Report to Cabinet

Subject: Annual Treasury Activity Report 2017/18

Date: 24 May 2018

Author: Deputy Chief Executive and Director of Finance

Wards Affected

All

Purpose

To inform Members of the outturn in respect of the 2017/18 Prudential Code Indicators, and to advise Members of the outturn on treasury activity, both as required by the Treasury Management Strategy.

Key Decision

This is not a key decision.

Background

1.1 The Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury review of its 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 For 2017/18 the minimum reporting requirements were that the Full Council should receive the following reports:

- An Annual Treasury Management Strategy Statement (TMSS) in advance of the year. This was considered by Cabinet on 16 February 2017 and subsequently approved by Full Council on 1 March 2017.

- A Mid-Year Treasury Update report (In accordance with best practice, Members will note that, as in previous years and in accordance with best practice, quarterly monitoring reports for treasury activity have been provided, and that this exceeds the minimum requirements).

- 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. The Annual Treasury Activity Report provides details of the outturn position for treasury activities during the year, and highlights compliance with the Council's policies, previously approved by Members.

1.4 The Council has complied with the requirement under the Code to give prior scrutiny to all the above treasury management reports by submitting them to Cabinet before they are reported to Full Council.

1.5 Member training on treasury management issues is undertaken by the Chief Financial Officer as it is needed in order to support Members' scrutiny role. In addition, the Council's treasury advisers, Link Asset Services (LAS) periodically deliver more detailed training sessions for Members.

Proposal

2.1 <u>The economy and interest rates in 2017/18</u>

2.1.1 During 2017 there was a major shift in expectations in financial markets of how soon Bank Rate would start to rise. After the UK economy surprised with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year, meaning that growth was 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 in the cost of imports into the UK 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, which accounts for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure.

2.1.2 Growth picked up modestly in the second half of 2017 and market expectations grew significantly during the autumn that Bank Rate may rise imminently. The minutes of the September Monetary Policy Committee (MPC) meeting indicated that this might soon be the case, and the November meeting duly delivered a rise of 0.25% to 0.5%, reversing the emergency cut after the Brexit vote. The February MPC minutes revealed another hardening of more imminent and faster paced increases in Bank Rate than had previously been expected.

2.1.3 As late as February 2018, financial markets were viewing a May Bank Rate increase as a certainty, however a sharp downturn in data since February led the MPC to leave it unchanged. The Council's treasury

advisors, Link Asset Services (LAS), are now predicting the next rise to be in November 2018. It is considered unlikely that a further rise would come in February 2019 as this would be just ahead of the March deadline for leaving the EU, and LAS therefore currently predict a further rise in September 2019, followed by two more in June and November of 2020.

2.1.4 The landmark UK event of 2017 was the inconclusive result of the general election on 8 June, however this had relatively little impact on the financial markets.

2.2 The overall treasury position 31 March 2018

The Council's debt and investment position is organised to ensure adequate liquidity for revenue and capital activities, security of investment, and to manage risks within all treasury management activities. At the beginning and end of 2017/18, the treasury position was as follows:

	1 April 2017 £000s	31 March 2018 £000s
Total external debt	6,812	6,812
Capital Financing Requirement (CFR)	11,777	11,262
Over/(under) borrowing to CFR	**(4,965)**	**(4,450)**
Total external debt	6,812	6,812
Total investments	(8,790)	(8,290)
Net debt/(investment)	**(1,978)**	**(1,478)**

2.3 The treasury strategy for 2017/18

2.3.1 The expectation for interest rates within the strategy for 2017/18 (the TMSS) was that the Monetary Policy Committee (MPC) would be unlikely to raise rates during the Brexit negotiation period, and accordingly that a first rise would come in Q2 of 2019 - unless strong domestically generated inflation was to emerge. There was even an acknowledgement that a further cut was possible should economic growth dip. Medium and longer term fixed rates were expected to rise gradually during the year and variable or short term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 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. In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments, and to reduce counterparty risk.

2.3.2 In the event, growth in 2017 was 1.8% and CPI inflation peaked at 3.1% in November 2017, therefore it was unsurprising that in November the MPC reversed the emergency cut in Bank Rate following the Brexit vote in June 2016, and increased it to end the year at 0.5%.

2.3.3 During 2017/18 there was considerable volatility in longer term PWLB rates with little consistent trend. Shorter term rates were on a rising trend through the second half of the year.

2.4 The Council's Borrowing Requirement

The Council's underlying need to borrow for capital expenditure is termed the capital financing requirement (CFR), and is a gauge of the Council's indebtedness.

The CFR results from the Council's capital activity, and the resources it uses to pay for that capital spending, and represents unfinanced expenditure that has not yet been paid for from revenue or other resources.

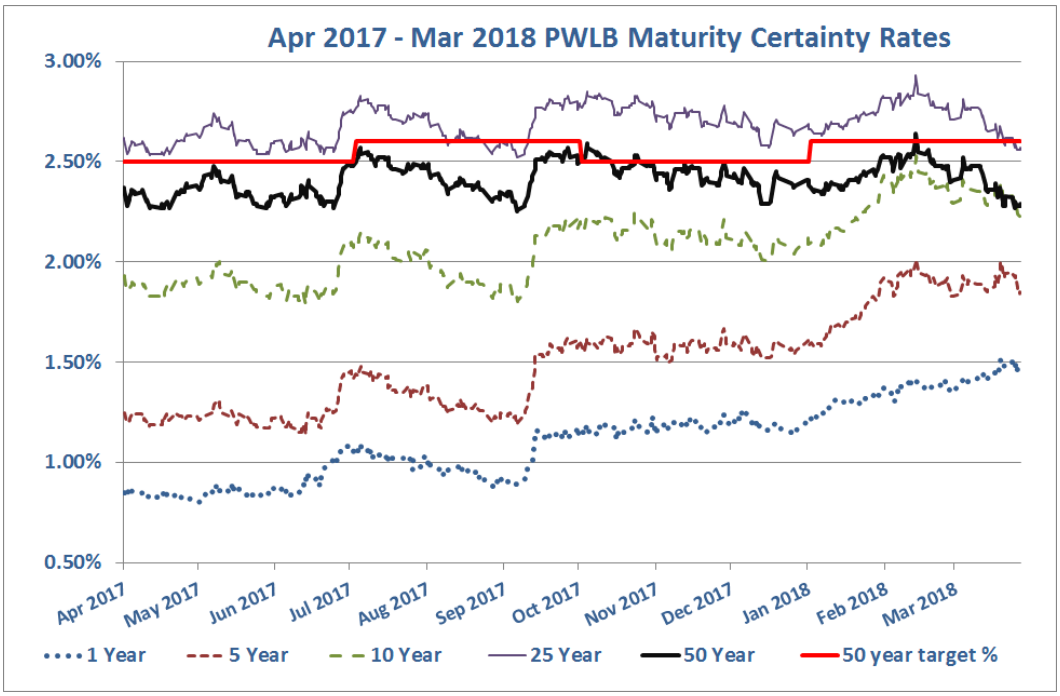
	1 April 2017 (Actual) £000s	31 March 2018 (Orig. Est) £000s	31 March 2018 (Actual) £000s
Capital Financing Requirement	11,777	13,160	11,262

The 2017/18 variance is due to slippage and savings on the 2016/17 capital programme which together with additional capital receipts reduced the borrowing requirement in that year, and to amendments to the capital programme during 2017/18, including the slippage of schemes to 2018/19.

2.5 Borrowing rates in 2017/18

PWLB 25 and 50 year rates were volatile during 2017/18, with little consistent trend, however shorter rates were on a rising trend during the second half of the year, reaching peaks in February and March.

The graph below has been provided by the Council's treasury advisers.



The table below shows the LAS forecasts for interest rates as at 11 May 2018.

Link Asset Services Interest Rate View	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.50%	0.50%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.60%	0.70%	0.90%	0.90%	0.90%	1.10%	1.20%	1.30%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.70%	0.80%	1.00%	1.00%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	0.80%	0.90%	1.10%	1.10%	1.20%	1.30%	1.40%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	1.90%	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%
10yr PWLB Rate	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%
25yr PWLB Rate	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%

2.6 <u>The borrowing outturn for 2017/18</u>

2.6.1 No loans were redeemed during 2017/18, and no new long term debt was taken during the year.

The Council has embarked upon a commercialisation programme aimed at the generation of funding to replace central government support, which is scheduled to be withdrawn by 2020. Significant additional borrowing may be required to support this commercial programme, which will be supported by individual business case assessments to demonstrate that each project generates a return sufficient to cover any borrowing costs.

Advice will be taken from LAS with regard to the amount and timing of any additional borrowing, and should conditions become advantageous, some borrowing in advance of need will also be considered by the Chief Financial Officer.

2.6.2 Total outstanding debt at 31 March 2018 was £6.812m. All loans held are repayable on maturity, and are at fixed rates.

2.6.3 There was no rescheduling of PWLB debt undertaken during the year, as the average 1% differential between PWLB new borrowing rates and premature repayment rates made such action unviable.

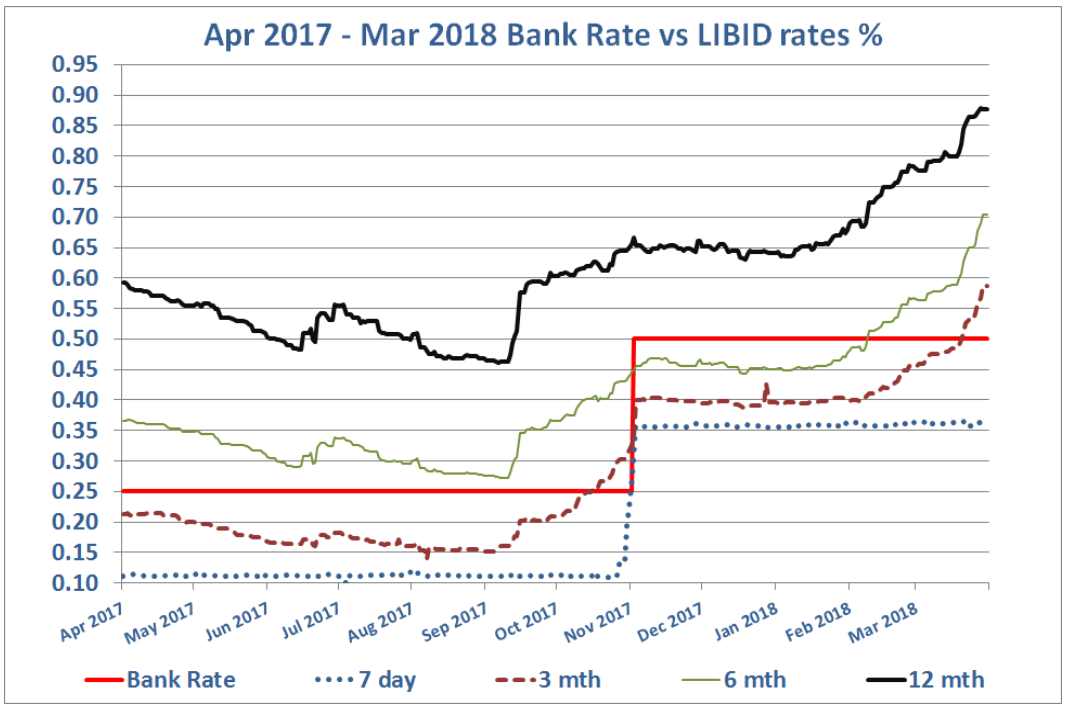
2.6.4 Two temporary loans were arranged for cashflow purposes during 2017/18, however the maximum duration of these was only seven days, and the average rate paid was 0.18%. Interest paid totalled £136.

2.7 Investment rates in 2017/18

Deposit rates continued into 2017/18 at the previous depressed levels, due in part to a large tranche of cheap financing made available to the banking sector by the Bank of England under the Term Funding Scheme. This facility ended at the end of February 2018.

Investment rates for periods of 3 months and longer were on a rising trend during the second half of 2017/18, on the expectation of an increase in Bank Rate which was duly delivered in November.

The graph below has been provided by the Council's treasury advisers.



2.8 Investment outturn for 2017/18

2.8.1 The Council's investment policy is governed by MHCLG guidance and implemented by the Annual Investment Strategy, which formed part of the TMSS approved on 1 March 2017. This policy sets out the approach for selecting investment counterparties. For 2017/18 the Chief Financial Officer adopted the Link Asset Services (LAS) credit rating methodology, a sophisticated modelling approach utilising credit ratings from all three of the main rating agencies to give a suggested maximum duration for investments. Accordingly it does not place undue reliance on any one agency's ratings. The methodology subsequently applies an "overlay" to take account of positive and negative credit watches and/or credit outlook information, which may increase or decrease the suggested duration of investments. It then applies a second overlay based on the credit default swap spreads for institutions, the monitoring of which has been shown to give an early warning of likely changes in credit ratings. The methodology also incorporates sovereign ratings to ensure selection of counterparties from only the most creditworthy countries. The current Treasury Strategy permits the use of any UK counterparties, subject to their individual credit ratings under the LAS methodology. It also permits the use of counterparties from other countries with a minimum sovereign rating of AA. For information, at 31 March 2018 the UK currently had a rating of AA.

2.8.2 Whilst credit ratings advice is taken from the treasury advisers, the ultimate decision on what is prudent and manageable for the Council is taken by the Chief Financial Officer under the approved scheme of delegation.

2.8.3 The TMSS for 2017/18 was approved by Council on 1 March 2017. At Cabinet on 2 November 2017, Members agreed an amendment to Appendix 3 of the TMSS to add the use of Property Funds to the list of approved investment instruments, and referred the amendment to Full Council for approval as required by the regulations. Approval was confirmed on 15 November 2017.

2.8.4 The Council's investment priorities in 2017/18 remained the security of capital and good liquidity. Whilst the Council always seeks to obtain the optimum return (yield) on its investments, this is at all times commensurate with proper levels of security and liquidity. In the current economic climate it has remained appropriate either to keep investments short–term to cover cashflow needs, or to take advantage of fixed period up to six months with a small number of selected counterparties.

2.8.5 During 2017/18, significant use was made of two money market funds, currently achieving around 0.4%. These funds are AAA rated investment

vehicles which allows the pooling of many billions of pounds worth of assets into highly diversified funds, thus reducing risk.

2.8.6 Following approval for the use of Property Funds (see 2.8.3 above), an investment of £1m was made in the CCLA Local Authority Property Fund (LAPF) on 30 November 2017. The LAPF is a local government investment scheme approved by the Treasury under the Trustee Investments Act 1961 (section 11). Dividends are currently averaging around 4.5% per annum and are treated as revenue income. This investment has allowed the Council to introduce a property element into its investment portfolio without the risks associated with the direct purchase of assets. The main risk around Property Funds is the preservation of the capital sum; however evidence from recent years shows that over time the property market has been a positive long-term investment. It is accordingly anticipated that this investment will be held for at least five years to minimise any risk.

The property fund investment purchased a number of units, determined by the unit price on the entry date. This valued the initial investment of £1m at £936,770, setting the implied entry fee at £63,230, or 6.32%. The certified value of the property fund investment at 31 March 2018 was £956,242, and the difference of £43,758 has been transferred to an Available for Sale Financial Instruments Reserve in accordance with accounting requirements.

2.8.7 Investment interest of £65,684 (including dividends on the property fund totalling £14,083) was generated in the year, representing an equated rate of 0.54%. This outperforms the benchmark average 7 day LIBID rate, which ended the year at 0.21%, and in cash terms represents additional income to the General Fund of £40,100. This was achieved as a result of positive investment management, together with dividends on the new Property Fund. Performance in respect of the longer average 3 month LIBID rate, which ended the year at 0.28%, still represents additional income of £31,600.

2.8.8 Investment activity during the year conformed to the approved strategy and the Council had no liquidity difficulties. The investment counterparty limit of £3m was exceeded by £90k on a single occasion during Q3 of 2017/18 for operational reasons, however the Chief Financial Officer has delegated authority to vary the limit as appropriate, and the matter was reported to Cabinet at its next meeting in February 2018, as required by the TMSS.

2.8.9 The Treasury Activity Report for the year ended 31 March 2018 is attached at Appendix 1 in accordance with the TMSS. For reference, definitions of LIBOR and LIBID are given at Appendix 2.

2.8.10 Under the cash-backed Local Authority Mortgage Scheme, launched in April 2012, the Council made two advances of £1m each to Lloyds Banking Group, each for a period of five years to match the life of the indemnities. The first advance matured in April 2017 but the other remains active, and is due to mature on 11 June 2018. This advance is classified as service investment, rather than a treasury management investment and is therefore outside the specified/non-specified categories.

2.9 Compliance with Prudential and treasury indicators

2.9.1 It is a statutory duty for the Council to determine and keep under review the affordable borrowing limit. The Council's approved Prudential and Treasury Indicators (affordability limits) are included in the Treasury Management Strategy Statement (TMSS) approved by Council on 1 March 2017.

2.9.2 During the financial year 2017/18 the Council has at all times operated within the Prudential and Treasury Management Indicators set out in the Council's TMSS, and in compliance with the Council's Treasury Management Practices. A summary of the outturn position at 31 March in respect of each of the 2017/18 Prudential and Treasury Management Indicators is shown at Appendix 3.

a) Prudential Indicators:

i) Capital Expenditure

Capital expenditure for 2017/18 totalled £3,514,156. This differs to the approved indicator of £4,967,900 due to the inclusion of approved carry forward requests from 2016/17, and to the approved variations to the capital programme during 2017/18, which include the slippage of schemes to 2018/19.

ii) Capital Financing Requirement (CFR)

The CFR represents the Council's underlying need to borrow and totalled £11,261,803 at 31 March 2018. This is lower than the approved indicator of £13,160,400 due to savings on the 2016/17 capital programme, slippage of schemes from 2016/17 to 2017/18, and additional capital receipts, all of which reduced the borrowing requirement in 2016/17. There have also been amendments to the capital programme during 2017/18, including the slippage of schemes to 2018/19.

iii) Ratio of Financing Costs to Net Revenue Stream

The outturn of 8.05% represents a decrease on the approved indicator of

11.00%. This is due to a reduction in MRP arising from savings and slippage on the capital programme in 2016/17, a saving in PWLB interest because planned new borrowing was not undertaken, additional investment interest, and lower than expected revenue contributions to capital due to delays with the Arnold Market scheme.

iv) Maximum gross debt

The Council must ensure that its gross debt does not, except in the short term, exceed the opening capital financing requirement, plus estimates of any additional CFR for 2017/18 and the following two financial years. This allows flexibility for early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes. Gross debt at 31 March 2018 was £6.812m which was well within the approved indicator.

(b) Treasury Management Indicators:

The Treasury Management indicators are based on limits, beyond which activities should not pass without management action, and the Council has operated within these limits at all times during 2017/18. They include two key indicators of affordability and four key indicators of prudence and Appendix 3 demonstrates the outturn position compared to each limit.

Affordability

i) Operational boundary for external debt

This is the limit above which external debt is not “normally” expected to pass. In most cases this would be a similar figure to the CFR but may be lower or higher depending on the level of actual debt.

ii) Authorised limit for external debt

This limit represents a control on the “maximum” level of borrowing and is the statutory limit determined under s3(1) of the Local Government Act 2003. It represents the limit beyond which external debt is prohibited.

The Authorised limit must be set, and revised if necessary, by Full Council. It reflects a level of external debt which, whilst neither desirable nor sustainable in the longer term, could be afforded in the short term. The Government retains an option to control either the total of all Councils’ plans, or a specific Council, although this power has not yet been exercised.

Prudence

iii) Upper limit for fixed interest exposure – represented by the maximum permitted net outstanding principal sum borrowed at fixed rates. Please note that a negative indicator represents a position of net investment.

iv) Upper limit for variable interest rate exposure – represented by the maximum permitted net outstanding principal sum borrowed at variable rates. Please note that a negative indicator represents a position of net investment.

v) Maximum new principal sums to be invested during 2017/18 for periods in excess of 364 days - such investments are classified as a "non-specified". This indicator is subject to the overall limit for non-specified investments set in the TMSS.

vi) Upper limits for the maturity structure of borrowing - set to reduce the Council's exposure to large fixed rate sums falling due for refinancing.

2.10 Other Issues

2.10.1 Revised Cipfa Codes of Practice

Revised editions of the Prudential Code and the Treasury Management Code and Cross Sectoral Guidance Notes were published in December 2017. Changes, whilst not wide ranging, will be effective from 2018/19. A particular focus of the revised guidance was how to deal with local authority investments which are not "treasury investments", eg. property purchases, in order to generate income for the authority at a higher level than can be attained by treasury investments.

The most significant change in the revised Prudential Code is the explicit requirement for the preparation of a Capital Strategy, setting out the long term context in which capital expenditure and investment decisions are made. The strategy must give due consideration to both risks and rewards, as well as any impact on the achievement of the Council's priority outcomes. The Council already produces a Capital Programme and Capital Investment Strategy and this will be reviewed to ensure that any additional requirements of the revised Code are incorporated.

The revised Codes acknowledge the drive for income generation and the use of non-treasury related investment instruments, such as investment property, but they reiterate the need for risk management - including proportionality in respect of overall resources.

2.10.2 Revised Investment and MRP Guidance

The Ministry of Housing, Communities and Local Government (MHCLG) issued revised Investment Guidance and Minimum Revenue Provision (MRP) Guidance in February 2018, again for implementation in 2018/19. Noteworthy is the change in the definition of "investment" to include expenditure driven activity, eg. commercial property, as well as simple treasury cash. Such activity would represent "non-treasury investments", ie investments in "non-financial assets".

The effective definition in the 2010 guidance of short term investment being that repayable "within 12 months" has been removed from the 2018 guidance. A long term investment now is therefore one in excess of 365 days (previously 364 days).

The revised MRP guidance also focused on expenditure on non-financial investments, eg. property, making it clear that the duty to make MRP extends to investment property where its acquisition has been partially or fully funded by an increase in borrowing. The guidance also confirms that borrowing may only be undertaken for strategic purposes and not purely for financial return.

2.10.3 MiFID II

The Markets in Financial Instruments Directive (MiFID II) regulations came into effect on 3 January 2018 and govern the relationship between financial institutions conducting lending and borrowing transactions and local authorities from that date. Local authorities are now classed as "retail clients" unless they opt up to "professional status", which is done by the completion of a form for each individual institution (investment counterparties and advisers etc) to confirm that a minimum investment portfolio of £10m is held at the opt-up date, and that **either** a minimum number of transactions are conducted with that institution in a year, **or** that the authority (effectively the CFO) has at least one year's experience in a professional position in financial markets which require knowledge of the transactions or services envisaged.

Most of Gedling's treasury investment instruments are straightforward cash deposits with banks and building societies, which are not affected, therefore there should be no major impact on the Council, since remaining a retail client in these circumstances should cause no difficulty. Most Money Market Funds and Property Funds **are** however covered by the new regulations and during the year the CFO has completed the opt-up procedure to be recognised as a professional client where appropriate. Opt-ups have also been made to maintain current relationships with the Council's treasury advisers (LAS) and brokers for the arrangement of

temporary borrowing (ICAP).

Alternative Options

There are no alternative options, this report being a requirement of the Council's Treasury Management Strategy Statement (TMSS).

Financial Implications

No specific financial implications are attributable to this report.

Appendices

1. Annual Treasury Activity Report 2017/18.
2. Definitions of LIBOR and LIBID
3. Outturn Prudential and Treasury Management Indicators for 2017/18.

Background Papers

None identified.

Recommendation

That:

Members approve the Annual Treasury Activity Report and refer it to Full Council for approval as required by the regulations.

Reasons for Recommendations

To comply with the requirements of the Council's Treasury Management Strategy Statement.

For more information, please contact:

Alison Ball, Financial Services Manager, on 0115 901 3980.