This report will be made public on 9 July 2019

Folkestone & Hythe District Council

Report Number **C/19/10**

To:	**Cabinet**
Date:	**17 July 2019**
Status:	**Non-Key Decision**
Head of Service:	**Charlotte Spendley – Assistant Director Finance, Customer & Support Services**
Cabinet Member:	**Councillor David Monk, Leader**
SUBJECT:	**TREASURY MANAGEMENT ANNUAL REPORT 2018/19**

SUMMARY: This report reviews the council's treasury management activities for 2018/19, including the actual treasury management indicators. The report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

REASONS FOR RECOMMENDATION:
Cabinet is asked to agree the recommendations set out below because:-

a) Both CIPFA's Code of Practice on Treasury Management in the Public Services and their Prudential Code for Capital Finance in Local Authorities, together with the Council's Financial Procedure Rules, require that an annual report on treasury management is received by the Council after the close of the financial year.

RECOMMENDATION:

1. To receive and note Report C/19/10.

1. INTRODUCTION

1.1 The annual treasury report is a requirement of the council's reporting procedures. It covers the treasury activity for 2018/19 compared to the approved strategy for the year. It also summarises the actual treasury management indicators for 2018/19 compared to those approved for the year.

1.2 The report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

1.3 Full Council approved the Treasury Management Strategy for 2018/19 on 28 February 2018 (report A/17/22 refers). On 17 October 2018 Cabinet received an update on the council's treasury management activities and projections against the approved treasury management indicators for 2018/19 (report C/18/34 refers).

1.4 The council's formal treasury management reporting arrangements comply with the requirements of the CIPFA's Treasury Management Code and also provide the opportunity for proper scrutiny of its treasury management activities.

2. ECONOMIC COMMENTARY

(Based on commentary supplied by Arlingclose Ltd, the council's Treasury Advisor)

2.1 Economic Background

2.1.1 The key issues affecting the UK economy over the past year are summarised below.

i) **Growth** - UK Gross Domestic Product (GDP) grew by 1.4% over the year, down from 1.8% for the previous year. This was viewed as being lower than anticipated and due, in part, to the continued uncertainty regarding the country's exit from the European Union.

ii) **Inflation** – Consumer Price Inflation (CPI) fell during the year to an annual rate of 1.9% at March 2019. In part this was due to the falling out of sterling's depreciation which began in 2016. Oil prices peaked at $85 a barrel in October then fell sharply to about $50 a barrel by late December before rising towards $70 by the end of March highlighting the volatility it has on the economy.

iii) **Wages and Employment** – The labour market continued to show resilience with unemployment falling to a new low of just 3.9% by the end of March 2019 and employment at a record high of 76.1%. Real average earnings, after inflation and excluding bonuses, were up at 1.4% providing some limited pressure on inflation.

iv) **Bank Base Rate** – In August 2018 the Monetary Policy Committee (MPC) increased the Base Rate by 0.25% to 0.75% broadly due to inflationary concerns, and it remained unchanged for the rest of the financial year.

v) **Eurozone & US** – The Eurozone started to lose traction with signs of a significant slowdown in Germany and France's manufacturing sectors affecting growth prospects. Wider economic uncertainty has been caused by the US protectionist trade policy, particularly in its relationship with China, threatening to spill over and affect the EU too. As expected, the Fed continued to tighten its economic policy leading to US interest rates increasing over the past year to a range between 2.25% - 2.5%. However more recent sluggish economic data from the US means there is growing pressure to begin to reduce interest rates again.

2.2 Financial Markets

2.2.1 The increase in Bank Rate resulted in higher money markets rates: 1-month, 3-month and 12-month LIBID rates averaged 0.53%, 0.67% and 0.94% and at 31st March 2019 were 0.61%, 0.72% and 0.94% respectively.

2.2.2 Gilt yields, which regulate borrowing rates through the Public Works Loan Board (PWLB), displayed significant volatility over the twelve-month period due to the ongoing economic and political uncertainty in the UK and Europe in particular. 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%. In summary, despite the volatility during the year, gilt yields were broadly at similar levels at the end of financial year as they were at the start of it.

2.2.3 The equities market as measured by the FTSE 100 also experienced notable volatility during the past year falling from a high of 7,776 in August to a low of 6,584 in December before rallying to 7,279 at the end of March 2019.

2.3 Credit Background

2.3.1 The ringfencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc) saw them transfer their business lines into retail (ringfenced) and investment banking (non-ringfenced) entities. Any unsecured deposits the council make with these banks will be with the investment banking side.

2.3.2 In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty. Following this move the same treatment was applied to UK banks and a number of government-related entities.

2.3.3 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.

3. TREASURY POSITION AT 31 MARCH 2019

3.1 On 31 March 2019, the council had net borrowing of £14.2m arising from its revenue and capital income and expenditure, a decrease on 2018 of £6.3m. 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 and the year-on-year change are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.18 Actual £m	**2018/19 Movement £m**	**31.3.19 Actual £m**
General Fund CFR	18.1	2.3	20.4
HRA CFR	47.4	-	47.4
Total CFR	**65.5**	**2.3**	**67.8**
Less: Usable reserves	(41.0)	(10.2)	(51.2)
Less: Working capital	(4.0)	1.6	(2.4)
Net borrowing	**20.5**	**(6.3)**	**14.2**

3.2 Net borrowing decreased mainly due to an increase in usable reserves resulting from delays to the HRA capital programme in particular. This increased the balances to for the HRA General Reserve and the Major Repairs Reserve.

3.3 The council's current strategy is 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 in show in table 2 below.

Table 2: Treasury Management Summary

	31.3.18 Balance £m	2018/19 Movement £m	31.3.19 Balance £m
Long-term borrowing Short-term borrowing	55.9 1.9	(1.1) (0.3)	54.8 1.6
Total borrowing	**57.8**	**(1.4)**	**56.4**
Long-term investments Short-term investments Cash and cash equivalents	(13.9) (19.8) (3.6)	(5.1) 9.8 (9.6)	(19.0) (10.0) (13.2)
Total investments	**(37.3)**	**(4.9)**	**(42.2)**
Net borrowing	**20.5**	**(6.3)**	**14.2**

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

3.4 The decrease in net borrowing was mainly due to the reprofiling of the authority's capital expenditure programme between 2018/19 and 2019/20. As the table above shows, there was a net movement in investment funds to long-term investments. In broad terms this reflected the decision to invest £10m in multi-asset pooled funds, partly offset by existing investments being reclassified to short-term as at 31 March 2019. This is covered in more detail in section 5 of this report. There was also a change between short-term investments, held for a period of up to 12 months, to the more liquid asset category of cash and cash equivalents. This was to provide cash to meet planned capital expenditure for the acquisition of the Connect 38 building in the early part of 2019/20.

4. BORROWING ACTIVITY 2018/19

4.1 At 31 March 2019, the council held £56.4m of loans, a reduction of £1.4m on the previous year, as part of its strategy for funding previous years' capital programmes. Following the introduction of the Housing Revenue Account (HRA) Self-Financing regime in 2012 the council operates a two pool debt approach allocating its loans between the General Fund and HRA. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position – Two Pool Debt Approach

	31.3.18 Balance £m	2018/19 Movement £m	31.3.19 Balance £m	31.3.19 Rate %
<u>General Fund</u> Public Works Loan Board	7.7	(0.5)	7.2	4.76%
Local authorities (short-term)	0.5	-	0.5	0.95%
Total General Fund borrowing	8.2	(0.5)	7.7	4.52%
<u>Housing Revenue Account</u> Public Works Loan Board	49.6	(0.9)	48.7	3.24%
Total HRA borrowing	49.6	(0.9)	48.7	3.24%
Total borrowing	**57.8**	**(1.4)**	**56.4**	**3.42%**

4.2 The weighted average maturity of the overall loans portfolio at 31 March 2019 is 13.2 years.

4.3 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 should the authority's long-term plans change being a secondary objective.

4.4 In furtherance of these objectives no new long term borrowing was undertaken in 2018/19, while existing loans were allowed to mature without replacement. The council's CFR exceeded its gross borrowing position by £11.4m at 31 March 2019, i.e. it used internal borrowing from its cash surpluses to meet this difference. This strategy enabled the council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

4.5 The "cost of carry" analysis performed by the council's treasury management advisor Arlingclose did not indicate any value in borrowing in advance for future years' planned expenditure and therefore none was taken.

4.6 **Debt Rescheduling** – Opportunities to undertake debt rescheduling were monitored throughout the year in conjunction with Arlingclose. However, as expected, PWLB interest rates did not reach a level where it would have been beneficial to undertake debt rescheduling to create a net saving in borrowing costs.

4.7 Temporary Borrowing

4.7.1 The council can borrow temporarily at times to meet cash outflows not covered by receipts and to finance capital expenditure which will ultimately be met from long term loans or grant receipts due. During 2018/19 £500,000 of temporary short-term borrowing was taken up in a series of call notice loans from Folkestone Town Council. These remained in place at 31 March 2019.

5. INVESTMENT ACTIVITY 2018/19

5.1 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 £36.0 and £57.5 million due to timing differences between income and expenditure. The council had an average investment balance of £46.8m during 2018/19 generating a return, net of fees, of 1.56% over the year. The year-end investment position and the year-on-year change are shown in table 4 below. A list of the individual investments held at 31 March 2019 is shown in appendix 1 to this report

Table 4: Investment Position

	31.3.18 Balance £m	2018/19 Movement £m	31.3.19 Balance £m
Banks & building societies (unsecured)	-	-	-
Covered bonds (secured)	7.3	(3.8)	3.5
Government (incl. local authorities)	21.0	(11.0)	10.0
Money Market Funds	3.6	9.6	13.2
Property Pooled Funds	5.4	0.1	5.5
Multi-Asset Income Funds	0.0	10.0	10.0
Total investments	**37.3**	**4.9**	**42.2**

5.2 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 investments before seeking the highest 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.

5.3 These objectives were been met during the year demonstrated in particular with the council's decision to invest £10m of its forecast long term cash balances in four different multi-asset income funds, covered in more detail in the Treasury Management Monitoring Report considered by Cabinet on 17 October 2018. These are pooled investment funds operated by professional fund managers who invest in a diversified range of good quality financial instruments and are seen as long term investments with a typical minimum duration of 3 years to obtain the maximum financial benefit from them. One of the key aims of these investments is to help mitigate the risk of capital erosion of the authority's cash reserves and balances.

5.4 The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 5 below.

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

	Credit Score	**Credit Rating**	**Bail-in Exposure**	**WAM (days)**	**Income Return**
FHDC					
31.03.2018	3.25	AA-	12%	189	0.86%
31.03.2019	**4.34**	**AA-**	**49%**	**75**	**0.85%**
Similar LAs	**4.13**	**AA-**	**53%**	**86**	**0.86%**
All LAs	**4.20**	**AA-**	**55%**	**29**	**0.85%**

5.5 The investment benchmarking, which is a snapshot at the end of each quarter and only covers in-house managed investments, demonstrates the council had a similar risk and return profile as both its peer group and the wider local authority population in 2018/19 (measured against other Arlingclose clients only).

5.6 As shown in table 4 above, £15.5m of the council's investments are held in externally managed pooled multi-asset and property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated a total return of £537k (5.14%), comprising a £462k (4.42%) income return which is used to support services in year, and £75k (0.72%) of unrealised capital growth. Notably, the council's investment in the CCLA Local Authorities' Property Fund has seen its capital value increase by £84k over the past year and by £515k since the original investment was made.

5.7 Because the pooled 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 is regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three to five-year period total returns will exceed cash interest rates.

6. FINANCIAL SUMMARY

6.1 The following table summarises the council's net interest cost for its treasury management activities in 2018/19 and shows the outturn is significantly lower than the approved estimate, subject to audit:

Table 6: Net Interest Cost

	2017/18 Actual	2018/19 Estimate	**2018/19 Actual**	**2018/19 Variance Estimate to Actual**
	£'000	£'000	**£'000**	**£'000**
Interest Paid	*2,110*	1,961	**1,959**	**(2)**
Interest Received(net of fees)	*(478)*	(502)	**(730)**	**(228)**
Net Interest	*1,632*	1,459	**1,229**	**(230)**
<u>Net Impact</u>				
General Fund	*44*	(63)	**(287)**	**(224)**
H.R.A	*1,588*	1,522	**1,516**	**(6)**
	1,632	1,459	**1,229**	**(230)**

6.2 The main reasons for the reduction in the net interest cost are due to additional interest received from higher than anticipated usable reserves and other cash balances being invested during the year (£50k) and the benefit from improved investment returns (£180k). The improved investment returns include the enhanced yields received from multi-asset income funds. This position has previously been reported to Cabinet as part of the authority's regular budget monitoring process.

7. OTHER NON-TREASURY HOLDINGS AND ACTIVITY

7.1 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 it 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. The assets are summarised in the table below and the valuations at 31 March 2019 are subject to audit:

Table 7: Non-Treasury Holdings and Returns

Investment Type	Value 31/03/18 £m	Value 31/03/19 £m	Income 2018/19 £'000	Rate of Return %
Investment Property				
Agricultural Land	5.5	27.2	66	0.24
Commercial Land	1.1	1.1	-	-
Commercial Units	1.4	1.4	99	6.92
Residential Units	-	1.9	-	-
Assets Under Construction	-	0.2	-	-
Total Investment Property	**8.0**	**31.8**	**165**	**0.52**
Subsidiary Company				
Oportunitas loan	3.1	3.5	168	4.84
Oportunitas equity	0.5	1.3	0	0
Total Subsidiary	**3.6**	**4.8**	**168**	**3.52**
Total	**11.6**	**36.6**	**333**	**0.91**

7.2 Ordinarily the rate of return on non-treasury investment assets would be expected to be higher than that earned on treasury investments reflecting the additional risks to the council of holding such investments. This is demonstrated with the return on the commercial units and Oportunitas. However the return on the investment property portfolio for 2018/19 is significantly distorted because of the land acquisition taking place for the Otterpool Park project in particular. The council anticipates receiving rental streams from some of the property being acquired in the short to medium term.

7.3 Notably, the agricultural land at Otterpool benefitted from a significant increase in value of £21.9m, from £5m to £26.9m to reflect its current market value for housing development. This unrealised gain in value for the site is seen as a highly encouraging indicator for the council's involvement in the proposed development of the Otterpool Park Garden Town.

8. COMPLIANCE WITH INVESTMENT LIMITS AND TREASURY INDICATORS

8.1 The Corporate Director for Customer, Support and Specialist Services is pleased to report 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 specific investment and Treasury Indicators is demonstrated in appendix 2 to this report.

9. LEGAL/FINANCIAL AND OTHER CONTROLS/POLICY MATTERS

9.1 Legal Officer's Comments (NE)

There are no significant legal implications as a result of the recommendations in this report which are not covered in the body of the report. Compliance with the CIPFA Code of Practice for Treasury Management in the Public Services and the CIPFA Prudential Code for Capital Finance in Local Authorities issued under the Local Government Act 2003 provides assurance that the council's investments are, and will continue to be, within its legal powers.

9.2 Finance Officer's Comments (LW)

This report has been prepared by Financial Services and relevant financial implications are included within it.

9.3 Diversities and Equalities Implications

The report does not cover a new service or policy or a revision of either and therefore does not require an Equality Impact Assessment.

10. CONTACT OFFICER AND BACKGROUND DOCUMENTS

Councillors with any questions arising out of this report should contact the following officer prior to the meeting:

Lee Walker, Group Accountant (Capital and Treasury Management)
Telephone: 01303 853593 Email: lee.walker@folkestone-hythe.gov.uk

The following background documents have been relied upon in the preparation of this report:

Arlingclose Ltd – Model Treasury Management Annual Report Template

Appendices:

Appendix 1 – Investments held at 31 March 2019

Appendix 2 – Compliance with specific investment and borrowing limits and Treasury Indicators

APPENDIX 1 – INVESTMENTS HELD AT 31 MARCH 2019

Counterparty	Amount £	Terms	Yield or Interest Rate %
Covered Bonds (Secured)			
Royal Bank of Scotland	1,001,740	Covered floating rate note to 15/05/2020	1.10
Royal Bank of Scotland	2,505,563	Covered floating rate note to 15/05/2020	1.05
Government			
London Borough of Croydon	5,000,000	2 year fixed deposit to 31/05/2019	0.80
Surrey County Council	5,000,000	6 month fixed deposit to 15/05/2019	0.95
Money Market Funds			
Aberdeen Standard MMF	5,000,000	No notice instant access	0.78
Federated MMF	5,000,000	No notice instant access	0.78
Legal and General MMF	3,172,000	No notice instant access	0.74
Other Pooled Funds			
Property Funds			
CCLA Property Fund	5,517,771		4.36*
Multi-Asset Income Funds			
CCLA Diversified Income Fund	1,972,257		3.02
UBS Multi-Asset Income Fund	984,901		4.29
Kames Diversified Monthly Income Fund	3,515,015		4.35
Investec Diversified Income Fund	3,519,577		3.33
Total Investments	**42,188,824**		

* Net of Fees

APPENDIX 2 – COMPLIANCE WITH SPECIFIC INVESTMENT AND TREASURY INDICATORS

Compliance with specific investment limits is demonstrated in table 1 below.

Table 1: Specific Investment Limits

	2018/19 Maximum	**31.3.19 Actual**	**2018/19 Limit**	**Complied**
Any single UK organisation, except UK Government	£5m	£5m	£5m	✓
Any single non-UK organisation	-	-	£5m	✓
Individual foreign countries	-	-	£5m	✓
Any group of funds under the same management - UK	£7.5m	£7.5m	£10m	✓
Registered Providers (total)	-	-	£10m	✓
Unsecured investments in Building Societies (total)	-	-	£5m	✓
Loans to unrated Corporates (total)	-	-	£5m	✓
Money Market Funds (total)	£25.0m	£13.2m	£25m	✓
Non-specified investments (total)	£19.0m	£19.0m	£38m	✓

Treasury Management Indicators

The council measures and manages its exposures 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.

	31.3.19 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 to meet unexpected payments within a rolling three-month period, without additional borrowing
.

	31.3.19 Actual	2018/19 Target	Complied
Total cash available within 3 months	£23.2m	£5m	✓

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 amount of net principal borrowed is shown in table 3 below:

Table 3: Interest Rate Exposures

	31.3.19 Actual	2018/19 Limit	Complied
Upper limit on fixed interest rate exposure	£54.8m	£66m	✓
Upper limit on variable interest rate exposure	(£40.6m)	£0m	✓

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. Compliance with the upper and lower limits on the maturity structure of fixed rate borrowing is shown in table 4 below:

Table 4: Maturity Structure of Borrowing

	31.3.19 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	2.0%	30%	0%	✓
12 months and within 24 months	2.3%	40%	0%	✓
24 months and within 5 years	18.5%	50%	0%	✓
5 years and within 10 years	35.8%	80%	0%	✓
10 years to 20 years	17.9%	100%	0%	✓
20 years to 30 years	11.0%	100%	0%	✓
30 years to 40 years	12.5%	100%	0%	✓
40 years to 50 Years	0%	100%	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 364 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. Compliance with the limits on the long-term principal sum invested to final maturities beyond the period end is shown in table 5 below:

Table 5: Principal Sums Invested for Periods Longer than 364 days

At 31.3.19	**2018/19**	**2019/20**	**2020/21**
Actual principal invested for longer than 364 days	£3.5m	-	-
Limit on principal invested beyond 364 days	£23m	£18m	£13m
Complied	✓	✓	✓

Although the council's investments in the pooled funds of £15.5m are accounted for as non-current (long term) assets, based on the intention to continue to hold them for longer than 12 months, they do not have a fixed maturity date and can be redeemed within a short notice period if required so do not feature in this indicator.