Agenda Item No.5 (b)

DERBYSHIRE COUNTY COUNCIL

AUDIT COMMITTEE

26 September 2018

Report of the Director of Finance & ICT

TREASURY MANAGEMENT ANNUAL REPORT 2017-18

1 Purpose of the Report

To report on Treasury Management activities during the last financial year 2017-2018 and to indicate the Council's compliance with the prudential indicators set by Council at its meeting of 8 February 2017, in accordance with the terms of the Prudential Code for Capital Finance in Local Authorities.

2 Information and Analysis

(i) Introduction

In April 2002, the Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services Code of Practice (the CIPFA Code). The CIPFA Code was last revised in 2011 and this revision was subsequently approved by Council. The CIPFA Code requires the Council to approve a Treasury Management Annual Report after the end of each financial year. The report fulfils the Council's obligation in respect of the CIPFA Code.

The Council's Treasury Management Strategy for 2017-18 was approved by Council on 8 February 2017. The Council has borrowed and invested substantial sums of money and is therefore potentially 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 is therefore central to the Council's Treasury Management Strategy.

(ii) External Context

Economy

The United Kingdom (UK) economy showed signs of slowing, with latest estimates showing that Gross Domestic Product (GDP), helped by an improving global economy, grew by 1.8% in the Calendar Year 2017, the same level as in 2016. The inflationary impact of rising import prices, a consequence of the fall in

Sterling associated with the European Union (EU) referendum result, resulted in the year-on-year Consumer Price Index (CPI) rising to 3.1% in November, before falling back to 2.7% in February 2018. The labour market showed resilience as the unemployment rate fell back to 4.3% in January 2018.

This was is in spite of political uncertainty following the surprise General Election in June 2017 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 span Quarter 2 in 2019 to Quarter 4 in 2020.

The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate (Base Rate) by 0.25% in November 2017, the first rate rise in ten years. The February Inflation Report indicated that 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.

The United States Federal Reserve Open Market Committee (US 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 imposition of tariffs, initiated by the US, has led to retaliation by China, which could escalate into a trade war.

The European Central Bank appeared some way off returning interest rates to typical levels.

Financial markets

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 5-year gilts, which had fallen to 0.35% in mid-June 2017, rose to 1.65% by the end of March 2018. 10-year gilt yields also rose from their lows of 0.93% in June 2017, to 1.65% by mid-February, before falling back to 1.35% at March 2018. 20-year gilt yields followed an even more erratic path, with lows of 1.62% in June 2017 and highs of 2.03% in February 2018, only to fall back down to 1.70% by the end of the financial year.

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

Credit background

Credit Metrics - 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 1 January 2019.

Money Market Fund regulation - The new EU regulations for Money Market Funds (MMFs) were finally approved and published in July and existing funds will have to be compliant by no later than 21 January 2019. The key features include Low Volatility Net Asset Value (LVNAV) Money Market Funds, which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements.

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.

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 are being 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 (the Council is to produce its Capital Strategy in the near future). 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 to be identified and reported.

Investment Guidance and Minimum Revenue Provision

In February 2018 the Ministry of Housing, Communities and Local Government (MHCLG) published revised Guidance on Local Government and Investments and Statutory Guidance on Minimum Revenue Provision (MRP).

Changes to the Investment Guidance include a wider definition of investments to include non-financial assets held primarily for generating income return and a new category called “loans” (e.g. temporary transfer of cash to a third party, joint venture, subsidiary or associate). The Guidance introduces the concept of proportionality, proposes additional disclosure for borrowing solely to invest and also specifies additional indicators. Investment strategies must detail the extent to which service delivery objectives are reliant on investment income and a contingency plan, should yields on investments fall.

The definition of prudent MRP has been changed to “put aside revenue over time to cover the Capital Financing Requirement (CFR)”; it cannot be a negative charge and can only be zero if the CFR is nil or negative. Guidance on asset lives has been updated, applying to any calculation using asset lives. Any change in MRP policy cannot create an overpayment; the new policy must be applied to the outstanding CFR going forward only.

MiFID II

As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3 January 2018 local authorities were automatically treated as retail clients but could “opt up” to professional client status, providing certain criteria were met, which includes having an investment balance of at least £10 million and the persons 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 had to assess that that persons have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The Council has met the conditions to opt up to professional status and has done so in order to maintain its former MiFID II 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.

(iii) Local Context

On 31 March 2018, the Council had net borrowing of £36.071m arising from its revenue and capital income and expenditure, a decrease on 2017 of £26.259m. The underlying need to borrow for capital purposes is measured by the CFR, while usable reserves and working capital are the underlying resources available for investment. These factors and the year-on-year change are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.17 Actual £m	**2017-18 Movement £m**	**31.3.18 Actual £m**
General Fund CFR	468	-11	457
Less: Other debt liabilities *	79	-3	76
Borrowing CFR	**389**	**-8**	**381**
Less: Usable reserves	-303	+4	-307
Less: Working capital	-24	+14	-38
Net borrowing	**62**	**-26**	**36**

* finance leases, PFI liabilities and transferred debt that form part of the Council's total debt

Net borrowing has decreased due to a fall in the CFR, as new capital expenditure was lower than the financing applied including minimum revenue provision. Usable reserves increased and working capital (due to the timing of receipts and payments) also increased.

The Council'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 31 March 2018 and the year-on-year change is shown in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £m	**2017-18 Movement £m**	**31.3.18 Balance £m**	**31.3.18 Interest Rate %**
Long-term borrowing	311.519	-17.575	293.944	4.68
Short-term borrowing	14.000	-8.000	6.000	2.36
Total borrowing	**325.519**	**-25.575**	**299.944**	**4.58**
Long-term investments	58.190	2.465	60.655	1.34
Short-term investments	204.999	-1.781	203.218	0.86
Total investments	**263.189**	**0.684**	**263.873**	**1.03**
Net borrowing	**62.330**	**-26.259**	**36.071**	

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

The decrease in borrowing has not resulted in a corresponding fall in investment balances.

The Council continues to pursue its policy of internal borrowing.

Borrowing Activity

At 31 March 2018, the Council held £299.944m of loans, a decrease of £25.575m on the previous year, as part of its strategy for funding previous years' capital programmes. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position

	31.3.17 Balance £m	**2017-18 Movement £m**	**31.3.18 Balance £m**	**31.3.18 Interest Rate %**	**31.3.18 WAM* %**
Public Works Loan Board	283.519	-4.575	278.944	4.66	19
Banks (LOBO)	18.000	-13.000	5.000	4.50	21
Banks (fixed-term)	10.000	0.000	10.000	4.69	24
Local authorities (short-term)	14.000	-8.000	6.000	0.63	0
Total borrowing	**325.519**	**-25.575**	**299.944**	**4.65**	**19**

*WAM – Weighted Average Maturity

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 being a secondary objective, should the Council's long-term plans change.

In furtherance of these objectives, no new borrowing was undertaken in 2017-18. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

The internal borrowing (reserves and working capital) of the Council at 31 March 2018 was £80.775m. If the Council had externally borrowed £80.775m over 19 years, at a rate of 2.74%, the Council would have incurred additional debit interest of £2.213m. If the Council had invested this sum of £80.775m at 1.03%, then the Council would have received £0.832m of interest. In 2017-18, the Council saved net interest of £1.381m by utilising internal borrowing.

For the majority of the year the "cost of carry" analysis performed by the Council's Treasury Management Advisor, Arlingclose, did not indicate value in borrowing in advance for future years' planned expenditure and therefore none was taken.

The Council continues to hold £5.000m of LOBO (Lender's Option Borrower's Option) loans, where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during 2017-18.

In 2017-18, two LOBO loans with Commerzbank with a fair value (market value) of £21.302m (£13.000m nominal) were repaid earlier than scheduled, for a total of £17.418m. The £4.418m premium incurred was only 53% of the £8.302m premium due, therefore after consultation with the Council's Treasury Management advisor, it was decided that this early repayment opportunity should be taken up.

Other Debt Activity

After £3.998m repayment of prior years' Private Finance Initiative/finance leases/transferred debt liabilities, total debt other than borrowing stood at £75.592m on 31 March 2018, taking total debt to £375.536m.

Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure, money borrowed in advance of need plus balances and reserves held. During 2017-18, the Council's investment balance ranged between £263.186m and £405.983m, due to timing differences between income and expenditure. The year-end investment position and the year-on-year change in show in table 4 below.

Table 4: Investment Position (Treasury Investments)

	31.3.17 Balance £m	**2017-18 Movement £m**	**31.3.18 Balance £m**	**31.3.18 Rate %**
Banks and building societies (unsecured)	75.875	-26.371	49.504	0.65
Government (including local authorities)	148.516	24.010	172.526	0.96
Registered Providers	5.000	15.000	20.000	1.49
Non Treasury Management Loans	0.190	1.955	2.145	4.85
Money Market Funds	24.128	-24.128	0.000	n/a
Pooled Funds (Property)	9.480	0.450	9.930	4.54
Pooled Funds (Multi Asset Credit)	0.000	9.768	9.768	3.60
Total investments	**263.189**	**0.684**	**263.873**	**1.03**

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.

In furtherance of these objectives, and given the increasing risk and low returns from short-term unsecured bank investments, the Council further diversified into a combination of either more secure, or higher yielding asset classes, during 2017-18. £10.000m available for longer-term investment was moved from bank and building society deposits into pooled multi asset credit funds. As a result, investment risk was lowered, while the average rate of return has increased by 0.16% to 1.03%. The progression of credit risk and return metrics for the Council's investments managed in-house are shown in the extracts from the Council's external investment advisor's (Arlingclose) quarterly investment benchmarking in table 5 below.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	3.81	AA-	33%	225	0.87
30.06.2017	3.94	AA-	38%	185	0.78
30.09.2017	4.51	A+	42%	219	0.88
31.12.2017	4.41	AA-	34%	205	1.06
31.03.2018	4.18	AA-	17%	241	1.03
Similar Local Authorities	**3.94**	**AA-**	**48%**	**879**	**1.31**
All Local Authorities	**4.24**	**AA-**	**55%**	**35**	**1.05**

The £19.698m portfolio of externally managed pooled property and multi asset credit funds generated an average total return of 2.31%, comprising a 1.58% income return used to support services in year and 0.73% of capital growth. 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 is therefore regularly reviewed. In light of their strong income generation performance and the Council's latest cash flow forecasts, investment in these funds has been increased for the 2018-19 financial year.

Financial Implications

The outturn for debt interest paid in 2017-18 was £20.515 million, on a debt portfolio of £299.944 million, at an average interest rate of 4.58%. This figure includes £4.044m repaid to Derby City Council in respect of transferred debt and £4.418m for the early repayment of the two Commerzbank LOBOs.

The outturn for investment income received in 2017-18 was £4.358 million, on an investment portfolio of £263.873 million, at an average interest rate of 1.03%.

This figure includes £1.295m from Derby City Council, being the premium on repayment of transferred debt referred to above.

Other Non-Treasury Holdings and Activity

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. The Council also holds £2.145m of investments in loans to local businesses and subsidiaries. This represents an increase of £1.955m on the previous year due to new investment of £1.645m in Buxton Crescent & Thermal Spa Co Limited and further investment of £0.310m in Derbyshire Developments Limited.

A register of such investments and financial guarantees is maintained and reviewed monthly as part of the Council's performance reporting arrangements.

These non-treasury investments generated £0.026m of investment income for the Council after taking account of direct costs, representing a rate of return of 4.85%. This is higher than the return earned on treasury investments but reflects the additional risks to the Council of holding such investments.

Performance Report

The Council measures the financial performance of its treasury management activities by benchmarking against the Arlingclose clients Local Authority Average. Investment benchmarking is quarterly and debt benchmarking annually.

Table 6: Performance

	Actual %	**Benchmark %**	**Over/ under**	**Comment**
Total debt	4.58	3.71	-0.87	Longstanding (pre-crisis) debt
Total investments	1.01	1.08	-0.07	Strategy is to increase the returns achieved to a rate above benchmark by 31 March 2019

Compliance Report

The Director of Finance & ICT 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 the authorised limit and operational boundary for external debt is demonstrated in table 7 below and compliance with specific investment limits is demonstrated in table 8 below.

Table 7: Debt Limits

	2017-18 Maximum £m	**31.3.18 Actual £m**	**2017-18 Operational Boundary £m**	**2017-18 Authorised Limit £m**	**Complied**
Total debt	**404**	**375**	**644**	**674**	✓

Table 8: Investment Limits

	31.3.18 Actual	**2017-18 Limit**	**Complied**
Any single organisation, except the UK Central Government (+£20m Lloyds (Main Bank))	29	30	✓
Any group of organisations under the same ownership	29	30	✓
Any group of pooled funds under the same management	10	30	✓
Negotiable instruments held in a broker's nominee account	0	100	✓
Foreign countries	0	100	✓
Registered Providers	20	20	✓
Unsecured investments with Building Societies	0	100	✓
Loans to unrated corporates	2	100	✓
Money Market Funds	0	150	✓

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 value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size 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 rating	AA-	A-	✓

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 one month period, without additional borrowing or that it can borrow each month without giving prior notice.

	31.3.18 Actual	2017-18 Target	Complied
Total cash available within 1 month	52	30	✓
Total sum borrowed in past 1 month without prior notice	5	10	✓

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	98	100	✓
Upper limit on variable interest rate exposure	2	40	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year, or the transaction date if later. All other instruments are classed as variable rate.

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	6	20	0	✓
12 months and within 24 months	3	10	0	✓
24 months and within 5 years	4	40	0	✓
5 years and within 10 years	9	40	0	✓
10 years and within 20 years	37	40	10	✓

20 years and within 30 years	31	40	10	✓
30 years and above	10	40	10	✓

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	61	36	21
Limit on principal invested beyond year end	100	80	60
Complied	✓	✓	✓

3 Considerations

In preparing this report the relevance of the following factors has been considered:- financial, legal, prevention of crime and disorder, equality and diversity, human resources, environmental, health, property, transport and social value considerations.

4 Background Papers

Treasury Management Strategy 2017-18.

Papers held in Technical Section, Finance & ICT Division, Room 137.

5 Key Decision

No

6 Is it necessary to waive the call-in period?

No

7 Officer's Recommendation

That Audit Committee notes the Treasury Management Annual Report 2017-18 and notes the Council's compliance with the prudential indicators set by Council for 2017-18, in accordance with the terms of the Prudential Code for Capital Finance in Local Authorities.

PETER HANDFORD

Director of Finance and ICT