

AUDIT COMMITTEE

27 JUNE 2018

TREASURY MANAGEMENT OUTTURN ANNUAL REPORT

Report from: Phil Watts, Chief Finance Officer

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Summary

This report gives an overview of treasury management activity during 2017/18.

1. Budget and Policy Framework

1.1. The Council's treasury management strategy and policy are approved by Full Council following consideration by Cabinet and Audit Committee. The Audit Committee is responsible for approving the annual treasury outturn. In line with the Constitution an annual report must be taken to Cabinet detailing the Council's treasury management outturn within six months of the close of each financial year.

2. Background

2.1. This Council is required by regulations issued under the Local Government Act 2003 to produce an annual review of treasury management 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).

2.2. During 2017/18 the minimum reporting requirements were that the full Council should receive the following reports:

- An annual treasury strategy in advance of the year (Council 23 February 2017).
- A mid-year treasury review report (Council 12 October 2017).

2.3. The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

- 2.4. This Council also promotes prior scrutiny of the Treasury Strategy and mid-year review by submission to Audit Committee before reporting to Cabinet and Full Council.
- 2.5. This annual treasury outturn report covers:
- The Council's treasury position as at 31 March 2018
 - Borrowing activity 2017/18
 - Performance measurement
 - The strategy for 2017/18
 - The economy and interest rates in 2017/18
 - Borrowing rates in 2017/18
 - The borrowing outturn for 2017/18
 - Debt rescheduling;
 - Compliance with treasury limits and Prudential Indicators
 - Investment rates in 2017/18
 - Investment outturn for 2017/18

3. The Economy and Interest Rates

- 3.1. During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year which meant 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 into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up modestly in the second half of 2017. Consequently, market expectations during the autumn, rose significantly that the MPC would be heading in the direction of imminently raising Bank Rate. The minutes of the MPC meeting of 14 September indicated that the MPC was likely to raise Bank Rate very soon. The 2 November MPC quarterly Inflation Report meeting duly delivered by raising Bank Rate from 0.25% to 0.50%. The 8 February MPC meeting minutes then revealed another sharp hardening in MPC warnings on a more imminent and faster pace of increases in Bank Rate than had previously been expected. Market expectations for increases in Bank Rate, therefore, shifted considerably during the second half of 2017-18 and resulted in investment rates from 3 – 12 months increasing sharply during the spring quarter.
- 3.2 PWLB borrowing rates increased correspondingly to the above developments with the shorter term rates increasing more sharply than longer term rates. In addition, UK gilts have moved in a relatively narrow band this year, (within 25 bps for much of the year), compared to US treasuries. During the second half of the year, there was a noticeable trend in treasury yields being on a rising trend with the Fed raising rates by 0.25% in June, December and March,

making six increases in all from the floor. The effect of these three increases was greater in shorter terms around 5 year, rather than longer term yields.

- 3.3 The major UK landmark event of the year was the inconclusive result of the general election on 8 June. However, this had relatively little impact on financial markets.

4. Overall Treasury Position as at 31 March 2018

- 4.1 The Council's debt and investment position at the beginning and end of the year was as follows.

Table 1 – borrowing and investment levels

	31/03/17 £m	Rate	31/03/18 £m	Rate
Long Term Borrowing – PWLB/LOBO	162.30	4.22%	162.30	4.22%
Long Term Borrowing – Growing Places/Salix	7.40		7.30	
Finance Leases	0		0.06	
Embedded Leases	0.30		0	
Short Term Borrowing	36.20	0.36%	67.50	0.63%
Total Debt	206.20		237.16	
Capital Financing Requirement (CFR)	255.44		255.05	
(Under)/Over Borrowing	(49.24)		(17.89)	
Less investments (exc Property Funds)	21.80	1.30%	28.31	1.11%
Less Property Fund Investments *	2.80	3.17%	22.31	1.50%
Net borrowing	181.60		186.54	

- * The return on the property fund investments includes the change in capital value. Just under an additional £20m was invested mid way through the year. The overall return is net of a downward revaluation of almost £470,000, largely reflecting the bid-offer pricing spread.

5. The Strategy for 2017/18

- 5.1 The expectation for interest rates within the treasury management strategy for 2017/18 anticipated that Bank Rate would not start rising from 0.25% until quarter 2 2019 and then only increase once more before 31.3.20. There would also be gradual rises in medium and longer term fixed borrowing rates during 2017/18 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates. The expectation for interest rates within the treasury management strategy for 2016/17 anticipated low but rising Bank Rate, (starting in quarter 1 of 2016), and gradual rises in medium and longer term fixed borrowing rates during 2016/17. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low

counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

- 5.2 In this scenario, the treasury strategy was to postpone long term borrowing to use short duration loans to reduce borrowing costs.
- 5.3 During 2016/17 there was major volatility in PWLB rates with rates falling during quarters 1 and 2 to reach historically very low levels in July and August, before rising significantly during quarter 3, and then partially easing back towards the end of the year.

6. The Borrowing Requirement and Debt

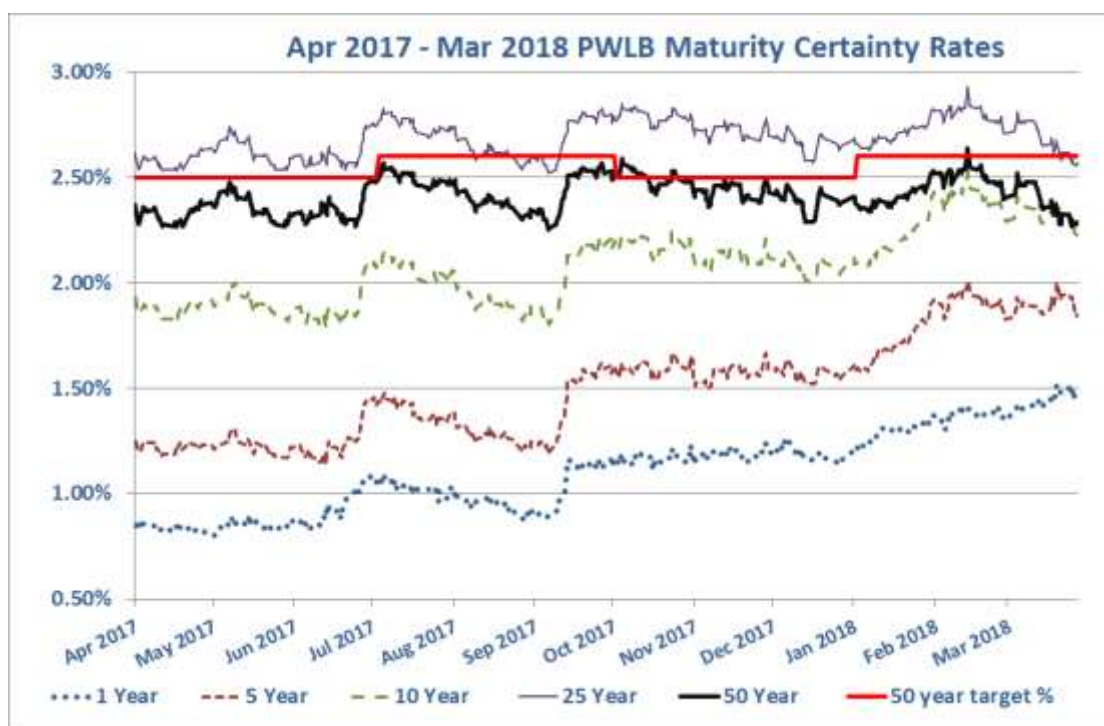
- 6.1. The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR).

Table 2 Capital Financing Requirement

	31 March 2017 Actual £000	31 March 2018 Budget £000	31 March 2018 Actual £000
CFR General Fund (£m)	213,499	219,028	213,414
CFR HRA (£m)	41,941	43,705	41,640
Total CFR	255,440	262,733	255,054

7. Borrowing rates in 2017/18

- 7.1. As depicted in the graph and tables below and in appendix 4, PWLB 25 and 50 year rates have been volatile during the year with little consistent trend. However, shorter rates were on a rising trend during the second half of the year and reached peaks in February / March.
- 7.2. During the year, the 50 year PWLB target (certainty) rate for new long term borrowing was 2.50% in quarters 1 and 3 and 2.60% in quarters 2 and 4.
- 7.3. The graphs and tables for PWLB rates show, for a selection of maturity periods, the average borrowing rates, the high and low points in rates, spreads and individual rates at the start and the end of the financial year.



8. Borrowing Outturn for 2017/18

- 8.1 The borrowing strategy for the council confirmed the holding of £101.8 million in Lenders Options, Borrowers Options (LOBO) debt. These are debts that are subject to immediate repayment or variation of interest chargeable and the option to repay, on request from the lender on the review dates. However, the lender can only apply this clause once within the lifetime of the LOBO.
- 8.2 No new long term loans were taken out and no repayments of long term loans made except for annuity repayments.
- 8.3 The approach during the year was to use cash balances to finance new capital expenditure so as to run down cash balances and minimise counterparty risk incurred on investments. This also maximised treasury management budget savings, as investment rates were much lower than most new borrowing rates.
- 8.4 Details of the short term borrowing at 1 April 2017 is shown in the table below

Lender	Amount Borrowed	Date Borrowed	Date Repaid	Annual Interest Rate (inc brokerage)
Middlesborough Borough Council	£10m	27/2/17	28/4/17	0.33%
Royal Borough of Kensington & Chelsea	£5m	24/10/16	17/10/17	0.43%
City of London Corporation	£10m	7/3/17	28/4/17	0.48%
Gateshead Council	£5m	7/3/17	18/4/17	0.48%
Police & Crime Commissioner for West Midlands	£5m	7/3/17	3/4/17	0.40
Total Short Term Borrowing at 1 April 2017	£35m			

8.5 New loans taken during 2017/18 but repaid before 31 March 2018 were

Lender	Amount Borrowed	Date Borrowed	Repayment Date	Annual Interest Rate (inc brokerage)
London Borough of Croydon Pension Fund	£10m	3/4/17	3/5/17	0.45%
Royal Borough of Kensington & Chelsea	£5m	17/10/17	17/1/18	0.37%
Westminster City Council	£10m	19/4/17	20/2/18	0.61%
Derbyshire Pension Fund	£10m	24/4/17	29/9/17	0.55%
Lieicester City Council	£5m	28/4/17	31/10/17	0.55%
Essex County Council	£10m	28/4/17	31/10/17	0.55%

8.6 The following loans taken out during 2017/18 were still outstanding at 31 March 2018.

Lender	Amount Borrowed	Date Borrowed	Repayment Date	Annual Interest Rate (inc brokerage)
Oxfordshire County Council	£5m	16/10/17	12/10/17	0.65%
Greater Manchester Pension Fund	£10m	26/10/17	26/7/18	0.57%
Somerset County Council	£5m	1/11/17	1/11/18	0.71%
City of Edinburgh Council	£10m	23/11/17	23/5/18	0.60%
Bolton MBC	£5m	21/12/18	21/12/18	0.73%
Westminster City Council	£10m	9/2/18	9/11/18	0.76%
Oxfordshire County Council	£5m	1/3/18	16/4/18	0.78%
Stevenage Council	£1m	2/3/18	19/4/18	0.73%
Swansea Council	£1.5m	5/3/18	24/4/18	0.73%
Hertfordshire County Council	£5m	26/3/18	26/6/18	0.88%
London Borough of Newham	£10m	29/3/18	29/6/18	0.70%
Total Short Term Borrowing at 31 March 2018	£67.5m			

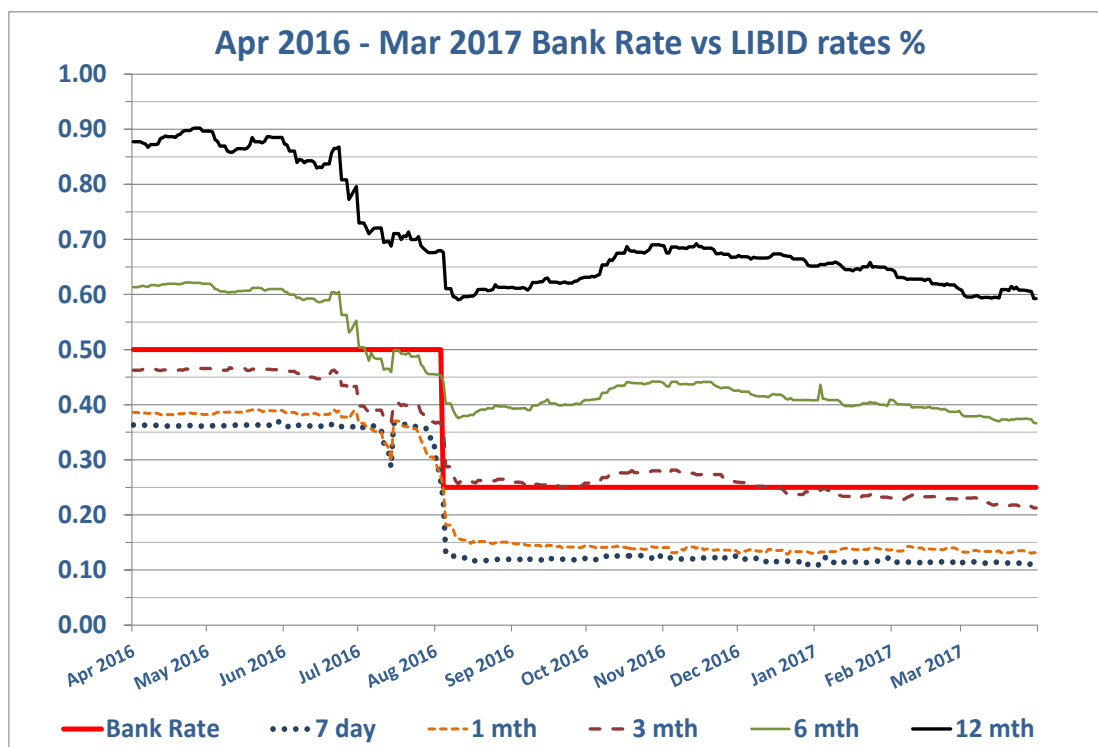
9. Debt Rescheduling

9.1 No debt restructuring was undertaken during 2017/18 as the average differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable. It is not envisaged that there will be any opportunities where the debt restructuring would be economically viable in 2018/19 however some of the short term loans above may be replaced by longer term loans to reduce liquidity risk by smoothing the repayment profile.

10. Investment Rates in 2017/18

10.1 Investments rates for 3 months and longer have been on a rising trend during the second half of the year in the expectation of Bank Rate increasing from its floor of 0.25%, and reached a peak at the end of March. Bank Rate was duly raised from 0.25% to 0.50% on 2 November 2017 and remained at that level for the rest of the year. However, further increases are expected over the next

few years. Deposit rates continued into the start of 2017/18 at previous depressed levels due, in part, to a large tranche of cheap financing being made available under the Term Funding Scheme to the banking sector by the Bank of England; this facility ended on 28 February 2018.,



11. Investment Outturn for 2017/2018

- 11.1 **Investment Policy** – the Council’s investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council on 25 February 2016. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).
- 11.2 **Internally Managed Investments** – The Council manages its investments in-house using the institutions listed in the Council’s approved lending list. These funds are identified as ‘core funds’ where the investment can be for an extended time period and usually fixed prepayment date, or ‘cash flow’ where the investment is required to be available for immediate liquidity. The council can invest for a range of periods from overnight to 5 years dependent on forecast of the Council’s cash flows, the duration and counterparty limits set out in the approved investment strategy, its interest rate view and the interest rates on offer. During the year all investments were made in full compliance with the Council’s treasury management policies and practices. The Annual Investment Strategy, outlines the Council’s investment priorities as:
- (1) Security of capital and liquidity; and
 - (2) The achievement of optimum return (yield) on investments.
- 11.3 **Externally Managed Investments** – The Council invested £23m in property funds managed by Churches Charities & Local Authorities (CCLA), Lothbury

and Rockspring. These redemption value of these funds (fair value) at 31 March 2018 was £22.3m.

- 11.4 **Investment performance for 2017/18** – Detailed below is the result of the investment strategy undertaken by the Council.

Table 3 Internally Managed Investment Performance 2017/18

	Average Investment	Rate of Return (gross of fees)
Internally Managed – Core Funds	£16,226,027	2.17%
Internally Managed – Cash Flow Funds	£21,024,535	0.28%
Overall Internally Managed Funds (excluding Property Funds)	£37,240,662	1.11%

- 11.5 Core funds were invested with other local authorities as follows:

Authority	£m	Maturity Date	Rate%
City of Newcastle Upon Tyne	5.000	31/7/19	2.35
Lancashire County	5.000	1/8/18	2.00
Doncaster Metropolitan Borough	5.000	8/8/19	2.35
Newport City	4.475	10/7/17	1.50
Total Core Investment at 1 April 2017	19.475		

- 11.6 Property fund investments and income are summarised below:

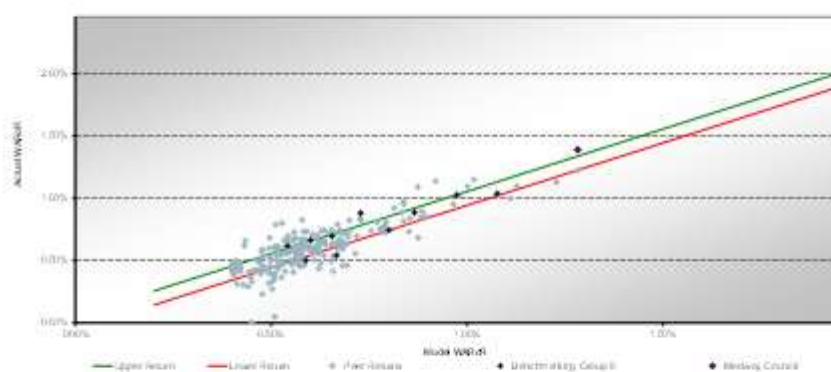
	CCLA	Lothbury	Rockspring	Total
	£000	£000	£000	£000
Opening Value	2,778	0	0	2,778
New Investment	10,000	5,000	4,999	19,999
Revaluation	-365	-157	52	-470
Closing Value	<u>12,413</u>	<u>4,843</u>	<u>5,051</u>	<u>22,307</u>
Cash Dividend	240	76	96	412
Accrued Dividend	<u>134</u>	<u>40</u>	<u>59</u>	<u>233</u>
Total Dividend	<u>374</u>	<u>116</u>	<u>155</u>	<u>645</u>
Overall Gain/ (Loss)	9	-41	207	175

- 11.7 No institutions in which investments were made during 2016/2017 had any difficulty in repaying investments and interest in full during the year.
- 11.8 The graph below is produced by Link Asset Services (our external adviser) in its own benchmarking exercises which are built to compare return vs. risk. Please note that property fund data is not included in the graph.
- 11.9 The “x” axis of the graph shows the “Model Weighted Average Rate of Return” (WARoR), this is the level of return we should expect for the level of risk that we are taking with our investment portfolio. This is then plotted against the “Actual Weighted Average Rate of Return” on the “y” scale. Running diagonally upwards across the graph are two parallel lines, if a Council

performance falls between these lines then they are deemed to be receiving a return as would be expected for their level of risk, below these two lines and performance is considered below that expected and above indicates that the return being received is above expectation. As can be seen Medway's return is "above" that expected for our level of risk.

- 11.10 The Link benchmarking is run as a snap shot as at 31 March 2018 and not the performance for the whole of 2017-18 financial year.

Population Returns against Model Returns



12. Compliance with Treasury Limits

- 12.1. There were no breaches of treasury limits in 2017-18. The outturn for the Prudential Indicators is shown in Appendix 1.

13. Risk Management

- 13.1. Risk and the management thereof is a key feature throughout the strategy and in detail within the treasury management practices (TMP1) within the Treasury Strategy.

14. Other Matters

- 14.1. Revised CIPFA Codes:

- 14.2. In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued a revised Treasury Management Code and Cross Sectoral Guidance Notes, and a revised Prudential Code.

- 14.3. A particular focus of these revised codes was how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the Authority at a much higher level than can be attained by treasury investments. One recommendation was that local authorities should produce a new report to members to give a high level summary of the overall capital strategy and to enable members to see how the cash resources of the Authority have been

apportioned between treasury and non-treasury investments. Officers will report to members when the implications of these new codes have been assessed as to the likely impact on this Authority.

- 14.4. **Markets in Financial Instruments Directive ii (MIFID II)** – The EU set the date of 3 January 2018 for the introduction of regulations under MIFID II. These regulations govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This has had little effect on this Authority apart from having to fill in forms sent by each institution dealing with this Authority and for each type of investment instrument we use, apart from for cash deposits with banks and building societies.

15. Financial Implications

- 15.1. Overall the Interest and Financing budget made a deficit over its targeted budget of £112k.
- 15.2. A breakdown of the Interest and Financing budget is shown below

Table 4 Interest and Finance Budget against spend

	Budget 2017/18 £000	Actual 2017/18 £000	(Under)/ Overspend £000
Treasury Expenses	190	200	10
Interest Earned	-3,170	-3,133	37
Interest Paid	8,665	8,669	4
KCC Principal	1,477	1,477	0
MRP	3,330	3,378	48
Invest to Save recharges	-1,133	-1,133	0
Treasury Advice	28	40	12
Total	9,387	9,498	111

- 15.3. The shortfall in interest earned is due to the low interest rates available and the squeeze on cash resources from spending of past receipts and reserves for capital expenditure.
- 15.4. Actual MRP charges reflect additional borrowing as part of the financing of 2016/17 expenditure the exact figure was not known at the time of budgeting.
- 15.5. The body of the report and the appendix outline the significant financial implications. Any transactions undertaken on either investments or borrowings are governed by the London Code of Conduct, the council's treasury policy statement, and the CIPFA Code of Practice on Treasury Management in Local Authorities.

16. Legal implications

- 16.1 For the financial year 2017/18 our investments were managed in compliance with the Codes of Practices, guidance and regulations made under the Local Government Act 2003.

17. Recommendation

17.1 The Committee is asked to approve this treasury management outturn annual report and refer it to Cabinet.

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Appendices

Appendix 1 Prudential and Treasury Indicators

Background papers

None

PRUDENTIAL AND TREASURY INDICATORS

	2016/17	2017/18	2017/18
	£'000	£'000	£'000
	Actual	Estimate	Actual
Capital Expenditure			
Non - HRA	40,073	32,418	31,980
HRA	7,656	7,054	4,895
TOTAL	47,729	39,472	36,875
Ratio of financing costs to net revenue stream			
Non - HRA	4.16%	4.46%	5.03%
HRA	17.24%	14.44%	13.97%
Gross borrowing requirement			
brought forward 1 April	180,797	187,899	207,684
carried forward 31 March	207,684	200,292	240,229
in year borrowing requirement	26,888	12,393	32,545
Capital Financing Requirement as at 31 March			
Non – HRA	213,499	219,373	213,414
HRA	41,941	43,360	41,640
TOTAL	255,440	262,733	255,054
HRA Limit on Indebtedness	45,846	45,864	45,864
Annual change in Cap. Financing Requirement			
Non – HRA	1,983	1,307	(85)
HRA	1,375	(300)	(301)
TOTAL	3,358	1,007	(386)

	2016/17	207/18	2016/17
	Limit	Limit	Breach?
	£'000	£'000	
Authorised Limit for external debt -			
borrowing	408,296	439,620	No Breach
other long term liabilities	1,100	550	No Breach
TOTAL	409,396	440,170	No Breach
Operational Boundary for external debt -			
borrowing	371,178	399,655	No Breach
other long term liabilities	1,000	500	No Breach
TOTAL	372,178	400,155	No Breach
HRA Limit on Debt	45,846	45,846	No Breach

Maturity structure of fixed rate borrowing during 2015/16	upper limit	lower limit	Breach?
under 12 months	50%	0%	No Breach
12 months and within 24 months	50%	0%	No Breach
24 months and within 5 years	50%	0%	No Breach
5 years and within 10 years	50%	0%	No Breach
10 years and above	100%	0%	No Breach