

AUDIT COMMITTEE – 22 JUNE 2018

Title of paper:		TREASURY MANAGEMENT 2017/18 ANNUAL REPORT	
Director(s)/ Corporate Director(s):		Laura Pattman, Director of Strategic Finance	Wards affected: All
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Other colleagues who have provided input:		Members of Treasury Management Panel	
Recommendation(s):			
1	To note the performance information in relation to Treasury Management for 2017/18.		

1 REASONS FOR RECOMMENDATIONS

- 1.1 The CIPFA Prudential Code requires local authorities to nominate a body within the organisation to be responsible for scrutiny of treasury management activity. It is considered that the City Council's Audit Committee is the most appropriate body for this function.
- 1.2 In undertaking this function, the Audit Committee holds the responsibility to provide effective scrutiny of treasury management policies and practices.

2 BACKGROUND

- 2.1 Treasury management is the management of an organisation's borrowings and investments, the effective management of the associated risks and the pursuit of optimum performance or return consistent with those risks.
- 2.2 The treasury management function is governed by provisions set out under Part 1 of the Local Government Act 2003, whereby the City Council must have regard to the CIPFA Prudential Code and the CIPFA Code of Practice. Under the latter Code, an annual report is required to be submitted to and considered by councillors.

3 TREASURY MANAGEMENT ACTIVITY IN 2017/18

- 3.1 This report sets out the 2017/18 performance in respect of the management of the Council's external debt and investments. The key points are:
 - 3.1.1 the balance of external debt increased by £76.7m to £865.6m. The average rate of interest payable on the debt portfolio increased from 3.270% at 31 March 2017 to 3.398% at 31 March 2018 (see section 3.4);
 - 3.1.2 the council secured £180m of new long term borrowing during 2017/18. These loans have an average fixed interest rate of 2.38% with an average life of 47 years.
 - 3.1.3 the average rate of interest earned on short-term investments was 0.324%. This is benchmarked against the 7 day London Inter-bank (LIBID) rate provided by the Bank of England, which averaged 0.310% for the same period (see section 3.8);

- 3.1.3 the 2017/18 budget outturn for General Fund Treasury Management was £69.174m (see section 3.12);
- 3.1.4 there were no breaches of the Prudential Indicators set for 2017/18 (see section 3.11).
- 3.1.5 the Operational Boundary and the Authorised Limit for external debt within the Prudential Indicators were increased by £167m and £152m resp. within 2017/18 which was approved by Full Council on 22 January 2018 (see section 3.11.7).
- 3.1.5 the Debt Repayment Strategy known as Minimum Revenue Provision (MRP) was revised within 2017/18 and approved by Full Council on 5 March 2018 (see section 3.13).

3.2 Growth and Inflation:

- 3.2.1 During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year at 0.3% in both quarters 1 & 2 (+1.5% y/y at Q2).

The main reason for this was the sharp increase in inflation caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up in quarter 3 to 0.5% before dipping slightly to 0.4% in quarter 4.

3.2.2 UK Monetary Policy:

The Monetary Policy Committee (MPC) meeting of 14 September provided a shock to the markets with a sharp increase in tone in the minutes where the MPC considerably hardened their wording in terms of needing to raise Bank Rate very soon.

The 2 November MPC quarterly Inflation Report meeting duly delivered on this warning by withdrawing the 0.25% emergency rate cut which had been implemented in August 2016.

The UK growth in the second half of 2017 came in stronger than expected, while in the new year there was evidence that wage increases had started to rise. The 8 February MPC meeting minutes therefore revealed another sharp hardening in MPC warnings focusing on a reduction in spare capacity in the economy, weak increases in productivity, higher GDP growth forecasts and a shift of their time horizon to focus on the 18 – 24 month period for seeing inflation come down to 2%. (CPI inflation ended the year at 2.7% but was forecast to still be just over 2% within two years.)

This resulted in a marked increase in expectations that there would be another Bank Rate increase in May 2018 and a bringing forward of the timing of subsequent increases in Bank Rate.

During 2017/18, longer term PWLB rates were volatile but with little overall direction, whereas shorter term PWLB rates were on a rising trend during the second half of the year.

Appendix 3 shows the money market interest rates and the Public Works Loans Board (PWLB) borrowing rates for 2017/18.

3.3 Local Context

3.3.1 The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

3.3.2 At 31/03/2018 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £1,369.8m.

3.3.3 At 31/03/2018, the Council had £1,073.6m of borrowing including £208.0m of Private Finance Initiative (PFI) Debt and £31.3m of investments. The Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, subject to maintaining a liquidity investment balance of around £30m.

3.3.4 The Council has an increasing CFR over the next 3 years due to the capital programme, investments are expected to remain at around £30m resulting in around £264m of new borrowing being required as reported in the 2018/19 Treasury Management Strategy Report.

3.4 Borrowing

3.4.1 The CFR is a gauge of the Council's indebtedness and results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2017/18 unfinanced capital expenditure, and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

3.4.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, (such as the Government, through the Public Works Loan Board (PWLB) or the money markets), or utilising temporary cash resources within the Council (Internal Borrowing).

3.4.3 Total outstanding debt in 2017/18 increased by £76.7m to £865.6m as at 31 March 2018. The total long term debt increased by £163.7m while temporary borrowing had decreased by £87.0m as at 31 March 2018. The average rate of interest on total debt increased, from 3.270% at 31 March 2017 to 3.398% at 31 March 2018.

Table 2 analyses the debt portfolio:

TABLE 2: DEBT PORTFOLIO				
	01-Apr-17		31-Mar-18	
DEBT	£m	%	£m	%
PWLB borrowing	623.6	3.729	787.3	3.448
Market loans	49.0	4.348	49.0	4.348
Local bonds & Stock	0.6	3.001	0.6	3.001
Temporary borrowing	115.7	0.338	28.7	0.430
TOTAL DEBT	788.9	3.270	865.6	3.398

- 3.4.4 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.
- 3.4.5 The Council raised a total of £180m of new long term fixed rate loans in 2017/18. These had an average life of 47 years and an average rate of 2.38% with a revenue cost of c.£4.278m per annum in interest payable. The increase in fixed rate loans provide long term cost certainty and reduces the Councils exposure to increases in long term interest rates. The PWLB was the Council's preferred source of long term borrowing given the transparency and control that its facilities continue to provide.
- 3.4.6 Temporary loans borrowed from the markets, predominantly from other local authorities, has also remained affordable and attractive. £314m of such loans were borrowed at an average rate of 0.37% and an average life of 90 days this total includes the replacement of maturing loans. The Council's outstanding balance of Temporary loans has decreased by £87m with the debt portfolio showing £28.7m outstanding as at 31 March 2018.
- 3.4.7 The Council has increased the under-borrowed position in 2017/18 by £31m with Internal Borrowing of c.£296m at 31 March 2018. This meant that the capital borrowing need (the Capital Financing Requirement), was not fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow was used as a temporary measure. This strategy was prudent as investment returns were low and counterparty risk was still an issue that needed to be considered.
- 3.4.8 The second half of 2017/18 displayed an increase in risks within the economic forecasts, caution was adopted within the treasury operations. The Director of Finance therefore monitored interest rates in financial markets and it was felt that there was a significant risk of a sharper rise in long and short term rates than initially expected, arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, so the portfolio position was re-appraised and an increased level of fixed rate funding was drawn down whilst interest rates were lower than they were projected to be in the next few years.
- 3.4.9 An interest equalisation reserve has been maintained to mitigate the risk of unexpected rises in long term interest rates with c.£12.5m ring-fenced to smooth the impact of further increasing the proportion of fixed long term loans.
- 3.5 Lender Option Borrower Option (LOBOs)
- 3.5.1 The Council holds £34.000m of LOBO loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost.

£14.000m of these LOBO loans had options during the year, none have been exercised by the lender. The Council acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

- 3.5.2 The council previously held LOBO loans with Barclays Bank, but in 16/17 the Bank cancelled all the embedded options within the loans. This effectively converted the £15m of Barclays LOBO loans to fixed rate loans removing the uncertainty on both interest cost and maturity date.

3.6 Debt Rescheduling

- 3.6.1 The PWLB continued to operate a spread of approximately 1% between “premature repayment rate” and “new loan” rates so the premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Council’s portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

3.7 Housing Revenue Account (HRA) Borrowing

- 3.7.1 From 1 April 2002, the Council’s HRA was allocated a separate debt portfolio based on the appropriate proportion of the Councils existing debt at that time. As a result of existing debt maturing and not being replaced the HRA accumulates a variable rate internal borrowing position. During 2014/15 the HRA fixed £37.161m of internal borrowing on a maturity loan basis for 30 years with reference to the PWLB interest rate quoted on the day. No further fixed rate HRA borrowing has taken place in 2017/18.
- 3.7.2 The HRA element of the CFR was £294.1m and is fully financed at an average rate of 4.23% as at 31 March 2018. The HRA interest charge for 2017/18 was £12.158m.

3.8 Investments

- 3.8.1 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.
- 3.8.2 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council’s minimum long-term counterparty rating was A- across rating agencies Fitch, S&P and Moody’s); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.
- 3.8.3 In the past 12 months, the Council’s investment balance has ranged between £24m and £64m. The strategy of maintaining investment balances towards £30m has seen the dual benefit of reducing the Council’s exposure to bank credit risk and has allowed the budget to benefit from the net borrowing exposure to the low interest rate environment.
- 3.8.4 The average sum invested during the year was £64.6m, earning total interest of £0.449m at an average rate of 0.324%. After the EU referendum, Bank Rate was cut from 0.5% to 0.25% on 4 August 2016 and remained until November 2017 when the Bank Rate returned to 0.50%. The low short-term interest rates (see appendix 3), meant that the average return for 2017/18 was below that of recent years, but higher

than the original budget estimate of 0.30%, due to the unforeseen November rate rise and subsequent increases in short term Money Market interest rates.

- 3.8.5 The Council benchmarks its average return against the 7-day London Interbank (LIBID) rate provided by the Bank of England. For 2017/18, the average 7-day LIBID rate was 0.31%.

TABLE 3 - Investment Activity in 2017/18

Investments	Balance on 01/04/2017 £m	Balance on 31/03/2018 £m	Avg Rate/Yield (%) Avg days to maturity
Short term Investments (call accounts, deposits)			
- Banks and Building Societies with ratings of A- or higher	5.0	0	N/A
- Local Authorities	10.0	10.0	0.40% / 2
Long term Investments	0.0	0.0	N/A
Money Market Funds	12.0	21.3	0.46% / 1
TOTAL INVESTMENTS *	27.0	31.3	0.44% / 1
- Increase/ (Decrease) in Investments £m		4.3	

Note: * excludes balance in Icelandic ISK Escrow account

- 3.8.6 Table 3 above shows the movement in investments by type during 2017/18. The council has retained its use of instant access money market funds with the dual benefit of increased diversity and a credit rating of AAAm.
- 3.8.7 The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.
- 3.8.8 Appendix 2 provides details of the Council's external investments at 31 March 2018, analysed between investment type and individual counterparties showing the Fitch long-term credit rating.
- 3.9 Icelandic Krona (ISK) in Escrow
- 3.9.1 The administrators for the recovery of Glitnir Bank deposits (£11m) have made repayment to all priority creditors, including the City Council, in full settlement of the accepted claims. However, approximately 21% (£2.3m) of this sum had been paid in ISK and due to currency restrictions in Iceland, this sum had been retained in an interest-bearing escrow account with the Central Bank of Iceland. On 27 June 2017 the Council received £3.2m as proceeds from the sale of the restricted ISK balance including accrued interest as the Central Bank of Iceland starts to remove the currency controls and normalise their economy.

The council has now received 100% of the principal balance deposited with Glitnir Bank.

3.10 External advisors

3.10.1 External treasury management advisors are retained to provide additional input on treasury management matters. The service comprises economic and interest rate forecasting, advice on strategy, portfolio structure, debt restructuring, investment policy and credit ratings and technical assistance on other matters, as required.

3.10.2 The council has retendered the advisor contract in 2016/17, and starting from 1st April 2017 has received good quality services from Link Asset Services (previously known as Capita Asset Services).

3.11 Compliance with Prudential Indicators

3.11.1 The Council confirms compliance with its Prudential Indicators for 2017/18 set on 6 March 2017 as part of the Council's Treasury Management Strategy Statement. Appendix 1 shows the complete list of indicators including actual performance against these indicators for 2017/18 together with comparative figures for 2016/17.

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

3.11.3 Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The limits on net fixed and variable rate interest rate exposures are:

	2017/18 £m	2018/19 £m	2019/20 £m
Upper limit on fixed interest rate exposure	900	900	900
Actual	741		
Upper limit on variable interest rate exposure	300	300	300
Actual	93		

3.11.4 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 will be:

	Lower	Upper	Actual
Under 12 months	0%	25%	7%
12 months and within 24 months	0%	25%	4%
24 months and within 5 years	0%	25%	10%
5 years and within 10 years	0%	25%	15%
10 years and within 25 years	0%	50%	18%
25 years and within 40 years	0%	50%	20%
40 years and above	0%	25%	25%

3.11.5 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 total principal sum invested to final maturities beyond the period end will be:

	2016/17 £m	2017/18 £m	2018/19 £m
Limit on principal invested beyond year end	20	20	20
Actual	0		

3.11.6 Operational Boundary and Authorised Limit 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. 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.

	2017/18 Original Estimate £m	2017/18 Revised PI Limits £m	2017/18 Max Debt in year £m
Borrowing	831.5		866.6
Other Long-term Liabilities *	215.8		208.0
Total External Debt	1,047.3		1,073.6
Operational Boundary	1,107.2	1,275.0	
Authorised Limit	1,147.2	1,300.0	

* Includes PFI and Leases liabilities

3.11.7 The Operational Boundary and Authorised limit for external debt was increased as part of a revision to the Treasury Management Strategy which was approved by Full Council on 22 January 2018. This was due to additional approvals within the capital program since the original strategy was approved. The additional capital expenditure will have been subject to an affordability assessment as part of the business case approval from the Section 151 Officer.

3.11.8 Adoption of the CIPFA Treasury Management Code:

The Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice*.

3.12 General Fund Revenue Implications

3.12.1 Revenue costs associated with borrowing and lending can be volatile, being affected by a number of factors including movements in interest rates, the timing of capital spending, the extent of reserves held and actual cash flows during the year.

3.12.2 The outturn in 2017/18 for treasury management costs was £69.174m. The total treasury management-related costs in 2017/18, comprising interest charges less receipts, plus provisions for repayment of debt, were £81.333m. Of this PFI related expenditure accounted for £29.703m which includes the NET lines 1 & 2. A proportion of the Council's debt relates to capital expenditure on council housing and £12.159m of these costs was charged to the HRA.

The remaining General Fund costs of £69.174m gave a favourable variance of £0.220m which is included within the treasury management section of the General Fund corporate Budget Outturn Report on the 19 June 2018 Executive Board agenda.

3.13 Revision to 2017/18 Minimum Revenue Provision

3.13.1 The Debt Repayment Strategy known as Minimum Revenue Provision (MRP) was revised within 2017/18 and approved by Full Council on 5 March 2018 (see published report Treasury Management Strategy 2018/19 and Revision to 2017/18 Debt Repayment Strategy).

3.13.2 This revision approved the retrospective calculation of a c.£28m overprovision in the period 2007 – 2016 based on applying the existing MRP policy on the repayment of the Pre-2007 debt known as ‘Supported Borrowing’. The amount of MRP charged from 2017/18 to 2023/24 will be adjusted for this overprovision (reduction of c.£4m pa for 7 years) and used to finance ‘transformation of services’ works to be carried out that support achieving a sustainable medium term financial plan including the resulting future MRP charges.

3.14 Treasury Management Reserve

3.14.1 The Treasury Management Reserve is maintained to smooth the impact of any volatility in treasury management revenue charges in any one year. The balance on the Reserve at 31 March 2018 is £3.513m.
A separate reserve for interest equalisation has been set up with a balance £12.537m specifically to balance the risk of having to secure new long term loans at higher interest rates than anticipated.

3.15 Value for Money

3.15.1 Management of borrowing and investments is undertaken in conjunction with our appointed advisors, with the aim of minimising net revenue costs, maintaining an even debt maturity profile and ensuring the security and liquidity of investments.

3.16 Risk Management

3.16.1 Risk management plays a fundamental role in treasury activities, due to the value and nature of transactions involved. The management of specific treasury management risks is set out in the Manual of Treasury Management Practices and Procedures and a risk register is maintained for the treasury function.

3.16.2 The treasury management risk register’s overall risk rating at 31 March 2018 was Likelihood = unlikely, Impact = moderate which represents the same risk assessment as at 31 March 2017. The Treasury Management working group continue to manage this risk and take appropriate actions as required.

3.17 Revised CIPFA Codes

3.17.1 In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued a revised Treasury Management Code and Cross Sectoral Guidance Notes, and a revised Prudential Code.
A particular focus of these revised codes was how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing

property in order to generate income for the council at a much higher level than can be attained by treasury investments. One recommendation was that local authorities should produce a new report to councillors to give a high level summary of the overall capital strategy and to enable councillors to see how the cash resources of the council have been apportioned between treasury and non-treasury investments.

3.17.2 Full implementation is not required until 31 March 2019 i.e. the 2019/20 budget cycle.

3.18 Markets in Financial Instruments Directive II (MiFID II)

3.18.1 The EU set the date of 3 January 2018 for the introduction of regulations under MIFID II. These regulations govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This has had little effect on this council apart from having to fill in forms sent by each institution dealing with this council and for each type of investment instrument we use, apart from for cash deposits with banks and building societies.

4 BACKGROUND PAPERS OTHER THAN PUBLISHED WORKS OR THOSE DISCLOSING EXEMPT OR CONFIDENTIAL INFORMATION

4.1 None

5 PUBLISHED DOCUMENTS REFERRED TO IN COMPILING THIS REPORT

5.1 Treasury Management in the Public Services, Code of Practice 2011 – CIPFA

5.2 CIPFA statistics, Bloomberg sourced Money Market rates and PWLB loan rates 2017/18.

5.3 Treasury Management Strategy 2018/19 and Revision to 2017/18 Debt Repayment Strategy.