REPORT to :	Audit and Governance Committee
LEAD OFFICER:	Director of Finance and Customer Services
DATE:	24th July 2018

WARD/S AFFECTED: All

Treasury Management Annual Report 2017/18

1. PURPOSE

1.1 To formally report the Treasury outturn for 2017/18, as also reflected in the 2017/18 Outturn Corporate Monitoring Report (5 July Executive Board).

2. RECOMMENDATIONS

2.1 Audit and Governance Committee is recommended to note the Outturn position for 2017-18.

3. BACKGROUND

3.1 In February 2017 the Council agreed a Treasury Management Strategy and Minimum Revenue Provision (MRP) Policy for 2017/18.

3.2 The CIPFA Treasury Management Code requires the Council to approve a Treasury Management Strategy (including various Treasury Management indicators) before the start of each financial year, and to consider the outturn after each year end. This report is to update Audit and Governance Committee on the overall outturn position for 2017/18.

4. KEY ISSUES AND RISKS

4.1 Treasury Priorities

The Council has operated within CIPFA and statutory guidance and requirements in respect of Treasury Management practice. The approved Treasury Management Policy Statement, together with the more detailed Treasury Management Practices and each year's Annual Strategy have all emphasised the importance of security and liquidity over yield.

5. 2017/18 OUTTURN

5.1 Original Strategy for 2017/18

5.1.1 The Strategy for 2017/18 was approved by Council on 26th February 2017. The main aspects of the strategy are outlined below :

- With short-term interest rates expected to continue to be lower than long-term rates it was acknowledged, for another year, that it may continue to be more cost effective not to borrow and instead reduce the level of investments.

- Long-term borrowing would be taken if it became apparent that there was a risk of significantly increased interest rates.

- Any balances over and above those required to maintain basic liquidity could be invested either in the medium term (out to a year) or the longer term (over a year), though it was recognised that long term investment was unlikely. Priority was given to security of funds and liquidity (accessibility) over yield (or return).

- The limits to investment by reference to amount, duration and credit rating were largely unchanged from those applying in previous years

5.2 Economic Review 2017/18

5.2.1 The year was characterised by continued uncertainty and volatility in various markets, with expectations of reduced Quantitative Easing and higher interest rates being only partially fulfilled. The UK economy showed signs of slowing, but still delivered growth in 2017 at around the same level as in 2016, partly as a result of international growth momentum generated by a more buoyant US economy, and a recovery in parts of the Eurozone.

5.2.2 Reflecting the fall in sterling following the EU referendum result, rising import prices pushed UK inflation to a CPI peak of 3.1% in November 2017, with inflation then starting to ease more recently. Though unemployment levels were low, real average earnings growth was negative before again starting to recover in 2018. Political uncertainty over the terms of Brexit helped keep UK business investment levels low.

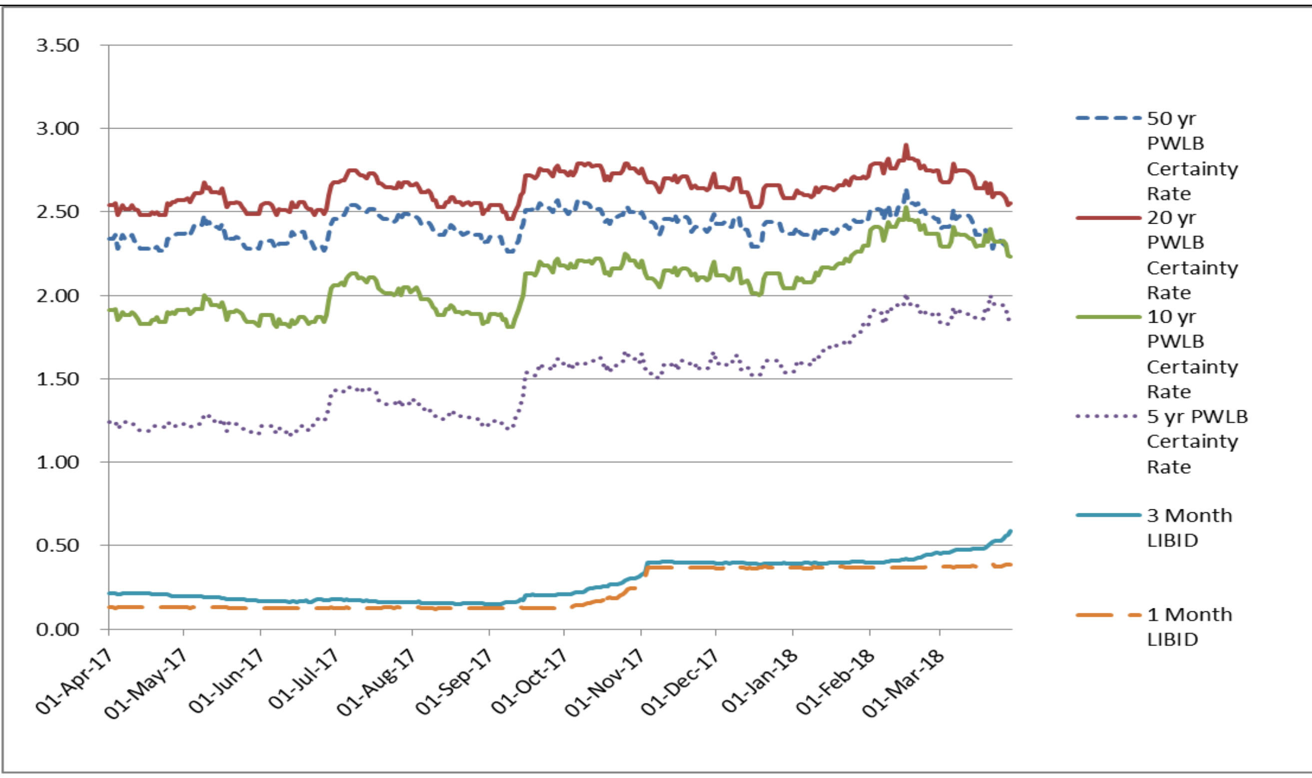
5.2.3 The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 0.25% in November, the first rate hike in ten years, though in essence only a reversal of the August 2016 cut following the referendum result. The MPC made it clear that it was keen to return inflation to the 2% target, with gradual and limited policy tightening over the next 18-24 months, and the March minutes suggested that an increase in May 2018 was highly likely. The increase in Bank Rate resulted in higher money market rates.

5.2.4 By contrast, economic activity in the Eurozone gained momentum, though the European Central Bank remained some way off normalising interest rates. The US economy grew steadily, and the Federal Reserve increased interest rates in December 2017 and in March 2018, with further increases expected in 2018.

5.2.5 Gilt yields – reflecting the cost of UK government borrowing – were volatile, but shorter term borrowing (out to 10 years) was more expensive by the end of the year.

The pattern of interest rates over the year is summarised in the chart below. Local government long term borrowing costs are set by the Public Works Loans Board (PWLB) - these directly mirror gilt yields. Nominal investment rates, measured through the London Inter-Bank Bid Rate (LIBID), are also shown.

Interest Rate Movements in 2017/18 -



5.3 Treasury Management Performance 2017/18

5.3.1 By 31st March 2018, the Council had net borrowing of over £176 M, arising from its revenue and capital income and expenditure, up £14.5 M from the previous year.

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 the table below.

Balance Sheet Summary	31 March 2017 £M	2017/18 Movement £M	31 March 2018 £M
General Fund CFR	301.7	-1.8	299.9
Less CFR re Debt -			
managed by Lancashire County Council (LCC)	-16.3	0.3	-16.0
re Private Finance Initiative (PFI) arrangements	-70.0	0.1	-69.9
Loans/Borrowing CFR	**215.4**	**-1.5**	**214.0**
Less Usable Reserves	-49.4	8.4	-41.0
Less Working Capital	-3.9	7.5	3.6
Net Borrowing	**162.1**	**14.5**	**176.6**

The overall increase in **net borrowing** was because of a decline in both usable reserves and in working capital, with the opportunity taken to pay three years of Local Government Pension deficit lump sum in April 2017 (which will lead to net budget savings) being the main factor in the latter.

Under the Council's new Minimum Revenue Provision (MRP) Policy, adopted in 2016/17,

(a) the MRP charge to the accounts in respect of both PFI debt and debt managed by LCC has been less than the actual debt repaid, and

(b) the MRP charge to the accounts in respect of the Council's own capital spend financed from borrowing has been reduced.

This has resulted in the Council's CFR being higher than it otherwise would have been, and will increase borrowing interest costs in the short run.

5.3.2 The following table summarises debt and investments at the start and end of the year:

	31 Mar 2017 Principal (£ M)	Rate / Return	Avg Life (Yrs)	31 Mar 2018 Principal (£ M)	Rate / Return	Avg Life (Yrs)
Fixed rate funding:						
Public Works Loans Board	105.3	4.18%	23.5	104.5	4.20%	22.7
Market Debt (Long Term)	10.3	4.47%	37.7	10.3	4.47%	36.7
Market Debt (Short Term)	57.0	0.40%		85.0	0.57%	
	172.6			**199.8**		
Variable rate funding:						
Public Works Loans Board	0.0			0.0		
Market	11.5	5.38%	17.0	10.5	5.24%	17.5
	13.5			**10.5**		
Loans taken by Blackburn with Darwen Borough Council	**184.1**	**4.32%**	**24.0**	**210.3**	**4.30%**	**23.4**

Debt from PFI arrangements	68.6			66.8		
Debt managed by LCC	16.0	2.1%		15.4	2.0%	
Total debt	**268.7**			**292.5**		

Total investments	**22.2**	**0.31%**		**33.7**	**0.52%**	

No new long term borrowing was taken in 2017/18. The key changes to the Council's overall debt position across the year were:

a) An increase in the level of short term borrowing, from £57M to £85M,
b) Repayment of a £1M money market loan,
c) Principal repayments on PWLB (Public Works Loans Board) debt:
£0.8M on EIP (Equal Instalment of Principal) loans,
d) Repayments of part of the outstanding PFI debt recognised on the balance sheet for Building Schools for the Future (BSF), and of debt managed by LCC.

No debt rescheduling was undertaken, because the premiums payable on early repayment of PWLB debt made it uneconomic to do so.

Short term loans were taken for a range of durations at various points across the year. Investments continued to be maintained to ensure sufficient resources to cover day to day cash flow needs, and would be higher when the timing of short term loans taken was not aligned to the immediate cash flow requirements of the Council.

Overall investment balances were significantly lower than they would have been if long term borrowing had been taken to cover the Council's CFR position, and the degree to which long term debt was less than CFR remained around the same, at around £88M.

The deliberate strategy of taking short term loans continued to reduce the interest earned on balances, but delivered large savings on borrowing costs.

5.3.3 In summary, the outturn position in respect of interest costs and income, and MRP charges, was as follows:

Outturn 2016/17 £'000		Original Budget 2017/18 £'000	Outturn 2017/18 £'000
5,917	Interest paid on borrowing	5,866	5,716
289	Interest paid on debt managed by LCC	303	315
6,460	PFI interest paid	6,411	6,420
(214)	Interest receipts	(135)	(247)
4,985	MRP on Council borrowing	5,585	5,734
130	MRP – PFI debt	141	141
340	MRP – debt managed by LCC	340	340

5.3.4 Interest paid on borrowing in 2017/18 was around £0.1M less than the Original Estimate, which had allowed for higher levels of borrowing. As already noted, there was no new long term borrowing taken in the year. Included in the interest paid was that on short term borrowing – the element relating to short term debt went up from around £124,000 to around £278,000.

PFI interest charges did not add to the "bottom line" faced by the Council Taxpayer, as grants covered their cost.

5.3.5 The average investment balance over the year was up, at £28M (£20M in 2016/17). Balances were lowest at the start of the year, in mid-summer, and early March (see **Appendix 1**). In turn, overall interest earned was up a little to £0.25M in 2017/18 (£0.21M in 2016/17). The most significant component was the dividend and interest income from the Council's BSF PFI holding, at £0.16M (£0.14M in 2016/17). Interest earned on treasury cash investments increased a little, from £67 k to £77 k, but the average rate of return fell to 0.25% (against 0.3% in 2016/17).

Interest rates have been low for several years, and the rates available from the limited range of institutions used by the Council remained low across 2017/18. Funds have continued to be invested for short periods, and sometimes with the government's Debt Management Office, to manage risk – this also contributed to the low returns.

5.3.6 The impact of the revised MRP Policy introduced in 2016/17 can be seen in the continuing lower MRP costs in 2017/18, which, at £6.2M, were still around £4M lower than they would have been under the previous policy. The final MRP costs at outturn were around £0.15M higher than originally anticipated, due to lower than forecast capital receipts.

5.3.7 The position with regard to performance against Treasury/Prudential Indicators in 2017/18 is summarised in **Appendix 2**. There were no breaches of the Borrowing Limits. At the Mid-Year Strategy Review, approved by Council 5th October 2017, changes were made to the Treasury Indicators for the Maturity Structure of Borrowing, and for the Upper Limit on Variable Interest Rate Exposure, to accommodate the ongoing and increasing high level of Short term Borrowing. Outturn capital spend was £19M, down on the £21M forecast.

<u>5.4 Treasury Management Consultancy</u>

5.4.1 The Council is contracted up to 31st March 2020 to receive treasury management support from Arlingclose Limited. They provide advice and information on the Council's investment and borrowing activities, although responsibility for final decision making remains with the Council and its officers.

5.4.2 Over the period, in providing support to the Council, Arlingclose have reviewed the Council's Treasury management procedures and activities. They have provided member training; ongoing officer training; support for and review of treasury decisions, reports and strategies; feedback on accounting for treasury activities; benchmarking with other authorities; guidance on borrowing and investment opportunities; forecasts of interest rates; and regular updates on credit ratings and other information on credit quality. The quality of the support provided has been of a high standard.

5.5 Counterparty Update

5.6.1 For most of the year, UK bank credit default swaps were low, after falling in the first quarter after confirmation that the Funding for Lending Scheme (giving banks access to cheaper funding) was being extended. UK bank ring-fencing - the process of splitting banks into core retail and investment components - began and will continue through to the end of 2018. This has generated some uncertainty for credit rating agencies over the credit-worthiness of the new entities.

5.6.2 The new EU regulations for Money Market Funds (MMFs) were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility Net Asset Value (LVNAV) Money Market Funds, which will continue to operate much like the funds currently used by the Council. Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure.

5.6.3 Moody's joined Fitch and Standard and Poor's in downgrading the UK sovereign credit rating. Otherwise, there was a mixed pattern, with some upward changes to outlooks or ratings, reflecting improved resilience and progress in meeting tighter regulatory requirements, and some negative outlooks or reviews, often reflecting ring-fencing uncertainty.

5.6.4 The changes in credit-rating assessments had little impact on the Council's lending, other than on lending to the Royal Bank of Scotland (RBS). In March Arlingclose advised removing them from the counterparty list, not because of a change in the bank's actual credit-worthiness but to reflect tighter criteria. RBS are the Council's current account bankers, so Treasury Management Group has determined to minimise the council's investment balances with RBS, subject to day to day operational practicalities.

6.5 Risk Management

6.5.1 The Council's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds before seeking the best rate of return. The majority of its surplus cash is therefore held as short-term investments with the UK Government, highly rated banks and pooled funds. In addition, the Council holds some investments that entail a slightly higher level of risk, including unrated building society deposits (where risks have been mitigated by limiting the amount and duration of exposure).

6.5.2 The Council's primary objective for the management of its debt is to ensure its long-term affordability. The largest part of its loans is from the Public Works Loan Board at long-term fixed rates of interest.

6.5.3 A combination of short duration investments and long duration debt exposes the Council to the risk of falling investment income during periods of low interest rates. However, the risk of low investment returns is viewed as of lower priority compared to the benefits of optimising the security and liquidity of investments, and the savings made on borrowing costs. Also, though the Council has no long term investments, it is hedged against the investment return risk by its short term debt.

6.5.4 The rapidly expanding part of the debt portfolio - of around £85M in short term loans from other local authorities - does raise new issues. If the medium to long term cost of debt were to move upwards, it may be necessary to restructure the Council's debt quickly, and cope with an increased cost of borrowing. This issue is kept under review, with regular updates from Arlingclose.

7. FINANCIAL IMPLICATIONS

The financial implications arising from the 2017/18 Treasury Outturn have been incorporated into Corporate Budget Monitoring Reports.

8. LEGAL IMPLICATIONS

8.1 Under the Local Government Act 2003, local authorities determine locally their levels of capital investment and associated borrowing. The Prudential Code has been developed to support local authorities in taking these decisions, and the Council is required by Regulation to have regard to the Code when carrying out its duties under Part 1 of the Local Government Act 2003.

8.2 The Department for Communities and Local Government issued Guidance on Local Government Investments, under the Local Government Act 2003, effective from 1st April 2010. Authorities must manage their investments within an approved strategy, setting out what categories of investment they will use and how they will assess and manage the risk of loss of investments.

9. POLICY IMPLICATIONS, RESOURCE IMPLICATIONS, CONSULTATIONS

None

10. STATEMENT OF COMPLIANCE

The recommendations are made further to advice from the Monitoring Officer and the Section 151 Officer has confirmed that they do not incur unlawful expenditure. They are also compliant with equality legislation and an equality analysis and impact assessment has been considered. The recommendations reflect the core principles of good governance set out in the Council's Code of Corporate Governance.

VERSION:	**0.02**

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DATE:	11th July 2018
BACKGROUND PAPER:	Treasury Management strategy for 2017/18 approved at Council 27th February 2017 and reviewed by Council 5th October 2017.