6	12.1	0.36
Total investments	**18.0**	**1.1**	**19.1**	**0.31**
Net (borrowing) / investments	**18.0**	**-110.7**	**-92.7**	

Note: the figures in the table are from the balance sheet in the Authority's statement of accounts and include accrued interest

5.0 Borrowing Activity

At 31st March 2018, the Authority held £111.8m of loans, an increase of £111.8m 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 Movement £m	31.3.18 Balance £m	31.3.18 Rate %	31.3.18 WAM* years
Public Works Loan Board	0	21.2	21.2	1.84	6.5
Local authorities	0	90.6	90.6	0.71	0.4
Total borrowing	**0**	**111.8**	**111.8**	**0.92**	**1.6**

*Weighted average maturity

The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

In furtherance of these objectives, new borrowing was kept to a minimum in 2017/18. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

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

6.0 Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. The year-end investment position and the year-on-year change in investments is shown in table 4 below.

Table 4: Investment Position (Treasury Investments)

	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Rate %
Banks & building societies (unsecured)	13.8	-11.2	2.6	0.30
UK Government	0	7.1	7.1	0.25
Money Market Funds	4.2	5.3	9.5	0.39
Total investments	**18.0**	**1.2**	**19.2**	**0.31**

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.

The type of investments held during the year has not changed significantly, but deposits with the Debt Management Account Debt Facility (DMADF - part of HM Treasury) have been added. Therefore although overall investment risk was lowered, the average rate of return has decreased from 0.52% to 0.31%. This has been driven by the need for borrowing during the year, and therefore only a relatively low level of investment balances being held, and invested for shorter durations.

The progression of credit risk and return metrics for the Authority's investments managed in-house are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 5 below.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	4.96	A+	100%	51	0.46
30.06.2017	4.70	A+	100%	4	0.41
30.09.2017	4.14	AA-	100%	10	0.18
31.12.2017	4.41	AA-	100%	1	0.32
31.03.2018	3.97	AA	100%	4	0.32
Similar LAs	4.22	AA-	59%	109	1.32%
All LAs	4.24	AA-	69%	35	1.08%

*Weighted average maturity

7.0 Financial Implications

The outturn for debt interest paid in 2017/18 was £358k on an average debt portfolio of £35.0m at an average interest rate of 1.02. This is in line with initial budget expectations and approved additional borrowing (e.g. Castle Quay).

The outturn for treasury investment income received in 2017/18 was £46k on an average credit portfolio of £14.8m at an average interest rate of 0.31%, against a budgeted £69k investment income receivable.

8.0 Other Non-Treasury Holdings and Activity

Although not classed as treasury management activities, the 2017 CIPFA Code now requires the Authority 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.

The Authority also holds £60.4m of investments in equity and loans to its subsidiary companies (Graven Hill and Crown House). This represents an increase of £28.2m on the previous year due to new investments.

These non-treasury investments generated £1.8m of investment income for the Authority, representing a rate of return of 3.9%. This is higher than the return earned on treasury investments but reflects the additional risks to the Authority of holding such investments.

9.0 Compliance Report

The Executive Director of Finance and Governance (Interim) is pleased to report that all treasury management activities undertaken during 2017/18 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy, with one minor exception (see Table 8: Investment Limits 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 / Total debt	111.5	111.5	120	220	✓

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. Total debt was above the operational boundary for 0 days during 2017/18.

Table 8: Investment Limits

	2017/18 Maximum £m	31.3.18 Actual £m	2017/18 Limit £m	Complied
Any single organisation, except the UK Central Government	10	4.8	10	✓
Any group of organisations under the same ownership	10	4.8	10	✓
Any group of pooled funds under the same management	0	0	10	✓
Negotiable instruments held in a broker's nominee account	0	0	10	✓
Foreign countries	8.2	2.6	10	✓
Registered Providers	0	0	10	✓
Unsecured investments with Building Societies	0	0	10	✓
Loans to unrated corporates	0	0	10	✓
Money Market Funds	17.1	9.5	15	See below*

**Money market investments marginally exceeded the approved limit for a period of 12 days from 3-14 January 2018. This was immediately prior to the acquisition of Castle Quay when funds were required to be held at short notice pending completion, as precise dates and values were being negotiated.*

10.0 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 proportion of net principal borrowed was:

	31.3.18 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure	26%	100%	✓
Upper limit on variable interest rate exposure	74%	100%	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

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

	31.3.18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	-	100%	0%	✓
12 months and within 24 months	7%	100%	0%	✓
24 months and within 5 years	-	100%	0%	✓
5 years and within 10 years	19%	100%	0%	✓
10 years and above	-	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.

Principal Sums Invested for Periods Longer than 364 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:

	2017/18 £m	2018/19 £m	2019/20 £m
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	5	5	5
Complied	✓	✓	✓

11.0 Conclusion and Reasons for Recommendations

The annual treasury report is a requirement of the Council's reporting procedures. It covers the treasury activity during 2017/18, including performance against budget and compliance with Indicators.

12.0 Alternative Options and Reasons for Rejection

This report illustrates the Council's Treasury performance for 2017/18 against budget and includes the Annual Treasury Report 2017/18.

The following options have been identified. The approach in the recommendations is believed to be the best way forward:

Option One To review current performance levels, and consider any actions arising.

Option Two To approve or reject the recommendations above or request that Officers provide additional information.

13.0 Implications

Financial and Resource Implications

13.1 There are no specific financial effects arising directly from this report.

Comments checked by:
Kelly Watson, Assistant Director – Finance and Procurement
kelly.watson@cherwellandsouthnorthants.gov.uk 0300 003 0206

Legal Implications

13.2 There are no legal implications arising directly from any outcome of this report.

Comments checked by:
Richard Hawtin, Team Leader – Non-contentious Business
richard.hawtin@cherwellandsouthnorthants.gov.uk 01295 221695

Risk management

13.3 There are no risk implications arising directly from any outcome of this report.

Comments checked by:
Louise Tustian, Team Leader – Insight Team
louise.tustian@cherwellandsouthnorthants.gov.uk 01295 221786

14.0 Decision Information

Wards Affected
All

Links to Corporate Plan and Policy Framework
All

Lead Councillor
Councillor Tony Ilott – Lead Member for Financial Management

Document Information

Appendix No	Title
None	
Background Papers	
None	
Report Author	Ian Robinson Principal Accountant
Contact Information	Direct Dial: 01295 221762 Ian.Robinson@cherwellandsouthnorthants.gov.uk