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| Brent | **Cabinet**<br>12 September 2018 |
| | **Report from the Chief Finance Officer** |

# 2017/18 Treasury Management Outturn Report

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| **Wards Affected:** | All |
| **Key or Non-Key Decision:** | Key |
| **Open or Part/Fully Exempt:**<br>(If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act) | Open |
| **No. of Appendices:** | Two:<br>• Debt and Investment Portfolio Position 31/3/2018<br>• Prudential Indicators |
| **Background Papers:** | N/A |
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## 1.0 Purpose of the Report

1.1 This report updates members on Treasury Management activity and confirms that the Council has complied with its Prudential Indicators for 2017/18.

## 2.0 Recommendation

2.1 Cabinet is asked to consider the 2017/18 Treasury Management outturn report, and ask that it be forwarded to Council, in compliance with CIPFA's Code of Practice on Treasury Management (the Code).

## 3.0 Detail

3.1 The Council's treasury management activity is underpinned by the Code, which requires authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year.

3.2 This report fulfils the Council's obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Investment Guidance.

3.3 The Council has borrowed money over the long term to support investment in the Council's infrastructure and also invests cash balances held for short periods. It 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 central to the Council's treasury management strategy.

**Economic background**

3.4 The UK grew at the same pace in 2017 as in 2016 however the latest estimates showed signs of slowing. Q1 2018 GDP showed year-on-year growth of 1.2% but quarterly growth of just 0.1%. Services and production grew in Q1 with agricultural and construction output decreasing. Consumer Price Index (CPI) has increased to 3.1% in November due to the weakness of the pound but has since fallen back to 2.4% at the time of writing. The Bank of England has indicated that it would like inflation to return to its 2% target over the next 18 to 24 months. Employment is currently at a record level of 75.6% of the working age population with the number of people in work increasing through the year. The unemployment rate fell to 4.2% from 4.6% a year earlier. Real wage growth remained negative for most of the year only turning positive at the end of the year.

3.5 Political events have continued to give rise to a very uncertain environment. Economic activity has gained momentum in the Eurozone and the US economy continues to grow steadily. However, this is balanced off against uncertainties over Brexit in the UK, geopolitical tensions and the imposition of tariffs initiated by the US. Therefore it is difficult to forecast what effect this will have on the way the UK economy develops.

**Gilt Yields and Money Market Rates**

3.6 Gilt yields (the rate of interest on UK government borrowing) showed significant volatility through the year. They fell in the first quarter of 2017/18 and then rose in the third and final quarters. 10 year yields ended the year at 1.35% and 20 years at 1.70% both higher than at the start of the year.

3.7 Interest rates on short term inter-bank lending rose as a result of the increase in the bank rate.

**The Borrowing Requirement and Debt Management**

3.8 The table below summarises the Council's borrowing activity during 2017/18. The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) was £665m at 31/03/2018.

| | **Balance 01/04/2017 (£m)** | **New Borrowing (£m)** | **Borrowing Repaid (£m)** | **Balance 31/03/2018 (£m)** | **Average Rate (%)** | **Average Life (Years)** |
|---|---|---|---|---|---|---|
| **CFR** | **581** | | | **665** | | |
| **Short Term Borrowing** | **0** | 51 | 30 | **21** | 0.57 | 0 |
| **Long Term Borrowing** | **415** | 0 | 4 | **411** | 4.82 | 34.6 |

3.9 At 1 April 2017 the Council had £415 million of long-term borrowing, to finance its previous years' capital programmes. With short-term interest rates being much lower than long-term rates, it was more cost effective in the short-term to use internal resources rather than undertake further long-term borrowing. By doing so, the Council has been able to reduce net borrowing costs and reduced overall treasury risk as overall long-term borrowing has been reduced slightly.

3.10 Temporary borrowing was used during the year at times of low cash balances to maintain liquidity. The average rate on long term borrowing of 4.82% was higher than last year's rate of 4.79% and this was due to the redemption of £4m of PWLB loans that are paid back steadily over their lifetime.

3.11 If the Council were to repay its long term borrowing this would involve paying a premium to compensate PWLB for their inability to relend the money at the rate at which they have financed the loan. For example, the Council's most expensive loan is £3.05m at a rate of 8.875%, to repay it would cost £0.781m, a 26% premium on the value of the loan before the cost of re-financing. In short, the cost of re-financing our loans under the Government's punitive approach means is not economical. However this analysis might change if interest rates returned to historically normal levels.

3.12 The Treasury Management Strategy approved by the Council in February 2017 states that the Council will maintain borrowing at the lowest level consistent with prudent management of the Council's finances. This implies that, at present discount rates, we will not undertake premature repayment of debt but that, in conjunction with our Treasury Management advisers, Arlingclose, we will remain abreast of developments and be prepared to borrow up to the level of CFR if a significant permanent rate rise appears likely. These circumstances did not arise during the year.

3.13 The Authority has £80.5m exposure to LOBO loans (Lender's Option Borrower's Option) of which £10m of these can be "called" within 2018/19.

3.14 Under the LOBO arrangements lenders can exercise their rights at set times to amend the interest rate on the loan. At that point, the Borrower can accept the revised terms or reject them and repay the loan without penalty. LOBO loans present a potential refinancing risk to the Authority since the decision to call a LOBO is entirely at the lender's discretion. This risk is mitigated by the fact that the Council's current cash holdings mean that any repayment could be accommodated by reducing deposits. It is also unlikely that LOBO loans will be called at the present time due to low interest rates – this may change in the future if rates rise.

3.15 Any LOBOs called will be discussed with Arlingclose prior to acceptance of any revised terms. The default position will be the repayment of the LOBO without penalty i.e. the revised terms will not be accepted.

3.16 There are complex arguments made about LOBOs, by their supporters and by their detractors. The Council's position is simply that the LOBOs are part of its portfolio, and must therefore be managed as effectively as possible. There are no plans to enter into further LOBO contracts. However, it should be noted that the average rate of interest being paid on LOBOs is little different to that on PWLB debt (4.87% compared to 4.80% at 31 March). The most expensive LOBO was at 7.386% on 31 March 2018, compared with the most expensive PWLB at 8.875%.

**Forward Borrowing**

3.17 The Council is currently reviewing the feasibility of taking out forward loans to fund the burgeoning capital programme. Options are available to fix the rate now for a period of up to five years in advance. This would allow the Council to maintain a short term, cheap position, with the added comfort of fixed rate loans being drawn down in the future in parallel with our capital commitments.

3.18 The risks are, once committed the funds must be taken and the market rates could potentially be cheaper in future although this is unlikely with current interest rates being so low. The Treasury function is currently looking at options with our advisers and are in active discussions with potential lending institutions. A detailed report setting out those considerations is included elsewhere on the agenda.

**Investment Activity**

3.19 Both CIPFA and the CLG Investment Guidance require the Council to invest prudently and have regard to the security and liquidity of investments before seeking the optimum yield. The table below summarizes investment activity during 2017/18.

| **Investments** | **Balance on 01/04/2017 (£m)** | **Investments made (£m)** | **Investments repaid (£m)** | **Balance on 31/03/2018 (£m)** | **Average Rate on 31/03/2018 (%)** |
|---|---|---|---|---|---|
| **Fixed Term Deposits** | 151 | 221 | 267 | 105 | 0.48 |
| **Marketable instruments** | 0 | 15 | 15 | 0 | n/a |
| **Money Market Funds and notice deposits** | 16 | 736 | 717 | 35 | 0.43 |
| **TOTAL INVESTMENTS** | **167** | **972** | **999** | **140** | **0.47** |

3.20 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 which defined "high credit quality organisations" as those having a long-term credit rating of A- or higher that are domiciled in the UK or overseas where the sovereign rating is AA+ or higher.

3.21 The growth of bail-in risk gave rise to the decision to restrict the maximum maturity with market financial institutions to three months and use only marketable instruments issued by them. Bail-in means that long-term loans in financial institutions are converted into equity (shares) that are not easily convertible for many years, preventing Brent from accessing the resources, and potentially giving them a hefty cut in their value.

3.22 New investments with banks and Building Societies have been undertaken by means of marketable instruments. The risk of bail in has recently declined for many UK institutions, but investment decisions still need to be made on a case by case basis.

3.23 Following the financial crisis and the increasing complexity of financial products the European Commission conducted a review of the existing Markets in Financial Instruments Directive (MiFID) regulations. The result of this review is the MiFID II regulations which took effect from January 2018. The main change from these regulations is that the council would be reclassified as a retail client with the opportunity to opt up to professional client status. As a retail client the council would have increased protection however this would be balanced against potentially higher fees and access to a more limited range of products. The Authority has met the conditions to opt up to professional status and has done so in order to maintain its status prior to January 2018.

**Credit developments and credit risk management**

3.24 The Council assessed and monitored counterparty credit quality with reference to credit ratings, credit default swaps (a means of insuring loans), perceived credit-worthiness of the country in which the institution is registered and its share price. The minimum long-term counterparty credit rating determined by the Council for the 2017/18 treasury strategy was A- across rating agencies Fitch, S&P and Moody's. The Council continues to monitor risks, with advice from Arlingclose. The Council did not make any deposits with institutions in the Eurozone during the year.

**Liquidity Management**

3.25 Combining changes to the regulatory environment and our adoption of a mainly three month lending limit, investments with financial institutions are now normally by means of purchasing 3 month Certificates of Deposit (CDs). Longer maturities with more attractive rates can be obtained from Local Authorities, though these will depend on being able to satisfy demand when it arises. At peak periods, mindful of the primacy of security as a criterion for decision making, substantial balances may be held in short term investments, particularly Money Market Funds. The use of short term borrowing at times of lower cash balances is judged to maintain a prudent balance between maintaining security and liquidity and achieving a reasonable yield on investments, this approach was required during February and March 2018.

**Yield**

3.26 The UK Bank Rate increased to 0.50% in November 2017. Short term money market rates increased as a result but remained relatively low. This continued to have a significant impact on investment income. The average 3-month LIBID rate during 2017/18 was 0.39% and the 1-year LIBID rate averaged 0.69%. The low rates of return on the Council's short-dated money market investments reflect prevailing market conditions and the Council's objective of optimising returns commensurate with the principles of security and liquidity.

3.27 The Council's budgeted investment income for the year had been estimated at £1.4m. The average cash balance during 2017/18 was £179m during the period and interest earned was £0.7m, an average return of 0.41%. (2016/17 - £0.9m on an average cash balance of £199m or 0.52%).

**Update on Investments with Icelandic Banks**

3.28 The Council has recovered 98% of its £10 million deposit with Heritable Bank. The administrators have not made any further estimate of final recoveries yet, though a further distribution is expected, subject to the outcome of a legal case.

**Compliance**

3.29 The Council confirms that it has complied with its Prudential Indicators for 2017/18, which were approved by the Council on 27 February 2017 as part of the Council's Treasury Management Strategy Statement.

3.30 In accordance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2017/18. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield. Further information is set out in Appendix 1 and 2.

**Investment Training**

3.31 The needs of the Council's treasury management staff for training in investment management are kept under review and considered as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

3.32 During 2017/18 staff attended training courses, seminars and conferences provided by Arlingclose and CIPFA.

**4.0 Financial Implications**

4.1 Already noted within the report as this is the Treasury Management Outturn Report.

**5.0 Legal Implications**

5.1 None identified.

**6.0 Equality Implications**

6.1 None identified.

**7.0 Consultation with Ward Members and Stakeholders**

7.1 On the 26 July 2018 the Audit & Advisory Standards Committee reviewed the contents of the Treasury Outturn report and resolved that it should be forwarded to Cabinet in compliance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management.

**8.0 Human Resources/Property Implications (if appropriate)**

8.1 None identified.

***Report sign off:***

***CONRAD HALL***
Chief Finance Officer