Public

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DERBYSHIRE COUNTY COUNCIL

CABINET

21 November 2019

Report of the Director of Finance & ICT

TREASURY MANAGEMENT ANNUAL REPORT 2018-19
(CORPORATE SERVICES)

1 Purpose of the Report

To report on Treasury Management activities during the last financial year 2018-19 and to indicate the Council's compliance with the prudential indicators set by Council at its meeting of 7 February 2018, in accordance with the Treasury Management in the Public Services: Code of Practice and Cross-Sectorial Guidance Notes 2017 (the Code).

2 Information and Analysis

(i) Introduction

Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Council to approve a Treasury Management Strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Council's obligation under the CIPFA Code to produce a Treasury Management Annual Report.

The Council's Treasury Management Strategy for 2018-19 was approved by Council on 7 February 2018, as part of the Prudential Code for Capital Finance, Capital Programme Approvals and Treasury Management Strategy Report. The Council has borrowed and invested substantial sums of money and is therefore potentially 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 is therefore central to the Council's Treasury Management Strategy.

(ii) External Context

Economy

Annual UK Gross Domestic Product (GDP) growth was 1.4%, following slower growth of 0.2% in the fourth quarter. The UK Consumer Price Inflation Index (CPI) for March 2019 remained at 1.9% year on year, just below the 2% inflation target. UK labour market data for the three months to March 2019 showed that the unemployment rate fell to a record low of 3.8% and the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3%, with real wages up 1.5%.

The Bank of England's Bank Rate (Base Rate) increased by 0.25% in August 2018 and remained at 0.75% for the remainder of 2018-19.

The original deadline for Britain's European Exit (Brexit) of 29 March 2019, came and went as the Prime Minister's deal was defeated for the third time by a majority of one (313 to 312). To avoid a "no-deal" scenario, an extension was requested from the European Union (EU). The EU agreed to a revised deadline of 31 October 2019.

Sterling depreciated against both the US Dollar and the Euro because of increased uncertainty.

The United States Federal Reserve continued to tighten policy by increasing interest rates throughout 2018, to a maximum policy rate target range of 2.25%-2.50% in December 2018, before a pause and review in March 2019.

The United States continues to be set on a path of protectionist trade policies and tensions with China in particular. The knock on effect of reciprocal tariffs has led the International Monetary Fund to downgrade its forecasts for global economic growth in 2019 and beyond.

Financial markets:
The FTSE 100 fell by 13% in December 2018 but had recovered 10% by 31 March 2019. UK Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. Since October 2018, 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%, respectively. Globally, the US yield curve inverted (10-year Treasury yields were lower than shorter US 3-month money market rates) during March 2019 and German 10-year Bund yields turned negative. The increase in UK Bank Rate pushed up money market 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.

Credit background:
The big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc) transferred their business lines into retail (ring-fenced)

and investment banking (non-ring-fenced) entities.

(iii) Local Context

On 31 March 2019, the Council had net borrowing of £39.961m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.19 Actual £m
General Fund CFR	536.209
Less: *Other debt liabilities	-72.822
Borrowing CFR	**463.387**
Less: Usable reserves	-366.731
Less: Working capital	-56.695
Net borrowing	**39.961**
Borrowing CFR is comprised:	
External borrowing	313.124
Internal borrowing	150.263
	463.387

* finance leases, PFI liabilities and transferred debt that form part of the Council's total debt

The Council's strategy was to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31 March 2019 and the year-on-year change is shown in table 2 below.

Table 2: Treasury Management Summary

	31.3.18 Balance £m	2018-19 Movement £m	31.3.19 Balance £m	31.3.19 Rate %
Long-term borrowing	293.944	-7.320	286.624	4.68
Short-term borrowing	6.000	20.500	26.500	0.78
Total borrowing	**299.944**	**13.180**	**313.124**	**4.30**
Long-term strategic pooled funds	19.697	48.547	68.244	4.45
Long-term investments	39.010	-15.500	23.510	1.32
Short-term investments	165.516	-20.807	144.709	1.16
Cash and cash equivalents	39.650	-2.950	36.700	0.73
Total investments	**263.873**	**9.290**	**273.163**	**1.92**
Net borrowing	**36.071**	**3.890**	**39.961**	

Borrowing Activity

At 31 March 2019, the Council held £313.124m of loans, an increase of £13.180m, as part of its strategy for funding previous and current years' capital programmes. The year-end borrowing position and the year-on-year change is shown in table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	2018-19 Movement £m	31.3.19 Balance £m	31.3.19 Interest Rate %	31.3.19 WAM* Years
Public Works Loan Board	278.944	-7.320	271.624	4.69	17.9
Banks (LOBO)	5.000	0	5.000	4.50	20.4
Banks (fixed-term)	10.000	0	10.000	4.69	23.4
Local authorities (long-term)	0	0	0	N/A	N/A
Local authorities (short-term)	6.000	20.500	26.500	0.78	0.1
Total borrowing	**299.944**	**13.180**	**313.124**	**4.30**	**16.8**

*WAM – Weighted Average Maturity

The 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 being a secondary objective, should the Council's long-term plans change.

In furtherance of these objectives, no new long-term borrowing was undertaken in 2018-19, while £7.320m of existing loans were allowed to mature without replacement. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

The internal borrowing (reserves and working capital) of the Council at 31 March 2019 was £150.263m. If the Council had externally borrowed £150.263m over 18 years, at a rate of 2.29% (the PWLB Certainty Rate for 18 years, the average length of borrowing), the Council would have incurred additional interest of £3.441m. If the Council had invested this sum of £150.263m at 1.92% (the Council's investment return for 2018-19, including pooled funds), then the Council would have received £2.885m of interest. In 2018-19, the Council saved net interest of £0.556m by utilising internal borrowing.

With short-term interest rates remaining much lower than long-term rates, the Council considers it to be more cost effective in the near term to use both internal resources and short-term loans instead. The net movement in short-term loans is shown in table 3 above.

The Council continues to hold £5.000m of LOBO (Lender's Option Borrower's Option) loans, where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the year.

Other Debt Activity

After £2.770m repayment of prior years' Private Finance Initiative contracts, finance leases and transferred debt liabilities, total debt other than borrowing stood at £72.822m on 31 March 2019, taking total debt to £385.946m.

Treasury Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2018-19, the Council's investment balance ranged between £257.294m and £394.793m, because of timing differences between income and expenditure. The year-end investment position and the year-on-year change is shown in table 4 below.

Table 4: Investment Position (Treasury Investments)

	31.3.18 Balance £m	2018-19 Movement £m	31.3.19 Balance £m	31.3.19 Income Return %	31.3.19 Weighted Average Maturity days
Banks and building societies (unsecured)	51.650	4.551	56.201	0.91	91
Government (including local authorities)	172.526	-34.516	138.010	1.16	225
Corporate Bonds	0	10.709	10.709	1.38	323
Registered Social Providers	20.000	-20.000	0	N/A	N/A
Money Market Funds	0	0	0	N/A	N/A
Pooled Funds – Strategic Bond Funds	0	4.865	4.865	3.26	N/A
Pooled Funds – Equity Income Funds	0	14.362	14.362	5.47	N/A
Pooled Funds – Property Funds	9.930	14.176	24.106	4.26	N/A
Pooled Funds – Multi Asset Income Funds	9.767	15.143	24.910	4.30	N/A
Total investments	**263.873**	**9.290**	**273.163**	**1.92**	**201**

Both the CIPFA Code and Government guidance require the Council to invest its funds prudently and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The 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.

In furtherance of these objectives and given the increasing risk and low returns from short-term unsecured bank investments, the Council has further diversified into a combination of either more secure, or higher yielding, asset classes during 2018-19, as shown in table 4 above. Around £50m available for longer-term investment was moved from bank and building society deposits into strategic bond, equity income, property and multi-asset funds.

As a result, investment risk was lowered, while the average rate of income return on investments has increased from 1.03% in 2017-18 to 1.92% in 2018-19.

The progression of credit risk and return metrics for the Council's investments managed in-house are shown in the extracts from the Council's external investment advisor's (Arlingclose) quarterly investment benchmarking in table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2018	4.18	AA-	17%	241	1.03
31.03.2019	4.15	AA-	33%	201	1.92
Similar Local Authorities	4.07	AA-	55%	692	1.56
All Local Authorities	4.20	AA-	55%	29	1.45

At 31 March 2019, the Council's portfolio of externally managed pooled strategic bond, equity income, property and multi-asset funds amounted to £68.243m. The Council holds these funds with the aim of receiving regular revenue income and because over the long-term their prices are relatively stable. During 2018-19 these funds generated a net return of £1.583m (2.32%), comprising a £2.982m (4.37%) income return, which has been used to support services in 2018-19 and a £1.399m (-2.05%) unrealised capital loss.

These funds have no defined maturity date but are available for withdrawal after a notice period. Their performance and continued suitability in meeting the Council's investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down over months, quarters and even years; but with the confidence that over a three to five-year period total returns will exceed cash interest rates. In light of their performance over the medium-term and the Council's latest cash flow forecasts, investment in these funds has been increased during 2018-19 (see table 4).

In respect of planning for Britain's exit from the European Union, with little clarity as to whether there would be an agreed deal prior to leaving, the Council has ensured that there were enough funds available at either UK-domiciled banks or in Money Market Funds to provide sufficient liquidity, particularly around the expected departure date of 29 March 2019. The Council also ensured that its account with the Debt Management Account Deposit Facility (DMADF) remained available for use in an emergency.

The Council's borrowing decisions are not predicated on any one outcome for interest rates. The Council maintained a balanced portfolio of short and long-term borrowing throughout 2018-19.

Other Non-Treasury Holdings and Activity

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in the Ministry of Housing, Communities and Local Government's (MHCLG) Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return. This includes service investments for operational and/or regeneration, as well as commercial investments which are made mainly for financial reasons.

At 31 March 2019, the Council held £7.908m of investments in loans to local businesses and subsidiaries:

- loans to subsidiaries - £0.500m - Derbyshire Developments Ltd;
- regeneration loan - £7.408m - Buxton Crescent & Thermal Spa Co Ltd.

This represents an increase of £5.763m on the previous year because of further investment in Buxton Crescent & Thermal Spa Co Limited.

These investments generated £0.312m of investment income for the Council, after taking account of direct costs, representing a rate of return of 6.20%.

Treasury Performance

The Council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below. Investment benchmarking is performed quarterly and debt benchmarking is performed annually.

Table 6: Performance

	Actual £m	Budget (CFR) £m	Over/ (Under) £m	Interest Actual %	Interest Other LA Benchmark %	Interest Over/ (Under) %
Borrowing	14.909	23.253	(8.344)	4.30	3.65	0.65
Investments	5.309	5.000	0.309	1.92	1.40	0.52

The Council's average interest rate on borrowing is higher than the Other Local Authority Benchmark because of the Council's longstanding pre-financial crisis debt; the Council has a higher average interest payable than other local authorities who have borrowed at the lower prevailing interest rates since then.

The Council achieved its 2018-19 investment strategy of achieving returns higher than the Other Local Authority Benchmark by 31 March 2019.

Compliance Report

The Director of Finance & ICT reports that all treasury management activities undertaken during 2018-19 complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below and compliance with specific investment limits is demonstrated in table 8 below.

Table 7: Debt Limits

	2018-19 Maximum £m	31 March 2019 Actual £m	2018-19 Operational Boundary £m	2018-19 Authorised Limit £m	Complied
Total debt	425.707	386.117	600.000	628.000	✓

Table 8: Investment Limits

	2018-19 Maximum £m	**2018-19 Limit £m**	**March 2019 Actual £m**	**Complied**
Any single organisation, except UK Central Government (+£30m Lloyds (Main Bank))	59.482	60.000	25.653	✓
Any group of organisations under the same ownership (Money Market Funds - Individual)	30.000	30.000	0.000	✓
Any group of pooled funds under the same management (CCLA)	30.000	30.000	29.454	✓
Negotiable instruments held in a broker's nominee account	10.709	100.000	10.709	✓
Foreign countries	0.016	50.000	0.000	✓
Registered providers	15.000	50.000	0.000	✓
Unsecured investments with Building Societies	1.000	100.000	0.000	✓
Money Market Funds – Total	95.000	200.000	0.000	✓
Non Treasury Investments (loans to unrated bodies)	7.908	50.000	7.908	✓
Non-Specified investments (Local Authority Loans > 365 days, Strategic Pooled Funds & Non-Treasury Loans)	133.634	150.000	129.289	✓

Treasury Management Indicators

The Council measures and manages its exposure to treasury management risks using the following indicators.

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31 March 2019 Actual	2018-19 Target	Complied
Portfolio average credit rating	AA-	A-	✓

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available within a rolling three-month period and additional borrowing secured without giving prior notice.

	31 March 2019 Actual £m	2018-19 Target £m	Complied
Total cash available within 3 months	66.694	30.000	✓
Total sum borrowed in past 3 months without prior notice	82.750	30.000	✓

Interest Rate Exposures: This indicator is set to control the Council’s exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed were:

	31.3.19 Actual	2018-19 Limit	Complied
Upper limit on fixed interest rate exposure	92	100	✓
Upper limit on variable interest rate exposure	8	40	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year, or the transaction date if later. All other instruments are classed as variable rate.

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	31 March 2019 Actual %	Upper Limit %	Lower Limit %	Complied
Under 12 months	13	40	0	✓
12 - 24 months	1	20	0	✓
24 months - 5 years	4	20	0	✓
5 - 10 years	12	20	0	✓
10 - 20 years	32	40	10	✓
20 - 30 years	28	40	10	✓
Over 30 years	9	40	0	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 365 days: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	Beyond 31 March 2020 £m	Beyond 31 March 2021 £m	Beyond 31 March 2022 £m
Actual principal invested beyond the year end	99.789	76.279	76.279
Limit on principal invested beyond the year end	150	125	100
Complied	✓	✓	✓

3 Considerations

In preparing this report the relevance of the following factors has been considered:- financial, legal, prevention of crime and disorder, equality and diversity, human resources, environmental, health, property, transport and social value considerations.

4 Background Papers

Treasury Management Strategy 2018-19.

Papers held in Technical Section, Finance & ICT Division, Room 137.

5 Key Decision

No.

6 Is it necessary to waive the call-in period?

No.

7 Officer's Recommendation

That Cabinet notes the Treasury Management Annual Report 2018-19 and notes the Council's compliance with the prudential indicators set by Council for 2018-19, in accordance with the terms of the Treasury Management in the Public Services: Code of Practice and Cross-Sectorial Guidance Notes 2017.

PETER HANDFORD

Director of Finance & ICT