**Treasury Management Annual Report 2018/19**

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| Summary: | This report sets out the Treasury Management activities actually undertaken during 2018/19 compared with the Treasury Management Strategy for the year. |
| Options Considered: | This report must be prepared to ensure the Council complies with the CIPFA Treasury Management and Prudential Codes. |
| Conclusions: | Treasury activities for the year have been carried out in accordance with the CIPFA Code and the Council's Treasury Strategy. |
| Recommendations: | That the Council be asked to RESOLVE that The Treasury Management Annual Report and Prudential Indicators for 2018/19 are approved. |
| Reasons for Recommendation: | Approval by Council demonstrates compliance with the Codes. |

**LIST OF BACKGROUND PAPERS AS REQUIRED BY LAW**

*(Papers relied on to write the report, which do not contain exempt information and which are not published elsewhere)*

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|---|---|
| Cabinet Member(s): Cllr Eric Seward | Ward(s) affected: All |

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## 1. Introduction

1.1 The Chartered Institute of Public Finance and Accountancy's Treasury Management Code requires the Council to report on the performance of the treasury management function at least twice a year (mid-year and at the year-end).

1.2 Treasury Management activities for 2018/19 have been carried out in accordance with the Council's Treasury Management Strategy 2018/19 which was approved by Full Council on 21 February 2018.

1.1 The Council has 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. This report covers treasury activity and the associated monitoring and control of risk.

1.2 Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the

Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

1.3 The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 21 February 2018.

## 2. Context

2.1 With the 29th March 2019, the original EU 'exit day' now been and gone, having failed to pass a number of meaningful votes in Parliament, including shooting down Theresa May's deal for the third time, MPs voted by a majority of one (313 to 312) to force the prime minister to ask for an extension to the Brexit process beyond 12th April in order to avoid a no-deal scenario. Recent talks between the Conservative and Labour parties to try to reach common ground on a deal which may pass a vote by MPs have yet to yield any positive results. The EU must grant any extension and its leaders have been clear that the terms of the deal are not up for further negotiation. The ongoing uncertainty continues to weigh on sterling and UK markets.

2.2 While the domestic focus has been on Brexit's potential impact on the UK economy, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to be show signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

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

2.4 Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury yields were lower than US 3 month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling by 1.8% year-on-year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China which despite some moderation in January does suggest that the International Monetary Fund's (IMF) and Organisation for Economic Co-Operation & Development's (OECD) forecasts for global growth in 2019 of 3.5% might need to be revised downwards.

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

2.6 Local Context: On 31st March 2019, the Authority had net investments of £35.450m arising from its revenue and capital income and expenditure. 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.

2.7 The treasury management position at 31st March 2019 and the change during the year is shown below.

| | 31.3.18 Balance £m | Movement £m | 31.3.19 Balance £m | 31.3.19 Rate % |
|---|---|---|---|---|
| Long-term borrowing | 0.0 | 0.0 | 0.0 | 0 |
| Short-term borrowing | 0.0 | 3.0 | 3.0 | 0.87% |
| **Total borrowing** | **0.0** | **3.0** | **3.0** | **0.87%** |
| Long-term investments | 30.500 | 5.750 | 34.250 | 3.61% |
| Short-term investments | 3.460 | (1.260) | 4.200 | 0.63% |
| **Total investments** | **33.960** | | **38.450** | **2.82%** |
| **Net investments** | **33.960** | | **35.450** | |

## 3. Borrowing

3.1 At 31st March 2019 the Authority held £3m of loans, an increase of £3m over 31st March 2018. Outstanding loans on 31st March are summarised in Table 3 below.The Council is currently free from long-term external debt, although short-term borrowing has been entered into during the year for cash flow purposes. There is an underlying need to borrow assumed within the current three-year Capital Programme for the re-provision of Splash Leisure Centre and the construction of a 3G pitch in North Walsham, and this is covered by the Treasury Management Strategy 2018/19 and 2019/20.

| | 31.3.18 Balance £m | Net Movement £m | 31.3.19 Balance £m | 31.3.19 Weighted Average Rate % |
|---|---|---|---|---|
| Local authorities (short-term) | 0.0 | 3.0 | 3.0 | 0.87% |
| **Total borrowing** | **0.0** | **3.0** | **3.0** | **0.87%** |

3.2 The Authority's chief objective when borrowing will be 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 Authority's long-term plans change being a secondary objective.

3.3 With short-term interest rates remaining much lower than long-term rates, the Authority considers it to be more cost effective in the near term to use internal resources or borrowed rolling temporary / short-term loans instead of longer term debt.

## 4. Investment Activity

4.1 The Ministry of Housing, Communities and Local Government's (MHCLG) guidance on Local Government Investments requires the Council to focus on security and liquidity, rather than yield when undertaking its treasury activities.

4.2 The table below gives Members an appreciation of the investment activity undertaken in 2018/19, showing the position at the start and end of the year, together with the transactions during the year.

| | Balance 01/4/2018 £m | Net movement £m | Balance 31/3/2019 £m | Income return % |
|---|---|---|---|---|
| Short term Investments (call accounts, deposits and CDs with banks & building societies) | 0.000 | 0.000 | 0.000 | n/a |
| UK Government (DMADF and other local authorities) | 0.000 | 2.000 | 2.000 | 0.75% |
| Money Market Funds | 3.460 | (1.260) | 2.200 | 0.63% |
| Cash plus funds | 3.000 | 0.000 | 3.000 | 1.11% |
| Short dated bond funds | 3.000 | 0.000 | 3.000 | 0.90% |
| Strategic bond funds | 5.000 | 0.000 | 5.000 | 3.43% |
| Equity income funds | 6.000 | 2.000 | 8.000 | 4.67% |
| Property funds | 5.000 | 0.000 | 5.000 | 5.83% |
| Multi asset funds | 4.000 | 4.000 | 8.000 | 4.33% |
| Covered Bonds | 4.500 | (2.250) | 2.250 | 1.09% |
| All investments | 33.960 | 4.490 | 38.450 | 2.82% |

4.3 Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority'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. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2018/19.

4.4 In accordance with this strategy, the Council made further investments in pooled funds during 2018/19. During the year, an additional £6m was invested in pooled funds. The Council's existing holdings in M&Gs Global Dividend Fund was increased to £2m from £1m, a further £1m was invested in the CCLA Diversified Income Fund, an additional £1m in the Schroder Income Maximiser Fund and £3m was invested in the Kames Capital Diversified Monthly Income Fund. Pooled Fund Investments generate a large income return for the Council, but their Net Asset Values are subject to fluctuations over time. For this reason, the Council's investment in strategic pooled funds has only been made with funds it anticipates will remain available for investment over the medium to long-term (i.e. 3 to 5 years). This will minimise the risk from incurring any potential capital loss on selling the investment at an unfavourable point in time. As at the end of March 2018, the capital variance on the pooled fund investments was a gain of £1,371,467 to point of purchase, and a gain of £172,129 in year (which would only be realised if the holdings had to be sold).

4.5 With little by way of political clarity as to the exact date or whether there would be an agreed deal prior to leaving the EU and to be prepared for the outside chance of a particularly disruptive Brexit (such as last-minute no-deal) on 29th March, the Authority ensured there were enough accounts open at UK domiciled banks and Money Market Funds to hold sufficient liquidity over the year end and that its account with the Debt Management Account Deposit Facility (DMADF) remained available for use in an emergency.

4.5 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for specified investments is A- across the rating agencies Fitch, Standard & Poors and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

## 5. Credit Risk

Given the increasing risk and falling returns from short-term unsecured bank investments, the Authority has diversified into more secure and/or higher yielding asset classes. As a result, investment risk was diversified while the average rate of return has increased. The Authority's Treasury advisors, Arlingclose, compile quarterly investment benchmarking across their client base. The table below shows extracts from this, focussing on measures of risk (credit rating and bail-in exposure) and return (Rate of return).

| Date | Credit Score | Credit Rating | Bail –in exposure | Rate of Return % |
|---|---|---|---|---|
| 31/03/2018 | 2.52 | AA | 43% | 0.86% |
| 31/03/2019 | 3.00 | AA | 34% | 0.92% |
| Similar LAs | 4.20 | AA- | 53% | 0.86% |
| All LAs | 4.13 | AA- | 55% | 0.85% |

5.1 All investment counterparties are given a credit score. Weighted average scores are then calculated for both value and time. The value weighted average reflects the credit quality of investments compared to the size of the deposit. The time weighted average reflects the credit quality of investments compared to the number of days to maturity of the deposit.

5.2 In the Treasury Management Strategy 2018/19 the Council adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score 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. The target credit score has been set at 6 which equates to a long term rating of A (or equivalent).

5.3 The table shows how the scores and ratings have changed over the financial year. The more investments the Council has with counterparties with higher credit ratings, the lower the score will be. Over the year, the time weighted average scores have fallen indicating that the credit rating on both a time weighted basis has improved. However, the value weighted average score as increased, indicating that the credit rating on this basis has reduced.

## 6. Non-Treasury Investments

6.1 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in MHCLG's Investment

Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

6.2 The Authority also holds £4.423m of such investments in

- directly owned property £0.923m
- loans to housing associations £3.5m

The rate of return on the loan to Broadland Housing Association is 3.8% which compares favourably to Treasury investment rates. The direct property investments delivered a rate of return of -1.60%. This is largely due to the fact that the depot site at Grove Lane did not generate an income for the Council for the first three quarters of 2018-19. These investments represent a different risk to the Authority, as property investments do not carry the same interest rate or credit risk, but there is the risk of loss of income through voids and other market factors. They also require more staff time to manage than externalised pooled investments. Risks of voids are mitigated by, where possible, the use of long leases and active marketing of vacant properties. A Holiday let strategy is in development to enable return from the Council's existing and future holiday lets to be maximised. This will include a revised marketing strategy. Other market factors are largely outside of the Council's control, but will be monitored by the Estates team in the context of the current portfolio and possible future opportunities.

6.3 The Authority does not currently rely on these funds from Non-Treasury investments to balance the budget, but in a climate of reduced Government funding, is likely to do so more in the future. To guard against the risk of reducing levels of income from these investments, they are proactively managed by experienced and qualified individuals within the Authority, with external advice as required.

## 7. Investment Performance

7.1 The income budget for 2018/19 anticipated £1,158,300 would be earned in interest from an average balance of £35.1m at a rate of 3.3%. A total of £1,295,337 was earned from investments over the year from an average balance of £44.7m at an average rate of interest of 2.89%. This resulted in a favourable variance against the budget of £138,034.

7.2 Throughout the year, investment balances were consistently higher than anticipated; although overall the rate of interest earned was lower than budget.

## 8. Compliance with Prudential Indicators

8.1 The Council confirms compliance with its Prudential Indicators for 2018/19 which were set on 21 February 2018 as part of the Council's Treasury Management Strategy Statement.

| | 2018/19 Maximum | 31.3.19 Actual | 2018/19 Operational Boundary | 2018/19 Authorised Limit | Complied? |
|---|---|---|---|---|---|
| Borrowing | £3m | £3m | £15.03m | £23.4m | Yes |

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.

Non-specified investments ceased to be relevant during the year, so the relevant indicators have been removed.

| | 2018/19 Maximum | 31.3.19 Actual | 2018/19 Limit | Complied? |
|---|---|---|---|---|
| Any single organisation, except the UK Government | Nil | Nil | £3m each | Yes |
| Any group of organisations under the same ownership | Nil | Nil | £3m per group | Yes |
| Any group of pooled funds under the same management | Max is £7m with CCLA | Max is £7m with CCLA | £10m per manager | Yes |
| Negotiable instruments held in a broker's nominee account | £2.25m (King and Shaxon) | £2.25m (King and Shaxon) | £10m per broker | Yes |
| Limit per non-UK country | Nil | Nil | £5m per country | Yes |
| Registered providers | Nil | Nil | £7.5m in total | Yes |
| Unsecured investments with building societies | Nil | Nil | £3m in total | Yes |
| Loans to unrated corporates | Nil | Nil | £3m in total | Yes |
| Money Market Funds | £19.3m | £2.2m | £20m in total | Yes |

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

8.3 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 exposures, expressed as the proportion of net principal borrowed (i.e. fixed rate debt net of fixed rate investments, will be:

| | 2018/19 | 2019/20 | 2020/21 |
|---|---|---|---|
| Upper limit on fixed interest rate exposure | (100%) | (100%) | (100%) |
| Actual | (100%) | | |
| Upper limit on variable interest rate exposure | (100%) | (100%) | (100%) |
| Actual | (100%) | | |

8.4 As the Council's investments exceed its borrowing, these calculations have resulted in a negative figure. The purpose of the limit is to ensure that the Council is not exposed to interest rate rises on any borrowing which could adversely impact the revenue budget. Variable rate borrowing can be used to offset exposure to changes in short term rates on investments. These limits therefore allowed maximum flexibility for fixed or variable rate investments and investment decisions were ultimately made on expectations of interest rate movements as set out in the Strategy. 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.

8.5 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 set as follows.

| Maturity structure of fixed rate borrowing | Lower Limit for 2018/19 % | Upper Limit for 2018/19 % | Actual 2018/19 |
|---|---|---|---|
| under 12 months | 0 | 100 | 100 |
| 12 months and within 24 months | 0 | 100 | 0 |
| 24 months and within 5 years | 0 | 100 | 0 |
| 5 years and within 10 years | 0 | 100 | 0 |
| 10 years and above | 0 | 100 | 0 |

8.6 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:

| | 2018/19 | 2019/20 | 2020/21 |
|---|---|---|---|
| Limit on principal invested beyond year end | £35m | £35m | £35m |
| Actual | £34.25m | | |

8.7 Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average [credit rating] or [credit score] 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.

| | Target | Actual |
|---|---|---|
| Portfolio average credit score | 6.0 | 3.0 |

8.8 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 month period, without additional borrowing.

| | Target | Actual |
|---|---|---|
| Total cash available within 3 months | £3.0m | £4.2m |

**9. Financial Implications and Risks**

9.1 The financial impact of implementing the Council's treasury strategy for 2018/19 has been set out in this report.

**10. Sustainability** – None as a direct consequence of this report.

**11. Equality and Diversity** – None as a direct consequence of this report.

**12. Section 17 Crime and Disorder considerations** – None as a direct consequence of this report.