HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Audit Committee
Date:	23 May 2019
Title:	Annual Treasury Outturn Report 2018/19
Report From:	Deputy Chief Executive and Director of Corporate Resources

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Purpose of the report

1. The County Council has adopted the key recommendations of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code), last updated in 2017. The CIPFA Code requires the County Council to approve a treasury management strategy before the start of the year and a semi-annual and annual treasury outturn report.

Recommendation

2. The Audit Committee are asked to note the following recommendations being reported to Cabinet and Full Council:

3. That the outturn review of treasury management activities be noted.

Executive Summary

4. The report fulfils the County Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

5. The County Council's treasury management strategy was most recently updated and approved at a meeting of Full Council in February 2019. The County Council 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 County Council's treasury management strategy.

6. 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.”

7. This annual report sets out the performance of the treasury management function during 2018/19, to include the effects of the decisions taken and the transactions executed in the past year.

8. Overall responsibility for treasury management remains with the County Council. No treasury management activity is without risk and the effective identification and management of risk are integral to the County Council’s treasury management objectives.

9. All treasury activity has complied with the County Council’s Treasury Management Strategy and Investment Strategy for 2018/19, and all relevant statute, guidance and accounting standards. In addition, support in undertaking treasury management activities has been provided by the County Council’s treasury advisers, Arlingclose. The County Council has also complied with all the prudential indicators set in its Treasury Management Strategy.

10. The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The County Council’s Capital and Investment Strategy, complying with CIPFA’s requirement, was approved by full Council on 14 February 2019.

External Context

11. The following sections outline the current key economic themes against which investment and borrowing decisions were made in 2018/19:

Economic commentary

12. UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year/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%.

13. 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.

14. While the domestic focus has been on Brexit's potential impact on the UK economy, which has weighed on sterling and UK markets, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

Financial markets

15. Markets for riskier asset classes fell in December 2018, most notably for equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE 100 and FTSE All share indices were both around 10% higher than at the end of 2018.

16. 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.

Credit background

17. Credit Default Swap (CDS) spreads drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms. After hitting around 129 basis points in December 2018, the spread on non-ringfenced bank NatWest Markets plc fell back to around 96bps at the end of March, while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 33 and 79bps at the end of the period.

18. The ringfencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds,

HSBC and RBS/NatWest Bank plc) transferred their business lines into retail (ringfenced) and investment banking (non-ringfenced) entities.

19. In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty, following this move with the same treatment for UK banks and a number of government-related entities.

20. There were minimal other credit rating changes during the period. Moody's revised the outlook on Santander UK to positive from stable to reflect the bank's expected issuance plans which will provide additional protection for the its senior unsecured debt and deposits.

Local Context

21. At 31 March 2019, the County Council's underlying need to borrow for capital purposes was £780.9m as measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment and amounted to £589.5m (principal invested plus gains on investments with a variable net asset value). These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary	**31/3/18 Balance £m**	**Movement £m**	**31/03/19 Balance £m**
CFR	(764.0)	(16.9)	(780.9)
Less: Other debt liabilities*	164.2	(7.2)	157.0
Borrowing CFR	(599.8)	(24.1)	(623.9)
Less: resources for investment	570.7	18.8	589.5
Net borrowing	(29.1)	(5.3)	(34.4)

* PFI liabilities that form part of the County Council's total debt

22. The CFR increased by £24.1m during 2018/19 as a result of the County Council's capital programme, however this increase was largely offset by an increase in cash balances of £18.8m, resulting in an increase in net borrowing of £5.3m.

23. The County Council's strategy was to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, to reduce risk and keep interest costs low. The treasury management position at 31 March 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary	31/3/18 Balance £m	Movement £m	31/3/19 Balance £m	31/3/19 Rate %
Long-term borrowing Short-term borrowing	(280.0) (7.8)	8.7 (1.3)	(271.3) (9.1)	4.6 4.2
Total borrowing	**(287.8)**	**7.4**	**(280.4)**	**4.6**
Long-term investments Short-term investments Cash and cash equivalents	289.3 240.5 32.4	53.0 (56.5) 23.9	342.3 184.0 56.3	3.3 1.2 0.8
Total investments	**562.2**	**20.4**	**582.6**	**2.4**
Net investments	**274.4**	**27.8**	**302.2**	

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

24. The County Council's internal borrowing policy is the reason for the large variance between the positions shown in Tables 1 and 2. The movement that has taken place during 2018/19 in net borrowing shown in Table 1 has translated into a rise in investment balances as shown in Table 2.

Borrowing Activity

25. At 31 March 2019 the County Council held £280.4m of loans (a decrease of £7.4m from 31 March 2018) as part of its strategy for funding previous years' capital programmes. The year-end treasury management borrowing position and year-on-year change are summarised in Table 3 below.

Table 3: Borrowing Position	31/3/18 Balance £m	Net Movement £m	31/3/19 Balance £m	31/3/19 Weighted Average Rate %	31/3/19 Weighted Average Maturity (years)
Public Works Loan Board	243.4	(7.8)	235.6	4.70	11.9
Banks (LOBO)	20.0	0.0	20.0	4.76	14.3
Other (fixed term)	24.4	0.4	24.8	3.46	16.4
Total borrowing	**287.8**	**(7.4)**	**280.4**	**4.60**	**12.5**

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

26. The County 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. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

27. Short-term interest rates have remained much lower than long-term rates and the County Council has therefore considered it to be more cost effective in the near term to use internal resources than to use additional borrowing.

28. With the assistance of Arlingclose, the benefits of this internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years, when long-term borrowing costs may be higher.

29. As a result, new borrowing was kept to a minimum during 2018/19 (£0.4m) and was taken out to fund energy efficiency initiatives. These Salix loans will incur no interest whilst also enabling the County Council to make future cost savings against revenue energy budgets.

30. £7.8m of existing PWLB loans were allowed to mature without replacement. This strategy enabled the County Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

31. The County Council continues to hold £20.0m 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 County Council has the option to either accept the new rate or to repay the loan at no additional cost. None of the LOBO loan options were exercised by the lender in the year.

Treasury Investment Activity

32. The County Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Councils's investment balances ranged between £562m and £672m due to timing differences between income and expenditure. The investment position is shown in Table 4 below.

Table 4: Treasury Investment Position	**31/03/2018 Balance £m**	**Net Movement £m**	**31/03/2019 Balance £m**	**31/3/19 Income Return %**	**31/3/19 Weighted Average Maturity years**
Short term investments					
- Banks and Building Societies:					
- Unsecured	11.7	18.7	30.4	0.93	0.28
- Secured	55.0	(40.0)	15.0	1.34	0.31
- Money Market Funds	25.7	29.6	55.3	0.79	0.00
- Local Authorities	160.5	(36.0)	124.5	1.12	0.41
- Corporate Bonds	-	-	-	-	-
- Registered Provider	20.0	(15.0)	5.0	3.40	0.08
- Cash Plus funds	-	10.0	10.0	1.50	n/a
Total	**272.9**	**(32.7)**	**240.2**	**1.10**	**0.27**
Long term investments					
- Banks and Building Societies:					
- Secured	78.3	(5.0)	73.3	1.31	2.16
- Local Authorities	61.0	17.0	78.0	1.36	2.23
Total	**139.3**	**12.0**	**151.3**	**1.33**	**2.20**
Long term investments – high yielding strategy					
- Local Authorities					
- Fixed deposits	20.0	-	20.0	3.96	14.97
- Fixed bonds	10.0	-	10.0	4.20	14.77
- Pooled Funds					
- Pooled property**	55.0	12.0	67.0	4.35	n/a
- Pooled equity**	40.0	12.0	52.0	5.78	n/a
- Pooled multi-asset**	20.0	22.0	42.0	5.38	n/a
- Registered provider	5.0	(5.0)	0.0	-	-
Total	**150.0**	**41.0**	**191.0**	**4.92**	**14.91**
Total investments	**562.2**	**20.3**	**582.5**	**2.41**	**2.00**

** The rates provided for pooled fund investments are reflective of the average of the most recent dividend return as at 31 March 2019.

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

33. The CIPFA Code and government guidance both require the County 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 County Council's objective when investing money is therefore to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults against the risk of receiving unsuitably low investment income.

34. Security of capital has remained the County Council's main investment objective and has been maintained by following the County Council's counterparty policy as set out in the Treasury Management Strategy Statement.

35. Counterparty credit quality has been assessed and monitored with reference to credit ratings, the analysis of funding structures and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

36. The County Council also makes use of secured investment products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

37. To reduce risk, approximately 79% of the County Council's surplus cash is invested so that it is not subject to bail-in risk, as it is invested in local authorities, registered providers, secured bank bonds, and pooled property, equity and multi-asset funds. The remaining balance is largely held in overnight money market funds and cash plus funds, which are subject to reduced bail in risk. By comparison, only 55% of the cash held by other similar Local Authorities is not subject to bail-in risk.

38. To ensure sufficient liquidity, the County Council has made use of call accounts and money market funds. With the uncertainty around Brexit, the Council also ensured there were enough accounts open at UK domiciled banks and Money Market Funds to hold sufficient liquidity over the year end and that its account with the Debt Management Account Deposit Facility (DMADF) remained available for use in an emergency.

39. The UK Bank Rate increased marginally by 0.25% in August 2018 to 0.75% and with short-term money market rates also remaining relatively low, there has been an ongoing impact on the Council's ability to generate income on cash investments. The rate of return achieved on the County Council's internally managed funds was 1.35% in the year to 31 March 2019, broadly

the same as for the previous year.

40. The progression of risk and return metrics for the County Council's investments that are managed in-house (excluding external pooled funds) are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking (excluding pooled funds)	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2018	AA	8%	735	1.36%
31.03.2019	AA	21%	758	1.35%
Similar LAs	AA-	55%	692	1.02%
All LAs	AA-	55%	29	0.85%

41. As part of the 2017/18 Investment Strategy the total amount targeted towards higher yielding investments was increased to £200m, further increased to £235m as part of the Treasury Management Strategy Statement agreed in February 2019. Of the £235m available, £191m had been invested at 31 March 2019, an increase of £41m since 31 March 2018.

42. The £171m portfolio of externally managed funds generated an average total return of 5.92% in the year to 31 March 2019, comprising 4.78% income return, which is used to support services in year, and 1.14% of capital growth.

43. The high yielding strategy overall generated an average income return of 4.92% (£8.0m), contributing to an average return for the investment portfolio in aggregate of 2.09% at 31 March 2019. By comparison, the average income return for all other investments was 1.03% (£4.9m).

44. £161m of the externally managed portfolio is invested in strategic multi-asset, equity and property funds which are more volatile in the short-term but which generate regular revenue income alongside providing diversification and the potential for enhanced returns over the longer term.

45. Although money can usually be redeemed from these pooled funds at short notice, the County Council's intention is to hold them for at least the medium-term. Investments are made in the knowledge that capital values will move both up and down in the short term, but with the confidence that over a three- to five- year period total returns should exceed cash interest rates. The performance and ongoing suitability of these pooled funds in meeting the County Council's investment objectives is monitored regularly and discussed with Arlingclose.

Financial Implications

46. The outturn for debt interest paid in 2018/19 was £13.6m against a budgeted £13.8m on an average debt portfolio of £284.2m.

47. The outturn for investment income received in 2018/19 was £12.9m on an average investment portfolio of £618m, giving a yield of 2.09%. By comparison, investment income received in 2017/18 was £11.2m on an average portfolio of £602m with a yield of 1.86%.

Non-Treasury Investments

48. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the County Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

49. This could include loans made to Hampshire based businesses or the direct purchase of land or property and such loans and investments will be subject to the County Council's normal approval process for revenue and capital expenditure and need not comply with the treasury management strategy.

50. The County Council's existing non-treasury investments are listed in Table 6 below.

Table 6 – Non-Treasury Investments	31/03/19 Asset value £m	31/03/19 Rate %
Loans to Hampshire based business	4.5	4.00
Total	4.5	4.00

51. These investments generated £0.135m of investment income for the County Council in 2018/19.

Compliance Report

52. The County Council confirms compliance of all treasury management activities undertaken during 2018/19 with the CIPFA Code of Practice and the County Council's approved Treasury Management Strategy.

53. Compliance with the authorised limit and operational boundary for external debt, is demonstrated in Table 7 below.

Table 7 – Debt Limits	**2018/19 Maximum**	**31/03/19 Actual**	**2018/19 Operational Boundary**	**2018/19 Authorised Limit**	**Complied?**
Borrowing	288	281	650	700	✓
PFI and Finance Leases	164	157	170	210	✓
Total debt	**452**	**438**	**820**	**910**	✓

Treasury Management Indicators

54. The County Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

55. The following indicator shows the sensitivity of the County Council's current investments and borrowing to a change in interest rates.

Table 8 – Interest Rate Exposures	**31/03/19 Actual**	**Impact of +/-1% interest rate change**
Variable interest rate investment exposure	£311m	+/- £3.1m
Variable interest rate borrowing exposure	£23m	+/- £0.2m

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

56. This indicator is set to control the County Council's exposure to refinancing risk. The upper and lower limits show the maximum and minimum maturity exposure to fixed rate borrowing as agreed in the Treasury Management Strategy Statement.

Table 9 – Maturity Structure of Borrowing	31/03/19 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	3.3%	50%	0%	✓
12 months and within 24 months	4.8%	50%	0%	✓
24 months and within 5 years	8.8%	50%	0%	✓
5 years and within 10 years	18.9%	75%	0%	✓
10 years and within 20 years	53.5%	75%	0%	✓
20 years and within 30 years	10.7%	75%	0%	✓
30 years and above	0.0%	100%	0%	✓

57. The County Council holds £20m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the County Council has the option to either accept the new rate or to repay the loan at no additional cost. If not repaid before maturity, these loans have an average maturity date of 14 years (minimum 8 years; maximum 26 years).

Principal Sums Invested for Periods Longer than 364 days

58. The purpose of this indicator is to control the County 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:

Table 10 – Principal Sums Invested Beyond Year End	2018/19	2019/20	2020/21
Actual principal invested beyond year end	£342m	£264m	£236m
Limit on principal invested beyond year end	£375m	£410m	£350m
Complied?	✓	✓	✓

REQUIRED CORPORATE AND LEGAL INFORMATION:

Links to the Strategic Plan

This proposal does not link to the Strategic Plan but, nevertheless, requires a decision because it relates to the effective management of the County Council's cash balances.

Other Significant Links

Links to previous Member decisions:	
Title	Date
Treasury Management Strategy Statement (as presented to the Audit Committee)	21 February 2019

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

Document	Location
None	

EQUALITIES IMPACT ASSESSMENT:

1. Equality Duty

   The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

   - Eliminate discrimination, harassment and victimisation and any other conduct prohibited by or under the Act with regard to the protected characteristics as set out in section 4 of the Act (age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation);
   - Advance equality of opportunity between persons who share a relevant protected characteristic within section 149(7) of the Act (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, sex and sexual orientation) and those who do not share it;
   - Foster good relations between persons who share a relevant protected characteristic within section 149(7) of the Act (see above) and persons who do not share it.

   Due regard in this context involves having due regard in particular to:

   - The need to remove or minimise disadvantages suffered by persons sharing a relevant protected characteristic that are connected to that characteristic;
   - Take steps to meet the needs of persons sharing a relevant protected characteristic that are different from the needs of persons who do not share it;
   - Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity in which participation by such persons is disproportionally low.

2. Equalities Impact Assessment:

Equalities objectives are not expected to be adversely impacted by the proposals in this report.