Review of Treasury Management 2017/18

Introduction

The county council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which recommends that committee members review a treasury management report after the end of each financial year.

Economic Summary 2017/18

Treasury management activity is influenced by the actual and forecast economic position. During 2017/18 the UK economy showed signs of slowing economic growth with latest estimates showing GDP grew by 1.7% in the calendar year 2017, with growth for 2016 and 2015 being 1.8% and 2.3% respectively. This was a far better outcome than the majority of forecasts following the EU referendum in June 2016 and reflected the impact of the international growth momentum generated by the increasingly buoyant US economy and the re-emergence of the Eurozone economies.

The year saw an increase in inflation with the Consumer Prices Index (CPI) rising to 3.1% in November partly due to the impact of the falling exchange rate before returning back to 2.7% in February 2018.This is above the Bank of England's target which has been set by the Government at 2%. Data on the unemployment rate was positive with the rate falling to 4.3% in January. However there still remained concerns over the strength of the economy. Average real earnings growth, i.e. after inflation, turned negative before slowly recovering which indicated a potential weakness in consumer spending, an important source of economic growth. There were also signs of weakness in UK business investment which was not helped by political uncertainty following the general election in June 2017 and by the lack of clarity on Brexit. Although the UK and the EU reached an agreement in March 2018 on a transition which will run to the end of 2020, there is still significant uncertainty over the long term trade arrangements.

With concerns over inflation being above its target the Bank of England's Monetary Policy Committee (MPC) increased the bank rate by 0.25% in November 2017. This was the first rate increase in ten years, although in essence the MPC only 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 months) horizon and indicated there would be 'gradual' and 'limited' increases in rates.

However, the reduction in inflation and the timing of increases in interest rates are not certain as changes in the economy may impact on the policy. For example, 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 increases.

Interest Rate Environment

Short term interest rates continue to be at historically very low levels. 2017/18 saw the first increase in interest rates for a decade when in November the base rate was increased to 0.50% from 0.25%. The expectation during the year was that interest rates would remain low for the rest of the financial year and beyond. It is anticipated that although rates may increase they will remain at low levels. Arlingclose are forecasting two small increases in 2018/19 with base rates being at 1% in March 2019.

Credit environment

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. Under these rules the largest UK banks will be required to separate their retail banking services to individuals and small businesses from their investment banking activities with the retail bank being referred to as the ring-fenced bank. As it was unclear which banking entities the council would be dealing with once ring-fencing was implemented 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. This uncertainty around the banking sector has a limited impact on the council as the policy is not to have long term fixed investments with the banks. However, the council will continue to need short term or call accounts and the banks used will be kept under review.

Credit Rating developments

The most significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2. Following this, Moody's downgraded UK local authorities, reflecting the close economic, financial and institutional linkages between the sovereign and sub-sovereign sectors. This credit rating downgrade for the county council, to Aa3 from Aa2, has no expected practical implications based on current plans.

Other developments

Although there was no ongoing lending to Northamptonshire County Council (NCC), in February, Arlingclose advised against lending to this Council. NCC issued a section 114 notice in light of the risk that it would not be in a position to deliver a balanced budget. The guidance has now been revised to "Arlingclose is now comfortable with clients lending to Northamptonshire County Council for treasury management purposes for a maximum duration of 12 months".

Treasury Management Activity 2017/18

Treasury Management activity is undertaken in accordance with the council's Treasury Management Strategy. Full Council approved the 2017/18 Treasury Management Strategy at its meeting on 9 February 2017. The council's stated investment priorities were maintaining:

(a) Security of capital and
(b) Liquidity of investments

The council has a "low credit risk" investment policy. Therefore investments are primarily in bonds issued by governments, government agencies, government guaranteed bodies, supranational bodies and covered or collateralized corporate bonds. The council's position is not to invest in banks, other than call accounts, and therefore it is substantially insulated from the effects of an individual or systemic banking "credit event". This management of credit risk was a key driver in the treasury activities undertaken in 2017/18. With the forecast reduction in reserves, moves were made to reduce long term investment holdings to reduce market risk too.

The council also aimed to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. 2017/18 saw continued low interest rates with significant economic uncertainty.

The council's stated borrowing strategy is to fund its capital expenditure in a cost effective manner. This will involve using short term and variable rate loans when these are seen as being the most beneficial. However, consideration is also given to the long term funding needs of the council and the stability provided to budgets through fixed interest loans. The council also regularly evaluates debt restructuring opportunities of the existing portfolio. With low interest rates it was considered that renewing to short term borrowing continued to be the most appropriate strategy in 2017/18 and will likely continue to be the most cost effective financing method until there is a significant increase in interest rates.

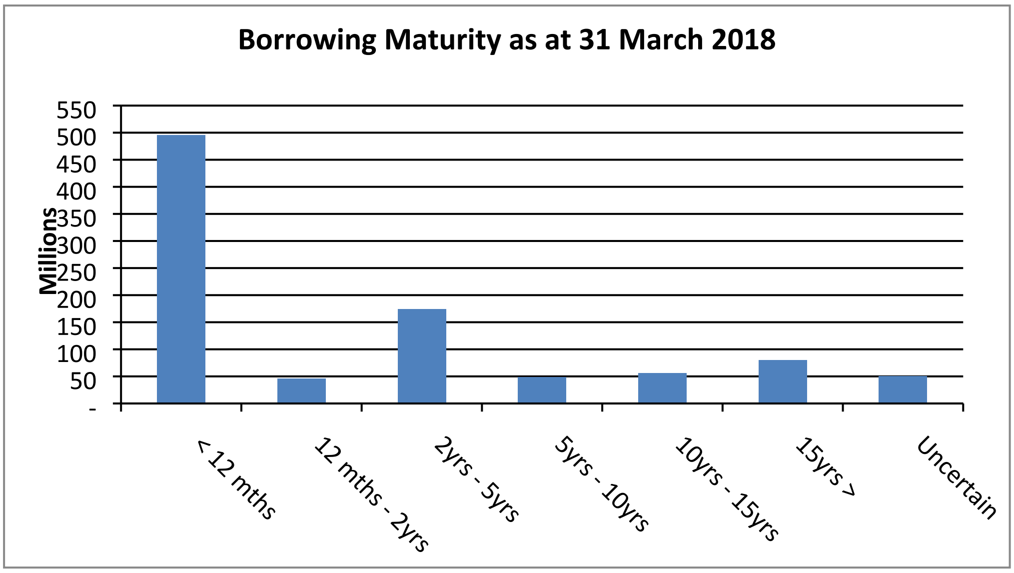
Borrowing Activity

During the year borrowing was undertaken to finance new capital investment, to replace maturing debt and to cover short term cash-flow variations. In summary the holdings were:

	Debt 31/03/2017		**Borrowing**	**Repayments**	**Debt 31/03/2018**	
	£m	**%**	**£m**	**£m**	**£m**	**%**
Fixed Rate Funding						
Public Works Loan Board	213.1	20.5	0	0	213.1	22.4
Market Borrowing	590.0	56.8	512.5	(584.0)	518.5	54.4
Total Fixed Rate	**803.1**	**77.3**	**512.5**	**(584.0)**	**731.6**	**76.8**
Variable Rate Funding						
Public Works Loan Board	125.7	12.1	0	0	125.7	13.2
LOBO *	50.0	4.8	0	0	50.0	5.3
Shared Investment Scheme	60.8	5.8	496.9	(512.5)	45.2	4.7
Total Variable Rate	**236.5**	**22.7**	**496.9**	**(512.5)**	**220.9**	**23.2**
Total Borrowing	**1,039.6**	**100.0**	**1,009.4**	**(1,096.5)**	**952.5**	**100.0**

*Lender option borrower option

With the low interest rates anticipated to continue the council maintained its policy of taking short term market borrowing and this is reflected in the activity in the year and the structure of the debt at 31 March 2018. The maturity profile of borrowing at the end of the year was as follows:



In the chart, the 'uncertain' category refers to the lender option borrower option (LOBO) loan. This matures in November 2060. However, within the contract there is an option every 5 years for the bank to change the interest rate which if the council does not consider acceptable then it can repay the loan without incurring any penalties.

With short-term interest rates being lower than long-term rates, it was more cost effective in the short-term to borrow short-term loans from the market, mainly from other local authorities. Whilst such a strategy is most likely to be beneficial over the next year as official interest rates remain low, it is a situation that is regularly reviewed. The Director of Finance will, in conjunction with Arlingclose, continue to closely monitor interest rate forecasts in order to establish when the strategy should be adjusted.

Overall the average rate of interest paid in 2017/18 on the debt administered by the council was 2.07% compared with an average rate of 2.12% in 2016/17. The council did not enter into any new other long term liability arrangements in the year. The outstanding PFI liability at 31 March 2018 was £152.4m.

Investment Activity

The council holds investments as it has reserves and other cash balances in its balance sheet. The total amount of investments (excluding fair value adjustment), held at 31 March 2018 was £320.8m. This is £253.8m lower than at 31 March 2017 and the movements are detailed in the following table. The overall reduction shown is largely due to the sale of bonds towards the end of the financial year, with funds reinvested early in 2018/19 in line with the approved investment limits for 2018/19.

Maturity Range	Position as at 31 March 2017 £m	2017/18 Movement £m	Position as at 31 March 2018 £m
Call, Money Market Funds & Under 1yr	147.7	-34.6	113.1
Bank Deposit 1-2 Years	36.5	-36.5	0.0
Bank & Local Authority Deposits 2-3 years	0.0	1.3	1.3
Bank & Local Authority Deposits 3-5 Years	0.0	0.0	0.0
Bank Deposit 5 Years +	10.0	0.0	10.0
Local Authority Bonds	35.9	-0.2	35.7
UK Government and Supranational Bonds	344.5	-183.8	160.7
Total	**574.6**	**-253.8**	**320.8**

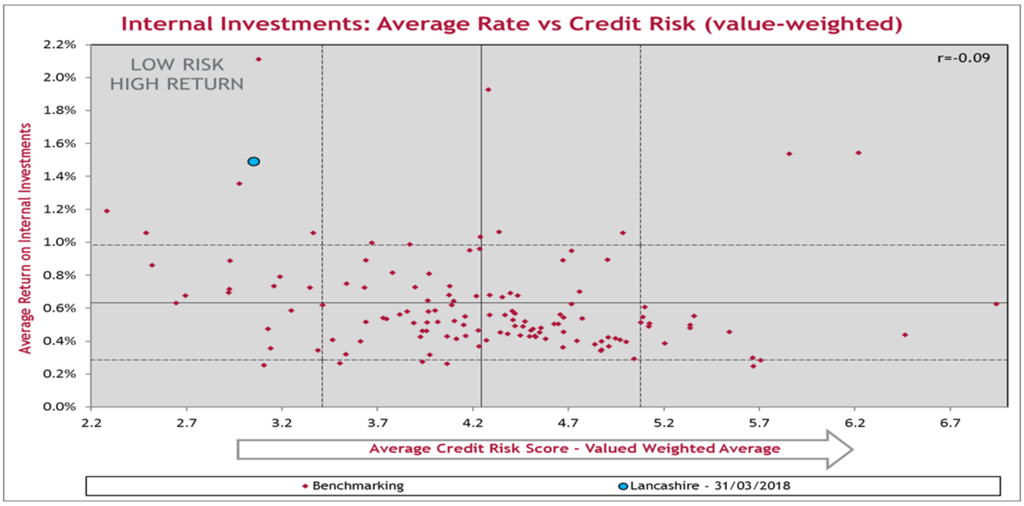
The investments are considered to be very secure, with 94% credit rated at least AA- with the others rated at A+. The average credit score is well within the policy limit.

Security of capital remained the council's main investment objective. This was maintained by following the council's Counterparty Policy, as set out in its Treasury Management Strategy Statement for 2017/18. This defined "high credit quality" organisations as those having a minimum long-term credit rating of A+. In practice the average credit rating in 2017/18 was higher at AA.

Investments with banks were held in call accounts only. Any longer term deposits have been restricted to other local authorities.

Credit Risk Comparisons

The following chart shows the credit risk scores of all Arlingclose clients. This comparison shows that at 31 March 2018 the council has one of the lowest credit risk scores in this population along with one of the best returns.



Liquidity Management

In keeping with the regulatory guidance on investments, the council maintained a minimum level of primary liquidity through the use of 'Call Accounts'. The council also has bond portfolios which are available for sale, at current market prices, if needed as 'secondary' liquidity.

Cash flow forecasting spreadsheets are used to determine the maximum period for which funds may prudently be committed allowing the council to meet its payment obligations.

Yield

The rates of return on the council's short-dated money market investments reflect prevailing market conditions and the objective of optimising returns commensurate with the principles of security and liquidity.

Overall the investment portfolio returned an average rate of 2.3% in 2017/18 which can be attributed to the categories as follows:

	Average Balance £m	Average Rate
Call, Money Market Funds & Under 1 year	164.5	0.50%
Bank & Local Authority Deposits 1-2 years	0.0	0.00%
Bank & Local Authority Deposits 2-3 years	1.3	0.88%
Bank & Local Authority Deposits 3-5 years	0.0	0.00%
Bank & Local Authority Deposits 5 Years +	10.0	2.95%
Local Authority Bonds	37.3	3.55%
UK Government & Other Bonds	281.8	3.17%
Total	**494.9**	**2.30%**

Impact of Treasury Management activity on the Council's revenue budget

The following table shows a net underspend of £8.9m on the financing charges budget. Income received in the year was £8.1m higher than anticipated in the budget. With the markets responding to economic and political events there was volatility in the price of gilts and other bonds. The increase in the price of gilts enabled some to be sold resulting in a net gain of £5.8m. There have also been net gains of £0.9m resulting from sales from the corporate bonds portfolio. Other interest received was £1.4m higher than anticipated due to the higher level of balances and interest rates while reductions arose with interest paid on debt of £0.7m with debt levels and interest rate being lower than forecast.

Cabinet have considered a change to the minimum revenue provision (MRP) policy for 2017/18 which is subject to approval by the Full Council on 19 July. The new policy reflects a revised calculation method and will reduce the MRP charge for 2017/18. The reduction will see a contribution to reserves for an equal value thereby having no impact on the overall net expenditure of the authority.

	Budget 2017/18 £m	Year End Position £m	Variance £m
MRP	21.383	21.337	(0.046)
Interest Paid	22.758	22.010	(0.748)
Interest Received/surplus on sale	(7.423)	(15.487)	(8.064)
Total	**36.718**	**27.860**	**(8.858)**

Treasury Management and Prudential Indicators 2017/18

The Local Government Act 2003 and supporting regulations require the council to have regard to the Prudential Code and to set prudential indicators to ensure the council's capital investment plans are affordable, prudent and sustainable**.**

A comparison of the actual position at 31 March 2018 compared to the indicators set in the Treasury Management Strategy for 2017/18 is set out as follows.

Authorised limit for external debt A prudent estimate of debt which reflects the authority's capital expenditure plans and allows sufficient headroom for unusual cash movements	**2017/18 £m**	**31st March Actual £m**
Borrowing	1,100	950
Other long term liabilities (PFI schemes)	200	157
TOTAL	**1,300**	**1,107**

Operational boundary for external debt The Operational Boundary is a prudent estimate of debt with no provision for unusual cash movements. It represents the estimated maximum external debt arising as a consequence of the council's current plans	**2017/18 £m**	**31st March Actual £m**
Borrowing	1,075	950
Other long term liabilities (PFI schemes)	170	157
TOTAL	**1,245**	**1,107**

Capital Financing Requirement to Gross Debt The Capital Financing requirement is the underlying need to borrow for capital purposes. This is the cumulative effect of past borrowing decisions and future plans. This is not the same as the actual borrowing on any one day, as day to day borrowing requirements incorporate the effect of cash flow movements relating to both capital and revenue expenditure and income	**2017/18 £m**	**31st March Actual £m**
Capital Financing Requirement	843	843
Estimated gross debt	1,003	950
Debt to Capital Financing Requirement	119%	113%

Gross borrowing appears higher than the capital financing requirement because the shared investment scheme is accounted for as borrowing, but it does not form part of the capital financing requirement calculation. Adjustments are also required for premiums, long term debtor and transferred debt. The adjusted gross debt is slightly above the CFR which represents borrowing in advance for capital which is allowable within the Code.

	Estimate %	**Actual %**
Ratio of financing costs to net revenue expenditure This indicator provides information on the impact of borrowing on the revenue budget and the long term affordability of the Capital Programme.	5.19	3.84

Interest Rate exposure The limit measures the council's exposure to the risk of interest rate movements. The one year impact indicator calculates the theoretical impact on the revenue account of an immediate 1% rise in all interest rates over the course of one financial year	**Upper Limit £m**	**Actual £m**
Net Interest Payable – Fixed Rate	50.40	9.80
Net Interest Payable – Variable Rate	5.00	3.20
1 year impact of a 1% rise	10.00	2.90

Maturity structure of debt The limit on the maturity structure of debt helps control refinancing risk	**Upper Limit %**	**Actual %**
Under 12 months	75	0
12 months and within 2 years	75	61
2 years and within 5 years	75	12
5 years and within 10 years	75	8
10 years and above	50	20

Investments over 364 days The limit on the level of long term investments helps to manage liquidity, although the majority of these investments are currently held in available for sale securities	**Upper Limit £m**	**Actual £m**
Total invested over 364 days	450	208

Minimum Average Credit Rating To control credit risk the council requires a very high credit rating from its treasury counterparties	**Minimum**	**Actual**
Average counterparty credit rating	A+	AA

The council complied with its Prudential Indicators for 2017/18, which were approved as part of its Treasury Management Strategy Statement.