TREASURY MANAGEMENT ANNUAL REPORT 2018/19

Cabinet – 12 September 2019

Report of the:	Chief Finance Officer
Status:	For decision
Also considered by:	Finance & Investment Advisory Committee – 3 September 2019
Key Decision:	No

Executive Summary: This report provides the customary review of investment and borrowing activity during 2018/19 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. Matthew Dickins

Contact Officer Roy Parsons, Principal Accountant - Ext 7204

Recommendation to Finance & Investment Advisory Committee: That Cabinet be asked to approve the Treasury Management Annual Report for 2018/19.

Recommendation to Cabinet: That the Treasury Management Annual Report for 2018/19 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 2018/19. 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 2018/19 the minimum reporting requirements were that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 20/02/2018)
- a mid year (minimum) treasury update report (former Finance Advisory Committee 15/11/2018, Cabinet 06/12/2018)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

3 The Council's treasury management advisers, Link Asset Services, also provided monthly reviews of our investment performance which were emailed 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 all of the above treasury management reports by the former Finance Advisory Committee before they were reported to Cabinet or the full Council. Member training was undertaken during the year on 14 November 2018 in order to support Members' scrutiny role.

Introduction

6 This **annual treasury report** covers:

(a) The Council's capital expenditure and financing;

(b) treasury position at the beginning and end of the financial year

(c) the economy and interest rates;

(d) investment strategy for 2018/19;

(e) borrowing requirement and debt;

(f) borrowing strategy in 2018/19;

(g) borrowing outturn 2018/19;

(h) investment outturn for 2018/19 and performance;

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

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

The Council's capital expenditure and financing

7 The Council undertakes capital expenditure on long-term assets. These activities may either be:

- financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no impact on the Council's borrowing need; or

- if insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

8 The actual capital expenditure forms one of the required prudential indicators. The following table shows the actual capital expenditure and how this was financed.

	31/3/18 Actual (£000)	**31/3/19 Actual (£000)**
Capital expenditure	10,600	16,557
Financed in year	(6,285)	(7,195)
Unfinanced capital expenditure	4,315	9,362

The unfinanced capital expenditure was funded by internal borrowing.

Treasury position at the beginning and end of the financial year

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

	31/3/18 Principal (£000)	**Rate Return (%)**	**Average Life (Years)**	**31/3/19 Principal (£000)**	**Rate Return (%)**	**Average Life (Years)**
Total debt	5,250	2.66	29.5	5,190	2.66	28.5
Capital Financing Requirement (CFR)	13,807	-	-	23,019	-	-

Over/(under) borrowing	(8,557)	-	-	(17,829)	-	-
Total investments	30,960	0.39	-	21,315	0.72	-
Net debt/ (investments)	**(25,710)**	**-**	**-**	**(16,125)**	**-**	**-**

10 The maturity structure of the debt portfolio was as follows:

	31/3/18 Actual (£000)	**31/3/19 Actual (£000)**
Under 12 months	-	-
12 months and over and within 20 years	-	-
20 years and over and within 30 years	5,250	5,190
30 years and over and within 50 years	-	-

11 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.

12 All investments were for periods up to one year in duration.

The economy and interest rates

13 **UK.** After weak economic growth of only 0.2% in quarter one of 2018, growth picked up to 0.4% in quarter 2 and to a particularly strong 0.7% in quarter 3, before cooling off to 0.2% in the final quarter. Given all the uncertainties over Brexit, this weak growth in the final quarter was as to be expected. However, some recovery in the rate of growth is expected going forward. The annual growth in Q4 came in at 1.4% y/y confirming that the UK was the third fastest growing country in the G7 in quarter 4.

14 After the Bank of England’s Monetary Policy Committee (MPC) raised Bank Rate from 0.5% to 0.75% in August 2018, it is little surprise that they have abstained from any further increases since then. We are unlikely to see any

further action from the MPC until the uncertainties over Brexit clear. If there were a disorderly exit, it is likely that Bank Rate would be cut to support growth. Nevertheless, the MPC has been having increasing concerns over the trend in wage inflation, which peaked at a new post financial crisis high of 3.5% (excluding bonuses) in the three months to December before falling only marginally to 3.4% in the three months to January. British employers ramped up their hiring at the fastest pace in more than three years in the three months to January as the country's labour market defied the broader weakness in the overall economy as Brexit approached. The number of people in work surged by 222,000, helping to push down the unemployment rate to 3.9%, its lowest rate since 1975. Correspondingly, the total level of vacancies has risen to new highs.

15 As for CPI inflation itself, this has been on a falling trend since peaking at 3.1% in November 2017, reaching a new low of 1.8% in January 2019 before rising marginally to 1.9% in February. However, in the February 2019 Bank of England Inflation Report, the latest forecast for inflation over both the two and three year time horizons remained marginally above the MPC's target of 2%.

16 The rise in wage inflation and fall in CPI inflation is good news for consumers as their spending power is improving in this scenario as the difference between the two figures is now around 1.5%, i.e. a real terms increase. Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months.

17 **Brexit.** The Conservative minority government has so far been unable to muster a majority in the Commons over its Brexit deal. The EU set a deadline of 12 April 2019 for the House of Commons to propose what form of Brexit it would support and this was further extended to 31 October 2019. If nothing happens by this date, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

18 **USA.** President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in 2018 which generated an upturn in the strong rate of growth; this rose from 2.2%, (annualised rate) in quarter 1 of 2018 to 4.2% in quarter 2, 3.5% in quarter 3 and then back to 2.2% in quarter 4. The annual rate came in at 2.9% for 2018, just below President Trump's aim for 3% growth. The strong growth in employment numbers has fed through to an upturn in wage inflation which hit 3.4% in February, a decade high point. However, CPI inflation overall fell to 1.5% in February, a two and

a half year low, and looks to be likely to stay around that number in 2019 i.e. below the Federal Reserve (Fed) target of 2%. The Fed increased rates by another 0.25% in December to between 2.25% and 2.50%, this being the fourth increase in 2018 and the ninth in the upward swing cycle. However, the Fed now appears to be edging towards a change of direction and admitting there may be a need to switch to taking action to cut rates over the next two years. Financial markets are now predicting two cuts of 25 bps by the end of 2020.

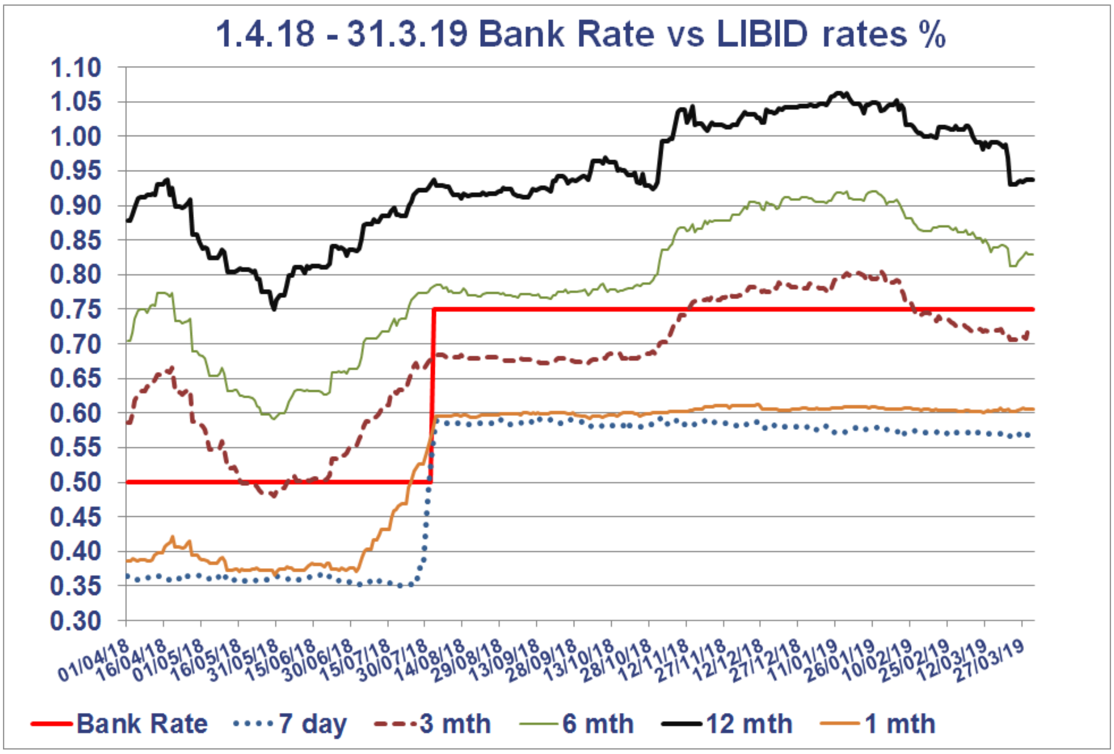
19 **Eurozone (EZ).** The European Central Bank (ECB) provided massive monetary stimulus in 2016 and 2017 to encourage growth in the EZ and that produced strong annual growth in 2017 of 2.3%. However, since then the ECB has been reducing its monetary stimulus measures and growth has been weakening - to 0.4% in quarters 1 and 2 of 2018, and then slowed further to 0.2% in quarters 3 and 4; it is likely to be only 0.1 - 0.2% in quarter 1 of 2019. The annual rate of growth for 2018 was 1.8% but is expected to fall to possibly around half that rate in 2019. The ECB completely ended its programme of quantitative easing purchases of debt in December 2018, which means that the central banks in the US, UK and EU have all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in growth, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), prompted the ECB to take new measures to stimulate growth. With its refinancing rate already at 0.0% and the deposit rate at -0.4%, it has probably reached the limit of cutting rates. At its March 2019 meeting it said that it expects to leave interest rates at their present levels "at least through the end of 2019", but that is of little help to boosting growth in the near term. Consequently, it also announced a third round of Targeted Longer Term Refinancing Operations (TLTROs); this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank is making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank's eligible loans.

20 **China.** Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

21 **Japan** - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

22 **World growth.** Equity markets are currently concerned about the synchronised general weakening of growth in the major economies of the world. They fear there could even be a recession looming up in the US, though this fear is probably overdone.

Investment strategy for 2018/19



23 Investment returns remained low during 2018/19. The expectation for interest rates within the treasury management strategy for 2018/19 was that Bank Rate would rise from 0.50% to 0.75%. At the start of the financial year, and after UK GDP growth had proved disappointingly weak in the first few months of 2018, the expectation for the timing of this increase was pushed back from May to August 2018. Investment interest rates were therefore on a gently rising trend in the first half of the year after April, in anticipation that the MPC would raise Bank Rate in August. This duly happened at the MPC meeting on 2 August 2018. During this period, investments were, therefore, kept shorter term in anticipation that rates would be higher later in the year.

24 It was not expected that the MPC would raise Bank Rate again during 2018/19 after August in view of the fact that the UK was entering into a time of major uncertainty with Brexit due in March 2019. Value was therefore sought by placing longer term investments after 2 August where cash balances were sufficient to allow this.

25 Investment rates were little changed during August to October but rose sharply after the MPC meeting of 1 November 2018 was unexpectedly hawkish about their perception of building inflationary pressures, particularly from rising wages. However, weak GDP growth data after December, plus increasing concerns generated by Brexit, resulted in investment rates falling back again.

26 Continued uncertainty in the aftermath of the 2008 financial crisis has 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.

The borrowing requirement and debt

27 The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR)

28 In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2017/18) plus the estimates of any additional capital financing requirement for the current (2018/19) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2018/19. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31/3/18 Actual (£000)	**31/3/19 Actual (£000)**
CFR General Fund	13,807	23,019
Gross borrowing position	5,250	5,190
Over/(under) funding of CFR	(8,557)	(17,829)

29 The "authorised limit" is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2018/19 the Council has maintained gross borrowing within its authorised limit.

30 The "operational boundary" is the expected borrowing position of the Council during the year. Periods where the actual position is either below or

over the boundary are acceptable subject to the authorised limit not being breached.

31 “Actual financing costs as a proportion of net revenue stream” is an indicator identifying the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream.

	2018/19 (£000)
Authorised limit	35,000
Maximum gross borrowing position during the year	5,250
Operational boundary	30,000
Average gross borrowing position	5,220
Financing costs as a proportion of net revenue stream	0.98%

Borrowing strategy in 2018/19

32 During 2018/19 the Council maintained an under-borrowed position. This meant that the capital borrowing need (the Capital Financing Requirement) was not fully funded with loan debt, as cash supporting the Council’s reserves, balances and cash flow was used as an interim measure. This is known as internal borrowing. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

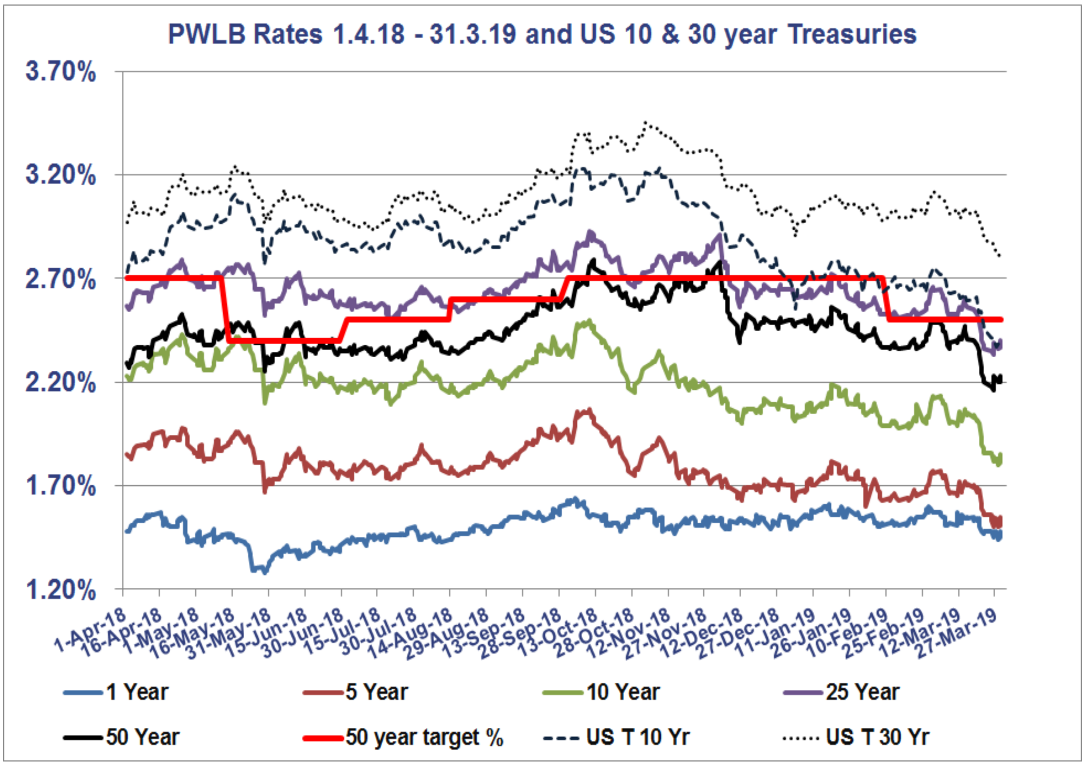
33 A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

34 The policy of avoiding new borrowing by running down spare cash balances, has served the Council well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

PWLB certainty maturity borrowing rates

35 Interest rate forecasts anticipated only gradual rises in medium and longer term fixed borrowing rates during 2018/19 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Forecasts from our treasury management advisors, Link Asset Services, together with historical rates appear below:

Link Asset Services Interest Rate View	12.2.18												
	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.50%
5yr PWLB Rate	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%
10yr PWLB Rate	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%



36 Since PWLB rates peaked during October 2018, most PWLB rates have been on a general downward trend, though longer term rates did spike upwards again during December, and (apart from the 1 year rate) reached lows for the year at the end of March. There was a significant level of correlation between movements in US Treasury yields and UK gilt yields, which

determine PWLB rates. The Fed in America increased the Fed Rate four times in 2018, making nine increases in all in this cycle, to reach 2.25% – 2.50% in December. However, it had been giving forward guidance that rates could go up to nearly 3.50%. These rate increases and guidance caused Treasury yields to also move up. However financial markets considered by December 2018, that the Fed had gone too far, and discounted its expectations of further increases. Since then, the Fed has also come round to the view that there are probably going to be no more increases in this cycle. The issue now is how many cuts in the Fed Rate there will be and how soon, in order to support economic growth in the US. But weak growth now also looks to be the outlook for China and the EU so this will mean that world growth as a whole will be weak. Treasury yields have therefore fallen sharply during 2019 and gilt yields / PWLB rates have also fallen.

Borrowing outturn for 2018/19

37 No borrowing was undertaken during the year. The following is the only loan outstanding:-

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£5.25m	Fixed interest rate - Annuity	2.66%	3/11/2047

38 There were no repayments or rescheduling of debt during 2018/19.

Investment outturn for 2018/19 and performance

39 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 20 February 2018. 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).

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

41 Appendix C shows the performance of the fund during 2018/19 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.

42 The graph shows actual monthly receipts for 2016/17, 2017/18 and 2018/19 plus budgeted monthly receipts for 2018/19. The monthly interest budget has been profiled in line with the previous year's monthly weighted average principal.

43 Over the course of the year interest receipts amounted to £270,700 compared with a budget of £157,000.

44 In 2018/19 the average return on the Council's investments was roughly in line with that of our neighbouring authorities. Our overall rate of return was 0.72% compared with 0.99% for Tonbridge & Malling Borough Council and 0.76% 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). Note that this Council has also invested in property which is not included in this report.

45 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 0.5068%
- 3-month LIBID uncompounded 0.6753%

Compliance with treasury management limits and prudential indicators

46 The Council operates to approved prudential indicators for treasury management as contained in the Treasury Management Strategy Statement (TMSS). The TMSS for 2018/19 was part of the annual treasury strategy reported to Council on 20 February 2018. 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.

Other issues

Update on the Municipal Bonds Agency

47 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.

48 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 25 councils, who can now avail themselves of borrowing from the agency.

49 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 in recent years. The latest set of accounts, covering the year to 30 November 2018, show that the agency reduced its operating expenditure to £733,000 from £1.1m in the previous year.

50 The agency has recently announced that it is to outsource its management and operations to an external provider. A tender has been issued for a "managed service provider" to develop a new operating model and corporate structure. The agency has also stated that the restructuring meant that "the directors have a reasonable expectation that the company will be able to provide financing to local authorities below the PWLB rate".

Non-treasury management investments

51 Members will be aware that significant property purchases have been carried out in recent years which are regarded as non-treasury investments. Further details are contained within Property Investment Strategy reports that are submitted to Members separately.

Key Implications

Financial

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

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.

This annual review report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2017.

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.

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

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

The overall return on the Council's investments was above budget in 2018/19 by approximately £113,700 and the percentage return exceeded the recognised benchmarks. Whilst returns exceeded budget, inflation continues to outpace investment returns, leading to the gradual erosion of capital in real terms.

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 2018/19
Background Papers:	Treasury Management Strategy for 2018/19 - Council 20 February 2018

Adrian Rowbotham
Chief Finance Officer