AUDIT COMMITTEE 31 MAY 2019

TREASURY MANAGEMENT ANNUAL OUTTURN REPORT 2018/19

1. PURPOSE

1.1. New Forest District Council has adopted the key recommendations of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code), last updated in 2017. The CIPFA Code requires the Authority to approve a treasury management strategy before the start of the year and a semi-annual and annual treasury outturn report.

2. SUMMARY

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

2.2. The Council's treasury management strategy was most recently updated and approved at a meeting of Full Council in February 2019. The Council has borrowed and invested sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

2.3. Treasury management in the context of this report is defined as:

"The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

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

2.5. Hampshire County Council's Investments & Borrowing Team has been contracted to manage the Council's treasury management balances since March 2014 but overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

2.6. All treasury activity has complied with the Council's revised Treasury Management Strategy and Investment Strategy for 2018/19, and all relevant statute, guidance and accounting standards. In addition support in undertaking treasury management activities has been provided by the Council's treasury advisers, Arlingclose. The Council has also complied with all of the prudential indicators set in its Treasury Management Strategy.

3. EXTERNAL CONTEXT

3.1. The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions were made in 2018/19.

Economic commentary

3.2. UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year/year, just above the consensus forecast but broadly in line with the Bank of England's February Inflation Report. The most recent labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

3.3. After rising to 0.6% in the third calendar quarter from 0.4% in the second, fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

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

Financial markets

3.5. Markets for riskier asset classes fell in December 2018, most notably for equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE 100 and FTSE All share indices were both around 10% higher than at the end of 2018.

3.6. Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new year - the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate pushed up money markets rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

Credit background

3.7. Credit Default Swap (CDS) spreads drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms. After hitting around 129 basis points in December 2018, the spread on non-ringfenced bank NatWest Markets plc fell back to around 96bps at the end of March, while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 33 and 79bps at the end of the period.

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

3.9. In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty, following this move with the same treatment for UK banks and a number of government-related entities.

3.10. There were minimal other credit rating changes during the period. Moody's revised the outlook on Santander UK to positive from stable to reflect the bank's expected issuance plans which will provide additional protection for the its senior unsecured debt and deposits.

4. LOCAL CONTEXT

4.1. At 31 March 2019 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £141.3m, while usable reserves and working capital which are the underlying resources available for investment were £64.3m (principal invested plus gains on investments with a variable net asset value). These factors and the year-on-year change are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31/03/18 Balance £m	Movement £m	31/03/19 Balance £m
General Fund CFR	(5.5)	0.6	(4.9)
Housing Revenue Account CFR	(1.9)	-	(1.9)
HRA Settlement	(138.6)	4.1	(134.5)
Total CFR	(146.0)	4.7	(141.3)
Less: Resources for investment	63.1	1.2	64.3
Net borrowing	(82.9)	5.9	(77.0)

4.2. The combination of overall CFR reducing due to the repayment of maturing Public Works Loan Board (PWLB) debt, the application of MRP, and resources for investment increasing during 2018/19 resulted in decreased net borrowing.

4.3. The Council's strategy was to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, to reduce risk and keep interest costs low. The treasury management position as at 31 March 2019 and the year-on-year change is shown in Table 2 below.

Table 2: Treasury Management Summary

	31/03/18 Balance £m	Movement £m	31/03/19 Balance £m	31/03/19 Rate %
Long-term borrowing	(135.5)	4.3	(131.2)	3.25
Short-term borrowing	(4.3)	0.0	(4.3)	2.02
Total borrowing	(139.8)	4.3	(135.5)	3.21
Long-term investments	21.2	7.6	28.8	2.93
Short-term investments	36.7	(8.0)	28.7	1.08
Cash and cash equivalents	5.2	1.6	6.8	0.79
Total investments	63.1	1.2	64.3	1.88
Net borrowing	(76.7)	5.5	(71.2)	

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

4.4. The Council's internal borrowing policy is the reason for the variance between the positions shown in Tables 1 and 2. Net borrowing in Table 2 has reduced during 2018/19 due to the repayment upon maturity of PWLB loans and an increase in balances available for investment. There has also been some movement between categories of investments, including increasing the balances held in strategic long term pooled funds by £2.5m.

5. BORROWING ACTIVITY

5.1. At 31 March 2019 the Council held £135.5m of loans, a decrease of £4.3m on the previous year, with the vast majority of the loan being in relation to the resettlement of the HRA in 2012/13. The year-end treasury management borrowing position and year-on-year change is shown in Table 3 below.

Table 3: Borrowing Position

	31/03/18 Balance £m	Movement £m	31/03/19 Balance £m	31/03/19 Rate %	31/03/19 WAM* years
Public Works Loan Board	139.8	(4.3)	135.5	3.21	16.82
Total borrowing	139.8	(4.3)	135.5	3.21	16.82

* Weighted average maturity

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts but adjusted to exclude accrued interest.

5.2. The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

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

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

5.5. During 2018/19 the Council repaid £4.3m of maturing PWLB debt and did not replace this borrowing. This will reduce the future cost of interest payments on the Council's external debt.

6. INVESTMENT ACTIVITY

6.1. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year the Council's investment balances have ranged between £63.5m and £105.7m due to timing differences between income and expenditure. The year-end investment position and the year-on-year change are shown in Table 4 below.

Table 4: Investment Position (Treasury Investments)

Investments	31/03/2018 Balance £m	Movement £m	31/03/2019 Balance £m	31/03/19 Rate %	31/03/19 WAM* years
Short term Investments					
- Banks and Building Societies:					
- Unsecured	3.5	4.5	8.0	0.95	0.17
- Secured	10.1	(4.4)	5.7	1.26	0.52
- Money Market Funds	2.2	4.6	6.8	0.79	0.00
- Local Authorities	16.0	(5.0)	11.0	0.85	0.36
- Corporate Bonds	6.1	(6.1)	0.0	-	-
- Registered Providers	4.0	(2.0)	2.0	1.92	1.00
- Cash Plus Funds	-	2.0	2.0	1.50	n/a
	41.9	**(6.4)**	**35.5**	**1.02**	**0.31**
Long term investments					
- Banks and Building Societies:					
- Secured	8.1	(1.1)	7.0	1.14	2.33
- Local Authorities	2.0	2.0	4.0	1.38	2.07
- Registered Providers	-	4.0	4.0	1.93	2.00
	10.1	**4.9**	**15.0**	**1.41**	**2.17**
High yield investments					
- Pooled Property Funds**	6.1	1.5	7.6	4.33	n/a
- Pooled Equity Funds**	3.0	0.0	3.0	5.25	n/a
- Pooled Multi-Asset Funds**	2.0	1.0	3.0	4.74	n/a
	11.1	**2.5**	**13.6**	**4.62**	**n/a**
TOTAL INVESTMENTS	**63.2**	**0.9**	**64.1**	**1.87**	**0.89**

* Weighted average maturity, excluding pooled funds

** The rates provided for pooled fund investments are reflective of the average of the most recent dividend return as at 31 March 2019.

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts but adjusted to exclude operational cash and accrued interest.

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

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

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

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

6.6. To reduce risk, 69% of the Council's surplus cash is invested so that it is not subject to bail-in risk, as it is invested in local authorities, registered providers, secured bank bonds and pooled funds. Of the remaining balance, the majority is invested in overnight money market funds and cash plus funds, which are subject to reduced bail in risk, or in short duration certificates of deposit. By comparison, only 47% of the cash held by other similar Local Authorities is not subject to bail-in risk

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

6.8. Against this backdrop, the Council has sought to optimise returns commensurate with the objectives of security and liquidity, achieving an average rate of return of 0.91% on internally managed funds during 2018/19 whilst also maintaining sufficient liquidity through the use of call accounts and money market funds.

6.9. In readiness for Brexit, and with the uncertainty around potential outcomes, the Council ensured there were enough accounts open at UK domiciled banks and money market funds to hold sufficient liquidity over the year end and that its account with the Debt Management Account Deposit Facility (DMADF) remained available for use in an emergency.

6.10. The progression of credit risk and return metrics for the Council's investments managed in-house are shown in extracts from Arlingclose's investment benchmarking in Table 5 below. This compares the data for the quarter ended 31 March 2019 with the same period from the previous year.

Table 5: Investment Benchmarking (excluding pooled funds)

	Credit Rating	Bail-In Exposure	Weighted Average Maturity (days)	Rate of Return
31.03.2018	AA	11%	302	0.73%
31.03.2019	AA-	31%	325	1.11%
Similar LAs	AA-	53%	86	0.86%
All LAs	AA-	55%	29	0.85%

6.11. In order to minimise the risk of receiving unsuitably low investment income, the Council has continued to invest in externally managed pooled funds as part of its high yielding strategy, increasing the amount invested in these funds by £2.5m during 2018/19.

6.12. These investments in pooled property, equity and multi-asset funds allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments, with £13.6m now invested. A further £2m is held in cash plus funds.

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

6.14. The £15.6m portfolio of externally managed funds generated an average return of 4.67% in the year to 31 March 2019, comprising 4.10% income return to support services in year, and 0.57% of capital growth. By comparison, the average rate of income return for internal investments was 0.91%, giving an average rate of income return across the whole investment portfolio of 1.39% (NB. Figures in table 4 are as at 31/03/19, the figures as quoted in this para are average throughout the 2018/19 financial year).

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

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

7. FINANCIAL IMPLICATIONS

7.1. The outturn for debt interest paid (HRA) in 2018/19 matched the budget set at £4.41m.

7.2. The outturn for investment income received in 2018/19 was £1.148m on an average investment portfolio of £82.86m, therefore giving a yield of 1.39%. In the context of 1.02% being achieved in 2017/18, and an original budgeted target of £0.857m, this is a positive outturn result for the Council.

7.3. The budget for interest payable (HRA) has been reduced within the base budget for 2019/20, in reflection of the principal repayments commencing from 2017/18. The Interest earning target for 2019/20 has been left at a level similar to the original budget for 2018/19, on the assumption that cash balances will reduce as a result of the Council implementing its Commercial and Residential Property Strategies.

8. OTHER NON-TREASURY HOLDINGS AND ACTIVITY

8.1. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

8.2. This could include service investments for operational and/or regeneration reasons as well as commercial investments which are made mainly for financial reasons.

8.3. The Council's existing non-treasury investments are listed in Table 6 below.

Table 6 – Non-Treasury Investments	31/03/19 Asset value £m	31/03/19 Rate of Return
Hythe Marina	2.54	6.26%
Saxon Inn Calmore	0.18	7.10%
Meeting House Lane	0.13	-
New Milton Health Centre	2.33	5.62%
Total	**5.18**	**5.85%**

8.4. In 2017/18, the Council purchased an investment property. This was the first purchase of this type for many years, and was completed as a result of the Council's adoption of the Asset Investment Strategy in February 2017. No investment property purchases were made in 2018/19.

8.5. The Councils investment property holdings total £5.18m as at 31/03/19. The Investment Property note within the Annual Financial Report gives further information on the net gains / losses, and fair value movements.

9. COMPLIANCE REPORT

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

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

Table 7: Debt Limits

	2018/19 Maximum £m	31/03/19 Actual £m	2018/19 Operational Boundary £m	2018/19 Authorised Limit £m	Complied
Total debt	139.8	135.5	180.9	196.2	✓

9.3. 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.

10. TREASURY MANAGEMENT INDICATORS

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

Interest Rate Exposures

10.2. The following indicator shows the sensitivity of the County Council's current investments and borrowing to a change in interest rates.

Table 8 – Interest Rate Exposures

	31/03/19 Actual	Impact of +/- 1% interest rate change
Variable interest rate investment exposure	£40.6m	+/- £0.4m
Variable interest rate borrowing exposure	£0.0m	+/- £0.0m

10.3. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing

10.4. This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits show the maximum and minimum maturity exposure to fixed rate borrowing as agreed in the Treasury Management Strategy Statement:

Table 9: Maturity Structure of Borrowing

	31/03/19 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	3%	25%	0%	✓
12 months and within 24 months	3%	25%	0%	✓
24 months and within 5 years	10%	25%	0%	✓
5 years and within 10 years	15%	25%	0%	✓
10 years and above	69%	100%	0%	✓

Principal Sums Invested for Periods Longer than 364 days

10.5. The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

Table 10: Principal Sums Invested for Periods Longer than 364 days

	2018/19	2019/20	2020/21
Actual principal invested beyond year end	£28.6m	£19.6m	£16.6m
Limit on principal invested beyond year end	£40m	£40m	£40m
Complied	✓	✓	✓

11. CRIME AND DISORDER AND ENVIRONMENTAL IMPLICATIONS

11.1. None arising directly from this report.

12. RECOMMENDATIONS

Members are recommended to:

12.1. consider the performance of the treasury function detailed in this report.

Further information	Background papers
Please contact; Rob Sarfas Senior Accountant Investments & Borrowing Hampshire County Council rob.sarfas@hants.gov.uk Alan Bethune Head of Finance (S151) New Forest District Council alan.bethune@nfdc.gov.uk	The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance Local Government Act 2003 SI 2003/3146 Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 Treasury Management Strategy Report 2018/19 Audit Committee – 26 January 2018 Council – 26 February 2018 Treasury Management Mid-Year Monitoring Report 2018/19 Audit Committee – 26 October 2018