Brent	**Cabinet** 9 September 2019 **Council** 16 September 2019
	Report from the Director of Finance

2018/19 Treasury Management Outturn Report

Wards Affected:	All
Key or Non-key Decisions	Key
Open or part/fully exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	Open
Number of Appendices:	Two: • Appendix 1 - Debt and Investment Portfolio • Appendix 2 - Prudential Indicators
Background Papers:	None
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1. Introduction

1.1 This report updates members on Treasury Management activity and confirms that the Council has complied with its Prudential Indicators for 2018/19.

2. Recommendations

2.1 Cabinet is asked to consider the 2018/19 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. Background

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 UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% compared to last year, just above the consensus forecast but broadly in line with the Bank of England's February Inflation Report. The most recent labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

3.5 After rising to 0.6% in the third calendar quarter from 0.4% in the second, fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

3.6 The ongoing uncertainty around Brexit continues to weigh on sterling and UK markets. Due to the continually changing circumstances a verbal update on Brexit, to the extent that it is relevant to this report, will be provided at the meeting.

3.7 While the domestic focus has been on Brexit's potential impact on the UK economy, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to be show signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

3.8 Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new year - the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate pushed up money markets rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

3.9 Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury yields were lower than US 3month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling by 1.8%

year-on-year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China which despite some moderation in January does suggest that the International Monetary Fund's (IMF) and Organisation for Economic Co-Operation & Development's (OECD) forecasts for global growth in 2019 of 3.5% might need to be revised downwards.

The Borrowing Requirement and Debt Management

3.10 The table below summarises the Council's borrowing activity during 2018/19. The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) was £688m at 31/03/2019.

	Balance on 01/04/2018	**Borrowing Repaid**	**New Borrowing**	**Balance on 31/03/2019**	**Average Rate**	**Average Life**
	£m	**£m**	**£m**	**£m**	**%**	**Years**
CFR	**670.9**			**688.0**		
Short Term Borrowing	**21.0**	(21.0)	0.0	**0.0**		
Long Term Borrowing	**413.6**	(27.8)	0.0	**385.8**	4.2	33.7
TOTAL BORROWING	**434.6**	**(48.8)**	**0.0**	**385.8**		

3.11 At 1 April 2018 the Council had £413 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 also fallen (£385 million).

3.12 Temporary borrowing was not required during the year. The average rate on long term borrowing of 4.78% was lower than last year's rate of 4.82% was due to the redemption of the RBS LOBO loan and PWLB loans that are paid back steadily over their lifetime.

3.13 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.

3.14 The Treasury Management Strategy approved by the Council in February 2018 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.

3.15 The Authority has £70.5m exposure to LOBO loans - Lender's Option Borrower's Option (2018/19 £80.5m) of which £31m of these can be "called" during 2019/20. 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 – although this may change in the future if rates rise.

3.16 The following LOBO loan was redeemed in Nov 2018.

<u>Details:</u>

Counterparty	RBS
Notional Amount	£10m
Original Maturity	01/04/2060
Date of Restructuring	29/11/2018

3.17 Prior to this redemption the Council had £80.5m in Lender Option Borrower Option ("LOBO") market loans. The majority of the loans were taken out before 2010 meaning that in the current interest rate environment the likelihood of these loans being "called" by the bank, in terms of changing the rate, is low.

3.18 However certain banks (including RBS) have been active in seeking to exit these loans for various reasons which possibly relate to either the regulatory rules required in terms of setting aside capital ("Risk Weighted Assets") which restrains the bank from lending further in other areas and more recently the changes in International Financial Reporting Standard (IFRS) and in particular IFRS9 which impacts the bank with regards to the accounting for these loans.

3.19 In Nov 2018 the Council was approached by RBS with a view to entering into negotiations for the early redemption of the above loan. As well as taking advice from Link Asset Services the Council undertook a detailed analysis of the options and merits of different approaches, including maintaining the status quo. This included sensitivity analysis, identification of potential risks with any existing structure and any potential new structure, a quantification of the potential benefits from restructuring as well as accounting implications.

3.20 A number of different rescheduling options were compared and written down over the life of the loan and the cash flow discounted back using rates taken from the HM Treasury Green Book. The results were used as benchmark from which to negotiate improved terms with RBS. In late Nov 2019 terms were agreed (based on the parameters modelled above). Furthermore, the Council has used internal investment balances available for the repayment of the principal and the premium. This means that the level of external investment will reduce by this amount, thus reducing the level of investment income due to the reduced cash.

3.21 However, with interest rates at low levels and the general expectation for a slow and gradual increase in rates in the medium term, the council's investment income is suppressed and therefore using this cash balance for the repayment of the loans could save money. In fact, the analysis indicates that, based on the amount paid to redeem the loan (par + 240 bps), there will be a substantial saving based on the interest saved on the loan, with even greater savings if the loan is not replaced. As noted above at this time the authority has chosen not to not refinance the loan with PWLB or any other borrowing but has utilised internal cash balances. However, this position is remains under constant review.

3.22 There are many 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 currently less than that paid on PWLB debt (4.60% compared to 5.19% at 31 March). The most expensive LOBO was at 6.234% on 31 March 2019, compared with the most expensive PWLB at 8.875%.

Forward Borrowing

3.23 The Council is continuing to assess the potential benefits of taking out forward loans to fund the expanding capital programme. This option allows the Council fix the rate now for a period of up to five years in advance. This would support 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. Officers are currently in the process of procuring both legal and technical advisors to assist in this endeavor and will report back to this committee later in the year.

Municipal Bonds Agency

3.24 In a recent note to shareholders, the MBA cited the requirement for a Joint and Several Guarantee (JSG) as the main reason why they have failed to issue any bonds to date and proposed assembling a group of authorities to redesign the bond offer, with the JSG removed. Clearly, dropping the JSG could improve clients' appetite for borrowing via this channel, but conversely may reduce investor appetite to buy bonds which would be reflected in pricing. In current markets it may prove difficult for the yield on MBA bonds and therefore loans to local authorities, to be attractive relative to PWLB in the absence of the guarantee, however this is continually under review.

Investment Activity

3.25 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 2018/19.

	Balance on 1/4/2018	**Investments made**	**Investments repaid**	**Balance on 31/03/2019**	**Average Rate**	**Average Term**
	£m	**£m**	**£m**	**£m**	**%**	**Days**
Fixed term deposits	**105.2**	475.0	519.0	**61.2**	1.0%	142
Money Market Funds and notice deposits	**35.2**	711.0	704.2	**42.0**	0.62%	
TOTAL INVESTMENTS	**140.4**	**1,186.0**	**1,223.2**	**103.2**	**0.85%**	**142**

3.26 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 2018/19 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.

Credit developments and credit risk management

3.27 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 2018/19 treasury strategy was A- across rating agencies Fitch, S&P and Moody's. The Council continues to monitor risks, with advice from Arlingclose.

Liquidity Management

3.28 With changes to the regulatory environment during the year the Council adopted a cautious approach to investments by adopting mainly 3-month lending limit, investments with financial institutions were primarily by means of purchasing 3 month Certificates of Deposit (CDs). Longer maturities with more attractive rates are available 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, larger balances were 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, however this was not required during 2018/19.

Yield

3.29 On the 7 Feb 2019 The Bank of England's monetary policy committee voted unanimously to keep the base rate at 0.75 per cent. The rate has stayed at this level since it was raised from 0.50 per cent in early August last year. Short term money market rates temporarily increased as a result but continue to remain relatively low. This has continued to have a significant impact on investment income. The low rates of return on the Council's short-dated money market investments reflect prevailing market conditions and the Council's objective during 2018/19 of optimising returns commensurate with the principles of security and liquidity.

3.30 The Council's budgeted investment income for the year had been estimated at £1m. The average cash balance during 2018/19 was £121.8m and interest earned was £1.03m, an average return of 0.85%. *(2017/18 – average cash balance of £179m and interest earned was £0.7m or 0.41%)*. The Council has set a higher investment income target for 2019-20 and the Treasury Strategy has been updated accordingly to reflect this.

Update on Investments with Icelandic Banks

3.31 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

3.32 The Council confirms that it has complied with its Prudential Indicators for 2018/19, which were approved by the Council on 26 February 2018 as part of the Council's

Treasury Management Strategy Statement.

3.33 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 2018/19. 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

3.34 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.

3.35 During 2018/19 staff attended training courses, seminars and conferences provided by Arlingclose and CIPFA.

4. Financial Implications

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

5. Legal Implications

5.1 None identified.

6. Diversity Implications

6.1 None identified.

7. Staffing Implications

7.1 None identified.

Related documents:
Treasury Management Strategy Report to Council – 26 February 2018

Report sign off:

MINESH PATEL
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