REPORT TITLE: TREASURY MANAGEMENT OUTTURN REPORT FOR 2017/18

18 JULY 2018

REPORT OF PORTFOLIO HOLDER: Finance – Cllr. Guy Ashton

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WARD(S): ALL WARDS

PURPOSE

In accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management, this report provides detail of the performance of the treasury management function, on the effects of the decisions taken and the transactions executed in the past year, and confirmation that there were no instances of non-compliance with the Council's Treasury Management Policy Statement and Treasury Management Practices, for the year 2017/18.

In 2017-18 the Council's investment strategy delivered £54k of additional income above budget. The level of borrowing undertaken was in line with the budget for the financial year; all borrowing related to the Housing Revenue Account and was undertaken in 2012.

RECOMMENDATIONS:

That Cabinet:

1. Note the Annual Treasury Outturn Report 2017/18.

IMPLICATIONS:

1 COUNCIL STRATEGY OUTCOME

1.1 Treasury management is an integral part of helping the deliver the Council Strategy and all of its outcomes. The Council set a target of achieving a 1% return on its investments in 2017/18 and achieved a return of 1.13%. This additional income is available to be used by Council in achieving its objectives.

2 FINANCIAL IMPLICATIONS

2.1 Effective treasury management ensures both the financial security and liquidity of the Council. The 2017-18 outturn shows £619k of income achieved against a budget of £567k; thus delivering an additional £54k of income above budget.

3 LEGAL AND PROCUREMENT IMPLICATIONS

3.1 None

4 WORKFORCE IMPLICATIONS

4.1 None

5 PROPERTY AND ASSET IMPLICATIONS

5.1 None

6 CONSULTATION AND COMMUNICATION

6.1 This report has been produced in consultation with Hampshire County Council's Investments & Borrowing team.

6.2 The report was considered at The Overview and Scrutiny Committee on 9 July 2018 where Members had no comments they wished to raise with Cabinet.

7 ENVIRONMENTAL CONSIDERATIONS

7.1 None

8 EQUALITY IMPACT ASSESSEMENT

8.1 None

9 DATA PROTECTION IMPACT ASSESSMENT

9.1 None required.

10 RISK MANAGEMENT

Risk	Mitigation	Opportunities
Returns from investments are too low	A diversified strategy that attempts to manage the balance between liquidity risk, credit risk and yield within the Council's risk appetite.	Returns 0.13% above budgeted levels
A counterparty fails	A diversified strategy that has relatively low levels of counter-party risk	
Cash is not available	A balanced portfolio of liquid and long term funds are held to ensure cash is available to utilise. The Council also mitigates this risk through cashflow forecasting	More accurate and immediate cashflow forecasting can help improve the return on investments through more active treasury management activity

11 SUPPORTING INFORMATION:

12 Introduction

12.1 The Council adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes an annual report on the treasury management strategy after the end of each financial year.

13 Summary

13.1 The Council's treasury management strategy for 2017/18 was approved at a meeting of full Council in 2017. The Council has borrowed and invested sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

13.2 Treasury management in the context of this report is defined as:

13.3 "The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

13.4 This annual report sets out the performance of the treasury management function during 2017/18, to include the effects of the decisions taken and the transactions executed in the past year.

13.5 Hampshire County Council's Investments & Borrowing Team has been contracted to manage the Council's treasury management balances since September 2014 but 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.

13.6 All treasury activity has complied with the Council's Treasury Management Strategy and Investment Strategy for 2017/18, and all relevant statute, guidance and accounting standards. In addition the Council's treasury advisers, Arlingclose, provide support in undertaking treasury management activities. The Council has complied with all of the prudential indicators set in its Treasury Management Strategy.

14 External Context

14.1 The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions were made in 2017/18.

Economic Background

14.2 The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in 2017, the same level as in 2016.

14.3 The inflationary impact of rising import prices, a consequence of the fall in Sterling associated with the EU referendum result, resulted in year-on-year CPI rising to 3.1% in November before falling back to 2.7% in February 2018. Real average earnings growth, i.e. after inflation, turned negative before slowly recovering. The labour market showed resilience as the unemployment rate fell back to 4.2% in March 2018. The outcome of Brexit negotiations will have an impact upon the wider macro economy and the future Council treasury management activities.

14.4 The Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate by 0.25% in November 2017. This action was significant as this was the first rate increase in ten years, although in essence the MPC reversed its August 2016 cut following the referendum result. The February Inflation Report indicated the MPC was keen to return inflation to the 2% target over a more conventional (18-24 month) horizon with 'gradual' and 'limited' policy tightening. Although in March two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates, the minutes of the meeting suggested that an increase in May 2018 was likely; however at the meeting in May 2018 the MPC again voted by a majority of 7-2 to maintain Bank Rate at 0.5%.

Credit Background

14.5 The rules for UK banks' ring-fencing were finalised by the Prudential Regulation Authority and banks began the complex implementation process ahead of the statutory deadline of 1st January 2019. As there was some uncertainty surrounding which banking entities the Council would be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would look like, in May 2017 Arlingclose advised adjusting downwards the maturity limit for unsecured investments to a maximum of 6 months. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

14.6 Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non ring-fenced bank.

14.7 In March 2018, following Arlingclose's advice, the Council removed RBS plc and National Westminster Bank from its counterparty list for unsecured investments. This did not reflect any change to the creditworthiness of either bank, but a tightening in Arlingclose's recommended minimum credit rating criteria to A- from BBB+ for 2018/19. The current long-term ratings of RBS and NatWest do not meet this minimum criterion, although if following ring-fencing NatWest is upgraded and Arlingclose approves investment, the bank would be reinstated on the Council's unsecured lending list.

Local Authority Regulatory Changes

14.8 CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The 2017 Prudential Code introduced the requirement for a Capital Strategy which provides a high-level overview of the long-term context of capital expenditure and investment decisions. It also set out the inclusion of their associated risks and rewards along with an overview of how risk is managed for future financial sustainability, as well as the process and governance issues of capital expenditure and investment decisions. The Council already produces a ten year Capital Strategy and will continue to do so in line with the annual budget setting process.

14.9 In the 2017 Treasury Management Code the definition of 'investments' has been widened to include financial assets as well as non-financial assets held primarily for financial returns such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be discussed in the Capital Strategy or Investment Strategy.

MiFID II

14.10 As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could "opt up" to professional client status, providing certain criteria were met which include having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority having at least one year's relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

14.11 The Council has met the conditions to opt up to professional status and took the decision to do so at Full Council on 11 October 2017 in order to maintain its previous MiFID status prior to January 2018. The Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

15 Local Context

15.1 At 31/03/2017 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £177.2m, while usable reserves and working capital which are the underlying resources available for investment were £40.5m (principal invested plus gains on investments with a variable net asset value). These factors and the year-on-year change are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m
General Fund CFR	(8.2)	(5.0)	(13.2)
Housing Revenue Account CFR	(162.1)	(1.9)	(164.0)
Total CFR	(170.3)	(6.9)	(177.2)
Less: Resources for investment	46.7	(6.2)	40.5
Net borrowing	(123.6)	(13.1)	(136.7)

15.2 Net borrowing has increased overall due to both a reduction in usable reserves and increases in both General Fund and Housing Revenue Account (HRA) CFR. CFR has risen as new capital expenditure increased, while no borrowing was repaid during 2017/18.

15.3 The Council's strategy was to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31 March 2018 and the year-on-year change is shown in Table 2 below.

Table 2: Treasury Management Summary

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %
Long-term borrowing	(156.7)	-	(156.7)	3.30
Short-term borrowing	-	-	-	-

Total borrowing	(156.7)	-	(156.7)	3.30
Long-term investments	11.5	6.4	17.9	1.90
Short-term investments	32.7	(12.9)	19.8	0.64
Cash and cash equivalents	2.5	0.3	2.8	0.42
Total investments	46.7	(6.2)	40.5	1.20
Net borrowing	(110.0)	(6.2)	(116.2)	

Note: 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.

15.4 The Council's internal borrowing policy is the reason for the variance between the positions shown in Tables 1 and 2. The movement that has taken place during 2017/18 in net borrowing shown in Table 1 has translated into a reduction in investment balances as shown in Table 2.

16 <u>Borrowing Activity</u>

16.1 At 31 March 2018 the Council held £156.7m of loans, with the vast majority of the loan being in relation to the refinancing resettlement of the HRA in 2012. The year-end treasury management borrowing position and year-on-year change is shown in Table 3 below.

Table 3: Borrowing Position

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %	31/03/18 WAM* years
Public Works Loan Board	156.7	-	156.7	3.30	22.6
Total borrowing	156.7	-	156.7	3.30	22.6

* Weighted average maturity

Note: The figures in the table above are from the balance sheet in the Council's statement of accounts, but adjusted to exclude accrued interest.

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

16.3 Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained and are likely to remain at least over the forthcoming two years, lower than long-term rates, the Council determined it was more cost effective in the short-term to use internal resources instead of taking out new borrowing. This strategy enables the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

16.4 The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with the monitoring of internal and external borrowing.

17 Investment Activity

17.1 The Council has held invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2017/18 the Council's investment balances have ranged between £39.4m and £67.8m due to timing differences between income and expenditure. The year-end investment position and the year-on-year change are shown in Table 4 below.

Table 4: Investment Position (Treasury Investments)

Investments	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %	31/03/18 WAM* years
Short term investments					
- Banks and Building Societies:					
- Unsecured	6.0	(1.1)	4.9	0.58	0.15
- Secured	6.0	(1.0)	5.0	0.74	0.67
- Money Market Funds	2.0	(1.1)	0.9	0.46	0.00
- Local Authorities	18.0	(11.5)	6.5	0.52	0.31
- Corporate Bonds	3.0	1.0	4.0	0.66	0.71
	35.0	(13.7)	21.3	0.61	0.42
Long term investments					
- Banks and Building Societies:					
- Secured	4.0	1.0	5.0	0.94	2.56
- Local Authorities	-	8.0	8.0	0.86	2.42
	4.0	9.0	13.0	0.89	2.48
High yield investments					
- Pooled Property Funds**	5.0	-	5.0	4.53	n/a
- Pooled Equity Funds	2.0	(2.0)	-	-	-
	7.0	(2.0)	5.0	4.53	n/a
TOTAL INVESTMENTS	46.0	(6.6)	39.4	1.20	1.20

* Weighted average maturity

** The rate provided for pooled property fund investments is reflective of the average of the most recent dividend return as at 31 March 2018

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

17.2 Both the CIPFA Code and the government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing 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.

17.3 In furtherance of these objectives, and given the increasing risk and low returns from short-term unsecured investments, the Council further diversified into more secure and higher yielding asset classes during 2017/18. For example, although cash balances have reduced, the proportion of funds to corporate bonds and secured bank investments has increased. Higher yields have been achieved in 2017/18 with a good income return on pooled property, as well as by reducing the proportion of short-term investments, by moving these funds into long-term investments.

17.4 Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2017/18.

17.5 Counterparty credit quality was assessed and monitored with reference to credit ratings, for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

17.6 The Council will also consider the use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

17.7 The Council maintained a sufficient level of liquidity through the use of call accounts and money market funds. The Council sought to optimise returns commensurate with its objectivity of security and liquidity. The UK Bank Rate increased by 0.25% to 0.50% in November 2017 and short term money market rates have remained at relatively low levels which continued to have a significant impact on cash investment income.

17.8 The progression of credit risk and return metrics for the Council's investments managed in-house (excluding pooled funds) are shown in the extracts from Arlingclose's investments benchmarking in Table 5 below.

Table 5: Investment Benchmarking (investments managed in-house)

	Credit Rating	Bail-In Exposure	WAM* (days)	Rate of Return
31.03.2017	AA	20%	184	0.61%
31.03.2018	AA	17%	441	0.72%
Similar Las	AA-	53%	109	0.71%
All Las	AA-	55%	35	0.63%

* Weighted average maturity

17.9 The Council has targeted a proportion of funds towards high yielding investments as shown in Table 4. Investments yielding higher returns will contribute additional income to the Council, although some come with the risk that they may suffer falls in the value of the principal invested.

17.10 The £5.5m investment in the externally pooled property fund generated an average total return of 5.79%, comprising 4.87% income return used to support services in year, and 0.92% capital gain. As 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 are regularly reviewed.

17.11 Investment in pooled vehicles allows the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. The funds which are operated on a variable net asset value (VNAV) basis offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short term. The Council's pooled fund investment is in the fund's distributing share class which pays out the income generated.

17.12 Although money can be redeemed from the pooled fund at short notice, the Council's intention is to hold them for at least the medium term. Their performance and suitability in meeting the Council's investment objectives are monitored regularly and discussed with Arlingclose.

17.13 In light of increasing volatility in the global equity markets, the Council decided to redeem its units in its pooled equities funds during 2017/18. In addition to the income received while the Council held these funds, the redemptions resulted in positive realised capital returns of 3% on average.

18 Update on Investments with Icelandic Banks

18.1 The collapse of Icelandic banks in October 2008 put at risk £1m of the Council's short term investments. The Council had invested with the Heritable Bank Ltd which was placed into administration on 7 October 2008. To date the Council has received 15 distributions amounting to £0.98m equating to a return of 98 pence to 100 in the pound. There have been no further updates since the previous report.

19 Financial Implications

19.1 The outturn for debt interest paid in 2017/18 was £5.17m on an average debt portfolio of £156.7m, against a budgeted £5.17m on an average debt portfolio of £156.7m at an average interest rate of 3.2%.

19.2 The outturn for investment income received in 2017/18 was £619,000 on an average investment portfolio of £54.7m, therefore giving a yield of 1.13%, against a budgeted £567,000 on an average investment portfolio of £56.7m at an average interest rate of 1%. In comparison in 2016/17 investment income received was £551,000 on an average investment portfolio of £59.9m, therefore giving a yield of 0.92%.

20 Other Non-Treasury Holdings and Activity

20.1 Although not classed as treasury management activities, the 2017 CIPFA Code now requires the Council to report on investments for policy reasons outside of normal treasury management. This includes service investments for operational and/or regeneration as well as commercial investments which are made mainly for financial reasons.

20.2 In 2017/18, the Council spent £116,000 on enhancements to its investment property portfolio and, following revaluations, the total value of investments properties as at 31 March 2018 was £47.7m (£46.4m as at 31 March 2017). Net rental income after costs amounted to £1.8m representing an average yield of 3.9% in 2017/18.

21 Compliance Report

21.1 The Council confirms compliance of all treasury management activities undertaken during 2017/18 with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy. Compliance with specific investment limits, as well as the authorised limit and operational boundary for external debt, is demonstrated in Tables 6 and 7 below.

Table 6: Debt Limits

	2017/18 Maximum £m	31/03/18 Actual £m	2017/18 Operational Boundary £m	2017/18 Authorised Limit £m	Complied
Borrowing	156.7	156.7	180.7	182.7	✓
Other long term liabilities	0.0	0.0	0.5	0.6	✓
Total debt	156.7	156.7	181.2	183.3	✓

21.2 Total debt has remained below the Capital Financing Requirement (see Table 1) during the period.

Table 7: Investment Limits

	2017/18 Maximum	31/03/18 Actual	2017/18 Limit	Complied
Any single organisation, except the UK Central Government	£3m	£3m	£7m	✓
Any group of organisations under the same ownership	£3m	£3m	£7m	✓
Any group of pooled funds under the same management	£6m	£5m	£7m	✓

Registered Providers	-	-	£6m	✓
Money Market Funds	30%	7%	50%	✓

Ratio of Financing Costs to Net Revenue Stream

21.3 This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Table 8: Ratio of Financing Costs to Net Revenue Stream

	2017/18 Estimate %	2017/18 Actual %
General Fund	(0.85%)	(0.77%)
Housing Revenue Account	17.73%	21.18%

21.4 The Ratio of Financing Costs to Net Revenue Stream for the General Fund was negative as interest receivable exceeded interest payable and Minimum Revenue Provision. The HRA ratio was higher following the decision to reduce prior year unfinanced capital expenditure by £1,029,000.

22 Treasury Management Indicators

22.1 The Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

22.2 This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal invested will be:

Table 9: Interest Rate Exposures

	31/03/18 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate investment exposure	£7.0m	£25.0m	✓
Upper limit on variable interest rate investment exposure	£32.3m	£100.0m	✓
Upper limit on fixed interest rate borrowing exposure	£156.7m	£201.5m	✓
Upper limit on variable interest rate borrowing exposure	£0.0m	£201.5m	✓

22.3 Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing

22.4 This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 10: Maturity Structure of Borrowing

	31/03/18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	0%	25%	0%	✓
12 months and within 24 months	0%	25%	0%	✓
24 months and within 5 years	3%	25%	0%	✓
5 years and within 10 years	22%	25%	0%	✓
10 years and within 20 years	32%	50%	0%	✓
20 years and within 30 years	13%	50%	0%	✓
30 years and within 40 years	13%	75%	0%	✓
40 years and within 50 years	17%	100%	0%	✓

Principal Sums Invested for Periods Longer than 364 days

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

Table 11: Principal Sums Invested for Periods Longer than 364 days

	2017/18	2018/19	2019/20
Actual principal invested beyond year end	£17m	£12m	£9m
Limit on principal invested beyond year end	£25m	£25m	£25m
Complied	✓	✓	✓

BACKGROUND DOCUMENTS:-

Previous Committee Reports:-

AUD119: Treasury Management Practices, 22 June 2015

CAB2898: Treasury Management Strategy 2017-18, 8 February 2017

CAB2939: Treasury Management Outturn 2016/17, 5 July 2017

AUD197: Treasury Management Mid-Year Review 2017/18, 28 September 2017

CAB3013: Treasury Management Strategy 2018-19, 14 February 2018

Other Background Documents:-

None

APPENDICES:

None