South
Derbyshire
District Council

Treasury Management Annual Report 2017/18

Introduction

The Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) which requires the Authority to approve a treasury management annual report after the end of each financial year.

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

The Authority's treasury management strategy for 2017/18 was approved at a meeting on 16th February 2017. The Authority 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 Authority's treasury management strategy.

External Context

Economic commentary (as at 9th April 2018)

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.

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 21st 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. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

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 deterioration in its financial position.

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 FY 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 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. Where this strategy is produced and approved by full Council, the determination of the Treasury Management Strategy can be delegated to a committee. The Code also expands on the process and governance issues of capital expenditure and investment decisions.

The Authority will be producing a Capital Strategy for review and approval at the Finance & Management Committee in August 2018

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.

MHCLG Investment Guidance and Minimum Revenue Provision (MRP)

In February 2018, the MHCLG (Ministry of Housing, Communities and Local Government) 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 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 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

On 31st March 2018, the Authority had net borrowing of £32.95m arising from its revenue and capital income and expenditure, a decrease on 2017 of £14.5m. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). Actual CFR versus budgeted CFR is summarised below.

Capital Financing Requirement (CFR)	**Actual £'000**	**Budget £'000**
CFR balance b/fwd April 2017	67,583	67,583
Less Minimum Revenue Provision (MRP)	-214	-214
Less Voluntary Revenue Provision (VRP)	-131	-131
CFR balance c/fwd 31st March 2018	**67,238**	**67,238**
General Fund CFR	5,654	5,654
HRA CFR	61,584	61,584
Total CFR	**67,238**	**67,238**

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 is show in the below.

Net Borrowing	April 17 B/fwd £'000	Movement £'000	March 18 C/fwd £'000	Average Rate %
Long-term Borrowing:				
Fixed	47,423	0	47,423	3.19%

Variable	10,000	0	10,000	0.79%
Short-term Borrowing	28	0	28	0.00%
Total Borrowing	**57,451**	**0**	**57,451**	
Long-term Investments	0	1,000	1,000	4.54%
Short-term investments	10,000	13,500	23,500	0.23%
Cash and Cash Equivalents	5,547	-2,493	3,092	0.20%
Total Investments	**15,547**	**12,007**	**27,592**	
Net Borrowing	**41,904**	**-12,007**	**29,859**	

The net borrowing of the Council reduced during 2017/18 due to an increase in investments. Lower expenditure and budget savings in year resulted in larger cash balances to invest which is reflected above.

Borrowing Activity

At 31st March 2018, the Authority held £57.4m of loans. These loans were taken out by the Authority in 2011/12 for the purpose of HRA self-financing. The following table shows the maturity dates of the loans and rate of interest payable.

Loan Profile	Type	Value (£'000)	Rate (%)	Maturity
Public Works Loan Board	Variable	10,000	0.79	2021/22
Public Works Loan Board	Fixed	10,000	2.70	2023/24
Public Works Loan Board	Fixed	10,000	3.01	2026/27
Public Works Loan Board	Fixed	10,000	3.30	2031/32
Public Works Loan Board	Fixed	10,000	3.44	2036/37
Public Works Loan Board	Fixed	7,423	3.50	2041/42
		57,423		

The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

For the majority of the year the "cost of carry" analysis performed by the Authority'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 was not required to undertake any temporary borrowing during 2017/18 but does hold money on deposit for 2 Parish Councils which is classed as temporary as it can be recalled on immediate notice.

Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2017/18, the Authority's investment balance ranged between £19m and £31m due to timing differences between income and expenditure. The year-end investment position is show below.

Investment Profile	Type	Value (£'000)	Average Rate (%)
Local Authorities	Fixed Rate	18,000	0.44
Debt Management Office	Fixed Rate	1,500	0.15
Money Market Funds	Variable Rate	4,000	0.42
CCLA Property Fund	Variable Rate	1,000	4.54
		24,500	

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 investments before seeking the highest 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.

In furtherance of these objectives, and given the increasing risk and low returns from short-term unsecured bank investments, the Authority diversified into the CCLA Property Fund and Money Market Funds which both offer a higher yield but remain secure during 2017/18. £1m that is available for longer-term investment was moved from bank and deposits into the CCLA Property Fund and £4m was invested into Money Market Funds. As a result, investment risk was marginally increased but funds have still remained secure and the average rate of return has increased from 0.25% to 0.39%.

Financial Implications

The outturn for debt interest paid in 2017/18 was £1.55 million at an average interest rate of 2.73% against a budgeted interest charge of £1.77 million at an average interest rate of 3.08%.

Lower interest costs have been achieved due to the variable element of the loans. The rate of interest budgeted was 2.5% but the average rate charged was only 0.79%

The outturn for interest income received in 2017/18 was £108,549 against a budget of £20,000. The average interest rate achieved was 0.39%.

Interest received in year was greater than budgeted due to higher levels of cash for investment plus a change in the investment portfolio. The CCLA Property Fund and Money Market investments have increased the average rate of return achieved.

Performance Report

The main indicator the Council uses to measure its return on investments to average, over the year, is the Average 7-Day Money Market Rate. This is a standard measure of performance. Performance in recent years is shown in the following table.

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
7 Day Rate (Target)	0.51%	0.62%	0.51%	0.47%	0.50%	0.50%	0.36%	0.35%
Actual Rate	0.78%	0.74%	0.31%	0.33%	0.31%	0.32%	0.25%	0.39%

Compliance Report

The Chief Finance Officer is pleased to report that all treasury management activities undertaken during 2017/18 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

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

Debt Limits	Actual Debt 17/18 £'000	Operational Boundary £'000	Authorised Limit £'000
HRA	57,423	57,423	66,853
General Fund	0	5,000	5,653

The Operational Boundary represents the expected external debt outstanding in the year. The limit on the General Fund of £5m is a provision for temporary borrowing and is included as a contingency should cash flow become negative during year. The HRA's Operational Boundary represents the current borrowing undertaken due to self-financing.

The Authorised Limit is the Borrowing Cap for the Council. It represents the CFR on the General Fund and the debt cap set by the Government on the HRA for self-financing.

The Council invests surplus funds in accordance with an approved policy and associated counterparty list. Below is a table showing the maximum investments during 2017/18 within each category on the Counterparty list and that the Council were fully compliant with the policy.

Investment Limits	Maximum Investment during 17/18 £m	Maximum invested per Counterparty £m	Limit	Maximum Term	Complied
Debt Management Office	£14m	£14m	£15m in total	364 days	✓
Other Local Authorities	£21m	£5m	£5m per Authority	364 days	✓
Money Market funds	£4m	£2m	£10m total, £2m per fund	60 days	✓
CCLA Property Fund	£1m	£1m	£1m	Indefinite period	✓
Named Counterparties (HSBC/Lloyds/BOS/Close Bros/Santander)	£2m	£2m	£2m per Bank	6 months	✓
Named Counterparties (Barclays/Goldman Sachs)	£2m	£2m	£2m per Bank	100 days	✓
Named Counterparties (RBS/NatWest) *	0	0	£1m per Bank	35 days	✓
Named Counterparties (Nationwide/Coventry)	0	0	5% of total deposits	6 months	✓
Named Counterparties (Leeds)	0	0	5% of total deposits	100 days	✓
Foreign Counterparties	0	0	AAA rated - £1m per Bank	1 month	✓
Independent Building Societies	0	0	£1m per Society	100 days	✓

*As previously reported, in line with Arlingclose advice, RBS/NatWest have been removed from the Counterparty list from 1st April 2018.