TREASURY MANAGEMENT ANNUAL REPORT 2017/18

Cabinet – 13 September 2018

Report of the:	Chief Finance Officer
Status:	For recommendation to Cabinet
Also considered by:	Finance Advisory Committee – 4 September 2018
Key Decision:	No

Executive Summary: This report provides the customary review of investment and borrowing activity during 2017/18 as required by the Council's Financial Procedure Rules. The report outlines the strategy adopted during the year, shows the position of the investment and debt portfolios at the beginning and the end of the year and gives details of how the investment fund performed in comparison with previous years and against various benchmarks.

This report supports the Key Aim of Effective Management of Council Resources.

Portfolio Holder Cllr. John Scholey

Contact Officer Roy Parsons, Principal Accountant, Ext. 7204

Recommendation to Finance Advisory Committee: That Cabinet be asked to approve the Treasury Management Annual Report for 2017/18.

Recommendation to Cabinet: That the Treasury Management Annual Report for 2017/18 be approved.

Reason for recommendation: As required by both the Council's Financial Procedure Rules and the CIPFA Code, an annual report of treasury management activity is to be presented to Members for approval.

Background

1 The Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2017/18. This report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

2 During 2017/18 the minimum reporting requirements were that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 21/2/2017)
- a mid year (minimum) treasury update report (Finance Advisory Committee 14/11/2017, Cabinet 7/12/2017)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

3 In addition, regular reports on progress were presented to the Finance Advisory Committee. The Council's treasury management advisers, Link Asset Services, also provided monthly reviews of our investment performance which were forwarded to Members.

4 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

5 This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to treasury management reports before they were reported to the full Council.

Introduction

6 This **annual treasury report** covers:

(a) The Council's treasury position at the beginning and end of the financial year;

(b) the economy and interest rates;

(c) investment strategy for 2017/18;

(d) borrowing requirement and debt;

(e) borrowing rates in 2017/18;

(f) borrowing outturn 2017/18;

(g) investment rates in 2017/18;

(h) investment outturn for 2017/18 and performance;

(i) compliance with treasury management limits and prudential indicators; and

(j) other issues (including an update on the Municipal Bonds Agency).

Treasury position at the beginning and end of the financial year

7 The Council's treasury position at the beginning and end of the financial year was as follows:

	31/3/17 Principal (£000)	Rate Return (%)	Average Life (Years)	31/3/18 Principal (£000)	Rate Return (%)	Average Life (Years)
Total debt	-	-	-	5,250	2.66	29.5
Capital Financing Requirement (CFR)	9,642	-	-	13,807	-	-
Over/(under) borrowing	(9,642)	-	-	(8,557)	-	-
Total investments	29,320	0.54	-	30,960	0.39	-
Net debt/ (investments)	**(29,320)**	**-**	**-**	**(25,710)**	**-**	**-**

8 The investment portfolio at the beginning and end of the financial year appears at Appendix A, whilst an analysis by maturity and repayment due dates appears at Appendix B.

The economy and interest rates

9 During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year which meant that growth was the slowest for the first half of any year since 2012. The main reason for this was the sharp increase in inflation caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure.

10 However, growth did pick up modestly in the second half of 2017. Consequently, market expectations during the autumn, rose significantly

that the Bank of England's Monetary Policy Committee (MPC) would be heading in the direction of imminently raising Bank Rate. The minutes of the MPC meeting of 14 September indicated that the MPC was likely to raise Bank Rate very soon. The 2 November MPC quarterly Inflation Report meeting duly delivered by raising Bank Rate from 0.25% to 0.50%.

11 The 8 February MPC meeting minutes then revealed another sharp hardening in MPC warnings on a more imminent and faster pace of increases in Bank Rate than had previously been expected.

12 Market expectations for increases in Bank Rate, therefore, shifted considerably during the second half of 2017/18 and resulted in investment rates from 3 – 12 months increasing sharply during the spring quarter. A further increase in Bank Rate to 0.75% was delivered on 2 August 2018.

13 Public Works Loan Board (PWLB) borrowing rates increased correspondingly to the above developments with the shorter term rates increasing more sharply than longer term rates. In addition, UK gilts have moved in a relatively narrow band this year, (within 25 bps for much of the year), compared to US treasuries. During the second half of the year, there was a noticeable trend in treasury yields being on a rising trend with the US Federal Reserve raising rates by 0.25% in June, December and March, making six increases in all from the floor. The effect of these three increases was greater in shorter terms, around 5 year, rather than longer term yields.

14 The major UK landmark event of the year was the inconclusive result of the general election on 8 June. However, this had relatively little impact on financial markets.

Investment strategy for 2017/18

15 The expectation for interest rates within the treasury management strategy for 2017/18 anticipated that Bank Rate would not start rising from 0.25% until quarter 2, 2019 and then only increase once more before March 2020. There would also be gradual rises in medium and longer term fixed borrowing rates during 2017/18 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

16 During 2017/18, longer term PWLB rates were volatile but with little overall direction, whereas shorter term PWLB rates were on a rising trend during the second half of the year.

The borrowing requirement and debt

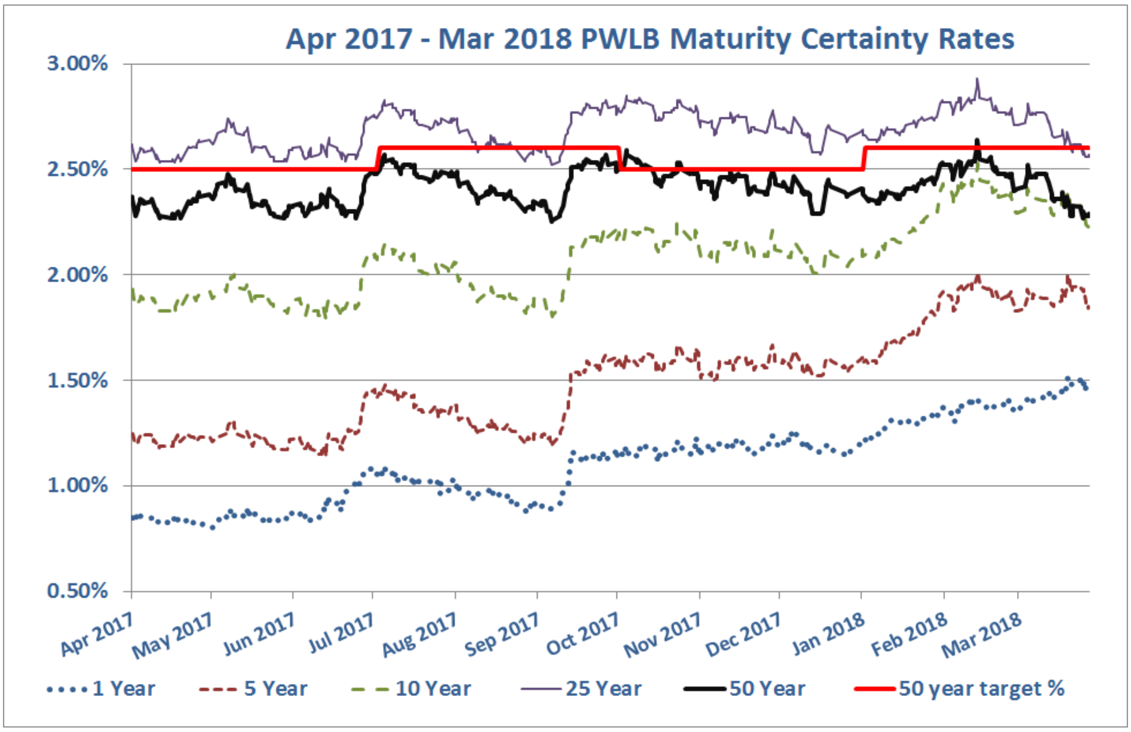
17 The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR) and is shown in the following table:

	31/3/17 Actual (£000)	31/3/18 Actual (£000)
CFR General Fund	9,642	13,807
Total CFR	9,642	13,807

Borrowing rates 2017/18

PWLB certainty maturity borrowing rates

18 As depicted in the graph below, PWLB 25 and 50 year rates have been volatile during the year with little consistent trend. However, shorter rates were on a rising trend during the second half of the year and reached peaks in February / March. During the year, the 50 year PWLB target (certainty) rate for new long term borrowing was 2.50% in quarters 1 and 3 and 2.60% in quarters 2 and 4. The graph for PWLB rates shows, for a selection of maturity periods, the average borrowing rates, the high and low points in rates, spreads and individual rates at the start and the end of the financial year.



Borrowing outturn for 2017/18

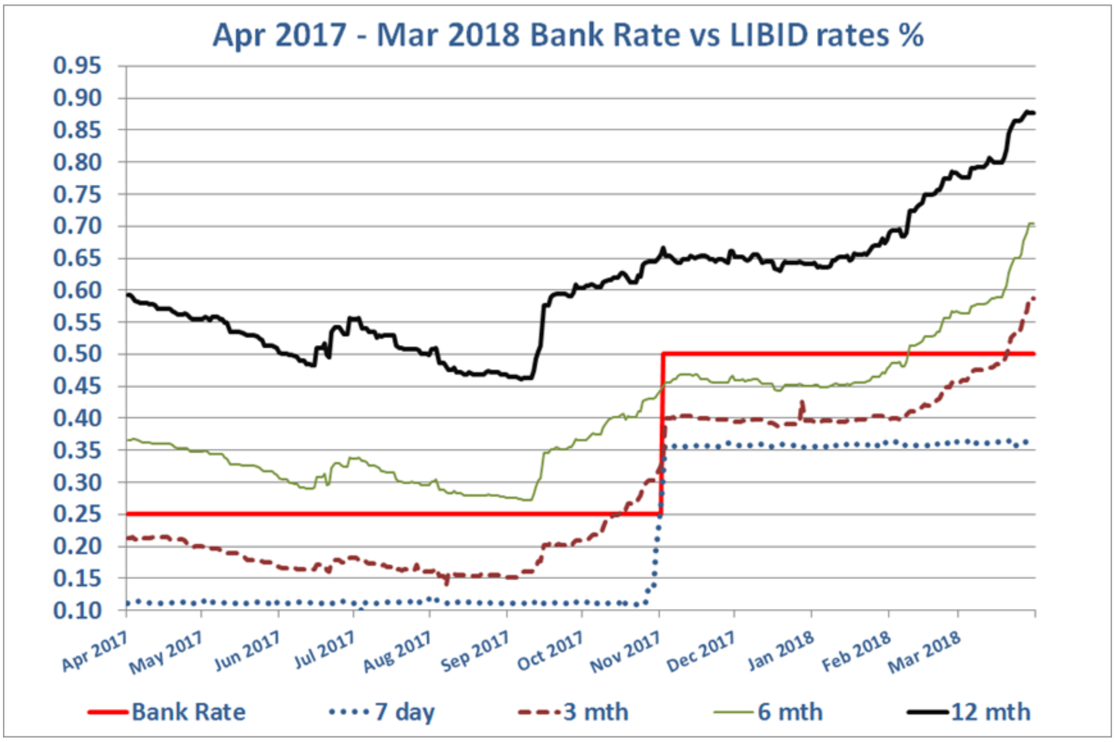
19 The following loan was taken during the year:

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£5.25m	Fixed interest rate - Annuity	2.66%	3/11/2040

20 There were no repayments or rescheduling of debt during 2017/18.

Investment rates in 2017/18

21 Investment rates for 3 months and longer have been on a rising trend during the second half of the year in the expectation of Bank Rate increasing from its floor of 0.25%, and reached a peak at the end of March. Bank Rate was duly raised from 0.25% to 0.50% on 2/11/17 and remained at that level for the rest of the year. However, further increases are expected over the next few years. Deposit rates continued into the start of 2017/18 at previous depressed levels due, in part, to a large tranche of cheap financing being made available under the Term Funding Scheme to the banking sector by the Bank of England; this facility ended on 28/2/18.



Investment outturn for 2017/18 and performance

22 The Council's investment policy is governed by Ministry of Housing Communities and Local Government (MHCLG) guidance, which has been implemented in the annual investment strategy approved by the Council on 21 February 2017. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc).

23 The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

24 Appendix C shows the performance of the fund during 2017/18 both in table and graphical form. The table shows the average percentage return on the fund, both monthly and for the whole year and compares them with the average 7-day and 3-month London Interbank Bid (LIBID) rates. The average return achieved by each broker is only a very basic measure of performance, because returns will depend on the number and length of each investment he/she is asked to carry out. If a particular broker is only asked to place short term investments, he/she may well not achieve the same overall rate as a broker who predominantly handles longer term investments for us.

25 The graph shows actual monthly receipts for 2015/16, 2016/17 and 2017/18 plus budgeted monthly receipts for 2017/18. The monthly interest budget has been profiled in line with the previous year's monthly weighted average principal.

26 Over the course of the year interest receipts amounted to £168,400 compared with a budget of £157,000.

27 In 2017/18 the average return on the Council's investments was roughly in line with that of our neighbouring authorities. Our overall rate of return was 0.39% compared with 0.67% for Tonbridge & Malling Borough Council and 0.45% for Gravesham Borough Council. It should be noted that investment returns are notoriously difficult to compare as they have often been compiled on a different basis (for example, whether or not interest has been compounded, whether or not cashflow generated balances have been included, whether or not externally managed funds have been included and whether or not the figures are net of borrowings).

28 Our treasury management advisers recommend the 3-month LIBID figure as a benchmark. This reflects a more realistic neutral investment position for core investments with a medium term horizon and a rate which is more stable with less fluctuation caused by market liquidity. Historically, this rate has been slightly higher than the 7-day rate and therefore more challenging a comparator, but one which does not necessitate a significantly increased level of risk. The figures calculated by our advisers for these two benchmarks are as follows:

- 7-day LIBID uncompounded 0.2145%

- 3-month LIBID uncompounded 0.2861%

Compliance with treasury management limits and prudential indicators

29 The Council operates to approved prudential indicators for treasury management as contained in the Treasury Management Strategy Statement (TMSS). The TMSS for 2017/18 was part of the annual treasury strategy reported to Council on 21 February 2017. The approved limits exist to regulate short-term borrowing for operational cash flow fluctuations, as well as long-term borrowing for financing capital investments. Additionally, the limits aim to mitigate against fluctuations in interest rates.

30 The Council's treasury management limits and indicators for 2017/18 are compared with the outturn position and previous year's outturn position in Appendix D.

Other issues

Update on the Municipal Bonds Agency

31 During 2014/15, the Council invested £50,000 to become an equity shareholder in the Local Capital Finance Company, which was set up by the Local Government Association under the name of the Municipal Bonds Agency (MBA). This was a 'Policy Investment' and does not form part of the treasury management strategy. The purpose of the agency is to facilitate borrowing by local authorities at rates that are expected to be more competitive than those of the Public Works Loan Board (PWLB). There are 56 shareholder councils.

32 The primary focus of the agency has been delivering its first debt financing and has engaged with numerous authorities with regard to their debt finance requirements. The agency has received a strong confidential credit rating and has had its "Framework Agreement" approved by at least 21 councils, who can now avail themselves of borrowing from the agency.

33 The agency is still preparing for its initial debt offering and related financing to local authorities and this process has taken longer than originally anticipated. Accordingly, the Board of Directors implemented a series of measures to reduce the cost base during the last year.

34 The Local Government Association (LGA), having been instrumental in the establishment of the MBA and as its largest shareholder, with retained powers, has provided the Board of Directors with a letter of comfort confirming it will stand behind the agency. The LGA has offered its ongoing support in promoting the agency and ensuring its business continuity going forward. The support has been offered for a period of 10 years from 18/1/2018 and the Board has no reason to believe that it might be withdrawn. Hence the Board view the agency as a going concern in their latest set of accounts.

Revised CIPFA Codes

35 In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued a revised Treasury Management Code and Cross Sectoral Guidance Notes, and a revised Prudential Code.

36 A particular focus of these revised codes was how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the Authority at a much higher level than can be attained by treasury investments. One recommendation was that local authorities should produce a new report to members to give a high level summary of the overall capital strategy and to enable members to see how the cash resources of the Authority have been apportioned between treasury and non-treasury investments. Officers will report to members when the implications of these new codes have been assessed as to the likely impact on this Authority.

Markets in Financial Instruments Directive II (MiFID II)

37 The EU set the date of 3 January 2018 for the introduction of regulations under MiFID II. These regulations govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This has had little effect on this Authority apart from having to fill in forms sent by each institution dealing with this Authority and for each type of investment instrument we use, apart from for cash deposits with banks and building societies.

Key Implications

Financial

38 The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority. The security of its capital and liquidity of its investments is of paramount importance.

Legal Implications and Risk Assessment Statement

39 Under Section 151 of the Local Government Act 1972, the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority, including securing effective arrangements for treasury management.

40 This annual review report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009.

41 Treasury management has two main risks :

- Fluctuations in interest rates can result in a reduction in income from investments; and

- A counterparty to which the Council has lent money fails to repay the loan at the required time.

42 Consideration of risk is integral in our approach to treasury management. However, this particular report has no specific risk implications as it is not proposing any new actions, but merely reporting performance over the last year.

Equality Assessment

43 The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act. There is no perceived impact on end users.

Conclusions

44 The overall return on the Council's investments was above budget in 2017/18 by approximately £11,400 and the percentage return exceeded the recognised benchmarks.

45 The economic situation both globally and within the Eurozone remains volatile, and this will have consequences for the UK economy. Treasury management in the past financial year was conducted against this background and with a cautious investment approach.

Appendices:	Appendix A – Investment portfolio at start and end of financial year
	Appendix B – Analysis of investment portfolio by maturity and repayment due dates
	Appendix C - Investment performance in 2017/18
	Appendix D – Prudential and treasury indicators
Background Papers:	Treasury Management Strategy for 2017/18 - Council 21 February 2017

Adrian Rowbotham
Chief Finance Officer