Annual Treasury Outturn Report 2017/18

1. Purpose

1.1. Hampshire Fire and Rescue Authority adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes approving an annual report on treasury management activity after the end of each financial year.

2. Summary

2.1. This report fulfils the Fire and Rescue Authority's legal obligation to have regard to the CIPFA Code.

2.2. The Fire and Rescue Authority's treasury management strategy for 2017/18 was approved at a meeting of Hampshire Fire and Rescue Authority in February 2017. The Fire and Rescue Authority has borrowed and invested sums of money and 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 therefore central to the Fire and Rescue Authority's treasury management strategy.

2.3. Treasury management in the context of this report is defined as:

"The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2.4. This annual report sets out the performance of the treasury management function during 2017/18, to include the effects of the decisions taken and the transactions executed in the past year.

2.5. Overall responsibility for treasury management remains with the Fire and Rescue Authority. No treasury management activity is without risk; the effective identification and management of risk are integral to the Fire and Rescue Authority's treasury management objectives.

2.6. All treasury activity has complied with the Fire and Rescue Authority's Treasury Management Strategy and Investment Strategy for 2017/18, and all relevant statute, guidance and accounting standards. In addition the Fire and Rescue Authority's treasury advisers, Arlingclose, provide support in undertaking treasury management activities. The Fire and Rescue Authority has also complied with all of the prudential indicators set in its Treasury Management Strategy.

3. External Context

3.1. The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions were made in 2017/18.

Economic Commentary

3.2. The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in 2017, the same level as in 2016. This was a far better outcome than the majority of forecasts following the EU Referendum in June 2016, but it also reflected the international growth momentum generated by the increasingly buoyant US economy and the re-emergence of the Eurozone economies.

3.3. The inflationary impact of rising import prices, a consequence of the fall in Sterling associated with the EU referendum result, resulted in year-on-year CPI rising to 3.1% in November before falling back to 2.7% in February 2018. Consumers felt the squeeze as real average earnings growth, i.e. after inflation, turned negative before slowly recovering. The labour market showed resilience as the unemployment rate fell back to 4.2% in March 2018. The inherent weakness in UK business investment was not helped by political uncertainty following the surprise General Election in June 2017 and by the lack of clarity on Brexit. The Withdrawal Treaty is yet to be ratified by the UK Parliament and those of the other 27 EU member states and new international trading arrangements are yet to be negotiated and agreed.

3.4. The Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate by 0.25% in November 2017. This action was significant as this was the first rate increase in ten years, although in essence the MPC 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 month) horizon with 'gradual' and 'limited' policy tightening. Although in March two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates, the minutes of the meeting suggested that an increase in May 2018 was highly likely, however at the meeting in May 2018 the MPC again voted by a majority of 7-2 to maintain Bank Rate at 0.5%.

Credit Background

3.5. 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. As there was some uncertainty surrounding which banking entities the Fire and Rescue Authority would be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would look like, 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.

3.6. Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non ring-fenced bank.

3.7. In March 2018, following Arlingclose's advice, the Fire and Rescue Authority removed RBS plc and National Westminster Bank from its counterparty list for unsecured investments. This did not reflect any change to the creditworthiness of either bank, but a tightening in Arlingclose's recommended minimum credit rating criteria to A- from BBB+ for 2018/19. The current long-term ratings of RBS and NatWest do not meet this minimum criterion, although if following ring-fencing NatWest is upgraded, the bank would be reinstated on the Fire and Rescue Authority's unsecured lending list.

Local Authority Regulatory Changes

3.8. CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The 2017 Prudential Code introduces the requirement for a Capital Strategy which provides a high-level overview of the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for future financial sustainability. Where this strategy is produced and approved by Hampshire Fire and Rescue Authority, the determination of the Treasury Management Strategy can be delegated to a committee. The Code also expands on the process and governance issues of capital expenditure and investment decisions. The Fire and Rescue Authority will be preparing the Capital Strategy in line with the 2019/20 budget setting process.

3.9. In the 2017 Treasury Management Code the definition of 'investments' has been widened to include financial assets as well as non-financial assets held primarily for financial returns such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be discussed in the Capital Strategy or Investment Strategy. Additional risks of such investments are to be set out clearly and the impact on financial sustainability is be identified and reported.

MiFID II

3.10. As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could "opt up" to professional client status, providing certain criteria were met which include having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority having at least one year's relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that the person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

3.11. The Fire and Rescue Authority has met the conditions to opt up to professional status and has done so in order to maintain its previous MiFID status prior to January 2018. The Fire and Rescue Authority will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

4. Local Context

4.1. At 31 March 2018 the Fire and Rescue Authority's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £11.7m, while usable reserves and working capital which are the underlying resources available for investment were £25.7m (principal invested plus gains on investments with a variable net asset value). These factors and the year-on-year change are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m
CFR	(12.2)	0.5	(11.7)
Less: Resources for investment	27.1	(1.0)	26.1
Net investments	14.9	(0.5)	14.4

4.2. CFR has reduced due to MRP as all 2017/18 capital expenditure was funded without new borrowing. The Fire and Rescue Authority's strategy was to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, in order to reduce risk and keep interest costs low. Internal borrowing has caused a reduction in resources for investment, which has resulted in a small decrease in net investments reported at 31 March 2018.

4.3. The treasury management position as at 31 March 2018 and the year-on-year change is shown in Table 2 below.

Table 2: Treasury Management Summary

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %
Long-term borrowing	(8.4)	-	(8.4)	4.71
Short-term borrowing	-	-	-	-
Total borrowing	(8.4)	-	(8.4)	4.71
Long-term investments	11.5	(5.0)	6.5	2.79
Short-term investments	10.4	5.1	15.5	0.64
Cash and cash equivalents	4.7	(1.0)	3.7	0.44
Total investments	26.7	(1.0)	25.7	1.16
Net investments	18.3	(1.0)	17.3	

Note: the figures in the table above are from the balance sheet in the Fire and Rescue Authority's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

4.4. The Fire & Rescue Authority's internal borrowing policy is the reason for the large variance between the positions shown in Tables 1 and 2. The use of internal borrowing shown in Table 1 has translated into a reduction in investment balances in Table 2. As there has been no change in total borrowing, this has resulted in a reduction in net investments in Table 2.

5. Borrowing Activity

5.1. At 31 March 2018 the Fire and Rescue Authority held £8.35m of loans as part of its strategy for funding previous years' capital programmes. The year-end treasury management borrowing position and year-on-year change is shown in Table 3 below.

Table 3: Borrowing Position

	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %	31/03/18 WAM* years
Public Works Loan Board	8.4	-	8.4	4.71	11.65
Total borrowing	8.4	-	8.4	4.71	11.65

* Weighted average maturity

Note: the figures in the table above are from the balance sheet in the Fire and Rescue Authority's statement of accounts, but adjusted to exclude borrowing taken out on behalf of others, and accrued interest.

5.2. The Fire and Rescue Authority'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 should the Fire and Rescue Authority's long-term plans change being a secondary objective.

5.3. Affordability and the "cost of carry" remained important influences on the Fire and Rescue Authority's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained and are likely to remain at least over the forthcoming two years, lower than long-term rates, the Fire and Rescue Authority determined it was more cost effective in the short-term to use internal resources instead of taking out new borrowing. This strategy enables the Fire and Rescue Authority to reduce net borrowing costs (despite forgone investment income) and reduce overall treasury risk.

5.4. The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Fire and Rescue Authority with the monitoring of internal and external borrowing.

6. Investment Activity

6.1. The Fire and Rescue Authority holds invested funds representing income received in advance of expenditure plus balances and reserves held. During 2017/18 the Fire and Rescue Authority's investment balances have ranged between £21.1 and £37.1 million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change are shown in Table 4 below.

Table 4: Investment Position (Treasury Investments)

Investments	31/03/17 Balance £m	Movement £m	31/03/18 Balance £m	31/03/18 Rate %	31/03/18 WAM* years
Short term investments					
- Banks and Building Societies					
- Unsecured	4.48	(2.37)	2.11	0.57	0.14
- Secured	0.42	6.58	7.00	0.89	0.53
- Money Market Funds	4.25	(1.19)	3.06	0.45	0.00
- Local Authorities	6.00	1.00	7.00	0.39	0.31
	15.15	4.02	19.17	0.60	0.33
Long term investments					
- Banks and Building Societies					
- Secured	8.00	(5.00)	3.00	0.82	1.72
	8.00	(5.00)	3.00	0.82	1.72
High yield investments					
- Pooled Property Funds**	2.00	-	2.00	4.53	n/a
- Pooled Equity Funds**	1.50	-	1.50	4.43	n/a
	3.50	-	3.50	4.49	n/a
TOTAL INVESTMENTS	26.65	(0.98)	25.67	1.16	0.51

* Weighted average maturity

** The rates provided for pooled fund investments are reflective of the average of the most recent dividend return as at 31 March 2018.

Note: the figures in the table above are from the balance sheet in the Fire and Rescue Authority's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

6.2. Both the CIPFA Code and the government guidance require the Fire and Rescue Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Fire and Rescue Authority'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.

6.3. In furtherance of these objectives, and given the increasing risk and low returns from short-term unsecured bank investments, the Fire and Rescue Authority further diversified into more secure and higher yielding asset classes during 2017/18. For example, the proportion of investments to liquid funds (i.e. invested in money market funds and unsecured call accounts) was reduced and instead invested in secure short-term investments with higher rates of return (such as secured bonds and local authorities). During the year the proportion of funds invested in long-term investments was reduced to enable the reduction in cash balances that was forecast in the treasury management strategy. Although cash balances have not reduced in the significant manner forecast, this reduction is still forecast to happen going forwards. In addition, while long term investments have reduced proportionately, the high yield portfolio has remained.

6.4. Security of capital has remained the Fire and Rescue Authority's main investment objective. This has been maintained by following the Fire and Rescue Authority's counterparty policy as set out in its Treasury Management Strategy Statement for 2017/18.

6.5. Counterparty credit quality was assessed and monitored with reference to credit ratings, for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

6.6. The Fire and Rescue Authority will also consider the use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

6.7. The Fire and Rescue Authority maintained a sufficient level of liquidity through the use of call accounts and money market funds. The Fire and Rescue Authority sought to optimise returns commensurate with its objectivity of security and liquidity. The UK Bank Rate increased by 0.25% to 0.50% in November 2017 and short-term money market rates have remained at relatively low levels which continued to have a significant impact on cash investment income.

6.8. The progression of credit risk and return metrics for the Fire and Rescue Authority's investments managed in-house (excluding external pooled funds) are shown in the extracts from Arlingclose's investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking (investments managed in-house)

	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	AA	37%	247	0.60%
31.03.2018	AA	23%	187	0.63%
Police & Fire Authorities	AA-	55%	90	0.50%
All LAs	AA-	55%	35	0.63%

* Weighted average maturity

6.9. The Fire and Rescue Authority has targeted a proportion of funds towards high yielding investments as shown in Table 4. Investments yielding higher returns will contribute additional income to the Fire and Rescue Service, although some come with the risk that they may suffer falls in the value of the principal invested.

6.10. The £3.5m portfolio of externally managed pooled equity and property funds generated an average total return of 6.2%, comprising 5.0% income return used to support services in year, and 1.2% of capital growth. As these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Fire and Rescue Authority's investment objectives are regularly reviewed.

6.11. The investments in pooled funds allow the Fire and Rescue Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. The funds are operated on a variable net asset value (VNAV) basis offers diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short term. All of the Fire and Rescue Authority's pooled fund investments are in the respective fund's distributing share classes which pay out the income generated.

6.12. Although money can be redeemed from pooled funds at short notice, the Fire and Rescue Authority's intention is to hold then for at least the medium-term. Their performance and suitability in meeting the Fire and Rescue Authority's investment objectives are monitored regularly and discussed with Arlingclose.

7. Financial Implications

7.1. The outturn for debt interest paid in 2017/18 was £393,000 on an average debt portfolio of £8.35m, against a budgeted £393,000 on an average debt portfolio of £8.35m.

7.2. The outturn for investment income received in 2017/18 was £316,000 on an average investment portfolio of £29.1m, therefore giving a yield of 1.09%, against a budgeted £248,000. In comparison to 2016/17 investment income received was £367,000 on an average investment portfolio of £34.9m, therefore giving a yield of 1.05%.

8. Other Non-Treasury Holdings and Activity

8.1. Although not classed as treasury management activities the Fire & Rescue Authority may also make loans and investments for service purposes, for example the direct purchase of land or property. Such loans and investments will be subject to the Fire & Rescue Authority's normal approval processes for revenue and capital expenditure and need not comply with this treasury management strategy. The Fire & Rescue Authority does not have any existing non-treasury investments.

9. Compliance Report

9.1. The Fire and Rescue Authority confirms compliance of all treasury management activities undertaken during 2017/18 with the CIPFA Code of Practice and the Fire and Rescue Authority's approved Treasury Management Strategy. Compliance with specific investment limits, as well as the authorised limit and operational boundary for external debt, is demonstrated in Tables 6 and 7 below.

Table 6: Debt Limits

	2017/18 Maximum £m	31/03/18 Actual £m	2017/18 Operational Boundary £m	2017/18 Authorised Limit £m	Complied
Borrowing	9.4	8.4	14.3	16.9	✓
Total debt	9.4	8.4	14.3	16.9	✓

Table 7: Investment Limits

	2017/18 Maximum	31/03/18 Actual	2017/18 Limit	Complied
Any single organisation, except the UK Central Government	£2.5m	£2m	£5m	✓
Any group of organisations under the same ownership	£2.5m	£2m	£5m	✓
Any group of pooled funds under the same management	£5m	£2m	£5m	✓
Registered providers	£0m	£0m	£6m	✓
Money market funds	47%	12%	50%	✓

10. Treasury Management Indicators

10.1. The Fire and Rescue Authority measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

10.2. This indicator is set to control the Fire and Rescue Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed will be:

Table 8 – Interest Rate Exposures

	31/03/18 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate investment exposure	£0m	£15m	✓
Upper limit on variable interest rate investment exposure	£25.7m	£50m	✓
Upper limit on fixed interest rate borrowing exposure	£8.9m	£17.1m	✓
Upper limit on variable interest rate borrowing exposure	£0m	£17.1m	✓

10.3. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing

10.4. This indicator is set to control the Fire and Rescue Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 9 – Maturity Structure of Borrowing

	31/03/18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	0%	50%	0%	✓
12 months and within 24 months	1%	50%	0%	✓
24 months and within 5 years	28%	50%	0%	✓
5 years and within 10 years	10%	75%	0%	✓
10 years and within 20 years	61%	75%	0%	✓
20 years and above	0%	100%	0%	✓

Principal Sums Invested for Periods Longer than 364 days

10.5. The purpose of this indicator is to control the Fire and Rescue Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

Table 10 – Principal Sums Invested for Periods Longer than 364 days

	2017/18	2018/19	2019/20
Actual principal invested beyond year end	£6.5m	£4.5m	£3.5m
Limit on principal invested beyond year end	£15m	£15m	£15m
Complied	✓	✓	✓