AUDIT COMMITTEE 31 MAY 2018

CABINET 4 JULY 2018

COUNCIL 9 JULY 2018

TREASURY MANAGEMENT ANNUAL OUTTURN REPORT 2017/18

1. PURPOSE

1.1. New Forest District Council adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes an annual report on the treasury management strategy after the end of each financial year.

2. SUMMARY

2.1. This report fulfils the Council's legal obligation to have regard to the CIPFA Code.

2.2. The Council's treasury management strategy for 2017/18 was approved at a meeting of full Council in February 2017, and revised in December 2017. 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 2017/18, 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 2017/18, and all relevant statute, guidance and accounting standards. In addition the Council's treasury advisers, Arlingclose, provide support in undertaking treasury management activities. 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 2017/18.

Economic commentary

3.2. The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in 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.

3.3. 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 2017 and by the lack of clarity on Brexit. The Withdrawal Treaty is yet to be ratified by the UK Parliament and those of the other 27 EU member states and new international trading arrangements are yet to be negotiated and agreed.

3.4. The Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate by 0.25% in November 2017. This action was significant as this was the first rate increase 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, however at the meeting in May 2018 the MPC again voted by a majority of 7-2 to maintain Bank Rate at 0.5%.

Credit background

3.5. The rules for UK banks' ring-fencing were finalised by the Prudential Regulation Authority and banks began the complex implementation process ahead of the statutory deadline of 1st January 2019. As there was some uncertainty surrounding which banking entities the Council would be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would look like, in May 2017 Arlingclose advised adjusting downwards the maturity limit for unsecured investments to a maximum of 6 months. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

3.6. Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non ring-fenced bank.

3.7. In March 2018, following Arlingclose's advice, the Council 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 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 and Arlingclose approves investment, the bank would be reinstated on the Council's lending list.

Local Authority regulatory changes

3.8. CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. 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 Council will be preparing the Capital Strategy in line with the 2019/20 budget setting process.

3.9. 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

3.10. 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 were met which include having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority having at least one 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.

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

4. LOCAL CONTEXT

4.1. At 31 March 2018 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £146.0m, while usable reserves and working capital which are the underlying resources available for investment were £63.1m (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

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m
General Fund CFR	(3.3)	(2.2)	(5.5)
Housing Revenue Account CFR	(1.9)	-	(1.9)
HRA Settlement	(142.7)	4.1	(138.6)
Total CFR	(147.9)	1.9	(146.0)
Less: Resources for investment	62.8	0.4	63.1
Net borrowing	(85.1)	2.3	(82.9)

4.2. The combination of overall CFR reducing due to the repayment of maturing Public Works Loan Board (PWLB) debt, and resources for investment increasing during 2017/18 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, in order to reduce risk and keep interest costs low. The treasury management position as at 31 March 2018 and the year-on-year change is shown in Table 2 below.

Table 2: Treasury Management Summary

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %
Long-term borrowing	(139.8)	4.3	(135.5)	(3.21)
Short-term borrowing	(4.3)	-	(4.3)	(1.80)
Total borrowing	(144.1)	4.3	(139.8)	(3.17)
Long-term investments	20.1	1.1	21.2	2.67
Short-term investments	29.4	7.3	36.7	0.75
Cash and cash equivalents	13.3	(8.1)	5.2	0.43
Total investments	62.7	0.4	63.1	1.37
Net borrowing	(81.4)	4.7	(76.7)	

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. The movement that has taken place during 2017/18 in net borrowing shown in Table 1 has translated into a small rise in investment balances as shown in Table 2. Total borrowing in Table 2 has reduced during 2017/18 due to repayment upon maturity of PWLB loans. There has also been some movement between categories of investments, as the opportunity was taken to invest liquid funds in short-term options, such as with a registered provider.

5. BORROWING ACTIVITY

5.1. At 31 March 2018 the Council held £139.8m 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

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %	31/03/18 WAM* years
Public Works Loan Board	144.1	(4.3)	139.8	3.17	17.3
Total borrowing	144.1	(4.3)	139.8	3.17	17.3

* 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, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

5.3. Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained and are likely to remain at least over the forthcoming two years, lower than long-term rates, the Council determined it was more cost effective in the short-term to use internal resources instead of taking out new borrowing. This strategy enables the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

5.4. The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with the monitoring of internal and external borrowing.

5.5. During 2017/18 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 has held invested funds representing income received in advance of expenditure plus balances and reserves held. During 2017/18 the Council's investment balances have ranged between £60.8 and £100.6 million 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	31/03/2017 Balance £m	Movement £m	31/03/2018 Balance £m	31/03/18 Rate %	31/03/18 WAM* years
Short term Investments					
- Banks and Building Societies:					
- Unsecured	7.0	(3.5)	3.5	0.41	0.05
- Secured	8.8	1.3	10.1	0.65	0.54
- Money Market Funds	12.3	(10.1)	2.2	0.46	0.00
- Local Authorities	12.0	4.0	16.0	0.72	0.31
- Corporate Bonds	2.6	3.5	6.1	0.67	0.70
- Registered Providers	-	4.0	4.0	1.25	0.85
	42.7	(0.7)	42.0	0.71	0.44
Long term investments					
- Banks and Building Societies:					
- Secured	11.8	(3.7)	8.1	0.77	2.61
- Local Authorities	3.0	(1.0)	2.0	1.00	1.89
	14.8	(4.7)	10.1	0.81	2.46
High yield investments					
- Pooled Property Funds**	3.2	3.0	6.2	4.52	n/a
- Pooled Equity Funds**	2.1	0.9	3.0	4.47	n/a
- Pooled Multi-Asset Funds**	-	2.0	2.0	3.66	n/a
	5.3	5.8	11.1	4.35	n/a
TOTAL INVESTMENTS	62.8	0.4	63.2	1.37	0.83

* Weighted average maturity
** The rates provided for pooled fund investments are reflective of the average of the most recent dividend return as at 31 March 2018.

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. Both the CIPFA Code and the government guidance require the Council 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 Council's objective when investing 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.

6.3. In furtherance of these objectives, and given the increasing risk and low returns from short-term unsecured investments, the Council further diversified into more secure and higher yielding asset classes during 2017/18. For example the proportion of investments to liquid funds (i.e. invested in money market funds and unsecured call accounts) was reduced and instead invested in short-term investments with greater security and higher rates of return (such as local authorities). Also £5.8m was added to externally-managed funds during 2017/18 as part of the investments targeting higher yields.

6.4. Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2017/18.

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

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

6.7. The Council maintained a sufficient level of liquidity through the use of call accounts and money market funds. The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate increased by 0.25% to 0.50% in November 2017 and short-term money market rates have remained at relatively low levels which continued to have a significant impact on cash investment income.

6.8. As a result, through lower bail-in exposure, investment risk was lowered, while the total average rate of return has increased by 0.06% from 0.96% during 2016/17 to 1.02% during 2017/18. The progression of credit risk and return metrics for the Council's investments managed in-house are shown in the extracts from Arlingclose's investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking

	Credit Rating	Bail-In Exposure	WAM* (days)	Rate of Return
31.03.2017	AA	34%	234	0.64%
31.03.2018	AA	11%	302	0.73%
Similar LAs	AA-	53%	109	0.71%
All LAs	AA-	55%	35	0.63%

* Weighted average maturity

6.9. The Council has targeted a proportion of funds towards high yielding investments as shown in Table 4. Investments yielding higher returns will contribute additional income to the Council, although some come with the risk that they may suffer falls in the value of the principal invested.

6.10. The £11.1m portfolio of externally managed pooled multi-asset, equity and property funds generated an average total return of 3.42%, comprising 4.75% income return used to support services in year, and 1.33% capital loss. The capital loss has mainly been experienced in the pooled equity funds; this was due to a market correction in January and February 2018.

6.11. The 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. The funds which are operated on a variable net asset value (VNAV) basis offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short-term. All of the Council's pooled fund investments are in the funds' distributing share classes which pay out the income generated.

6.12. As these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives are regularly reviewed.

6.13. Although money can be redeemed from the pooled funds at short notice, the Council's intention is to hold them for at least the medium-term. Their performance and suitability in meeting the Council's investment objectives are monitored regularly and discussed with Arlingclose.

7. FINANCIAL IMPLICATIONS

7.1. The outturn for debt interest paid (HRA) in 2017/18 matched the budget set at £4.47m.

7.2. The outturn for investment income received in 2017/18 was £0.82m on an average investment portfolio of £80.2m, therefore giving a yield of 1.02%. In the context of a 0.25% base rate for much of the year (increasing to 0.5% in November '17), and an original budgeted target of £0.51m, 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 2018/19, in reflection of the first principal repayment made in 2017/18. The Interest earning target for 2018/19 has been set at a level comparable to the outturn for 2017/18, and assisted the Council in achieving a balanced budget.

8. OTHER NON-TREASURY HOLDINGS AND ACTIVITY

8.1. Although not classed as treasury management activities, the 2017 CIPFA Code now requires the Council to report on investments for policy reasons outside of normal treasury management. This includes service investments for operational and/or regeneration as well as commercial investments which are made mainly for financial reasons.

8.2. In 2017/18, the Council purchased an investment property, at a total cost of £2.2m with a net yield of 6.23%. 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.

8.3. The Councils investment property holdings total £4.695m as at 31/03/18. 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 2017/18 with the CIPFA Code of Practice and the Council's approved revised Treasury Management Strategy. Some limits were revised in December 2017 due to the fact that investment balances were higher than predicted than when the Treasury Management Strategy was approved, which effectively resulted in a passive breach of the upper limit on variable interest rate investment exposure. Revisions were agreed in order to alleviate the upper limit on variable interest rate investment exposure, and reduce the risk of the Council experiencing the negative effect of higher inflation versus short-term deposit interest rates.

9.2. Compliance with specific investment limits, as well as the authorised limit and operational boundary for external debt, is demonstrated in Tables 6 and 7 below.

Table 6: Debt Limits

	2017/18 Maximum £m	31/03/18 Actual £m	2017/18 Operational Boundary £m	2017/18 Authorised Limit £m	Complied
Total debt	145.5	139.8	185.4	200.7	✓

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.

Table7: Investment Limits

	2017/18 Maximum	31/03/18 Actual	2017/18 Limit	Complied
Any single organisation, except the UK Central Government	£6m	£4m	£8m	✓
Any group of organisations under the same ownership	£6m	£4m	£8m	✓
Any group of pooled funds under the same management	£5m	£5m	£8m	✓
Registered providers	£4m	£4m	£6m	✓
Money market funds	22%	4%	50%	✓

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. This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed will be:

Table 8: Interest Rate Exposures

	31/03/18 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate investment exposure	£2.0m	£30.0m	✓
Upper limit on variable interest rate investment exposure	£60.8m	£100.0m	✓
Upper limit on fixed interest rate borrowing exposure	£4.3m	174.4m	✓
Upper limit on variable interest rate borrowing exposure	£135.5m		✓

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 on the maturity structure of fixed rate borrowing will be:

Table 9: Maturity Structure of Borrowing

	31/03/18 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	9%	25%	0%	✓
5 years and within 10 years	15%	25%	0%	✓
10 years and above	70%	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

	2017/18	2018/19	2019/20
Actual principal invested beyond year end	£21m	£18m	£13m
Limit on principal invested beyond year end	£30m	£30m	£30m
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 Andrew Boutflower (HCC), or Alan Bethune	The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance
	Local Government Act 2003
email: andrew.boutflower@hants.gov.uk alan.bethune@nfdc.gov.uk	SI 2003/3146 Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
	Treasury Management Strategy Report 2017/18 Audit Committee – 27 January 2017 Council - 20 February 2017 Changes to the Treasury Management Strategy Report Cabinet – 6 December 2017 Council – 11 December 2017 Treasury Management Strategy Report 2018/19 Audit Committee – 26 January 2018 Council – 26 February 2018 Treasury Management Mid-Year Monitoring Report 2017/18 Audit Committee – 25 August 2017 Treasury Management Annual Outturn Report 2016/17 Audit Committee – 23 June 2017 Cabinet – 5 July 2017 Council – 10 July 2017
	Published Papers