Medway COUNCIL
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AUDIT COMMITTEE

27 JUNE 2019

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 2018/19.

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 2018/19. 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 2018/19 the minimum reporting requirements were that the full Council should receive the following reports:

- An annual treasury strategy in advance of the year (Council 22 February 2018).
- A mid-year treasury review report (Council 11 October 2018).

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 economy and interest rates
- Overall treasury position as at 31 March 2019
- The strategy for 2018/19
- The borrowing requirement and debt
- Borrowing rates in 2018/19
- Borrowing outturn 2018/19
- Debt rescheduling
- Investment rates 2018/19
- Investment outturn 2018/19
- Compliance with treasury limits
- Risk management
- Financial implications
- Legal implications
- Prudential and treasury indicators

3. The Economy and Interest Rates

3.1. The following commentary has been provided by our advisors Link Asset Services.

3.2. After weak economic growth of only 0.2% in quarter one of 2018, growth picked up to 0.4% in quarter 2 and to a particularly strong 0.7% in quarter 3, before cooling off to 0.2% in the final quarter. Given all the uncertainties over Brexit, this weak growth in the final quarter was as to be expected. Subsequently, the date for the UK leaving the EU has been put back to 31st October 2019 and although Q1 growth in 2019 came in at 0.5%, this performance was due in many areas to stockpiling ahead of the original 31st March 2019 exit day, and the economy is therefore expected to cool in Q2 2019.

3.3. The annual growth in Q1 2019 came in at 1.8% y/y, generally in line with the Bank of England's estimate of trend growth for the UK.

3.4. After the Monetary Policy Committee raised **Bank Rate** from 0.5% to 0.75% in August 2018, it is little surprise that they have abstained from any further increases since then. We are unlikely to see any further action from the MPC until the uncertainties over Brexit clear. If there were a disorderly exit, it is likely that Bank Rate would be cut to support growth. Nevertheless, the MPC has been having increasing concerns over the trend in **wage inflation** which peaked at a new post financial crisis high of 3.5%, (excluding bonuses), in the three months to December before falling only marginally to 3.4% in the three months to January. British employers ramped up their hiring at the fastest pace in more than three years in the three months to January as the country's labour market defied the broader weakness in the overall economy as Brexit

approached. The number of people in work surged by 222,000, helping to push down the unemployment rate to 3.9 percent, its lowest rate since 1975. Correspondingly, the total level of vacancies has risen to new highs.

3.5. As for **CPI inflation** itself, this has been on a falling trend since peaking at 3.1% in November 2017, reaching a new low of 1.8% in January 2019 before rising marginally to 1.9% in February. However, in the February and May 2019 Bank of England Inflation Reports, the forecast for inflation over both the two and three year time horizons remained marginally above the MPC's target of 2%.

3.6. The rise in wage inflation and fall in CPI inflation is good news for consumers as their spending power is improving in this scenario as the difference between the two figures is now around 1.5%, i.e. a real terms increase, albeit the distribution of wage increases is broadly spread with those changing jobs enjoying significantly higher wage increases than the norm. Given the UK economy is very much services sector driven, an increase in **household spending power** is likely to feed through into providing some support to the overall rate of economic growth in the coming months.

3.7. **Brexit.** The Conservative minority government was unable to muster a majority in the Commons over its Brexit deal and the Prime Minister, Theresa May, subsequently resigned as Leader of the Conservative Party in June 2019. The EU continues to wait for the House of Commons to propose what form of Brexit it would support. At the time of writing, a Conservative leadership election process has been initiated and this will directly impact future Brexit negotiations throughout 2019/20. However, it still appears unlikely that there would be a Commons majority which would support a disorderly Brexit or revoking article 50, (cancelling Brexit). There would also need to be a long delay if there is no majority for any form of Brexit. If that were to happen, then it increases the chances of a general election in 2019; this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

3.8. **USA.** President Trump's massive easing of fiscal policy in 2018 fuelled a (temporary) boost in consumption which generated an upturn in the strong rate of growth; this rose from 2.2%, (annualised rate) in Q1 of 2018 to 4.2% in Q2, 3.5% in Q3 and then back to 2.2% in Q4. The annual rate came in at 2.9% for 2018, just below President Trump's target of 3% growth. The strong growth in employment numbers has fed through to an upturn in wage inflation which hit 3.4% in February, a decade high point. However, CPI inflation overall fell to 1.5% in February, a two and a half year low, and looks to be likely to stay around that number in 2019 i.e. below the Fed's target of 2%. The Fed increased rates another 0.25% in December to between 2.25% and 2.50%, this being the fourth increase in 2018 and the ninth in the upward swing cycle. However, the Fed now appears to be heading towards a change of direction and admitting there may be a need to switch to taking action to cut rates over the next two years.

3.9. **EUROZONE.** The European Central Bank (ECB) provided massive monetary stimulus in 2016 and 2017 to encourage growth in the EZ and that produced strong annual growth in 2017 of 2.3%. However, since then the ECB has been reducing its monetary stimulus measures and growth has been weakening - to 0.4% in quarters 1 and 2 of 2018, and then slowed further to 0.2% in quarters 3 and 4; it is likely to remain weak in 2019. The annual rate of growth for 2018

was 1.8% but is expected to fall to possibly around half that rate in 2019. The ECB completely ended its programme of quantitative easing purchases of debt in December 2018, which means that the central banks in the US, UK and EU have all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in growth, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), prompted the ECB to take new measures to stimulate growth. With its refinancing rate already at 0.0% and the deposit rate at -0.4%, it has probably reached the limit of cutting rates. At its March 2019 meeting it said that it expects to leave interest rates at their present levels “at least through the end of 2019” (subsequently increased to June 2020), but that is of little help to boosting growth in the near term. Consequently, it also announced a third round of targeted longer-term refinancing operations (TLTROs); this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank is making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank’s eligible loans.

3.10. **CHINA.** Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

3.11. **JAPAN** - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

3.12. **WORLD GROWTH.** Equity markets are currently concerned about the synchronised general weakening of growth in the major economies of the world: they fear there could even be a recession looming up in the US, though this fear is probably overdone. It is evident that monetary policy in all the developed economies is going to remain loose for the time being and that any uplift in UK rates will be very much constrained by what is happening in the global economy as well as domestic factors.

4. Overall Treasury Position as at 31 March 2019

4.1. The Council’s debt and investment position at the beginning and end of the year was as shown overleaf.

Table 1 – borrowing and investment levels

	31/03/18 £m	Rate	31/03/19 £m	Rate
Long Term Borrowing – PWLB/LOBO*	162.30	4.22%	192.30	3.60%
Long Term Borrowing – Other Local Authority	0		10.00	1.50%
Long Term Borrowing – Growing Places/Salix/LEP	7.30		7.96	
Finance Leases	0.06		0.06	
Short Term Borrowing	67.50	0.63%	40.00	0.89%
Total Debt (Principal)	237.16		250.32	
Capital Financing Requirement (CFR)	255.99		278.76	
(Under)/Over Borrowing	(18.83)		(28.44)	
Less investments (exc. Property Funds)	28.31	1.39%	18.38	1.22%
Less Property Fund Investments **	22.31	1.50%	22.72	5.88%
Net borrowing	186.54		209.22	

* Includes £2m advanced in 2001 due for repayment in November 2019

** The return on the property fund investments includes the change in capital value.

5. The Strategy for 2018/19

5.1. The strategy for 2018/19 as set out before the start of the year was to continue to use cash balances to meet funding requirements but where necessary to use short term borrowing to fund borrowing. However when drafting the strategy for 2019/20 emphasis was changed to reducing reliance on short term borrowing and to for borrowing requirements to be met by taking longer term loans. At the same time long term borrowing would be structured so as to smooth out the maturity profile of debt. This process commenced towards the end of 2018/19 hence the increase in long term borrowing and reduction in short term loans.

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 2018 Actual £000	31 March 2019 Budget £000	31 March 2019 Actual £000
CFR General Fund (£m)	214,327	243,877	237,430
CFR HRA (£m)	41,641	42,504	41,328
Total CFR	255,968	286,381	278,758

7. Borrowing rates in 2018/19

7.1. Since PWLB rates peaked during October 2018, most PWLB rates have been on a general downward trend, though longer term rates did spike upwards again during December, and, (apart from the 1 year rate), reached lows for the year at the end of March. There was a significant level of correlation between movements in US Treasury yields and UK gilt yields -which determine PWLB rates. The Fed in America increased the Fed Rate four times in 2018, making nine increases in all in this cycle, to reach 2.25% – 2.50% in December. However, it had been giving forward guidance that rates could go up to nearly 3.50%. These rate increases and guidance caused Treasury yields to also move up. However financial markets considered by December 2018, that the Fed had gone too far, and discounted its expectations of further increases. Since then, the Fed has also come round to the view that there are probably going to be no more increases in this cycle. The issue now is how many cuts in the Fed Rate there will be and how soon, in order to support economic growth in the US. But weak growth now also looks to be the outlook for China and the EU so this will mean that world growth as a whole will be weak. Treasury yields have therefore fallen sharply during 2019 and gilt yields / PWLB rates have also fallen.

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. New long term PWLB loans totalling £30 million were taken out and a further £10milion from London Borough of barking & Dagenham as part of the aim of reducing dependence on short term borrowing.

8.3. The Council continued to use cash balances to finance new capital expenditure when possible 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 2018 is shown in the table below:

Lender	Amount Borrowed £m	Date Borrowed	Date Repaid	Annual Interest Rate
Oxfordshire County Council	5.0	1/3/18	16/4/18	0.7%
Stevenage Council	1.0	2/3/18	19/4/18	0.65%
Swansea Council	1.5	5/3/18	24/4/18	0.65%
City of Edinburgh	10.0	23/11/17	23/5/18	0.57%
Hertfordshire	5.0	26/3/18	26/6/18	0.85%
London Borough of Newham	10.0	29/3/18	29/6/18	0.6%
Greater Manchester Pension Fund	10.0	26/10/18	26/7/18	0.5%
Oxfordshire County Council	5.0	16/10/17	12/10/18	0.6%
Somerset County Council	5.0	1/11/17	1/11/17	0.65%
Westminster City Council	10.0	9/2/18	9/11/18	0.68%
Bolton MBC	5.0	22/12/17	21/12/18	0.65%
Total Short Term Borrowing at 1 April 2018	67.5			

8.5. New loans taken during 2018/19 but repaid before 31 March 2019 were:

Lender	Amount Borrowed £m	Date Borrowed	Repaymen t Date	Annual Interest Rate (inc brokerage)
City & County of Swansea	5.0	25/9/18	25/3/19	0.98%
Greater Manchester Pension Fund	5.0	25/9/18	25/3/19	0.98%

8.6. The following short term loans taken out during 2018/19 were still outstanding at 31 March 2019:

Lender	Amount Borrowed £m	Date Borrowed	Repayment Date	Annual Interest Rate (inc brokerage)
North East Combined Authority	10.0	26/4/18	15/4/19	1.00%
Tees valley Combined Authority	5.0	28/6/18	27/6/19	0.85%
Gloucestershire County Council	5.0	18/6/18	27/6/19	0.85%
Middlesbrough Teesside Pension Fund	10.0	25/7/18	2/7/19	0.85%
London Borough of Bromley	10.0	2/11/18	1/11/19	1.19%
Total Short Term Borrowing at 31 March 2018	40.0			

9. Debt Rescheduling

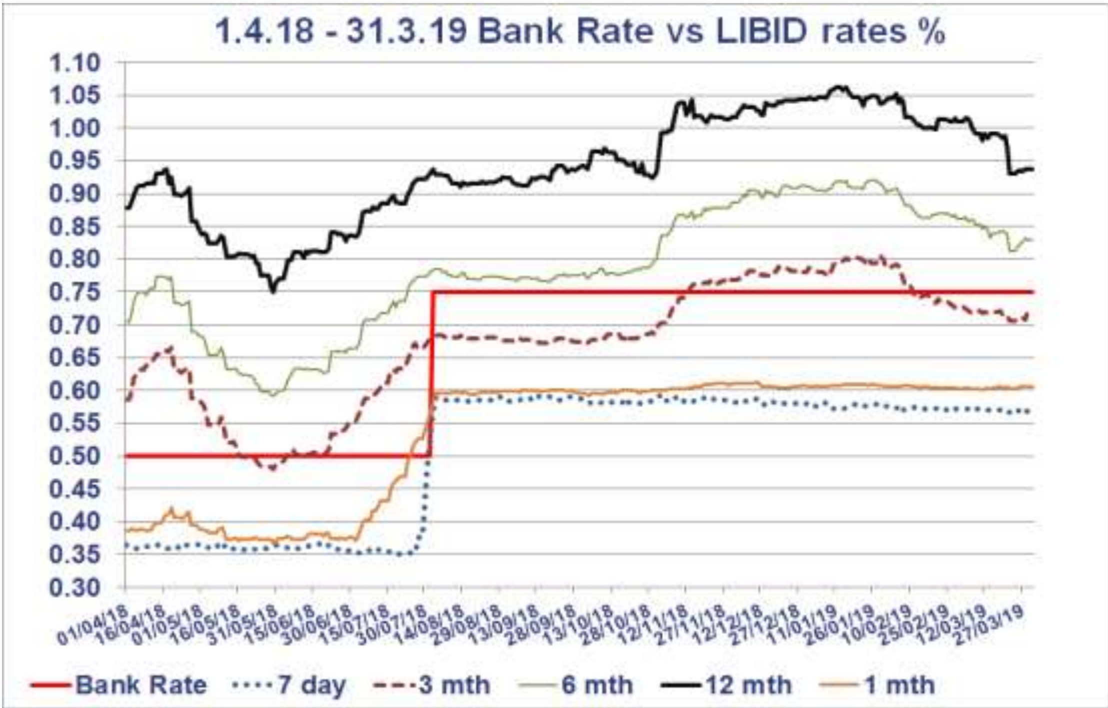
9.1. No debt restructuring was undertaken during 2018/19 as the average differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable. It is not envisaged that that there will be any opportunities where the debt restructuring would be economically viable in 2019/20.

10. Investment Rates in 2018/19

10.1. Investment returns remained low during 2018/19. The expectation for interest rates within the treasury management strategy for 2018/19 was that Bank Rate would rise from 0.50% to 0.75%. At the start of 2018-19, and after UK GDP growth had proved disappointingly weak in the first few months of 2018, the expectation for the timing of this increase was pushed back from May to August 2018. Investment interest rates were therefore on a gently rising trend in the first half of the year after April, in anticipation that the MPC would raise Bank Rate in August. This duly happened at the MPC meeting on 2 August 2018.

10.2. It was not expected that the MPC would raise Bank Rate again during 2018-19 after August in view of the fact that the UK was entering into a time of major uncertainty with Brexit due in March 2019.

10.3. Investment rates were little changed during August to October but rose sharply after the MPC meeting of 1 November was unexpectedly hawkish about their perception of building inflationary pressures, particularly from rising wages. However, weak GDP growth data after December, plus increasing concerns generated by Brexit, resulted in investment rates falling back again.



11. Investment Outturn for 2018/2019

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 2019 was £22.7m (31 March 2018 £22.3m).

11.4. **Investment performance for 2018/19 –** Detailed below is the result of the investment strategy undertaken by the Council.

Table 3 Internally Managed Investment Performance 2018/19

	Average Investment £m	Rate of Return %
Internally Managed – Core Funds	11.67	2.29
Internally Managed – Cash Flow Funds	19.78	0.60
Overall Internally Managed Funds (excluding Property Funds)	31.45	1.22

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

Authority	£m	Maturity Date	Rate%
City of Newcastle Upon Tyne	5.0	31/7/19	2.35
Lancashire County	5.0	1/8/18	2.00
Doncaster Metropolitan Borough	5.0	8/8/19	2.35
Total Core Investment at 1 April 2018	15.0		

11.6. Property fund investments and income are summarised below:

	CCLA	Lothbury	Rockspring	Total
	£000	£000	£000	£000
Opening Value	12,413	4,843	5,051	22,307
Revaluation	193	97	126	416
Closing Value	12,606	4,940	5,177	22,723
Cash Dividend	405	113	181	699
Accrued Dividend	138	39	60	237
Total Dividend	543	152	241	936
Overall Gain/ (Loss)	736	249	367	1,352

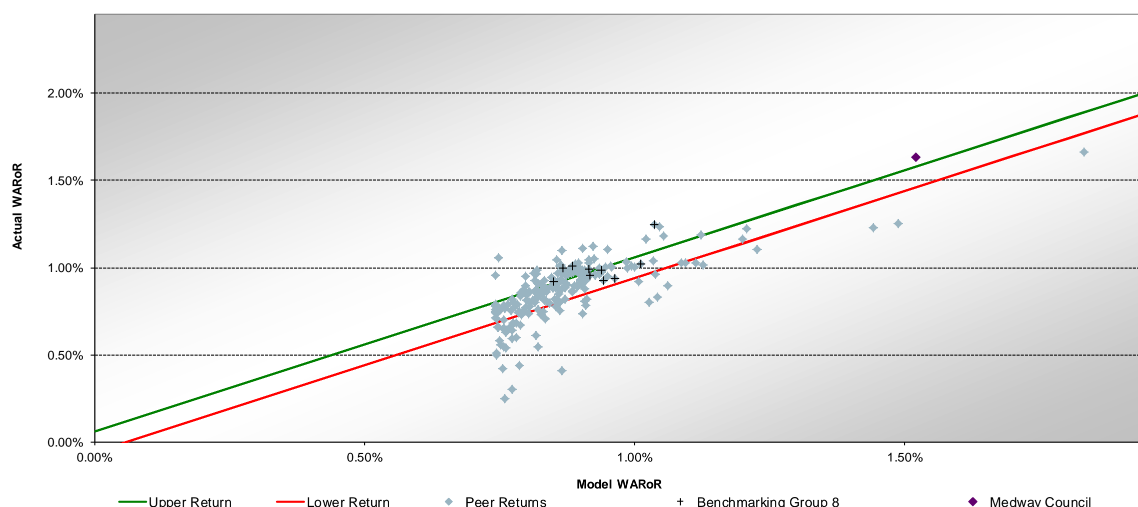
11.7. No institutions in which investments were held during 2018/2019 had any difficulty in repaying investments and interest in full during the year.

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 2019 and not the performance for the whole of 2018-19 financial year.

Population Returns against Model Returns



12. Compliance with Treasury Limits

12.1. There were no breaches of treasury limits in 2018-19. 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. Financial Implications

14.1. Overall the Interest and Financing budget made a surplus over its targeted budget of £348,000.

14.2. A breakdown of the Interest and Financing budget is shown below:

Table 4 Interest and Finance Budget against spend

	Budget 2018/19 £000	Actual 2017/18 £000	(Under)/ Overspend £000
Treasury Expenses	190	201	11
Interest Earned	-3,319	-3,319	0
Interest Paid	8,751	9,100	349
KCC Principal	1,477	1,418	-59
MRP	3,630	3,191	-439
Invest to Save recharges	156	0	-156
Treasury Advice	28	79	51
Brexit Grant	0	-105	-105
Total	**10,913**	**10,565**	**-348**

14.3. The overspend on interest paid is due to increased borrowing and the move from the use of short term to long term borrowing.

14.4. Actual MRP charges reflect additional borrowing as part of the financing of 2018/19 expenditure. The exact figure was not known at the time of budgeting.

14.5. The practice of recharging borrowing costs for invest to save projects was abandoned and is shown as an underspend above.

14.6. 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.

15. Legal implications

15.1. For the financial year 2018/19 our investments were managed in compliance with the Codes of Practices, guidance and regulations made under the Local Government Act 2003.

16. Recommendation

16.1. 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

Appendix 1

PRUDENTIAL AND TREASURY INDICATORS

	2017/18	2018/19	2018/19
	£'000	£'000	£'000
	Actual	Estimate	Actual
Capital Expenditure			
Non - HRA	31,980	47,606	46,106
HRA	4,895	5,860	3,771
TOTAL	36,875	53,466	49,877
Ratio of financing costs to net revenue stream			
Non - HRA	5.03%	6.25%	5.01%
HRA	13.97%	10.41%	14.36%
Gross borrowing requirement (Principal & Interest)			
brought forward 1 April	207,684	245,093	240,229
carried forward 31 March	240,229	265,969	253,517
in year borrowing requirement	32,545	20,876	13,288
Capital Financing Requirement as at 31 March			
Non – HRA	214,327	243,877	237,430
HRA	41,640	42,504	41,328
TOTAL	255,968	286,381	278,758
HRA Limit on Indebtedness	45,846	45,864	45,864
Annual change in Cap. Financing Requirement			
Non – HRA	(85)	29,485	23,102
HRA	(301)	564	(312)
TOTAL	(386)	30,049	22,790

	2017/18 Limit £'000	2018/19 Limit £'000	2016/17 Breach?
Authorised Limit for external debt -			
borrowing	439,620	425,019	No Breach
other long term liabilities	550	550	No Breach
TOTAL	440,170	425,569	No Breach
Operational Boundary for external debt -			
borrowing	399,655	386,381	No Breach
other long term liabilities	500	500	No Breach
TOTAL	400,155	386,881	No Breach
HRA Limit on Debt	45,846	45,846	No Breach

Maturity structure of fixed rate borrowing during 2018/19	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