CABINET
25 JULY 2019

ANNUAL TREASURY REPORT 2018/2019

1. Summary

1.1 To inform Cabinet of the outturn position (subject to audit) of the Council's investments and borrowing for the 2018/2019 financial year.

1.2 To inform Cabinet of the outturn position of the Council's treasury indicators.

2. RECOMMENDATIONS

2.1 That Members note the outturn for the Council's treasury management operations for 2018/2019.

2.2 That Members note the outturn for the Council's treasury indicators.

3. Background and Discussion

3.1 The CIPFA definition of Treasury Management is *"the management of the Council's investments and cash flows, its banking and its capital market transactions; the effective control of the risks associated with those activities and the pursuit of optimum performance consistent with those risks".*

The Treasury Management Code requires public sector authorities to determine an annual Treasury Management Strategy and as a minimum, formally report on their treasury activities and arrangements to Cabinet mid-year and after the year-end. These reports enable those tasked with implementing policies and undertaking transactions to demonstrate they have properly fulfilled their responsibilities, and enable those with ultimate responsibility/governance of the treasury management function to scrutinise and assess its effectiveness and compliance with policies and objectives.

Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

3.2 This report:
a) Is prepared in accordance with the latest CIPFA Treasury Management Code of Practice and the Prudential Code. The Treasury Strategy Statement for 2018/2019 was adopted at the GAC meeting of 26 February 2018. The 2017

Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 26 February 2018.

b) Presents details of the investment activity – both on internally and externally managed funds;

c) Details the current position on the debt incurred in March 2012 for Housing Self Financing Reform

d) Reports on the risk implications of treasury decisions and transactions;

e) Gives details of the outturn position on treasury management transactions in 2018/2019;

f) Confirms compliance with treasury limits and treasury Indicators.

This report is to Cabinet and will, in addition, be reviewed by the Treasury Management Panel which is responsible for scrutiny of the Treasury Management function.

3.3 Economic Background for 2018/2019

The following has been provided by the Council's Treasury advisors, Arlingclose and provides the economic background in which the Council operated its treasury function during 2018/2019.

After spiking at over $85/barrel in October 2018, oil prices fell back sharply by the end of the year, declining to just over $50 in late December before steadily climbing toward $70 in April 2019. UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year/year, just above the consensus forecast but broadly in line with the Bank of England's February inflation Report. The most recent labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

After rising to 0.6% in the third calendar quarter from 0.4% in the second, fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However, a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.

With the 29th March 2019, the original EU 'exit day' now been and gone, having failed to pass a number of meaningful votes in Parliament, including shooting down Theresa May's deal for the third time, MPs voted by a majority of one (313 to 312) to force the prime minister to ask for an extension to the Brexit process beyond 12th April in order to avoid a no-deal scenario. Recent talks between the Conservative and Labour parties to try to reach common ground on a deal which may pass a vote by MPs have yet to yield any positive results. The EU must grant any extension and its leaders have been clear that the terms of the deal are not up for further negotiation. The ongoing uncertainty continues to weigh on sterling and UK markets.

While the domestic focus has been on Brexit's potential impact on the UK economy, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to be showing signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

Financial Markets: December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE 100 and FTSE All Share indices were both around 10% higher than at the end of 2018.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new-year – the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period. The increase in Bank Rate pushed up money market rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury yields were lower than US 3 month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling 1.8% year on year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China.

Credit background*:* Credit Default Swap (CDS) spreads drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms.

The ring fencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/NatWest Bank plc) transferred their business lines into retail (ring-fenced) and investment banking (non ring-fenced entities).

In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty, following this move with the same treatment for UK banks and a number of government-related entities.

There were minimal other credit rating changes during the period. Moody's revised the outlook on Santander UK to positive from stable to reflect the bank's expected issuance plans which will provide additional protection for its senior unsecured debt and deposits.

3.4 The Council's Treasury Position as at 31 March 2019:

On 31st March 2019, the Council had investments (net of internal borrowing) of £109.11m arising from its net cash flow position. 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 are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.03.19 Actual £m
General Fund CFR	0
HRA CFR	55.85
Total CFR	**55.85**
External borrowing	55.85
Internal (over) borrowing	**0**
Less: General Reserve	3.74

HRA Balances	12.33
Earmarked/capital reserves	51.11
Less: Working capital and collection fund balances	41.93
Investments net of internal borrowing	**109.11**

The treasury management position at 31st March 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31st March 2018 £m	**31st March 2019 £m**
Short term borrowing (amounts falling due within one year)	(4.44)	(4.44)
Long-term borrowing	(55.85)	(51.41)
Total Borrowing	**(60.29)**	**(55.85)**
Long-term investments	43.14	61.84
Short-term investments	33.08	34.11
Cash & Cash Equivalents	20.70	13.16
Total Investments	**96.92**	**109.11**
Year End Net Treasury Position	**36.63**	**53.26**

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

3.5 Debt Portfolio as at 31st March 2019

The Council has now had a debt portfolio for seven full financial years, the debt having been taken on as a result of the Housing Self Financing regime on 28th March 2012. The total interest paid was £1.45m; this figure is adjusted in the accounts to reflect the actual interest due for the financial year. The adjusted interest figure is £1.44m. The movement in the debt is shown in the table below:

Table 3: Borrowing position

`	**Balance on 31/3/2018 £m**	**Debt repaid £m**	**Balance on 31/3/2019 £m**
Long Term Borrowing (Maturity fixed rate Loans)	5.00	0	5.00
Long Term Borrowing (EIP fixed rate Loans)	55.29	(4.44)	50.85
Total Borrowing*	**60.29**	**(4.44)**	**55.85**

Average Rate % / Life (yrs.)	2.45% / 13.99 yrs.		2.47% / 12.62 yrs.

Note*: The value of Long term borrowing that falls due within one year is re-defined at year end as short term borrowing. All the short- and long-term borrowing in the table above relate to loans for HRA self-financing.

The Council did not enter into any new long term borrowing during 2018/19. Should it be required to borrow new loans, the Council has been eligible to apply for new loans from the Public Works Loans Board (PWLB) at the PWLB Certainty Rate (0.2% below the PWLB standard rate). This eligibility is for a 12 month period from 1st November 2018.

The Council's strategy permits temporary borrowing to meet overnight or short-term Cashflow deficits and the prudent and efficient management of the Council's treasury position. There was no temporary borrowing during 2018/2019.

3.6 Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2018/19 the Council's investment balances have ranged between £103.6m and £142.7m. Table 4 below shows the year-end investment position and the total investments made and maturities/investments sold.

Table 4: Treasury Investment Position

Investments	Balance on 31/03/2018 £m	Investments made £m	Maturities/ Investments sold £m	Balance on 31/03/2019 £m
Short term investments Instant Access Deposit Accounts	6.00	14.59	(20.59)	0.00
Money Market Funds	14.70	154.85	(156.39)	13.16
External Pooled Funds[1]	76.22	24.00	(4.06)	95.95
Total Investments	**96.92**	**193.44**	**(181.04)**	**109.11**

[1] External fund holdings are re-valued at year end and carried at Fair Value.

Both the CIPFA code and government guidance require the Council to invest its funds prudently, and to have regard to 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, and given the increasing risk and low returns from short-term unsecured bank investments, the Council continued to keep the majority of investments in diversified funds through the use of money market funds and externally managed pooled funds. A small amount of investments were kept directly with banks in call accounts which were able to be recalled instantly if needed. The risk and return metrics are shown in the extract from Arlingclose's quarterly benchmarking in table 5 below.

<u>Table 5: Investment Benchmarking – Treasury investments (managed in-house)</u>

	Credit Score	**Credit Rating**	**Bail-in Exposure**	**WAM* (days)**	**Rate of Return (income only) internally and externally managed funds**
31.03.2018	4.77	A+	100%	1	1.60%
31.03.2019	4.84	A+	100%	1	2.15%
Similar LAs	4.13	AA-	53%	86	1.80%
All LAs	4.20	AA-	55%	29	1.43%

The Council's in-house investments generated a return of £0.20m at an average rate of return of 0.61%.

The Council's best performing investments in 2018/19 were the externally managed pooled funds which are spread over asset classes with the potential for higher return. The Council has investments in cash plus, bond, equity income, multi-asset and property funds which allow the Council to diversity into asset classes other than cash without the need to manage and own the underlying investments. The funds which are operated on a variable net asset value (VNAV) basis offer diversification of investment risk, coupled with the service of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short term. These generated an average total return of 2.36%, comprising a £2.29m (2.58%) income return and an unrealised capital loss of £0.2m (-0.24%). Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives is regularly reviewed.

The increase/decrease of monies invested in externally managed pooled funds is shown in table 2 in Appendix A.

Throughout the year, the Council continued to invest in Money Market Funds and instant access accounts. Rates on investments in MMFs ranged between 0.39% and 0.91% reflecting the funds' main objective of providing high same-day liquidity and high security of capital. Call-account rates ranged between 0.15% and 0.55% reflecting the low Bank of England base rate.

Details of the in-house investments and externally managed funds held at 31st March 2019 are shown in Appendix A.

Readiness for Brexit: With little by way of political clarity as to the exact date on whether there would be an agreed deal prior to leaving the EU and to be prepared for the outside chance of a particularly disruptive Brexit (such as last-minute no-deal) on 29th March, the Authority ensured there were enough accounts open at UK-domiciled banks and Money Market Funds to hold sufficient liquidity over the year end and that its account with the Debt Management Account Deposit Facility (DMADF) remained available for use in an emergency.

3.7 Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The Council held £11.15m of such investments in directly owned property. These properties were purchased many years ago and not originally as commercial investments, but for the wider benefits of the Borough, including improving the area and for economic development. The reason for the Council continuing to hold these properties is partially to make a profit and to receive income. These properties therefore fall under the definition of commercial investments. A full list of the Council's non-treasury investments is available at Appendix B.

3.8 Budgeted Income and Outturn – General Fund

The General Fund net budget for interest receivable in 2018/2019 was £0.65m with probable outturn reported in February as £1.5m. The budget is after the statutory transfer of interest to other funds – mainly the Housing Revenue Account. The Council has achieved investment income of £2.47m which is broken down as follows:

	2018/19 Outturn **£'000's**
Interest receivable on internally managed funds	195
Other Interest receivable [2]	1
Gains on sale of externally managed fund	61
Loss on sale of externally managed fund	(4)
Dividends - externally managed funds	2,290
	2,543
Less: 1) credit to the HRA (in accordance with the detailed provisions of the Local Government and Housing Act 1989), 2) and other minor items [3]	 (76) (2)
General Fund Net Investment Income	**2,465**

[2] Interest is also received on other items e.g. car loans made to staff, default interest on late contractual payments

[3] Interest is payable on the Kidd Legacy Funds and the sums held for Leaseholders in respect of future liabilities.

At the transition to IFRS 9 the Council made an irrevocable election to treat investments in long term pooled equity, multi asset, property and bond funds as fair value through other comprehensive income (FVOCI). However, conflicting views exist on the eligibility of these funds for election. Whilst the Council obtains further advice around the eligibility of these funds for election and seeks to come to a common view with its auditors, it has been considered sensible to account for these funds as FVPL (Fair Value through Profit & Loss) in the 2018/19 accounts. This is per the audit view. The Council will re-state the accounts should the outcome of the legal opinion find that the election is valid. The fair value of the longer-dated strategic externally managed pooled funds that the Council had elected at transition to IFRS 9 and new funds elected upon purchase during the year totalled £61.8m at 31/3/2019.

The interest budget has been exceeded for the year due to the strong income returns received from the externally managed pooled funds. These funds have performed well during the year resulting in large dividend payments, but there is no guarantee that future performance or income distribution will follow this trend.

3.9 Budgeted Income and Outturn – Housing Revenue Account

	2018/2019 Budget £'000	2018/2019 Outturn £'000
Interest Receivable - Investment Income on cash flow balances[1]	41	76
Interest Payable – PWLB[3]	(1,438)	(1,438)
Net HRA position	**(1,397)**	**(1,362)**

[1] This item is credited to the HRA in accordance with the detailed provisions of the Local Government and Housing Act 1989 – the corresponding contra entry is shown in the General Fund table above.

[3] This is the interest payable on the borrowing undertaken from the Public Works Loan Board (PWLB) under the Housing Self Financing regime and charged to the HRA in 2018/2019. Note that the actual interest paid to PWLB in 2018/2019 was £1.454m but this is apportioned to take into account the financial year for which the interest was due.

3.10 Compliance

All treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

3.11 Treasury Management Indicators

The Council measures and manages its exposure 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 long-term credit rating and will aim for a weighted average long-term rating of 'A' for its in-house managed cash balances placed with credit rated banks and building societies and, as applicable, MMFs.

	Target	**Actual**
Portfolio average credit rating (in-house managed cash balances – value weighted)	A	A+

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling one month period, without additional borrowing.

	Target
Total cash available within 1 month	£5m

In 2018/19 the Council had at least £5m available within one month at all times.

Interest Rate Exposures: These indicators represent the maximum level (as a percentage) of the Council's investment and borrowing that will be invested at either a fixed or variable rate of interest. These indicators set the parameters which allow the Council to manage the extent to which it is exposed to changes in interest rates.

The upper limit for variable rate exposure has been set to ensure that the Council is not exposed to interest rate rises which could adversely impact on the revenue budget. The limit allows for the use of variable rate borrowing to offset exposure to changes in short-term rates on investments.

	Approved Limits for 2018/19
Upper Limit for Fixed Interest Rate Exposure	100%
Compliance with Limits:	Yes
Upper Limit for Variable Interest Rate Exposure	100%
Compliance with Limits:	Yes

All of the Council's long term debt is at fixed rates of interest and, therefore, interest rate rises will not have an adverse impact on the budgetary position. The Council considers its investments to be at variable rates of interest (no fixed rate investments for periods longer than 12 months).

Maturity Structure of Borrowing

This indicator is to limit large concentrations of debt needing to be replaced at times of uncertainty over interest rates. It is designed to protect against excessive exposures to interest rate changes in any one period, in particular in the course of the next ten years.

Maturity structure of fixed rate borrowing	Lower Limit for 2018/19 %	Upper Limit for 2018/19 %	Actual Maturity % as at 31/03/2019	Actual Borrowing at 31/03/2019 £m
under 12 months	0%	25%	7.95%	4.44
12 months and within 24 months	0%	25%	7.95%	4.44
24 months and within 5 years	0%	50%	29.60%	16.53
5 years and within 10 years	0%	50%	28.27%	15.79
10 years and within 20 years	0%	50%	26.23%	14.65
20 years and within 30 years	0%	20%	0%	0
Total			**100%**	**55.85**

Principal Sums Invested for Periods Longer than 1 year

The purpose of this indicator is to control the Council's exposure to the risk of incurring loss by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end are:

Limits on principal invested beyond year end	2018/19	2019/20	2020/21
Internally Managed Funds	£20m	£15m	£10m
Externally Managed Funds	£120m	£125m	£125m

The Council did not exceed any of the limits above during 2018/19. All internally invested funds were invested for periods less than 364 days. The externally managed funds classified as long-term and therefore likely to be held for more than 1 year totalled £61.84m.

3.12 Other Items

External Service Providers

Arlingclose is appointed as the Council's treasury management adviser. The Council is clear as to the services it expects and is provided under the contract.

The Council is also clear that overall responsibility for treasury management always remains with the Council.

Training

Council Officers responsible for treasury management have attended training courses throughout the year.

4. Relationship to the Corporate Plan

Council Performing Strongly Theme PS1 – this is the robust management of the Council's day to day finances, enabling it to meet its financial obligations to all stakeholders by offering a high quality, value for money service.
Regular monitoring and scrutiny of the Council's financial position, and, in particular its treasury management function is key to maintaining a sound financial strategy. This is an important element of the Corporate Health theme.

5. Financial, legal, staffing and other administrative implications and risk assessments

Financial Implications	Total interest paid on the Council's outstanding debt was £1.45m. The net outturn for the Council's investments was £2.47m against a probable outturn of £1.5m, due to performance of the externally managed pooled funds.
Legal Implications	None
Staffing Implications	None
Administrative Implications	None
Risk Assessment	Treasury operations are tightly regulated and the Council's external advisers consulted regularly, thus minimising the risk to the Council.

CABINET
25 JULY 2019

Appendices -
Appendix A: Internally and externally managed investments
Appendix B: Non-treasury investments

BACKGROUND PAPERS

Documents consulted	Date	File Ref	Report Author	Section and Directorate	Exempt Information Category
Banking 2018/2019 Statement of Accounts 2018/19 & working papers Treasury Management Strategy 2018/19			Catherine Bailey 01322 343312	Strategic Directorate Internal Services Financial Services	N/A