Annual Treasury Management Review 2017/18

1 Introduction

1.1 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 CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

1.2 During 2017/18 the minimum reporting requirements were as follows:
- an annual treasury strategy in advance of the year (Council 22 February 2017)
- a mid year treasury update report (Governance & Audit Committee 28 November 2017)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

1.3 The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is 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.

1.4 The Council confirms that it has complied with the requirement under the Code to give prior scrutiny to the annual treasury strategy by the Scrutiny Panel before it was reported to the full Council.

1.5 This report summarises:
- Capital financing activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- The overall treasury position;
- The Treasury Management Strategy for 2017/18;
- The economy and interest rates;
- Borrowing activity; and
- Investment activity.

2 Capital expenditure and financing 2017/18

2.1 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 resultant 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.

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

	2016/17 Actual £'000	2017/18 Original £'000	2017/18 Actual £'000
General Fund capital expenditure	11,390	10,974	9,038
HRA capital expenditure	10,705	11,288	7,967
Total capital expenditure	22,095	22,262	17,005
Resourced by:			
· Capital receipts	4,782	7,786	2,768
· Capital grants	2,277	1,399	2,928
· Capital reserves	6,187	7,239	5,195
· Finance Leases	849	0	230
· Revenue	6,490	3,814	4,593
New borrowing requirement	1,510	2,024	1,291

3 The Council's overall borrowing need

3.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2017/18 new borrowing requirement (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

3.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the Capital Programme, the Accountancy team organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

3.3 The Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP), to reduce the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need (there is no statutory requirement to reduce the HRA CFR). This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR. The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

3.4 The Council's 2017/18 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report on 22 February 2017.

3.5 The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes leasing schemes on the balance sheet, which increase the

Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.

	31-Mar-17	31-Mar-18	31-Mar-18
	Actual	Original	Actual
CFR	£'000	£'000	£'000
Opening balance	153,563	154,138	154,597
Add unfinanced capital expenditure (as above)	1,510	2,024	1,291
Add on-balance sheet leasing schemes	849	0	230
Write-off of finance lease creditor	0	0	(675)
Less MRP/VRP	1,325	1,264	1,254
Closing balance	154,597	154,898	154,189

3.6 Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

3.7 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 plus the estimates of any additional capital financing requirement for the current 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 2017/18. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31-Mar-17	31-Mar-18	31-Mar-18
	Actual	Original	Actual
	£'000	£'000	£'000
Gross borrowing position	136,094	139,204	141,094
CFR	154,597	154,898	154,189

3.8 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 2017/18 the Council has maintained gross borrowing within its authorised limit.

3.9 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.

3.10 The **actual financing costs as a proportion of net revenue stream** indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2016/17	2017/18
	£'000	£'000
Authorised limit	170,190	169,635
Maximum gross borrowing position	136,094	141,094
Operational boundary	143,530	140,537
Average gross borrowing position	136,094	140,075
Financing costs as a proportion of net revenue stream	12.02%	10.93%

4 *Treasury position as at 31 March 2018*

4.1 The Council's debt and investment position is organised to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting (as detailed in the introduction), and through officer activity detailed in the Council's Treasury Management Practices. At the end of 2017/18 the Council's treasury position (excluding finance leases) was as follows:

	31-Mar-17 Principal	Rate/ Return	31-Mar-18 Principal	Rate/ Return
	£'000	%	£'000	%
Fixed rate funding:				
PWLB	101,594	3.80%	104,594	3.80%
LOBO	5,500	3.63%	5,500	3.63%
Market	9,000	4.28%	9,000	4.28%
Local Authorities	0	0.00%	2,000	1.02%
Stock Issue	20,000	8.79%	20,000	8.79%
Total debt	**136,094**	**4.56%**	**141,094**	**4.46%**
CFR	154,597		154,189	
Over/ (under) borrowing	(18,503)		(13,095)	
Investments - In house	45,236	0.47%	47,901	0.41%
Total investments	**45,236**	**0.47%**	**47,901**	**0.41%**

4.2 The maturity structure of the debt portfolio is shown below. It should be noted that for LOBO loans, the maturity date is deemed to be the next call date. They are therefore all shown as short-term debt:

	Approved Maximum	31-Mar-17 Actual		31-Mar-18 Actual	
	%	£'000	%	£'000	%
Under 1 year	15.0	5,500	4.0	5,500	3.9
1 - 2 years	15.0	0	0.0	0	0.0
2 - 5 years	15.0	20,000	14.7	22,000	15.6
5 - 10 years	15.0	700	0.5	700	0.5
10 - 20 years	30.0	10,500	7.7	14,300	10.2
20 - 30 years	30.0	36,000	26.5	36,000	25.5
30 - 40 years	40.0	35,694	26.2	35,394	25.1
40 - 50 years	40.0	18,700	13.8	18,200	12.9
Over 50 years	10.0	9,000	6.6	9,000	6.3
		136,094	**100.0**	**141,094**	**100.0**

4.3 All of the Council's investments were for a period of less than one year, and there was not any exposure to variable rates of interest.

4.4 The outturn position for the Central Loans and Investment Account (CLIA) is shown below. This shows the outturn position as being a small favourable variance of £21k.

		Budget	Actual	Variance
CLIA		£'000	£'000	£'000
Total Interest Paid		6,509	6,592	83
	Less: HRA recharge	(5,616)	(5,661)	(45)
Total less HRA		**893**	**931**	**38**
Total Investments		(176)	(255)	(79)
	Less: Item 8 credit	30	50	20
Total less HRA		**(146)**	**(205)**	**(59)**
Total CLIA		**747**	**726**	**(21)**

4.5 The CLIA comprises the Council's borrowing costs and investment income. It is difficult to predict and can be affected by several factors. The majority of the Council's debt is on fixed rates reflecting the longer-term nature of the borrowing decisions. Investments are generally made for shorter periods, making returns more variable. This mix is generally more beneficial when interest rates are high or increasing. It is important to add that the exposure to interest rate movements is regularly monitored to minimise risks to changes in returns. The reasons that have contributed to the above variances include:

- The variance against borrowing costs relates to the additional external borrowing that was taken on during the year. This is mitigated by a proportion of this cost being charged to the Housing Revenue Account.
- The variance against interest income is as a result of a higher level of funds than was envisaged being available for investment, and the rates against some investments being greater than the budgeted figure. A proportion of this income was moved to the Housing Revenue Account, based on average HRA balances and investment returns.

5 The strategy for 2017/18

5.1 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.

5.2 The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this was kept under review considering the long-term saving resulting from borrowing at very low rates, and to avoid incurring higher borrowing costs in the future. A cost of carry remained during the year on any new long-term borrowing due to the difference between borrowing costs and investment returns.

5.3 The investment policy reflected the Council's low appetite for risk, emphasising the priorities of security and liquidity over that of yield. The main features of the policy were that the Council will apply minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties, which also enables diversification and avoidance of concentration risk. Investment decisions also applies the creditworthiness service provided by Link Asset Services, which combines data from credit rating agencies with credit default swaps and sovereign ratings.

5.4 The Council would only use approved counterparties from countries with a minimum credit rating of ‘AA-’. The Council will consider longer-term deals if attractive rates are available within the risk parameters set by the Council. The suggested budgeted return on investments placed for periods up to 100 days during the year was 0.25%.

5.5 Investment returns remained low during 2017/18 but were on a gently rising trend in the second half of the year.

5.6 **Changes in strategy during the year** – the strategy adopted in the original Treasury Management Strategy for 2017/18 approved by the Council on 22 February 2017, was reviewed as part of the mid-year update report. There were no proposed changes to the strategy as a result of this review.

6 The economy and interest rates

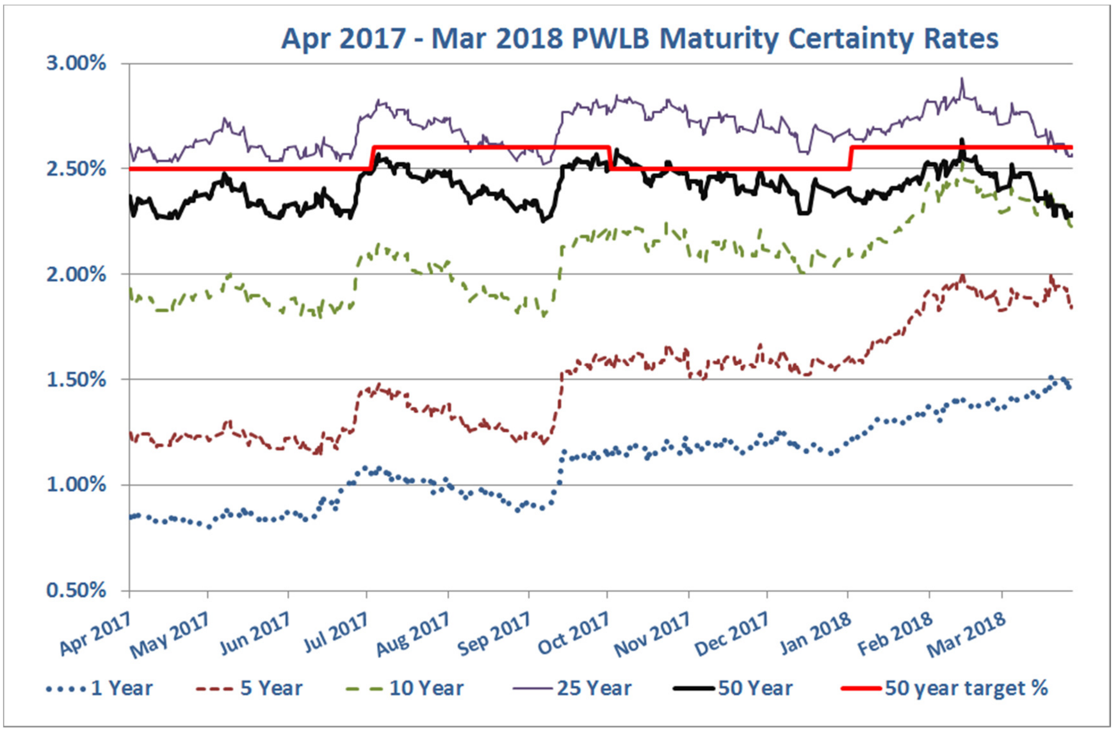
6.1 During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year, being 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. However, growth did pick up modestly in the second half of 2017.

6.2 Consequently, market expectations during the autumn, rose significantly that the 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%.

6.3 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. 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.

7 Borrowing

7.1 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 table for PWLB borrowing rates below shows, for a selection of maturity periods, the movement in rates during the course of the financial year.



7.2 The Council's total debt outstanding at 31 March 2018 was £141.1m, which was an increase of £5m from the figure at the end of the previous financial year. Due to the low rates available, this resulted in the average interest rate on the Council's debt at the end of the year reducing to 4.46%.

7.3 The Council's approach during the year was primarily to use cash balances to finance new capital expenditure. This minimised counterparty risk incurred on investments, and maximised treasury management budget savings as investment rates were much lower than most new borrowing rates. However, due to the overall financial position and the underlying need to borrow for capital purposes, new external borrowing of £5m was undertaken from the PWLB and other Local Authorities. No new short-term borrowing for cash flow purposes was undertaken during 2017/18.

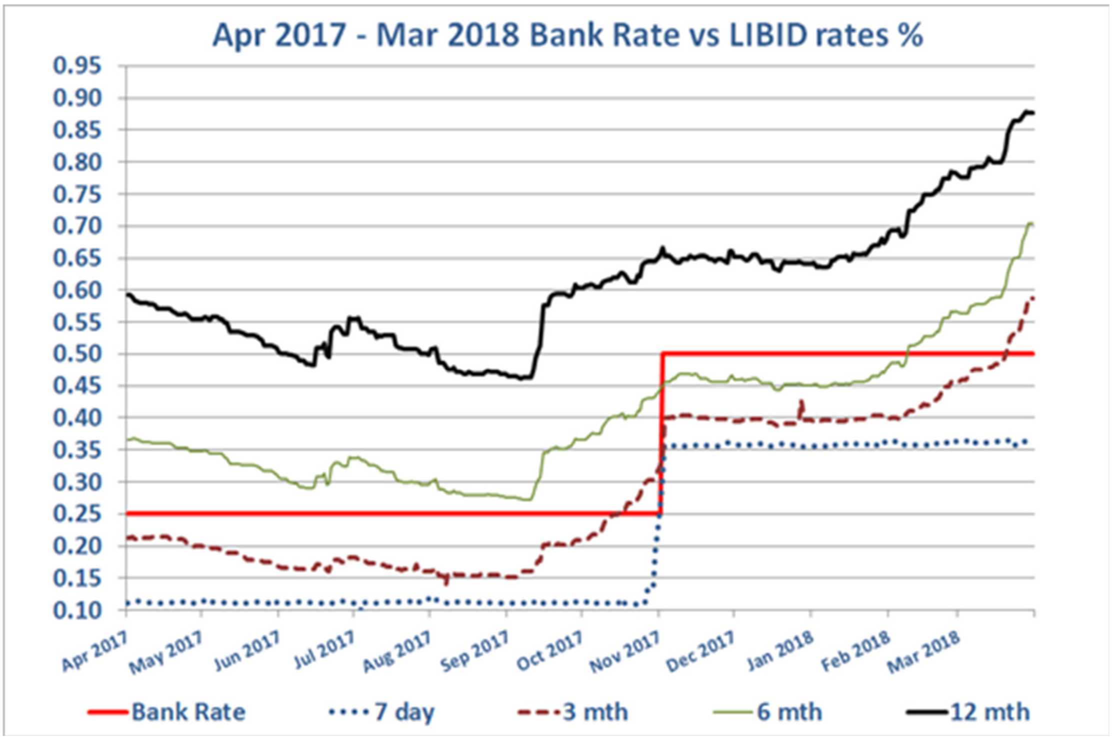
Source	Amount £'000	Duration (Years)	Rate %
Local Authority	2,000	4.5	1.02
PWLB	3,000	50.0	2.29

7.4 No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

8 Investments

8.1 Investments 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% in November 2017 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.



8.2 The Council manages its investments in-house, and its cash balances comprise revenue and capital resources and cash flow monies. The Council's investment policy is governed by MHCLG investment guidance, which was implemented in the Annual Investment Strategy approved by the Council on 22 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.)

8.3 The investment activity during the year conformed to the approved strategy, the Council had no liquidity difficulties, and no institutions in which investments were made during 2017/18 had any difficulty in repaying investments and interest in full.

8.4 The Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

	31-Mar-17	31-Mar-18
Balance Sheet Resources	£'000	£'000
Balances	12,327	9,491
Earmarked Reserves	20,221	23,963
Provisions	2,195	2,628
Capital Reserves	2,119	2,004
Total	**36,862**	**38,086**

8.5 The Council's internally managed funds earned an average rate of return of 0.41%. The comparable performance indicator is the average 3 month LIBID rate (London Interbank Bid Rate – the rate charged by one bank to another for a deposit) (uncompounded), which was 0.286%.

	2016/17	2017/18
Details	%	%
Temporary Investments	0.55	0.43
Overnight and Deposit Account	0.38	0.39
Total	**0.47**	**0.41**
Benchmark (3 month LIBID)	0.32	0.29
Return as a % of the Benchmark	149.2%	143.4%

8.6 The Council had temporary investments totalling £47.9m outstanding as at 31 March 2018. Of this, £24.6m relates to fixed-term deposits that are due to mature during 2018/19, £13.3m is held in 'AAA' rated money market funds, and the remaining £10.0m is held in notice accounts. All of the deposits were made in accordance with the 2017/18 Annual Investment Strategy. A full list of investments held as at 31 March 2018 is shown in **Appendix A** (confidential).

9 Other Issues

Revised CIPFA Codes

9.1 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.

9.2 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)

9.3 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 apart from having to fill in forms sent by each institution dealing with the Council for each type of investment instrument used.