Council
Monday 1 July 2019

Subject: Treasury Management Annual Report 2018/19

Report by:	Executive Director of Resources
Contact Officer:	Tracey Bircumshaw Strategic Finance and Business Support Manager tracey.bircumshaw@west-lindsey.gov.uk
Purpose / Summary:	To report on Annual Treasury Management activities and prudential indicators for 2018/19 in accordance with the Local Government Act 2003

RECOMMENDATION(S):

1. Members approve the Annual Treasury Management Report and actual Prudential Indicators 2018/19.

IMPLICATIONS

Legal: This report complies with the requirement of the Local Government Act 2003.

Financial : FIN/35/20/TJB

Treasury Investment activities have generated £0.246m of investment interest at an average rate of 1.57%.

Non-Treasury investments (Investment Property acquisitions) have totalled £13.494m in 2018/19 and the full portfolio has generated £0.662m of net income (7.27% net yield) after taking direct operating expenses in to account.

Financing activities has resulted in £11m of external borrowing at a cost in year of £0.105M, £0.251m, which will be funded from additional income generated from capital investments funded by borrowing.

Staffing : None from this report

Equality and Diversity including Human Rights :

None from this report

Risk Assessment :

The Treasury Management Strategy sets our assessment of Treasury risks.

Climate Related Risks and Opportunities :

None from this Report

Title and Location of any Background Papers used in the preparation of this report:

CIPFA Code of Treasury Management Practice

CIPFA The Prudential Code

Local Government Act 2003

Located in the Finance Department, Guildhall, Gainsborough

Call in and Urgency:

Is the decision one which Rule 14.7 of the Scrutiny Procedure Rules apply?

i.e. is the report exempt from being called in due to urgency (in consultation with C&I chairman)	**Yes**		**No**	**x**

Key Decision:

A matter which affects two or more wards, or has significant financial implications	**Yes**		**No**	**x**

1. Executive Summary

The Council are required to receive as a minimum the following reports;

- an annual treasury strategy in advance of the year (March 2018)
- a mid-year, (minimum), treasury update report (November 2018)
- an annual review following the end of the year describing the activity compared to the strategy, (this report)

In addition, this Corporate Policy and Resources Committee has received quarterly treasury management update reports.

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by either the Governance and Audit Committee who provide scrutiny of the Treasury Management Strategy and the Corporate Policy and Resources Committee who monitor in year performance and mid-year updates. Member training on treasury management issues was undertaken during the year in order to support members' scrutiny role.

During 2018/19, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	**2017/18 Actual £000**	**2018/19 Budget £000**	**2018/19 Actual £000**
Capital expenditure	6,534	30,267	21,079
Capital Financing Requirement:	4,714	29,700	23,082
Of which – Investment Properties	*2,490*	*22,910*	*15,984*
Gross borrowing (External)	**0**	**24,370**	**11,000**
Finance Lease	32	0	0
Investments			
• Longer than 1 year	3,000	3,000	3,000
• Under 1 year	12,200	9,310	11,200
• **Total**	**15,200**	**12,310**	**14,200**
Net borrowing	**(15,168)**	**(12,060)**	**(3,200)**

Other prudential and treasury indicators are to be found in the main body of this report. The Executive Director of Resources also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit, (the authorised limit), was not breached.

The financial year 2018/19 continued the challenging investment environment of previous years, namely low investment returns.

This report summarises the following:-

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness, (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

2. Capital Expenditure and Financing

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

Capital and Financing	**2017/18 Actual £000's**	**2018/19 Budget £000's**	**2018/19 Actual £000's**
Capital expenditure	**6,534**	**30,267**	**21,079**
Financed in year by:			
Capital Receipts	344	150	0
Capital grants/contributions	634	1,430	1,578
Revenue	1,786	3,644	1,053
Leases	0	0	0
S106	160	0	0
Prudential Borrowing	3,610	25,043	18,448

3. The Council's overall borrowing need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2018/19 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, (such as the Government, through the Public Works Loan Board [PWLB], or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively a repayment of the) borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources, (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

The Council's 2018/19 MRP Policy, (as required by MHCLG Guidance), was approved as part of the Treasury Management Strategy Report for 2018/19 on 6 March 2018.

In respect of Commercial Investment Properties, which are funded from borrowing, no MRP will be payable, however this will be determined on a case by case basis. Instead the Council has created a Valuation Volatility Reserve with a minimum balance of 5% of purchase price of the portfolio. This Reserve will be utilised to mitigate any loss of investment upon sale of the assets if the capital receipt does not meet the debt outstanding. This is considered a prudent approach for these specific assets.

The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.

Capital Financing Requirement (CFR)	31 March 2018 Actual £000's	31 March 2019 Budget £000's	31 March 2019 Actual £000's
Opening balance	1,219	4,715	4,715
Add adjustment for the inclusion of on-balance sheet leasing arrangements and Prudential Borrowing	3,610	25,043	18,448
Less Adjustment for Non Capital Loans	0	(45)	(45)
Less MRP/Finance Lease Repayments	(114)	(199)	(36)
Closing balance	**4,715**	**29,514**	**23,082**
Movement on CFR	*3,496*	*24,799*	*18,367*

Borrowing activity is constrained by prudential indicators for gross borrowing and the CFR, and by the authorised limit.

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council ensures that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2017/18) plus the estimates of any additional capital financing requirement for the current (2018/19) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2018/19. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2018 Actual £000's	31 March 2019 Budget £000's	31 March 2019 Actual £000's
Prudential borrowing position	3,610	28,448	18,403
CFR	4,715	29,513	23,082

The Authorised Limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2018/19 the Council has maintained gross borrowing within its authorised limit.

The Operational Boundary – 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.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream.

	2018/19 £000's
Authorised limit	42,202
Maximum gross borrowing position during the year	11,000
Operational boundary	23,170
Financing costs as a proportion of net revenue stream	0.68%

4. Treasury Position as at 31 March 2019

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the end of 2018/19 the Council's treasury, (excluding borrowing and finance leases), position was as follows:

4.1 Borrowing

TABLE 1	**31 March 2018 Principal £000's**	**Rate/ Return**	**Average Life yrs**	**31 March 2019 Principal £000's**	**Average Rate/ Return**	**Average Life yrs**
Fixed rate funding:						
-PWLB	0	0	0	11,000		
Total debt	**0**	**0**	**0**	**11,000**	**2.28%**	***26.67***
CFR	**4,715**		**-**	**23,082**	**-**	**-**
Over / (under) borrowing	**(4,715)**	**-**	**-**	**(12,082)**	**-**	**-**
Investments:						
	15,200	1.39%	-	14,200	1.57%	-
Total investments	**15,200**	**1.39%**	**-**	**14,200**	**1.57%**	**-**
Net debt	**(15,200)**	**-**	**-**	**(3,200)**	**-**	**-**

Under borrowing reflects Internal Borrowing from the Council's cash balances.

The maturity structure of the debt portfolio was as follows:

	31 March 2018 Actual £000's	31 March 2019 Actual £000's	%
5 years and within 10 years	0	2,500	1.70%
10 years and within 20 years	0	0	0
20 years and within 30 years	0	2,500	2.53%
30 years and within 40 years	0	0	0
40 years and within 50 years	0	6,000	2.43%

2018/19 was the first time in 2 decades that the Council has undertaken long term external borrowing as a result of a Capital Programme with significant construction schemes being funded from prudential borrowing.

All loans have been undertaken with the Public Works Loans Board at fixed rates on a maturity basis as detailed above.

Borrowing in advance of need

The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

The Council's capital investments and their subsequent financing costs as a % of the Net Revenue Stream is detailed below along with the impact on Council Tax (all other things being equal). The indicators reflect our Borrowing Strategy, that we will only borrow where schemes are able to provide sustained support for the costs of borrowing and reflect new income generated is in excess of the cost of borrowing.

	31 March 2018 Actual	31 March 2019 Budget	31 March 2019 Actual
Ratio of Financing Costs to Net Revenue Stream	0.06%	1.39%	-.91%
Increase/(Reduction) in Council Tax	£1.96	(6.77)	(15.68)

4.2 Investments

Investment Policy – the Council's investment policy is governed by MHCLG investment guidance, which has been implemented in the annual investment strategy approved by the Council on 6 March 2018. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Resources – the Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Balance Sheet Resources	**31 March 2018 £000's**	**31 March 2019 £000's**
General Fund Balance	3,914	3,848
Earmarked reserves	12,635	15,834
Provisions	935	1,196
Usable capital receipts	3,016	3,362
Capital Grants Unapplied	368	587
Total	**20,868**	**24,827**

Investments held by the Council

- The Council maintained an average balance of £15.975m of internally managed funds.
- The internally managed funds earned an average rate of return of 1.657%.
- The comparable performance indicator is the average 7-day LIBID rate, *(amend as appropriate),* which was 0.5071%.
- This compares with a budget assumption of £16.133m investment balances earning an average rate of 1.5%.
- Total investment income was £0.246m compared to a budget of £0.242m

Types of investments	**31 March 2018 Actual £000**	**31 March 2019 Actual £000**
Deposits with banks and building societies	6,000	6,200
Money Market Funds	1,400	8,000
Other Local Authorities	4,800	0
Property funds	3,000	3,000
TOTAL TREASURY INVESTMENTS	**15,200**	**14,200**

4.3 Non Treasury Investments

YEAR OF ACQUISITION	Commercial Property Portfolio	Sector	Total Acquisition Cost £'m
2017/18	Bradford Road, Keighley	Hotel	2.490
2018/19	43 Penistone Roade, Sheffield	Leisure	2.700
2018/19	Unit 7 Drake House, Sheffield	Manufacturing	3.174
2018/19	5 Sandars Road, Gainsborough	Manufacturing	6.470
2018/19	Heaton Street, Gainsborough	Retail	1.150
	TOTAL PORTFOLIO		**15.984**

The investments are held on the balance sheet at their Fair Value *(the price expected to be received in current market conditions).* Their Fair Value as at 31 March 2019 for the Commercial Property Portfolio is £15.178m, effectively reflecting a reduction for the costs of purchase.

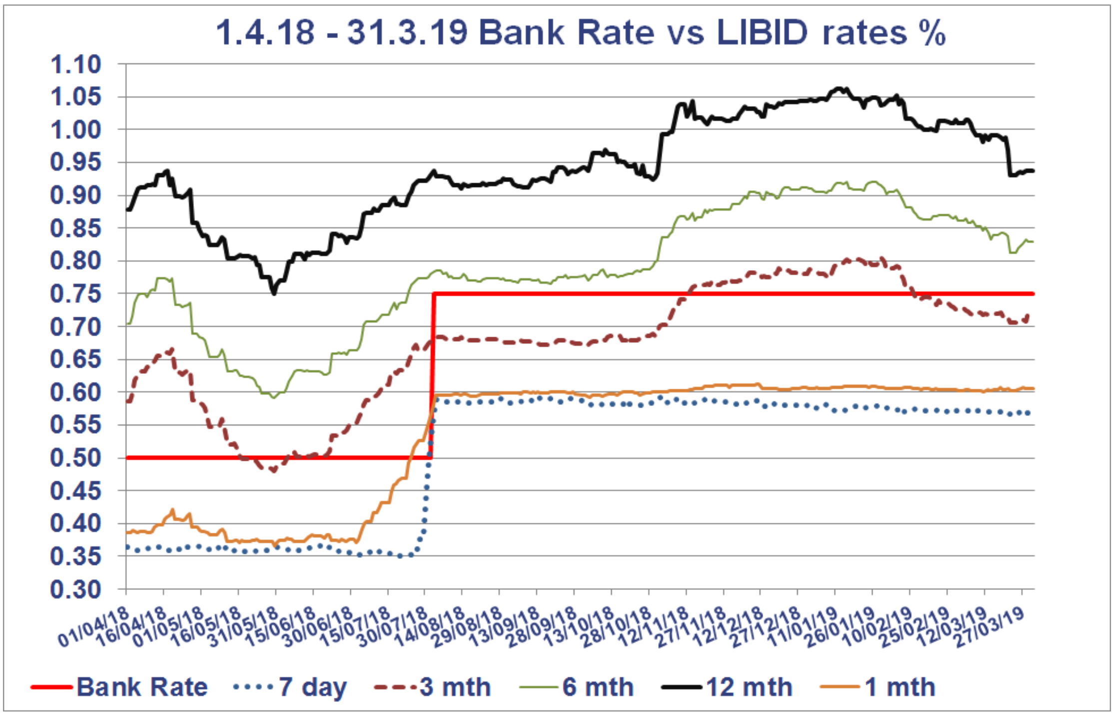
The actual net contribution to services for the year was £0.662m.

This investment portfolio is generating a gross yield of 7.27%

The Council mitigates any loss on investment by holding a Valuation Volatility Reserve at a minimum of 5% of the purchase price of properties. The balance on this reserve as at 31 March 2019 is £1.019m.

5. The strategy for 2018/19

5.1 Investment strategy and control of interest rate risk



Investment returns remained low during 2018/19. The expectation for interest rates within the treasury management strategy for 2018/19 was that Bank Rate would rise from 0.50% to 0.75%, an average 1% was used for budget purposes, to take into account our investment with the CCLA Property Fund which was achieving +4%. At the start of 2018-19, and after UK GDP growth had proved disappointingly weak in the first few months of 2018, the expectation for the timing of this increase was pushed back from May to August 2018. Investment interest rates were therefore on a gently rising trend in the first half of the year after April, in anticipation that the MPC would raise Bank Rate in August. This duly happened at the MPC meeting on 2 August 2018. During this period, investments were, therefore, kept shorter term in anticipation that rates would be higher later in the year.

It was not expected that the MPC would raise Bank Rate again during 2018-19 after August in view of the fact that the UK was entering into a time of major uncertainty with Brexit due in March 2019. Value was therefore sought by placing longer fixed term investments after 2 August where cash balances were sufficient to allow this.

Investment rates were little changed during August to October but rose sharply after the MPC meeting of 1 November was unexpectedly hawkish about their perception of building inflationary pressures, particularly from rising wages. However, weak GDP growth data after December, plus increasing concerns generated by Brexit, resulted in investment rates falling back again.

Continued uncertainty in the aftermath of the 2008 financial crisis has promoted a cautious approach whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

5.2 Borrowing strategy and control of interest rate risk

During 2018-19, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with external loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy is prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

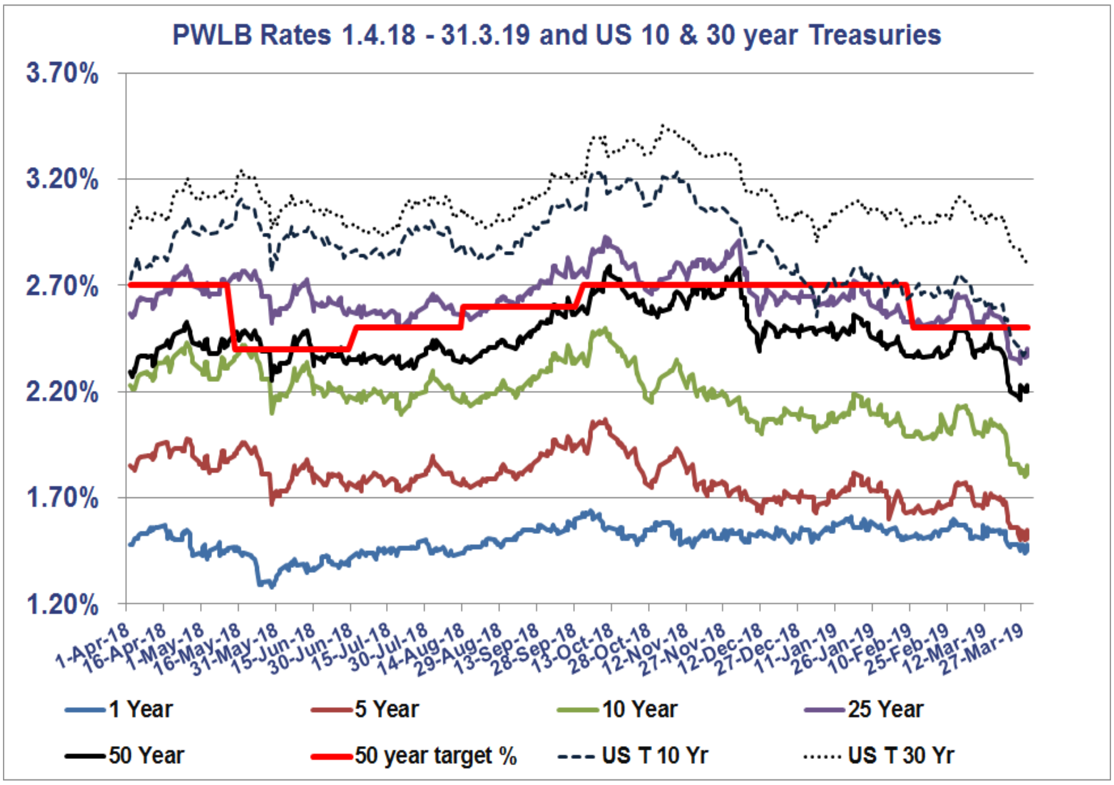
A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Executive Director of Resources therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks;

Rates have remained low during the year however have fluctuated with the Brexit issues being a factor. The Council has taken the view that rates will raise over the longer term. Borrowing has therefore been undertaken, as required for cash flow purposes and to mitigate interest rate risk over the longer term.

Link Asset Services Interest Rate View			12.2.18										
	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.50%
5yr PWLB Rate	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%
10yr PWLB Rate	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%



Since PWLB rates peaked during October 2018, most PWLB rates have been on a general downward trend, though longer term rates did spike upwards again during December, and, (apart from the 1 year rate), reached lows for the year at the end of March. There was a significant level of correlation between movements in US Treasury yields and UK gilt yields -which determine PWLB rates. The Fed in America increased the Fed Rate four times in 2018, making nine increases in all in this cycle, to reach 2.25% – 2.50% in December. However, it had been giving forward guidance that rates could go up to nearly 3.50%. These rate increases and guidance caused Treasury yields to also move up. However financial markets considered by December 2018, that the Fed had gone too far, and discounted its expectations of further increases. Since then, the Fed has also come round to the view that there are probably going to be no more increases in this cycle. The issue now is how many cuts in the Fed Rate there will be and how soon, in order to support economic growth in the US. But weak growth now also looks to be the outlook for China and the EU so this will mean that world growth as a whole will be weak. Treasury yields have therefore fallen sharply during 2019 and gilt yields / PWLB rates have also fallen.

6. Other Issues

International Financial Reporting Standard 9 (IFRS9) was adopted last at 1 April 2018. The Standard requires that Risk management will need to take account as prescribed in the 2018/19 Accounting Code of Practice for the valuation of investments including:

- Expected credit loss model. Whilst this has not been material for (below 1% for Money Market Funds and Investments with Banks and other Local Authorities) it has been considered for our investment with the CCLA Property Fund, where no adjustment is considered appropriate as only gains have been realised in the past 3 years. Capital loans to third parties have been affected and a loss value of £22k has been applied.

- The valuation of investments previously valued under the available for sale category e.g. equity related to the “commercialism” agenda, property funds, equity funds and similar, will be changed to **Fair Value through the Profit and Loss (FVPL).** For WLDC this relates to our CCLA Property Fund. In year gains have been reflected within the Financing and Investment Income and Expenditure within the Comprehensive Income and Expenditure Statement.

However, following the consultation undertaken by the Ministry of Housing, Communities and Local Government, [MHCLG], on IFRS9 the Government has introduced a mandatory statutory override for local authorities to reverse out all unrealised fair value movements resulting from pooled investment funds. This will be effective from 1 April 2018. The statutory override applies for five years from this date. Local authorities are required to disclose the net impact of the unrealised fair value movements in a separate unusable reserve throughout the duration of the override in order for the Government to keep the override under review and to maintain a form of transparency. We currently hold, £0.231m therefore in an unusable reserve, reflecting in year and previous gains from our investment.