APPENDIX A
AGENDA ITEM (10)

Treasury Management Outturn Report 2017/18

1. Introduction

1.1 In February 2010 the Authority adopted the revised Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve a treasury management annual report after the end of each financial year.

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

1.3 The Authority's treasury management strategy for 2017/18 was approved at Full Council on 21st February 2017. The Authority 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. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

2. Economic Commentary

2.1 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.

2.2 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.

2.3 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.

2.4 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.

2.5 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.

3. Financial Markets

3.1 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.

3.2 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.

3.3 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.

4. Credit Background

4.1 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.

4.2 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. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

5. Money Market Fund Regulation

5.1 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.

6. Local Authority Regulatory Changes

6.1 Revised CIPFA Codes

6.1.1 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.

6.1.2 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.

6.1.3 The Council prepared an initial Capital Strategy for 2018/19 as part of the Treasury Management Strategy, but before the guidelines had been published by CIPFA.

6.1.4 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.

6.2 MHCLG Investment Guidance and Minimum Revenue Provision (MRP)

6.2.1 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).

6.2.2 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.

6.2.3 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.

6.3 MiFID II

6.3.1 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.

6.3.2 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.

7. Local Context

7.1 On 31st March 2018, the Authority had net investments of £26.250m arising from its revenue and capital income and expenditure, a decrease on 2017 of £0.936m. 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. 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	0	0	0
Internal Borrowing	**3.100**	**(1.099)**	**2.001**
Less: Usable reserves	22.500	2.241	24.741
Less: Working capital	7.786	(4.276)	3.510
Net investments	**27.186**	**(0.936)**	**26.250**

7.2 The Authority's strategy was to maintain investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31st March 2018 and the year-on-year change in show in 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 Rate %	*31.3.18 Carrying Value £m*
Long-term borrowing	0	0	0		*0*
Short-term borrowing	3.000	(1.000)	2.000	0.80	*2.001*
Total borrowing	**3.000**	**(1.000)**	**2.000**	**0.80**	***2.001***
Long-term investments	4.553	(2.049)	2.504	2.01	*2.516*
Short-term investments	23.743	(0)	23.066	0.64	*23.118*
Cash and cash equivalents	1.890	0.790	2.680	0.29	*2.685*
Total investments	**30,186**	**(1.936)**	**28.250**	**0.59**	***28.319***
Net investments	**27,186**	**(936)**	**26.250**		***26.318***

Note: the figures in the table are shown at principal investment value except for available-for-sale externally managed funds which are included at Balance Sheet carrying value. Cash and cash equivalents excludes operational cash and bank balances.

8. Borrowing Activity

8.1 At 31st March 2018, the Authority held £2m of loans, a decrease of £1m on the previous year. The one month loan of £2m with East Herts District Council was required for cash-flow purposes at the year-end, when cash balances are at their lowest. 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 Rate %
Local authorities (short-term)	3	(1)	2	0.80
Total borrowing	**3**	**(1)**	**2**	**0.80**

8.2 The Authority'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.

8.3 In furtherance of these objectives, new borrowing was kept to a minimum in 2017/18. This strategy enabled the Authority to reduce net borrowing costs and reduce overall treasury risk.

9. Investment Activity

9.1 The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves. During 2017/18, the Authority's investment balance ranged between £41.175 and £23.867 million 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 & building societies (unsecured)	23.090	(4.640)	18.450	0.64
Government (incl. local authorities)	2.000	3.000	5.000	0.64
Covered Bond	0.743	(0.743)	0	---
Money Market Funds	1.800	0.430	2.230	0.29
Cash Plus Fund	1.046	0.005	1.051	0.70
Sterling Reserve Fund	1.018	(0.003)	1.015	0.69
Property Fund	0.489	0.015	0.504	4.64
Total investments	**30.186**	**(1.936)**	**28.250**	**0.59**

9.2 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.

9.3 The £2.5m portfolio of externally managed pooled funds generated a total return of £30,240 (2.016%) and the value of these funds stood at £2.569m as at 31st March 2018 a gain of £16,485. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives is regularly reviewed. In light of their strong income generation performance and the Authority's latest cash flow forecasts, investment in these funds has been increased for the 2018/19 financial year.

10. Investment Activity

10.1 The outturn for investment income received in 2017/18 was £198,874 on an average portfolio of £33.823 million against a budgeted £199,170 on an average investment portfolio of £32.5 million at an average interest rate of 0.58%.

11. Compliance Report

11.1 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.

11.2 Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 5 below.

Table 5: Debt Limits

	31.3.18 Actual £m	**2017/18 Operational Boundary £m**	**2017/18 Authorised Limit £m**	**Complied**
Borrowing	2.00	4.5	6.5	✓

11.3 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. Total debt was not above the operational boundary during 2017/18.

12. Treasury Management Indicators

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

(i) Security

The Authority 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	A+	A-	✓

(ii) Principal Sums Invested for Periods Longer than 364 Days

The purpose of this indicator is to control the Authority'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	£2m	£12m	£12m
Limit on principal invested beyond year end	£10m	£20m	£20m
Complied	✓	✓	✓

(END)