AG006
AUDIT & GOVERNANCE COMMITTEE

REPORT TITLE: TREASURY MANAGEMENT OUTTURN REPORT 2018/19

25 JULY 2019

REPORT OF CABINET MEMBER: CLLR CUTLER – CABINET MEMBER FOR FINANCE AND RISK

Contact Officer: Neil Aitken Tel No: 01962 848099 Email naitken@winchester.gov.uk

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 2018/19.

In 2018-19 the Council's investment strategy delivered £110k 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 2018/19.
2. Note that the limit on sums invested for over 364 days was breached by £35,000 from 12 March 2019 to 16 May 2019 and note the mitigating actions agreed to prevent this occurring again as detailed in paragraph 22.6.

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 2018/19 and achieved a return of 1.19%. 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 2018/19 outturn shows £660k of income achieved against a budget of £550k; thus delivering an additional £110k 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.

7 ENVIRONMENTAL CONSIDERATIONS

7.1 The Council’s ethical investment strategy, including its environmental impact, will be considered as part of the Treasury Management Strategy in February 2020.

8 EQUALITY IMPACT ASSESSMENT

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 0.19% 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 has adopted the key recommendations of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code), last updated in 2017.

12.2 The CIPFA Code requires the Council to approve a treasury management strategy before the start of the year and a semi-annual and annual treasury outturn report.

12.3 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

13 Summary

13.1 The Council's treasury management strategy was most recently updated and approved at a meeting of Full Council in February 2019. 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:

"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."

13.3 This annual report sets out the performance of the treasury management function during 2018/19, to include the effects of the decisions taken and the transactions executed in the past year.

13.4 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 and as such the effective identification and management of risk are integral to the Council's treasury management objectives.

13.5 Treasury activity has complied with the Council's Treasury Management Strategy for 2018/19 and 2019/20 and Investment Strategy for 2018/19 with one exception as detailed in paragraph 22.6, and has complied with all relevant statute, guidance and accounting standards. In addition, support in undertaking treasury management activities has been provided by the Council's treasury advisers, Arlingclose. The Council has also complied with all 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 2018/19.

Economic Background

14.2 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. 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%.

14.3 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.

14.4 While the domestic focus has been on Brexit's potential impact on the UK economy, which has weighed on sterling and UK markets, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

Financial markets

14.5 Markets for riskier asset classes fell in December 2018, most notably for 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 by the first week of April 2019.

14.6 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 dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate pushed up money markets 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.

Credit background

14.7 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. After hitting around 129 basis points in December 2018, the spread on non-ringfenced bank NatWest Markets plc fell back to around 96bps at the end of March, while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 33 and 79bps at the end of the period.

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

14.9 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.

14.10 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 the its senior unsecured debt and deposits.

15 Local Context

15.1 At 31/03/2019 the Council’s underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £190.0m, while usable reserves and working capital which are the underlying resources available for investment were £39.2m (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

	31/03/18 Balance £m	Movement £m	31/03/19 Balance £m
General Fund CFR	(13.2)	(13.9)	(27.1)
Housing Revenue Account CFR	(164.0)	1.1	(162.9)
Total CFR	(177.2)	(12.8)	(190.0)
Less: Resources for investment	40.5	(1.3)	39.2
Net borrowing	(136.7)	(14.1)	(150.8)

15.2 Net borrowing has increased overall due to an increase in General Fund CFR. CFR has risen as new capital expenditure increased, while no external borrowing was repaid during 2018/19. The Housing Revenue Account elected to pay down £1.1m of prior year unfinanced capital expenditure reducing its overall borrowing need.

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 2019 and the year-on-year change is shown in Table 2 below.

Table 2: Treasury Management Summary

	31/03/18 Balance £m	Movement £m	31/03/19 Balance £m	31/03/19 Rate %
Long-term borrowing	(156.7)	0.0	(156.7)	3.30
Short-term borrowing	0.0	0.0	0.0	0.0
Total borrowing	(156.7)	0.0	(156.7)	3.30
Long-term investments	17.9	(2.9)	16.0	3.17
Short-term investments	19.8	(3.7)	15.1	1.07
Cash and cash equivalents	2.8	5.3	8.1	0.77
Total investments	40.5	(1.3)	39.2	1.84
Net borrowing	(116.2)	(1.3)	(117.5)	

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.

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 2018/19 in net borrowing shown in Table 1 has translated into a reduction in investment balances as shown in Table 2.

16 Borrowing Activity

16.1 At 31 March 2019 the Council held £156.7m of loans, the vast majority of which relates 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

	31/03/18 Balance £m	Movement £m	31/03/19 Balance £m	31/03/19 Rate %	31/03/19 WAM* years
Public Works Loan Board	156.7	0.0	156.7	3.30	17.53
Total borrowing	156.7	0.0	156.7	3.30	17.53

* 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. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

16.3 Short-term interest rates have remained much lower than long-term rates and the Council has therefore considered it to be more cost effective in the near term to use internal resources than to use additional borrowing.

16.4 With the assistance of Arlingclose, the benefits of this internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years, when long-term borrowing costs may be higher.

17 Investment Activity

17.1 The Council has held 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 £38.1m and £72.5m 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	31/03/18 Balance £m	Movement £m	31/03/19 Balance £m	31/03/19 Rate %	31/03/19 WAM* years
Short term investments					
- Banks and Building Societies:					
- Unsecured	4.9	1.1	6.0	0.96	0.30
- Secured	5.0	(3.0)	2.0	1.23	0.30
- Money Market Funds	0.9	6.2	7.1	0.79	0.00

- Local Authorities	6.5	0.5	7.0	1.01	0.89
- Corporate Bonds	4.0	(4.0)	-	-	-
- Cash Plus Funds	-	1.0	1.0	1.50	n/a
	21.3	1.8	23.1	0.97	0.39
Long term investments					
- Banks and Building Societies:					
- Secured	5.0	3.5	8.5	2.77	2.18
- Local Authorities	8.0	(6.5)	1.5	1.33	2.20
	13.0	(3.0)	10.0	2.55	2.18
High yield investments					
- Pooled Property Funds**	5.0	-	5.0	4.40	n/a
	5.0	-	5.0	4.40	n/a
TOTAL INVESTMENTS	39.3	(1.2)	38.1	1.84	0.95

* Weighted average maturity

** The rate provided for pooled property fund investments is reflective of the average dividend return

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 The CIPFA Code and government guidance both require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Council's objective when investing money is therefore to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults against the risk of receiving unsuitably low investment income.

17.3 Security of capital has remained the Council's main investment objective and has been maintained by following the Council's counterparty policy, as set out in its Treasury Management Strategy Statement for 2018/19.

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

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

17.6 To reduce risk, 60% of the Council's surplus cash is invested so that it is not subject to bail-in risk, as it is invested in local authorities, secured bank bonds and pooled funds. The exposure to bail-in risk has increased since the end of 2017/18 and is the result of the reduced availability of secured investments that provide an acceptable combination of security (credit rating) and return (coupon), coupled with the Local Authority lending market being quite flat around year end. The bail-in risk has been mitigated by investing the majority of the balance in overnight money market funds and cash plus funds, which are subject to reduced bail in risk, or in short duration certificates of deposit. By comparison, only 47% of the cash held by other similar Local Authorities is not subject to bail-in risk.

17.7 The UK Bank Rate increased marginally by 0.25% in August 2018 to 0.75% and with short-term money market rates also remaining relatively low, there has been an ongoing impact on the Council's ability to generate income on cash investments.

17.8 Against this backdrop, the Council has sought to optimise returns commensurate with the objectives of security and liquidity, achieving an average rate of return of 0.83% on internally managed funds during 2018/19 (i.e. excluding external pooled funds) whilst also maintaining sufficient liquidity through the use of call accounts and money market funds.

17.9 In readiness for Brexit, and with the uncertainty around potential outcomes, the Council 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.

17.10 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 quarterly investments benchmarking in Table 5 below.

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

	Credit Rating	Bail-In Exposure	WAM* (days)	Rate of Return
31.03.2018	AA	17%	441	0.72%
31.03.2019	AA	40%	354	1.01%
Similar Las	AA-	53%	86	0.86%
All Las	AA-	55%	29	0.85%

* Weighted average maturity

17.11 In order to minimise the risk of receiving unsuitably low investment income, the Council has continued to invest in the externally managed CCLA Property pooled fund as part of its high yielding strategy.

17.12 This investment allows the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments, with £5m currently invested. A further £1m is held in cash plus funds

17.13 These funds are likely to be more volatile than cash in the short-term but generate regular revenue income whilst also providing diversification and the potential for enhanced returns over the longer term.

17.14 The £6m portfolio of externally managed funds generated an average return of 6.14% in the year to 31 March 2019, comprising 3.80% income return to support services in year, and 2.34% of capital growth. By comparison, the average income return for internal investments was 0.83%, giving an average income return across the whole investment portfolio of 1.19%.

17.15 Although money can usually be redeemed from the pooled funds at short notice, the Council's intention is to hold them for at least the medium-term. Investments are made in the knowledge that capital values will move both up and down in the short term, but with the confidence that over a three- to five-year period total returns should exceed cash interest rates.

17.16 The performance and ongoing suitability of these pooled funds in meeting the Council's investment objectives is monitored regularly and discussed with Arlingclose.

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 and it is unlikely the Council will recover the remaining outstanding amount.

19 Financial Implications

19.1 The outturn for debt interest paid in 2018/19 was £5.2m on an average debt portfolio of £156.7m at an average interest rate of 3.32%, against a budgeted £5.2 on an average debt portfolio of £156.7m at an average interest rate of 3.3%.

19.2 The outturn for investment income received in 2018/19 was £660,000 on an average investment portfolio of £55.4m, therefore giving a yield of 1.19%, against a budgeted £550,000 on an average investment portfolio of £55m at an average interest rate of 1%. In comparison in 2017/18 investment income received was £619,000 on an average investment portfolio of £54.7m, therefore giving a yield of 1.13%.

20 Other Non-Treasury Holdings and Activity

20.1 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.

20.2 This includes service investments for operational and/or regeneration as well as commercial investments which are made mainly for financial reasons.

20.3 Further information on the Council's non-Treasury investments is included in CAB3168 - Q4 Financial and Performance Monitoring presented to Cabinet on 17 July 2019.

21 Compliance Report

21.1 The Council confirms compliance of all treasury management activities undertaken during 2018/19 with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

21.2 Compliance with the authorised limit and operational boundary for external debt is demonstrated in Table 7 below.

Table 7: Debt Limits

	2018/19 Maximum £m	31/03/19 Actual £m	2018/19 Operational Boundary £m	2018/19 Authorised Limit £m	Complied
Borrowing	156.7	156.7	213.7	231.0	✓
Other long term liabilities	0.2	0.2	0.2	0.3	✓
Total debt	156.9	156.9	213.9	231.3	✓

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

Ratio of Financing Costs to Net Revenue Stream

21.4 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

	2018/19 Estimate %	2018/19 Actual %
General Fund	0.1%	(0.8%)
Housing Revenue Account	17.9%	17.7%

21.5 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.

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 8 – Interest Rate Exposures

	31/03/19 Actual	Impact of +/-1% interest rate change
Variable interest rate investment exposure	£27.1m	+/- £0.27m
Variable interest rate borrowing exposure	£0m	+/- £0.00m

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

	31/03/19 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	0.0%	25%	0%	✓
12 months and within 24 months	0.0%	25%	0%	✓
24 months and within 5 years	6.4%	25%	0%	✓
5 years and within 10 years	19.1%	30%	0%	✓
10 years and within 20 years	31.9%	50%	0%	✓
20 years and within 30 years	12.8%	50%	0%	✓
30 years and within 40 years	12.8%	75%	0%	✓
40 years and within 50 years	17.0%	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.

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

	2018/19	2019/20	2020/21
Actual principal invested beyond year end	£15m	£12m	£7m
Limit on principal invested beyond year end	£15m	£15m	£15m
Complied	x	✓	✓

22.6 The principal sum invested for longer than 364 days was £15.035m as at the 31 March 2019 and is now below £15m. This was the result of one investment made on 12 March 2019 shortly after the limit was revised from £20m to £15m as part of the Treasury Management Strategy update in February 2019 and fell back below on 16 May. The Council has sought assurances from Hampshire's Investment and Borrowing team that action has been taken to prevent this happening again and they have confirmed their internal controls have been reviewed. In addition, the matter has been discussed with Hampshire County Council's internal audit. The rolling internal audit plan includes a review of the treasury management function in 2019/20 and this matter will therefore be reviewed as part of this audit, which commences in July 2019; the results will be reported back to the Council's Audit & Governance Committee at the meeting immediately following completion of the review.

BACKGROUND DOCUMENTS:-

Previous Committee Reports:-

AUD119: Treasury Management Practices, 22 June 2015

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

CAB3064: Treasury Management Outturn 2017/18, 18 July 2018

AUD223: Treasury Management Mid-Year Monitoring Report 2018/19, 29 November 2018

CAB3133: Treasury Management Strategy 2019-20, 13 February 2019

Other Background Documents:-

None

APPENDICES:

None