Report to Audit Committee

12 July 2018
By the Director of Corporate Resources
INFORMATION REPORT

Not exempt

Horsham District Council

Treasury Management Activity and Prudential Indicators 2017/18

Executive Summary

This report covers treasury activity and prudential indicators for 2017/18. At 31 March 2018, the Council's external debt was £4m (£4m at 31 March 2017) and its investments totalled £37.7m (£50.1m at 31 March 2017) including call accounts and Money Market Funds.

During 2017/18, the Council's cash balances were invested in accordance with the Council's treasury management strategy. Interest of £0.911m (£0.605m in 2017/18) was earned on investments, an average return of 1.6% (1.2% in 2016/17). There was one instance when the single institution limit of £2.5m was breached overnight; otherwise all limits and indicators were within estimates.

Recommendations

The Committee is recommended to:

i) Note the Treasury Management stewardship report for 2017/18.
ii) Note the actual prudential indicators for 2017/18.

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 2017/18 in accordance with the requirements of the relevant CIPFA Codes of Practice.

Background Papers

"Treasury Management Strategy 2017/18" - Audit Committee 4 January 2017
"Budget for 2017/18 and Council Tax" - Council 15 February 2017
"Budget for 2018/19 and Council Tax" - Council 21 February 2018

Consultation: Arlingclose Ltd – the Council's Treasury Management advisers

Wards affected: All

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Background Information

1 Introduction

1.1 This report covers treasury management activity and prudential indicators for 2017/18. It meets the requirements of the 2011 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 2017/18. 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 2017/18 together with Treasury Management Strategy 2017/18 were agreed by Council on 15 February 2017 having been approved by this Committee on 4 January 2017.

1.4 The regulatory context of treasury management and capital finance is about to be changed by the revision of the CIPFA Treasury Management and Prudential Codes and new guidance from the MHCLG (Ministry of Housing, Communities and Local Government). The Council also had to deal with the introduction of the MiFID II directive. The effects of these changes are discussed in Appendix 1

2 The Council's Capital Expenditure and Financing 2017/18

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 21 February 2018 as a part of the budget report.

2017/18	Actual £000	Estimate £000	Variance £000
Total capital expenditure*	28,237	31,389	(3,152)
Resourced by:			
Capital receipts and third party contributions	(6,990)	(7,958)	968
Capital grants	(666)	(513)	(153)
Revenue reserves**	(5,194)	(7,112)	1,918
Unfinanced capital expenditure (additional need to borrow)	**15,387**	**15,806**	(419)

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

2.2 The capital spend in 2017/18 was under the budget as revised in the 2018/19 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 2017/18 MRP Policy (as required by MHCLG Guidance) was approved on 15 February 2017 as a part of the 2017/18 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 £000	Estimate £000	Variance £000
Opening balance 1 April 2017	15,992	15,989	3
plus unfinanced capital expenditure	15,387	15,806	(419)
less Minimum Revenue Provision	(991)	(924)	(67)
Closing balance 31 March 2018	**30,388**	**30,871**	**(483)**

4 Treasury Position at 31 March 2018

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 amounts to only £4m.

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 2018 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 2018		31 March 2017	
	Principal £m	Average Rate	Principal £m	Average Rate
Fixed Interest Rate Debt	4.0	3.4%	4.0	3.4%
Investments	(37.7)	1.5%	(50.1)	1.5%
Net borrowing position	**(33.7)**		**(46.1)**	

4.3 Returns continued at historically low levels during 2017/18 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 2017/18 plus the expected CFR movement over 2018/19 and 2019/20. As external debt was £4m and the CFR is £30m 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 £15m for 2017/18. The table below demonstrates that during 2017/18 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 £4m. Gross borrowing was at £4m for the majority of the year except for a period from late July to late October when temporary borrowing was used at the time of the purchase of the Forum retail units. The temporary borrowing peaked at £10m giving a maximum borrowing position of £14m.

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.

	2017/18
Authorised Limit	£15m
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 1.2% 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 2017/18. 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 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 has one longer term debt and has set the percentage range to allow it freedom to refinance the debt there is no danger of not meeting this indicator. The table below shows the 2017/18 estimates and the actual position.

Maximum percentage of borrowing in each age category	Original Indicator	Actual Position
Maturity Structure of fixed borrowing		
Under 12 months	100%	0%
12 months to 2 years	100%	100%
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	£4m

Economic and treasury management context for 2017/18

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 2017/18, is included as Appendix 2 to this report.

Debt management activity during 2017/18

5.9 No new long term borrowing was undertaken to add to the Council's £4m loan from the Public Works Loan Board borrowed on 23 April 2009 at 3.38% repayable on 31st March 2019. Temporary borrowing of £10m was taken out in late July when the Forum Retail Units' purchase was imminent. All temporary borrowing was repaid by the end of October.

5.10 As the CFR shown above is £30m 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 2.5%) and the Council's advisers predict that they will not be increasing significantly in the next three years.

6 Investment activity in 2017/18

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. The majority of its surplus cash is therefore held as short-term investments with the UK Government, local authorities, and highly credit-rated banks, building societies and 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 reduces the funds to be invested by £26m (2015/16 £12m). 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 2018 £m	31 March 2017 £m	31 March 2016 £m
Revenue reserves	20.9	20.0	17.3
Other reserves and provisions	17.2	14.4	3.5
Usable capital receipts	1.0	5.3	5.8
Unapplied capital contributions	17.4	13.2	8.6
Working capital	7.2	8.6	5.7
Total	**63.7**	**61.5**	**40.9**

6.4 **Yield** - The investment income budget for the year 2017/18 was £0.593m (2017/18 £0.275m). The actual interest received was £0.911m (2015/16 £0.605m). 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 1.6% (1.2% 2016/17) was achieved; the benchmark, which is the average LIBID 7 day rate, was 0.21% (0.20% in 2016/17).

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 two notches 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 2017/18 the benchmark amount was £3m. The actual funds available were well in excess of the benchmark for the whole year; the lowest amount available overnight was £2.6m with an additional £9.4m available within a week.

6.7 **Compliance with strategy** – There was an instance when the limit on single institution investments was breached. 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 is therefore reported here. The circumstances are detailed below.

6.8 On 2nd January the Council's balance with its own bank NatWest was £2.63m in total which exceeded the £2.5m single institution limit. The limit was exceeded due to a miscalculation in the necessary external investment of the Council Tax and Business Rates income received on that day. On the first working day of the month the Council receives over £8m in direct debt income which has to be balanced against outgoings to leave a predicted balance for the day. The position was rectified the next morning when the error was identified.

6.9 **Unrated Pooled funds** - 2017/18 was the second year that unrated pooled funds comprising equity, bonds and property were used. Just under £16m is invested in these funds which yielded £0.58m equating to around 3.7% 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 £280,000 below the initial investment. Late 2017 and early 2018 had seen increased volatility especially in equities and values had seesawed with the end of March 2018 a particular low point. By the end of May 2018, the capital values had rebounded showing no significant gain or loss. 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.

7 Outcome of consultations

7.1 The views of the Council's treasury management consultants, Arlingclose Ltd, have been incorporated in all aspects of the above report.

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 1

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.

In the 2017 Treasury Management Code the definition of 'investments' has been widened to include both financial assets and 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.

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 as to size of investment and expertise were met.

The Council 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.

Appendix 2

Economic Background in 2017/18: 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.

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 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: 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.