Report to Audit Committee

11 July 2019
By the Director of Corporate Resources
INFORMATION REPORT

Not exempt

Horsham District Council

Treasury Management Activity and Prudential Indicators 2018/19

Executive Summary

This report covers treasury activity and prudential indicators for 2018/19. At 31 March 2019, the Council's external debt was £4m (£4m in 2017/18) and investments totalled £36.1m (£37.7m in 2017/18) including call accounts and Money Market Funds.

During 2018/19, the Council's cash balances were invested in accordance with the Council's treasury management strategy. Interest of £0.887m (£0.911m in 2017/18) was earned on investments, an average return of 2.1% (1.6% in 2017/18). There was one instance reported to this Committee on 12 December 2018 when the single institution limit of £2.5m was breached overnight in the Council's own bank; otherwise all activity was within limits and in line with indicators.

Recommendations

The Committee is recommended to:

i) Note the Treasury Management stewardship report for 2018/19.
ii) Note the actual prudential indicators for 2018/19.
iii) Recommend that Council approve an increase from £1m to £1.5m in the limit on lending to subsidiary companies in the 2019/20 Investment Strategy.
iv) Recommend that Council approve a £0.5m limit on shareholding in its subsidiary companies in the 2019/20 Investment Strategy.

Reasons for Recommendations

i) The annual treasury report is a requirement of the Council's reporting procedures.
ii) This report also covers the actual Prudential Indicators for 2018/19 in accordance with the requirements of the relevant CIPFA Codes of Practice.
iii) & iv) Changes to the limits in the 2019/20 Investment Strategy are required to enable the housing companies agreed by Cabinet on 21 March 2019 to commence operations

Background Papers

"Treasury Management Strategy 2018/19" - Audit Committee 13 December 2017
"Budget for 2018/19" – Cabinet 25 January 2018
"Budget for 2019/20" - Cabinet 24 January 2019
"Treasury Management and Prudential Indicators mid-year report 2018/19"- Audit Committee 12 December 2018

Consultation: Arlingclose Ltd – the Council's Treasury Management advisers
Wards affected: All
Contact: Julian Olszowka, Group Accountant (Technical), 01403 215310

Background Information

1 Introduction

1.1 This report covers treasury management activity and prudential indicators for 2018/19. It meets the requirements of the 2017 editions of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

1.2 In line with the CIPFA Prudential Code for Capital Finance in Local Authorities the Council adopts prudential indicators for each financial year and reports on performance relative to those indicators. This requirement is designed to demonstrate that capital spending is prudent, affordable and sustainable and that treasury management decisions are taken in accordance with good professional practices. This report compares the approved indicators with the outturn position for 2018/19. Actual figures have been taken from or prepared on a basis consistent with the Council's Statement of Accounts.

1.3 The original prudential indicators for 2018/19 together with Treasury Management Strategy 2018/19 were agreed by Council on 21 February 2018 having been approved by this Committee on 13 December 2017.

1.4 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 13 February 2019.

2 The Council's Capital Expenditure and Financing 2018/19

2.1 This is one of the required prudential indicators and shows total capital expenditure for the year and how this was financed. The estimates include revisions to the original indicators approved by the Council on 13 February 2019 as a part of the budget report.

2018/19 £m	**Actual £000**	**Estimate £000**	**Variance £000**
Total capital expenditure*	14.6	15.5	(0.9)
Resourced by:			
Capital receipts and third party contributions	(3.1)	(3.8)	0.7
Capital grants	(1.4)	(1.2)	(0.2)
Revenue reserves**	(6.4)	(6.6)	0.2
Unfinanced capital expenditure (additional need to borrow)	**3.7**	**3.9**	(0.2)

*Capital expenditure here differs from capital outturn report by capitalised salaries
** Includes use of New Homes Bonus

2.2 The capital spend in 2018/19 was under the budget as revised in the 2019/20 budget report. The underspend resulted in a reduced need for financing from revenue reserves and capital receipts and contributions than estimated. The overall unfinanced capital spend was just slightly below estimate.

3 The Council's Overall Borrowing Need

3.1 The Council's underlying need to borrow is termed the Capital Financing Requirement (CFR). It represents the accumulated net capital expenditure which has not been financed by revenue or other resources. Part of the Council's treasury activities is to address this borrowing need, either through borrowing from external bodies, or utilising temporary cash resources.

3.2 The Council is required to make an annual revenue charge, the Minimum Revenue Provision (MRP), to reduce the CFR – effectively a repayment of the borrowing need. The Council's 2018/19 MRP Policy, as required by Ministry of Housing, Communities & Local Government (MHCLG) Guidance, was approved on 21 February 2018 as a part of the 2018/19 Budget report.

3.3 The Council's CFR for the year is shown below, and represents a key prudential indicator because it is a measure of the Council's underlying indebtedness. The movement in the CFR differs from the estimate mostly due to the unfinanced capital expenditure being under the estimate as shown above.

Capital Financing Requirement	Actual £m	Estimate £m	Variance £m
Opening balance 1 April 2018	30.4	30.4	0.0
plus unfinanced capital expenditure	3.7	3.9	(0.2)
less Minimum Revenue Provision	(0.9)	(0.9)	0.0
Closing balance 31 March 2019	**33.2**	**33.4**	**(0.2)**

4 Treasury Position at 31 March 2019

4.1 Whilst the Council's gauge of its underlying need to borrow is the CFR, the Director of Corporate Resources can manage the Council's actual borrowing position by either borrowing to the level of the CFR or choosing to utilise other available funds instead, sometimes termed under-borrowing. The Council is under-borrowed as its external debt amount was £4m which was due to be repaid on 31 March 2019 but was still outstanding as the 31 March was a Sunday and it was not repaid until Monday 1 April 2019.

4.2 Although the Council is under-borrowed relative to its CFR, it also holds investments and the summary treasury position on the 31 March 2019 compared with the previous year is shown below. This is a snapshot of investments on the date and will not necessarily be equal to the whole year average figures reported below.

Treasury position	31 March 2019		31 March 2018	
	Principal £m	Average Rate	Principal £m	Average Rate
Fixed Interest Rate Debt	4.0	3.4%	4.0	3.4%
Investments	(36.1)	2.4%	(37.7)	2.0%
Net borrowing position	**(32.1)**		**(33.7)**	

4.3 Returns continued at the historically low levels during 2018/19 reflecting the continuing low interest rates being offered by counterparties who are a good credit risk. The current outlook points to a continuation of relatively low rates with modest increases expected in the medium term. The use of pooled funds including a diversified selection of equity, bonds and property has lifted income to some extent but their use is limited by the desired overall risk profile of the Council's investments.

5 Prudential Indicators

5.1 **Gross Debt and the CFR** - In order to ensure that borrowing levels are prudent over the medium term the Council's external debt must only be for a capital purpose. Gross debt should not therefore, except in the short term, exceed the CFR for 2018/19 plus the expected CFR movement over 2019/20 and 2020/21. As external debt was £4m and the CFR is £33m and in the budget plans of the Council it is not projected to decrease over the relevant future period the Council has complied with this prudential indicator.

5.2 The **Authorised Limit** is the "Affordable Borrowing Limit" required by section 3 of the Local Government Act 2003. The Council set the Authorised Limit at £18m for 2018/19. The table below demonstrates that during 2018/19 the Council has maintained gross borrowing within its Authorised Limit.

5.3 The **Operational Boundary** is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the Boundary are acceptable subject to the Authorised Limit not being breached. This indicator was set at £9m. Gross borrowing was at £4m for the year well within the operational boundary.

5.4 **Actual financing costs as a proportion of net revenue stream** - This indicator shows the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. This is a gauge of the affordability of capital spend. As shown in the table below, the actual indicator was within the estimate. Financing costs were reduced compared to the estimate due to higher than estimated investment income.

	2018/19
Authorised Limit	£18m
Operational Boundary	£4m
Maximum gross borrowing position in the year	£14m
Minimum gross borrowing position in the year	£4m
Financing costs as a proportion of net revenue stream	Actual 0.8% Estimate 2.0%

5.5 **Upper limits on variable and fixed rate exposure** – These indicators identify maximum limits for variable and fixed interest rate exposures. The table below shows the actual maximums in 2018/19. 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. The variable exposure is a net investment position and thus appears as a negative figure as the indicator shows the net debt position.

	Limit	**Actual**	**Met?**
Upper limit on fixed rate exposure	£15m	£4m	✓
Upper limit on variable rate exposure	£0m	-£16m	✓

5.6 **Maturity structures of fixed borrowing -** These gross limits are set to reduce the Council's exposure to large fixed rate loans falling due for refinancing. As the Council only had one longer term debt and had set the percentage range to allow it freedom to refinance the debt if necessary there is no danger of not meeting this indicator. The table below formally shows the 2018/19 estimates and the actual position.

Maximum percentage of borrowing in each age category	Original Indicator	Actual Position
Under 12 months	100%	100%
12 months to 2 years	100%	0%
2 years to 5 years	100%	0%
5 years to 10 years	100%	0%
10 years and above	100%	0%

5.7 **Total Principal Funds Invested over 364 days** – This limit contains the Council's exposure to the possibility of loss that might arise as a result of it having to seek early repayment or redemption of investments. The actual position was well within the indicator.

2017/18	Indicator	Actual Position
Maximum principal sums invested > 364 days	£12m	£2m

Economic and treasury management context for 2018/19

5.8 The Council's treasury management activities are critically affected by what is happening in the general economy which is subject to continuing uncertainty. The Council has engaged Arlingclose Ltd to advise on various aspects of Treasury Management and a part of that advice, a commentary on the economic background and the finance sector during 2018/19, is included as the appendix to this report.

Debt management activity during 2018/19

5.9 No new long term borrowing was undertaken to add to the Council's £4m loan from the Public Works Loan Board at 3.38% which was repayable on 31 March 2019 but was actually repaid on Monday 1 April 2019.

5.10 As the CFR shown above is £33m the Council is using its internal resources in lieu of borrowing. This lowers overall treasury risk by reducing both external debt and temporary investments and was judged to be the best way of funding capital expenditure. Current borrowing costs are historically low (e.g. PWLB 50 year loan around 2.2%) and the Council's advisers predict that they will not be increasing significantly in the next three years.

6 Investment activity in 2018/19

6.1 The Council's objectives are to give priority to the security and liquidity of its funds before seeking the best rate of return. Its surplus cash is therefore held with local authorities, highly credit-rated banks, approved building societies and diversified pooled funds. The Council's treasury management activity fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Treasury Management Code of Practice and the MHCLG Investment guidance. These require the Council to approve an investment strategy before the start of each financial year and all investment activity during the year conformed to this strategy apart from breach of single institution limit detailed below.

6.2 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.

6.3 The Council's longer term cash balances comprise revenue and capital reserves and its core cash resources are shown in the table below. The Council is borrowing internally to cover its CFR which reduced the funds to be invested by £29m. It was judged prudent to continue internal borrowing in the year as any external borrowing would have had to have been invested at a lower rate than the borrowing rate producing a borrowing cost.

Balance Sheet Resources	31 March 2019 £m	31 March 2018 £m	31 March 2017 £m
Revenue reserves	23.0	20.9	20.0
Other reserves and provisions	15.7	17.2	14.4
Usable capital receipts	1.3	1.0	5.3
Unapplied capital contributions	18.9	17.4	13.2
Working capital	5.8	7.2	8.6
Total	**64.7**	**63.7**	**61.5**

6.4 **Yield** - The investment income budget for the year 2018/19 was £0.706m (£0.593m in 2017/18). The actual interest received was £0.887m (£0.911m in 2017/18). Cash balances were above budget due to slipping of capital spend, revenue underspending and higher receipts of developer contributions. Pooled funds boosted income while otherwise the returns available from 'good' quality counterparties remained at historic lows. An overall return of 2.1% (1.6% in 2017/18) was achieved; the benchmark, which is the average LIBID 7 day rate, was 0.51% (0.21% in 2017/18).

6.5 **Security** – A benchmark is used as a way of expressing the credit risk of the whole portfolio of counterparties that the Council invests with. The Council has adopted a benchmark of an equivalent credit rating of A against which the portfolio was assessed at the end of each month. The portfolio average credit rating was a minimum of A+ in the year which is one notch above the benchmark.

6.6 **Liquidity benchmark** – The Council needs to ensure it has a sufficient level of liquidity so it has funds available when necessary. To ensure liquidity the Council set a benchmark of the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing. For 2018/19 the benchmark amount was £3m. The actual funds available were in excess of the benchmark for the whole year; the lowest amount available overnight was £4m with an additional £9.4m available within a week for the whole year.

6.7 **Compliance with strategy** – There was an instance when the limit on single institution investments was breached when the cash in the Council's current account went over £2.5m. This was reported in detail on 12 December 2018 to this committee as a part of the usual mid-year report. While cash in the current account is not strictly an investment within the meaning of the MHCLG guidance and the CIPFA Code, it is still a credit exposure to the bank and was therefore reported to this committee.

6.8 **Unrated Pooled funds** – The Council holds £16.7m in unrated pooled funds comprising equity, bonds and property. These funds yield 3.8% which is significantly more than the other investments available. An increased return generally brings an increase in risk and in this case the risk is to the capital value of the investments and at the end of the year the capital value of these investments was £0.113m below the initial investment. However, it should be remembered that these investments are longer term so the capital losses should not be overemphasised as the Council will hold the funds through periods of volatility.

6.9 **Variable Net Asset Value Money Market Funds** – The Council uses Constant Net Asset Value Money Market Funds for day to day liquidity. The constant refers to the fact that each unit of the fund costs £1 to buy and is redeemed at £1. To facilitate this, the investments within the funds are short term and liquid and so returns are close to Bank of England bank rate. As the Council has cash it can invest over the medium term it has £9.4m in money market funds which can invest in longer term instruments like short term bonds and consequently produce higher yields (approx. 1.2%) but where the value of a unit invested can change. On 31 March 2019 the current value of the sum invested was £33,250 less than the purchase price. Under accounting rules this has been charged as though it was a normal expense although the loss in value has not been crystallised. The Council is able to hold these investments in the medium term so will not be forced to crystalize the loss.

Non-Treasury investments

6.10 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 Council 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.

6.11 At year end the Council held £50.9m of directly owned property and £0.2m loans to local bodies for service purposes. These investments generated £3.9m of investment income for the Council after taking account of direct costs, representing a rate of return of 7.6%. These returns are, on the face of it, higher than the return earned on treasury investments but significant indirect costs such as the property management costs and a share of the Minimum Revenue Provision are not netted off income. There are also additional risks of holding and managing commercial property as well as the fact they are highly illiquid.

6.12 The income from these non-treasury investments provides an important the contribution to finance the Council's overall service delivery. To ensure stable income flows the Council has a core of longer term leases. The Council's properties have very high occupancy in the high 90% and so can place reasonable reliance on a stable flow of rents. That said there is a significant retail element (£22.0m) which although not yet significantly affected by the general woes of the high street requires close monitoring by property management staff.

7 Proposed amendments to Investment strategy 2019/20

7.1 As a part of the budget the Council approved a Capital Strategy which set amongst other things limits for loans for service purposes to local bodies or Council subsidiaries and on shareholdings in companies for service purposes. The decision to set up housing companies on 21 March 2019 has led to the need to amend the relevant limits so as to allow the Council to operate the companies. As a consequence the Committee is asked to consider an increase from £1m to £1.5m on limit for loans for service purposes to local bodies or Council subsidiaries. To enable the Council to take a shareholding in its subsidiaries the limit on shareholdings in companies for service purposes which was zero is requested to be set at £0.5m. These are judged to be prudent limits to allow the companies to operate successfully.

8 Resource consequences

8.1 This report provides information only; no staffing or financial resources are required as a result of it.

9 Other considerations

9.1 There are no consequences in respect of legal, Crime & Disorder; Human Rights; Equality & Diversity and Sustainability.

Appendix

Economic Background in 2018/19

After spiking at over $85/barrel in October 2018, oil prices fell back sharply by the end of the year, declining to just over $50 in late December before steadily climbing toward $70 in April 2019. UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year/year, just above the consensus forecast but broadly in line with the Bank of England's February Inflation Report. The most recent labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

After rising to 0.6% in the third calendar quarter from 0.4% in the second, fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However, a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.

With the 29th March 2019, the original EU 'exit day' passed by without resolution. The EU subsequently granted extensions to 31st October 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.

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.

Financial markets: December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE 100 and FTSE All share indices were both around 10% higher than at the end of 2018.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new year - the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate pushed up money markets rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

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.

Credit background: The Credit Default Swap (CDS) spreads drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms. After hitting around 129 basis points in December 2018, the spread on non-ringfenced bank NatWest Markets plc fell back to around 96bps at the end of March, while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 33 and 79bps at the end of the period.

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.

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.

There were minimal other credit rating changes during the period. Moody's revised the outlook on Santander UK to positive from stable to reflect the bank's expected issuance plans which will provide additional protection for the its senior unsecured debt and deposits.