Treasury Management Outturn Report 2017/18

Introduction

The Council has adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Council to approve a treasury management annual report after the end of each financial year.

This report fulfils the Councils legal obligation to have regard to the CIPFA Code.

The Council's treasury management strategy for 2017/18 was approved at a meeting of the Authority on 23rd February 2017. The Authority has invested substantial 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 Authority's treasury management strategy.

External Context

Economic commentary 2017-18 was characterised by the push-pull from expectations of tapering of Quantitative Easing (QE) and the potential for increased policy rates in the US and Europe and from geopolitical tensions, which also had an impact.

The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in calendar 2017, the same level as in 2016. This was a far better outcome than the majority of forecasts following the EU Referendum in June 2016, but it also reflected the international growth momentum generated by the increasingly buoyant US economy and the re-emergence of the Eurozone economies.

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. Consumers felt the squeeze as 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 4.3% in January 2018. The inherent weakness in UK business investment was not helped by political uncertainty following the surprise General Election in June and by the lack of clarity on Brexit, the UK and the EU only reaching an agreement in March 2018 on a transition which will now be span Q2 2019 to Q4 2020.

The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 0.25% in November 2017. It was significant in that it was the first rate hike 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 highly likely.

Financial markets: The increase in Bank Rate resulted in higher money markets rates: 1-month, 3-month and 12-month LIBID rates averaged 0.32%, 0.39% and 0.69% and at 31st March 2018 were 0.43%, 0.72% and 1.12% respectively.

Gilt yields displayed significant volatility over the twelve-month period with the change in sentiment in the Bank of England's outlook for interest rates. The yield on the 5-year gilts which had fallen to 0.35% in mid-June rose to 1.65% by the end of March. 10-year gilt yields also rose from their lows of 0.93% in June to 1.65% by mid-February before falling back to 1.35% at year-end. 20-year gilt yields followed an even more erratic path with lows of 1.62% in June, and highs of 2.03% in February, only to plummet back down to 1.70% by the end of the financial year.

The FTSE 100 had a strong finish to calendar 2017, reaching yet another record high of 7688, before plummeting below 7000 at the beginning of 2018 in the global equity correction and sell-off.

Credit background: The most significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities.

Changes to credit ratings included Moody's downgrade of Standard Chartered Bank's long-term rating to A1 from Aa3 and the placing of UK banks' long-term ratings on review to reflect the impending ring-fencing of retail activity from investment banking (Barclays, HSBC and RBS were on review for downgrade; Lloyds Bank, Bank of Scotland and National Westminster Bank were placed on review for upgrade).

Standard & Poor's (S&P) revised upwards the outlook of various UK banks and building societies to positive or stable and simultaneously affirmed their long and short-term ratings, reflecting the institutions' resilience, progress in meeting regulatory capital requirements and being better positioned to deal with uncertainties and potential turbulence in the run-up to the UK's exit from the EU in March 2019. The agency upgraded Barclays Bank's long-term rating to A from A- after the bank announced its plans for its entities post ring-fencing.

Fitch revised the outlook on Nationwide Building Society to negative and later downgraded the institution's long-term ratings due to its reducing buffer of junior debt. S&P revised the society's outlook from positive to stable.

S&P downgraded Transport for London to AA- from AA following a deterioration in its financial position.

Moody's downgraded Rabobank's long-term rating due to its view on the bank's profitability and the long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment and the ratings of the large Australian banks on its view of the rising risks from their exposure to the Australian housing market and the elevated proportion of lending to residential property investors. S&P also upgraded the long-term rating of ING Bank to A+.

Other developments: In February, Arlingclose advised against lending to Northamptonshire County Council (NCC). NCC issued a section 114 notice in the light of severe financial challenge and the risk that it would not be in a position to deliver a balanced budget.

In March, following Arlingclose's advice, the Authority removed RBS plc and National Westminster Bank from its counterparty list. 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 FY 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, the bank would be reinstated on the Authority's lending list.

Local Authority Regulatory Changes

Revised CIPFA Codes: CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The required changes from the 2011 Code are being incorporated into Treasury Management Strategies and monitoring reports.

The 2017 Prudential Code introduces the requirement for a Capital Strategy which provides a high-level overview of the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for future financial sustainability. Where this strategy is produced and approved by full Council, the determination of the Treasury Management Strategy can be delegated to a committee. The Code also expands on the process and governance issues of capital expenditure and investment decisions. The Capital Strategy for Chesterfield Borough Council will be produced along with the Investment Strategy for 2019/20 in February 2019.

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. Additional risks of such investments are to be set out clearly and the impact on financial sustainability is be identified and reported.

MiFID II: 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 was met which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a 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.

The Authority has met the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. The Authority will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

Local Context

On 31st March 2018, the Authority had net borrowing of £85m arising from its revenue and capital income and expenditure, a decrease on 2017 of £13.2m. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the

underlying resources available for investment. These factors and the year-on-year change are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.17 Actual £000	2017/18 Movement £000	31.3.18 Actual £000
General Fund CFR	13,983	1,160	15,143
HRA CFR	134,359	(2,016)	132,343
Total	**148,342**	**(856)**	**147,486**
Less: Usable reserves	(39,932)	(11,508)	(51,440)
Less: Working capital	(10,183)	(922)	(11,103)
Net borrowing	**98,227**	**(13,286)**	**84,943**

Net borrowing has decreased due to a fall in the CFR as new capital expenditure was lower than the financing applied including minimum revenue provision; together with an increase in usable reserves, especially due to £2.4m in the HRA working balance and £5.5m in the Capital Grants Unapplied Reserve; and a rise in working capital due to the timing of receipts and payments.

The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31st March 2018 and the year-on-year change in show in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £000	2017/18 Movement £000	31.3.18 Balance £000	31.3.18 Rate %
Long-term borrowing Short-term borrowing	133,245 0	1,942 0	131,303 0	
Total borrowing	**133,245**	**1,942**	**131,303**	**3.79**
Long-term investments Short-term investments Cash and cash equivalents	3,256 15,169 16,593	(3,256) 5,069 9,529	0 20,238 26,122	
Total investments	**35,018**	**11,342**	**46,360**	**0.59**
Net borrowing	**98,227**	**13,284**	**84,943**	

The decrease in net borrowing in table 1 has translated into a rise in investment balances. A major contributing factor to this was the receipt of the Sheffield City Region grant towards the Northern Gateway project of £5.4m that was received in March 2018.

Borrowing Activity

At 31st March 2018, the Authority held £131m of loans, a decrease of £2m on the previous year, as part of its strategy for funding previous years' capital programmes. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position

	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Rate %	31.3.18 Average maturity years
Public Works Loan Board	133,243	1,941	131,302	3.79	28 years
Local Authorities (short term)	0	0	0		
Other	2	1	1	6.25	<1 year
Total borrowing	**133,245**	**1,942**	**131,303**		

The Authority'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 Authority's long-term plans change being a secondary objective.

In furtherance of these objectives, no new external borrowing was undertaken in 2017/18, while existing loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs and reduce overall treasury risk.

The “cost of carry” analysis performed by the Authority’s treasury management advisor Arlingclose did not indicate any value in borrowing in advance for future years’ planned expenditure and therefore none was taken.

Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2017/18, the Authority’s investment balance ranged between £38m and £56m million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change in show in table 4 below.

Table 4: Investment Position

	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Rate %	31.3.18 Average maturity years
Banks & building societies (unsecured)	15.5	(3.5)	12.0	0.56	<1 year
Covered bonds (secured)	2.0	(2.0)	0		
Government (incl. local authorities)	3.3	9.9	13.2	0.78	<1 year
Money Market Funds	14.2	6.9	21.1	0.45	<1year
Total investments	**35.0**	**11.3**	**46.3**		

Both the CIPFA Code and government guidance require the Authority 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 Authority’s objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Authority further diversified into more secure asset classes during 2017/18, particularly deposits with other Local Authorities. As a result investment risk was lowered.

Other Non-Treasury Holdings and Activity

Although not classed as treasury management activities, the 2017 CIPFA Code now requires the Authority to report on investments for policy reasons outside of normal treasury management. This includes service investments for operational and regeneration purposes as well as commercial investments which are made mainly for financial reasons. The Authority holds £46m of directly owned investment property and land. This represents a decrease of £4.2m on the previous year due to revaluation losses. The Authority also holds a £250,000 loan to the Derbyshire Building Control Partnership that commenced in March 2018.

Performance Report

The Authority measures the financial performance of its treasury management activities in terms of its impact on the revenue budget, as shown in table 6 below.

Table 6: Performance

	Actual £000	**Budget £000**	**Over/ under**
Total investment income	(224)	(225)	1
Total debt expense	5,169	5,181	(12)
GRAND TOTAL	4,945	4,956	(11)

Compliance Report

The Head of Finance and Resources is pleased to report that all treasury management activities undertaken during 2017/18 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	2017/18 Maximum	31.3.18 Actual	2017/18 Limit	Complied
Any single organisation	**£5m**	**£5m**	**£5m**	✓
Any group of funds under the same management	**£7.5m**	**£5m**	**£7.5m**	✓
Enhanced Money Market Funds	**£15m**	**£12m**	**£15m**	✓

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 8: Debt Limits

	2017/18 Maximum £000	31.3.18 Actual £000	2017/18 Operational Boundary £000	2017/18 Authorised Limit £000	Complied
Borrowing	**£133,245**	**£131,303**	**£133,250**	**£143,000**	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure. Total debt was above the operational boundary for the whole of 2017/18.

Treasury Management Indicators

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

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed was:

	31.3.18 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure	53%	100%	✓
Upper limit on variable interest rate exposure	47%	50%	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

	31.3.17 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	1.5%	15%	0%	✓
12 months and within 24 months	1.5%	15%	0%	✓
24 months and within 5 years	5.2%	45%	0%	✓
5 years and within 10 years	10.3%	75%	5%	✓
10 years and above	81.5%	95%	25%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days: These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

	2017/18	2018/19	2019/20
Actual principal invested > 364 days	0%	0%	0%
Limit on principal invested > 364 days	33%	25%	25%
Complied	✓	✓	✓