HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Audit Committee
Date:	22 May 2018
Title:	Annual Treasury Outturn Report 2017/18
Report From:	Director of Corporate Resources – Corporate Services

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1. Recommendation

The Audit Committee are asked to note the following recommendations being reported to Cabinet and Full Council:

1.1. The approval of the addition of a further £0.5m to the Investment Risk Reserve created in the County Council's accounts in 2017/18 as protections against the irrecoverable fall in value of any investments.

1.2. That the outturn review of treasury management activities be noted.

2. Purpose

2.1. The County Council adopted the key recommendations of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management in the Public Services: Code of Practice in February 2010. These recommendations include approving an annual report on treasury management activity after the end of each financial year.

3. Summary

3.1. This report fulfils the County Council's legal obligation to have regard to the CIPFA Code.

3.2. The County Council's treasury management strategy for 2017/18 was approved at a meeting of full Council in February 2017. The County Council has borrowed and invested 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 County Council's treasury management strategy.

3.3. Treasury management in the context of this report is defined as:

"The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

3.4. This annual report sets out the performance of the treasury management function during 2017/18, to include the effects of the decisions taken and the transactions executed in the past year.

3.5. Overall responsibility for treasury management remains with the County Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the County Council's treasury management objectives.

3.6. All treasury activity has complied with the County Council's Treasury Management Strategy and Investment Strategy for 2017/18, and all relevant statute, guidance and accounting standards. In addition the County Council's treasury advisers, Arlingclose, provide support in undertaking treasury management activities. The County Council has also complied with all of the prudential indicators set in its Treasury Management Strategy.

4. External Context

4.1. The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions were made in 2017/18.

Economic commentary

4.2. The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in 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.

4.3. 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 2017 and by the lack of clarity on Brexit. 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.

4.4. The Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate by 0.25% in November 2017. This action was significant as this was the first rate increase 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, however at the meeting in May 2018 the MPC again voted by a majority of 7-2 to maintain Bank Rate at 0.5%.

Credit background

4.5. 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 County Council would be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would 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.

4.6. 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.

4.7. In March 2018, following Arlingclose’s advice, the County Council removed RBS plc and National Westminster Bank from its counterparty list for unsecured investments. 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 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 County Council’s unsecured lending list.

Local Authority Regulatory Changes

4.8. CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. 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 County Council will be preparing the Capital Strategy in line with the 2019/20 budget setting process.

4.9. 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.

MiFID II

4.10. 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 were met which include having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority having at least one year’s relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that the person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

4.11. The County Council has met the conditions to opt up to professional status and has done so in order to maintain its previous MiFID status prior to January 2018. The County Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

Local Context

4.12. At 31 March 2018 the County Council’s underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £764m, while usable reserves and working capital which are the underlying resources available for investment were £571m (principal invested plus gains on investments with a variable net asset value). These factors and the year-on year change are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m
CFR	(755.4)	(8.6)	(764.0)
Less: Other debt liabilities*	171.0	(6.8)	164.2
Borrowing CFR	(584.4)	(15.4)	(599.8)
Less: Resources for investment	522.2	48.5	570.7
Net borrowing	(62.2)	33.1	(29.1)

* finance leases and PFI liabilities that form part of the County Council’s debt.

4.13. Although CFR has risen as new capital expenditure was higher in comparison to the amount of debt paid in 2017/18, net borrowing has decreased overall due to an increase in usable reserves, partly due to capital grants unapplied received in advance of spend, as well as an increase in the Grant Equalisation Reserve to enable the County Council to continue its financial strategy, and to allow delivery of the more complex savings to be achieved within the Transformation to 2019 Programme over the two years.

4.14. The County Council's strategy was to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31 March 2018 and the year-on-year change is shown in Table 2 below.

Table 2: Treasury Management Summary

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %
Long-term borrowing	(319.7)	39.7	(280.0)	(4.59)
Short-term borrowing	(13.6)	5.7	(7.9)	(3.28)
Total borrowing	(333.3)	45.5	(287.8)	(4.55)
Long-term investments	277.5	11.8	289.3	2.72
Short-term investments	160.1	80.4	240.5	1.30
Cash and cash equivalents	75.5	(43.1)	32.4	0.45
Total investments	513.1	49.1	562.2	1.98
Net investments	179.8	94.6	274.4	

Note: the figures in the table above are from the balance sheet in the County Council's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

4.15. The County Council's internal borrowing policy is the reason for the large variance between the positions shown in Tables 1 and 2. The movement that has taken place during 2017/18 in net borrowing shown in Table 1 has translated into a rise in investment balances as shown in Table 2. In addition, total borrowing in Table 2 has reduced during 2017/18 due to the early repayment of £32m of long-term borrowing in the form of LOBO (lender's option, borrower's option) loans and repayment upon maturity of £13.6m of Public Works Loan Board (PWLB) debt.

5. Borrowing Activity

5.1. At 31 March 2018 the County Council held £288m of loans, a decrease of £45m on the previous year, as part of its strategy for funding previous years' capital programmes. The year-end treasury management borrowing position and year-on-year change is shown in Table 3 below.

Table 3: Borrowing Position

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %	31/03/18 WAM* years
Public Works Loan Board	257.0	(13.6)	243.4	4.66	11.03
Banks (LOBO)	60.0	(40.0)	20.0	4.76	15.29
Banks (fixed term)	13.0	8.0	21.0	4.21	21.91
Total borrowing	330.0	45.6	284.4	4.63	12.13

* Weighted average maturity

Note: the figures in the table above are from the balance sheet in the County Council's statement of accounts, but adjusted to exclude borrowing taken out on behalf of others, and accrued interest.

5.2. The County 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 County Council's long-term plans change being a secondary objective.

5.3. Affordability and the "cost of carry" remained important influences on the County Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained and are likely to remain at least over the forthcoming two years, lower than long-term rates, the County Council determined it was more cost effective in the short-term to use internal resources instead of taking out new borrowing. This strategy enabled the County Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

5.4. The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the County Council with the monitoring of internal and external borrowing.

5.5. During 2017/18 the County Council repaid £13.6m of maturing PWLB debt, and did not replace this borrowing. This will reduce the future cost of interest payments on the County Council's external debt.

5.6. The County Council continues to hold £41m of market loans (£20m of which are LOBO loans, and £21m of which were LOBO but have now been converted to fixed term loans by the lender); this has reduced from the £73m historical balance due to the County Council having negotiated the early repayment of £32m of LOBO loans, and repaid these at a saving in comparison to the total cost expected over the loans' lifetime. LOBO loans are where the lender has the option to propose an increase in the interest rate at set dates, following which the County Council has the option to either accept the new rate or to repay the loan at no additional cost. None of the LOBO loan options were exercised by the lender in the year.

6. Investment Activity

6.1. The County Council holds invested funds representing income received in advance of expenditure plus balances and reserves held. During 2017/18 the Council's investment balances have ranged between £513m and £659m due to timing differences between income and expenditure. The year-end investment position and the year-on-year change are shown in Table 4 below.

Table 4: Investment Activity in 2017/18

Investments	31/03/2017 Balance £m	Movement £m	31/03/2018 Balance £m	Rate on 31/03/2018 %	WAM* on 31/03/2018 years
Short term Investments					
- Banks and Building Societies:					
- Unsecured	35.7	(24.0)	11.7	0.53	0.11
- Secured	20.0	35.0	55.0	1.00	0.56
- Money Market Funds	61.7	(36.0)	25.7	0.46	0.00
- Local Authorities	116.8	43.7	160.5	1.33	0.35
- Corporate Bonds	1.3	(1.3)	-	-	-
- Registered Provider	-	20.0	20.0	2.03	0.33
	235.6	37.3	272.9	1.20	0.35
Long term Investments					
- Banks and Building Societies:					
- Secured	70.0	8.3	78.3	0.79	2.57
- Local Authorities	97.5	(36.5)	61.0	1.41	1.94
	167.5	(28.2)	139.3	1.06	2.29
Long term Investments – high yielding strategy					
- Local Authorities					
- Fixed deposits	20.0	-	20.0	3.96	15.97
- Fixed bonds	10.0	-	10.0	3.78	15.77
- Pooled Funds					
- Pooled property**	45.0	10.0	55.0	4.60	n/a
- Pooled equity**	20.0	20.0	40.0	4.28	n/a
- Pooled multi-asset**	10.0	10.0	20.0	3.99	n/a
- Registered Provider	5.0	-	5.0	3.40	1.08
	110.0	40.0	150.0	4.25	13.79
TOTAL INVESTMENTS	513.1	49.1	562.2	1.98	2.00

* Weighted average maturity

** The rates provided for pooled fund investments are reflective of the average of the most recent dividend return as at 31 March 2018.

Note: the figures in the table above are from the balance sheet in the County Council's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

6.2. Both the CIPFA Code and the government guidance require the County 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 County 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. In furtherance of these objectives, and given the increasing risk and low returns from short-term unsecured bank investments, the County Council further diversified into more secure and higher yielding asset classes during 2017/18. For example, the proportion of investments to liquid funds (i.e. invested in money market funds and unsecured call accounts) was reduced and instead invested in secure short-term investments with higher rates of return (such as local authorities). Also £40m was added to externally-managed funds during 2017/18 as part of the investments targeting higher yields.

6.4. Security of capital has remained the County Council's main investment objective. This has been maintained by following the County Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2017/18.

6.5. Counterparty credit quality was assessed and monitored with reference to credit ratings, for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

6.6. The County Council will also consider the use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

6.7. The County Council maintained a sufficient level of liquidity through the use of call accounts and money market funds. The County Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate increased by 0.25% to 0.50% in November 2017 and short-term money market rates have remained at relatively low levels which continued to have a significant impact on cash investment income.

6.8. The progression of credit risk and return metrics for the County Council's investments managed in-house (excluding external pooled funds) are shown in the extracts from Arlingclose's investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking (investments managed in-house)

	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	AA	22%	709	1.21%
31.03.2018	AA	8%	735	1.36%
Similar LAs	AA-	48%	879	0.94%
All LAs	AA-	55%	35	0.63%

* Weighted average maturity

6.9. As part of the 2017/18 Investment Strategy the total amount targeted towards high yielding investments was increased to £200m. Investments yielding higher returns will contribute additional income to the County Council, although some come with the risk that they may suffer falls in the value of the principal invested.

6.10. Of the £200m available £150m has been invested (an increase of £40m since 31 March 2017), and an additional £10m has been committed but not called.

6.11. The £115m portfolio of externally managed pooled multi-asset, equity and property funds generated an average total return of 4.9%, comprising 4.88% income return used to support services in year, and 0.02% of capital growth. As these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the County Council's investment objectives are regularly reviewed.

6.12. The investments in pooled funds allow the County Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. The funds which are operated on a variable net asset value (VNAV) basis offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short-term. All of the County Council's pooled fund investments are in the respective fund's distributing share class which pay out the income generated.

6.13. Although money can be redeemed from the pooled funds at short notice, the County Council's intention is to hold them for at least the medium-term. Their performance and suitability in meeting the County Council's investment objectives are monitored regularly and discussed with Arlingclose.

6.14. The 2015/16 Investment Strategy recommended that the returns from a pooled property fund be used to contribute £0.5m each year to a reserve in the County Council's accounts as protection against the irrecoverable fall in value of any investments. It is now recommended that £0.5m is added to this reserve in line with this strategy to further protect the County Council's funds. This is prudent given the additional risk that is being taken in targeting investments with higher returns and will bring the total amount in the reserve to £2.0m.

7. Financial Implications

7.1. The outturn for debt interest paid in 2017/18 was £14.9m on an average debt portfolio of £311m, against a budgeted £14.8m on an average debt portfolio of £311m.

7.2. The outturn for investment income received in 2017/18 was £11.2m on an average investment portfolio of £602m, therefore giving a yield of 1.86%, against a budgeted £9.0m on an average investment portfolio of £600m at an average interest rate of 1.5%. In comparison in 2016/17 investment income received was £9.4m on an average investment portfolio of £565m, therefore giving a yield of 1.66%.

8. Other Non-Treasury Holdings and Activity

8.1. Although not classed as treasury management activities the Council may also make loans and investments for service purposes, for example loans to Hampshire based businesses or the direct purchase of land or property. Such loans and investments will be subject to the Council's normal approval processes for revenue and capital expenditure and need not comply with this treasury management strategy. The County Council's existing non-treasury investments are listed in Table 6 below.

Table 6: Non-Treasury Investments

	31/03/18 Asset value £m	31/03/18 Rate %
Loans to Hampshire based business	5.75	4.00
Total	5.75	4.00

9. Compliance Report

9.1. The County Council confirms compliance of all treasury management activities undertaken during 2017/18 with the CIPFA Code of Practice and the County Council's approved Treasury Management Strategy. Compliance with specific investment limits, as well as the authorised limit and operational boundary for external debt, is demonstrated in Tables 7 and 8 below.

Table 7: Debt Limits

	2017/18 Maximum £m	31/03/18 Actual £m	2017/18 Operational Boundary £m	2017/18 Authorised Limit £m	Complied
Borrowing	333	284	680	740	✓
Other long term liabilities	171	164	170	210	✓
Total debt	504	448	850	950	✓

Table 8: Investment Limits

	2017/18 Maximum	31/03/18 Actual	2017/18 Limit	Complied
Any single organisation, except the UK Central Government	£40m	£23m	£70m	✓
Any group of organisations under the same ownership	£40m	£23m	£70m	✓
Any group of pooled funds under the same management	£30m	£30m	£70m	✓
Registered Providers	£25m	£25m	£70m	✓
Money market funds	19%	5%	50%	✓

10. Treasury Management Indicators

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

Interest Rate Exposures

10.2. This indicator is set to control the County Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed will be:

Table 9 – Interest Rate Exposures

	31/03/18 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate investment exposure	£90m	£375m	✓
Upper limit on variable interest rate investment exposure	£473m	£700m	✓
Upper limit on fixed interest rate borrowing exposure	£277m	£960m	✓
Upper limit on variable interest rate borrowing exposure	£8m	£960m	✓

10.3. 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.

Maturity Structure of Borrowing

10.4. This indicator is set to control the County Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 10 – Maturity Structure of Borrowing

	31/03/18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	3%	50%	0%	✓
12 months and within 24 months	3%	50%	0%	✓
24 months and within 5 years	10%	50%	0%	✓
5 years and within 10 years	17%	75%	0%	✓
10 years and within 20 years	56%	75%	0%	✓
20 years and within 30 years	11%	75%	0%	✓
30 years and above	0%	100%	0%	✓

Principal Sums Invested for Periods Longer than 364 days

10.5. The purpose of this indicator is to control the County Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

Table 11 – Principal Sums Invested for Periods Longer than 364 days

	2017/18	2018/19	2019/20
Actual principal invested beyond year end	£280m	£227m	£173m
Limit on principal invested beyond year end	£375m	£300m	£300m
Complied	✓	✓	✓

CORPORATE OR LEGAL INFORMATION:

Links to the Strategic Plan

This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because the management of the County Council's cash balance needs to be decided

Other Significant Links

Links to previous Member decisions:	
Title	Date
Direct links to specific legislation or Government Directives	
Title	Date

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

Document	Location
None	

IMPACT ASSESSMENTS:

1. Equality Duty

1.1. The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited under the Act;
- Advance equality of opportunity between persons who share a relevant protected characteristic (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, gender and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

Due regard in this context involves having due regard in particular to:

a) The need to remove or minimise disadvantages suffered by persons sharing a relevant characteristic connected to that characteristic;

b) Take steps to meet the needs of persons sharing a relevant protected characteristic different from the needs of persons who do not share it;

c) Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity which participation by such persons is disproportionally low.

1.2. **Equalities Impact Assessment:**

Equalities objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

2.1. This proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

a) How does what is being proposed impact on our carbon footprint / energy consumption*?*

No specific impact.

b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.