MEETING:	**AUDIT COMMITTEE**
DATE:	**19 JULY 2018**
TITLE:	**TREASURY MANAGEMENT 2017/18**
PURPOSE:	**CIPFA's Code of Practice requires that a report on the results of the Council's actual treasury management is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
AUTHOR:	**CAROLINE ROBERTS, INVESTMENT MANAGER**

Executive Summary

During the 2017/18 financial year the Council's borrowing remained within the limits originally set and total interest received on deposits was £211,000 which was above the budgeted level of £172,750. There were no defaults by banks in which the Council had deposited money with.

1. Introduction and Background

CIPFA's revised Code of Practice on Treasury Management was adopted by the Council on 1st March 2011 and the Council fully complies with its requirements. The Code requires that I report on the results of the Council's actual treasury management results in the previous financial year against that which was expected. It is considered that the Audit Committee is the appropriate body to consider this report.

This report compares the actual performance for the Financial year 2017/18 against the strategy which was established in February 2018 and was approved by the full Council on 8 March 2018 and can be accessed at
https://democracy.cyngor.gwynedd.gov.uk/documents/s16299/Appendix%20A%20-%20Treasury%20Management.pdf

The report includes:

- the economic background;
- the borrowing requirement and debt management;
- investment activity;
- compliance with Prudential Indicators.

The report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the Welsh Government's Investment Guidance.

The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's Treasury Management Strategy.

2. External Context

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

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

The inflationary impact of rising import prices, a consequence of the fall in sterling associated with the EU referendum result, resulted in year-on-year CPI rising to 3.1% in November before falling back to 2.7% in February 2018. Consumers felt the squeeze as real average earnings growth, i.e. after inflation, turned negative before slowly recovering. The labour market showed resilience as the unemployment rate fell back to 4.3% in January 2018. The inherent weakness in UK business investment was not helped by political uncertainty following the surprise General Election in June and by the lack of clarity on Brexit, the UK and the EU only reaching an agreement in March 2018 on a transition which will now be span Q2 2019 to Q4 2020. The 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.

The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 0.25% in November 2017. It was significant in that it was the first rate hike in ten years, although in essence the MPC reversed its August 2016 cut following the referendum result. The February *Inflation Report* indicated the MPC was keen to return inflation to the 2% target over a more conventional (18-24 month) horizon with 'gradual' and 'limited' policy tightening. Although in March two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates, the minutes of the meeting suggested that an increase in May 2018 was highly likely.

In contrast, economic activity in the Eurozone gained momentum and although the European Central Bank removed reference to an 'easing bias' in its market communications and had yet to confirm its QE intention when asset purchases end in September 2018, the central bank appeared some way off normalising interest rates. The US economy grew steadily and, with its policy objectives of price stability and maximising employment remaining on track, the Federal Reserve Open Market Committee (FOMC) increased interest rates in December 2017 by 0.25% and again in March, raising the policy rate target range to 1.50% - 1.75%. The Fed is expected to deliver two more increases in 2018 and a further two in 2019. However, the imposition of tariffs on a broadening range of goods initiated by the US, which has led to retaliation by China, could escalate into a deep-rooted trade war having broader economic consequences including inflation rising rapidly, warranting more interest rate hikes.

Financial markets

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

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

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

Credit background

Credit Metrics

In the first quarter of the financial year, UK bank credit default swaps reached three-year lows on the announcement that the Funding for Lending Scheme, which gave banks access to cheaper funding, was being extended to 2018. For the rest of the year, CDS prices remained broadly flat.

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 Authority would will be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would look would actually 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.

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.

Credit Rating developments

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

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

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

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

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

Moody's downgraded Rabobank's long-term rating due to its view on the bank's profitability and the ratings of the large Australian banks on its view of the rising risks from their exposure to the Australian housing market and the elevated proportion of lending to residential property investors.

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

In March, following Arlingclose's advice, the Authority removed RBS plc and National Westminster Bank from its counterparty list. This did not reflect any change to the creditworthiness of either bank, but a tightening in Arlingclose's recommended minimum credit rating criteria to A- from BBB+ for 2018-19. The current long-term ratings of RBS and NatWest do not meet this minimum criterion, although if following ring-fencing NatWest is upgraded, the bank would be reinstated on the Authority's lending list.

Local Authority Regulatory Changes

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

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

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.

There have been no moves yet by Welsh Government on proposed changes to the Guidance on Local Authority Investments. The Authority is however aware of the MHCLG's changes to the Investment Guidance for English authorities.

Amendments to Capital Finance Legislation

The Welsh Government published the Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2018 in March 2018. It amends and clarifies erstwhile regulations so that investments in corporate bonds and shares in FCA (Financial Conduct Authority) approved UCITS (Undertakings for the Collective Investment of Transferable Securities) funds, Real Estate Investment Trusts (REITs) and investment schemes approved by HM Treasury are no longer treated as capital expenditure. This legislation came into effect in the 2017/18 financial year. It enables the Authority to invest in these instruments, if appropriate for the Authority's circumstance and objectives, without the potential revenue cost of MRP (Minimum Revenue Provision) and without the proceeds from sale being considered a capital receipt.

MiFID II

As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could "opt up" to professional client status, providing certain criteria was met which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a year's relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

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

Local Context

At 31 March 2018 the Council had net borrowing of £74m arising from its revenue and capital activities, a decrease against £82m in 2017. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The movements are summarised in the table below.

The Council has a decreasing CFR over the next 2 years and a reducing level of investments and therefore may need to borrow over the forecast period.

Balance Sheet Summary

	31.3.17 Actual £m	**2017/18 Movement £m**	**31.3.18 Actual £m**
CFR	177	0	177
Less: Other debt liabilities	(2)	0	(2)
Borrowing CFR	**175**	**0**	**175**
Less: Usable reserves	(57)	1	(56)
Less: Working capital	(36)	(12)	(48)
Net borrowing	**82**	**(11)**	**71**

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

Treasury management summary

	31.3.17 Balance £m	**31.3.17 Rate %**	**31.3.18 Balance £m**	**31.3.18 Rate %**
Long-term borrowing	(108,143)	5.71	(107,810)	5.6
Short-term borrowing	(2,645)	10.63	(10,865)	0.5
Total borrowing	**(110,788)**	**5.98**	**(118,675)**	**5.2**
Long-term investments	2,171	1.59	17	4.0
Short-term investments	25,810	0.51	35,028	0.4
Cash and cash equivalents	1,384	0.15	12,403	0.4
Total investments	**29,365**	**0.53**	**47,448**	**0.4**
Net borrowing	**81,423**	**5.95**	**71,227**	**5.2**

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

3. Borrowing Activity in 2017/18

At 31st March 2018, the Council held £117.8m of loans, an increase of £9.1m on the previous year.

The year-end borrowing position and the year-on-year change are summarised in the table below.

Borrowing Position

	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Rate %	31.3.18 WAM* years
Public Works Loan Board	92.5	(0.9)	91.6	5.86	21
Banks (fixed-term)	16.2	10.0	26.2	4.23	60
Total borrowing	**108.7**	**9.1**	**117.8**	**5.62**	**27**

*Weighted average maturity

The Council's main 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 a secondary objective of flexibility to renegotiate loans should the Council's long-term plans change.

Further to these objectives, no new long-term borrowing was undertaken in 2017/18, with existing loans maturing without replacement. This strategy enabled the Council to reduce net borrowing costs (despite foregoing investment income) and reduce overall treasury risk.

The "cost of carry" analysis performed by Arlinclose (the Council's treasury management advisor) did not indicate any value in long-term borrowing in advance for future years' planned expenditure and therefore none was taken.

The Council took out a short-term loan to ensure sufficient cash was available during the period from January to March 2018 rather than taking on long-term borrowing, which would increase the interest payable for many years in the future.

4. Investment Activity

The Council has held significant 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 £28.5million and £68.5 million.

The Welsh Government's Investment Guidance gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

Investment Position

	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Rate %	31.3.18 WAM* days
Banks & building societies (unsecured)	21.3	(10.0)	11.3	0.55	204
Covered bonds (secured)	2.1	(0.1)	2.0	0.7	148
Government (incl. local authorities)	6.0	19.0	25.0	0.50	161
Money Market Funds	0.0	9.2	9.2	0.30	3
Total investments	**29.4**	**18.1**	**47.5**	**0.44**	**137**

*Weighted average maturity

Both the CIPFA Code and 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 money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	3.27	AA-	64%	70	0.47%
30.06.2017	3.30	AA-	54%	72	0.48%
30.09.2017	3.97	AA-	57%	86	0.44%
31.12.2017	3.76	AA-	54%	77	0.47%
31.03.2018	3.96	AA-	43%	48	0.55%
Similar LAs	**4.17**	**AA-**	**48%**	**115**	**0.47%**
All LAs	**4.03**	**AA-**	**55%**	**35**	**1.08%**

*Weighted average maturity

During the year the exposure to 'bail-in' has reduced whilst the credit score has remained between 3 and 4.

Financial Implications

The outturn for debt interest paid in 2017/18 was £6.0 million on an average debt portfolio of £106.8 million at an average interest rate of 5.6%.

The average cash balances were £58.7m during the year. The UK Bank Rate has been between 0.25% and 0.5% since March 2009. Short-term money market rates have remained at relatively low levels. New deposits were made at an average rate of 0.55%. Investments in Money Market Funds generated an average rate of 0.45%.

The Council's budgeted investment income for the year was £0.17m. The Council's investment income outturn for the year was £0.21m.

Compliance Report

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

Investment Limits

	2017/18 Maximum	**31.3.18 Actual**	**2018/19 Limit**	**Complied**
Any single organisation, except UK Government	£8m each	£6m and below	£6m each	✓
Any group of funds under the same ownership	£8m per group	£4m and below	£6m per group	✓
Foreign countries	£8m per country	£3m and below	£6m per country	✓
Unsecured investments with Building Societies	£8m in total	£6m in total	£6m in total	✓
Money Market Funds	£40m in total	£12m in total	£30m in total	✓

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

Debt Limits

	2017/18 Maximum	**31.3.18 Actual**	**2017/18 Operational Boundary**	**2017/18 Authorised Limit**	**Complied**
Borrowing	£113m	£111m	£180m	£190m	✓

Treasury Management Indicators

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

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the time-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment and taking the arithmetic average, weighted by the length of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.3.18 Actual	2017/18 Target	Complied
Portfolio average credit score	3.96	a score of 7 or lower	✓

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	31.3.18 Actual	2017/18 Target	Complied
Total cash available within 3 months	£47.4m	£10m	✓

Interest Rate Exposures: 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 proportion of net principal borrowed was:

	31.3.18 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure	100%	100%	✓
Upper limit on variable interest rate exposure	0	50%	✓

Maturity Structure of Borrowing: 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 were:

	31.3.18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	8.8%	25%	0%	✓
12 months and within 24 months	1.9%	25%	0%	✓
24 months and within 5 years	3.9%	50%	0%	✓
5 years and within 10 years	14.5%	75%	0%	✓
10 years and within 20 years	27.7%	100%	0%	✓
20 years and within 30 years	6.4%	100%	0%	✓
30 years and within 40 years	15.2%	100%	0%	✓
40 years and within 50 years	7.9%	100%	0%	✓
50 years and above	13.7%	100%	0%	✓

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

Principal Sums Invested for Periods Longer than 364 days: 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 long-term principal sum invested to final maturities beyond the period end were:

	2017/18	**2018/19**	**2019/20**
Actual principal invested beyond year end	£2.1m	£0	£0
Limit on principal invested beyond year end	£40m	£20m	£10m
Complied	✓	✓	✓

Appendix 1

Prudential Indicators 2017/18

The Local Government Act 2003 requires the Council to have regard to CIPFA's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

This report compares the approved indicators with the outturn position for 2017/18. Actual figures have been taken from or prepared on a basis consistent with, the Council's statement of accounts.

Estimates of Capital Expenditure: The Council's capital expenditure and financing may be summarised as follows:

Capital Expenditure and Financing	2017/18 Estimate £m	2017/18 Actual £m	Difference £m
General Fund Expenditure	**27.7**	**23.4**	**1.6**
Capital receipts	0.7	1.4	0.1
Government Grants	10.7	11.5	0.8
Revenue contributions	5.5	5.9	0.4
Supported borrowing	4.1	4.1	0.0
Prudential borrowing	6.7	7.0	0.3
Total Financing	**27.7**	**23.4**	**1.6**

Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31/03/18 Estimate £m	31/03/18 Actual £m	Difference £m
General Fund	182.1	177.0	5.1

There was no change in the CFR as capital expenditure financed by debt was the same as the resources put aside for debt repayment.

Actual Debt: The Council's actual debt at 31 March 2018 was as follows:

Debt	**31/03/18 Estimate £m**	**31/03/18 Actual £m**	**Difference £m**
Borrowing	113.4	113.4	0
Finance leases	0.0	2.3	2.3
Total Debt	**113.4**	**115.7**	**2.3**

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt and CFR	**31/03/18 Estimate £m**	**31/03/18 Actual £m**	**Difference £m**
Total debt	113.4	113.4	0
CFR	175	177	2
Headroom	**61.6**	**63.6**	**2**

Total debt remained below the CFR during the year.

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

Operational Boundary and Total Debt	**31/03/18 Boundary £m**	**31/03/18 Actual Debt £m**	**Difference £m**
Borrowing	**175**	**113.4**	**61.6**
Other long-term liabilities	**0**	**2.3**	**(2.3)**
Total Debt	**175**	**115.7**	**59.3**

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Boundary and Total Debt	**31/03/18 Boundary £m**	**31/03/18 Actual Debt £m**	**Difference £m**
Borrowing	**195**	**113.4**	**81.6**
Other long-term liabilities	**0**	**2.3**	**(2.3)**
Total Debt	**195**	**115.7**	**79.3**

Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**31/03/18 Estimate %**	**31/03/18 Actual %**	**Difference %**
Total	**5.91**	**5.20**	**0.71**

APPENDIX 2

Credit Score Analysis

Scoring:

Long-Term Credit Rating	Score
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
BBB+	8
BBB	9
BBB-	10

The value weighted average reflects the credit quality of investments according to the size of the deposit. The time weighted average reflects the credit quality of investments according to the maturity of the deposit

The Council aimed to achieve a score of 7 or lower, to reflect the Council's overriding priority of security of monies invested and the minimum credit rating threshold of A- for investment counterparties.