CYNGOR SIR *POWYS* COUNTY COUNCIL

AUDIT COMMITTEE
6th July 2018

CABINET
10th July 2018

REPORT BY:	**Cllr. Aled Davies** **Portfolio Holder for Finance**
SUBJECT:	**Treasury Management Review 2017/18**

REPORT FOR:	**Approval**

1. Introduction:

1.1 The Council's Treasury Management Policy, as per the CIPFA Code of Practice, requires an annual report on Treasury Management activity to be approved by Cabinet by 30th September each year.

1.2 Treasury Management in this context is defined as:
"The management of the authority's 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. The Council's Overall Borrowing Need:

2.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represent's the current year's unfinanced capital expenditure and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

2.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through external borrowing or utilising temporary cash resources within the Council.

3. Strategy for 2017/18:

3.1 At the start of 2017/18 the Authority had an estimated Capital Financing Requirement of £326.5m, projected to rise by £72.5m during the course of the following four years to £399.0m. The Authority's external borrowing at 1st April 2017 stood at £251.4m. In relation to the CFR figure of £307.5m, this equated to the Authority being under borrowed by £56.1m.

3.2 The expectation for interest rates within the strategy for 2017/18 anticipated that Bank Rate would not start rising from 0.25% until Qtr 2 of 2019 and then only increase once more before 31st March 2020. There would also be gradual rises in medium and longer-term fixed borrowing rates during 2017/18 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty promoted a cautious approach whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates. In this scenario, the strategy was to postpone borrowing to avoid the cost of holding higher levels of investments.

The actual movement in gilt yields meant that longer term PWLB rates were volatile but with little overall direction whereas shorter term PWLB rates were on a rising trend during the second half of the year.

3.3 The Capital Programme for 2017/18 incorporated £28.2m of prudential borrowing at start of year so there was the possibility the Authority would need to externally borrow during the year. The agreed strategy for this at the start of the year, based on interest rate forecasts and discussions with Link (the Authority's advisors), was to set a benchmark of 1.40% for 5 year borrowing, 2.10% for 10 year borrowing, 2.70% for 25 year borrowing and 2.50% for 50 year borrowing. This was revised several times during the year before ending at 1.90% for 5 year borrowing, 2.50% for 10 year borrowing, 2.80% for 25 year borrowing and 2.60% for 50 year borrowing.

3.4 In light of the continuing stress on the world banking system, enhanced priority was given to the security and liquidity of investments.

The strategy for investments therefore was:

a) to ensure the security of the Authority's funds
b) to ensure the Authority had sufficient liquidity to meet its cashflow requirements
c) to achieve the optimum yield after ensuring a) and b) above.

4. Treasury Position:

4.1 The major issue for Treasury Management in 2017/18, alongside reducing cash balances, was the continuing challenging environment of previous years i.e. low investment returns and continuing counterparty risk which meant giving heightened preference to security and liquidity of investments. This resulted in the investment portfolio being in short-term investment instruments with lower rates of return but higher security and liquidity.

4.2 In order to balance the impact of the loss in investment income the Authority was mindful of the possibility of making premature repayments of debt if circumstances were conducive to this.

Net borrowing increased by £28.451M in the year. This increase arose as follows:

	£000s
Decrease in PWLB debt	(19)
Increase/Decrease in LOBO debt	Nil
Increase/Decrease in Market debt	20,000
Decrease in Temporary Borrowing	(20,000)
Decrease in Investments	28,470
	28,451

4.3 The table below summarises the borrowing and investment transactions during the year:

	Balance 01-04-17	**Borrowing**	**Investments**	**Repayments**	**Balance 31-03-18**
	£000's	**£000's**	**£000's**	**£000's**	**£000's**
PWLB *	181,378	Nil	N/A	(19)	181,359
LOBOs *	40,000	Nil	N/A	Nil	40,000
Market Loans	5,000	20,000	N/A	Nil	25,000
Temporary Borrowing	25,000	42,330	N/A	(62,330)	5,000
Total	251,378	62,330	N/A	(62,349)	251,359
Temporary Investments	(31,425)	N/A	(237,748)	266,218	(2,955)
Long Term Investments	Nil	N/A	Nil	Nil	Nil
Net Borrowing	219,953	62,330	(237,748)	203,869	248,404

Note: * Public Works Loan Board / Lender's Option Borrower's Option

4.4 A summary of the economy for 2017/18 is at Appendix A.

5. Debt Rescheduling/Repayment:

5.1 No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

6. Performance Measurement:

6.1 Whilst investment performance criteria have been well developed and universally accepted, debt performance indicators continue to be a more problematic area with the traditional average portfolio rate of interest acting as the main guide.
In this context, the overall average rate of interest paid on all debt in 2017/18 was 4.38%.

	31.03.18 £000's	Average rate for year	31.03.17 £000's	Average rate for year
Total debt	251,359	4.38%	251,378	4.51%
CFR	313,873		307,524	
Over/(under borrowing)	(62,514)		(56,146)	

6.2 The Treasury Management Policy stipulates that the Average Rate on External Investments should be compared with the 3-month uncompounded LIBID rate. This is in preference to the 7-day uncompounded LIBID rate and is in line with Link's advice. It reflects a more realistic neutral investment position for core investments with a medium-term horizon and a rate which is more stable with less fluctuations caused by market liquidity. Historically, the 3-month rate has been slightly higher than the 7-day rate and is, therefore, more challenging for the cash manager.

6.3

Average investments held during 2017/18 £000's	Average rate achieved	3 month LIBID	Average investments held during 2016/17 £000's	Average rate achieved	3 month LIBID
11,550	0.36%	0.587%	23,445	0.56%	0.32%

In 2017/18 the average rate on external investments achieved was 0.36% compared with the 3 month uncompounded LIBID rate of 0.587%. This was as expected due to the reduced and short-term nature of the Council's cash balances available for investment.

7. Summary Statement of Accounts

7.1 The Treasury Management Policy Statement stipulates that a summary Statement of Accounts for Treasury Management be produced at the year end and reported as part of the annual review (see Appendix B).

8. Prudential/Treasury Indicators

9.1 During the year the Authority operated the treasury limits as approved by Council.

9. Member Training

9.1 The CIPFA Code of Practice states that members charged with governance (all members as the annual strategy requires approval by Full Council) have a personal responsibility to ensure that they have the appropriate skills and training for their role. As such, the Authority provided two members' briefing sessions for treasury management in 2017/18.

10. Treasury Management Policy Statement

10.1 Any major changes to the Treasury Management Policy Statement are reported to Cabinet whilst any minor changes are circulated to members via the members' portal.

The Statement is available on the Intranet at:

http://intranet.powys.gov.uk/index.php?id=4585

Proposal

It is proposed that the Treasury Management Review Report is approved.

Statutory Officers

Chief Finance Officer's comment:
The Strategic Director Resources (S151 Officer) notes the report's contents and that by receiving the report before 30th September the Cabinet has met the Council's responsibility under the code of practice.

The Solicitor to the Council (Monitoring Officer) has made the following comment: "I have nothing to add to the report".

Future Status of the Report

Not applicable

<table>
<tr><td colspan="4">Recommendation:</td><td colspan="3">Reason for Recommendation:</td></tr>
<tr><td colspan="4">The contents of this report are approved.</td><td colspan="3">Statutory requirement</td></tr>
<tr><td colspan="4">Person(s) To Action Decision</td><td colspan="3"></td></tr>
<tr><td colspan="4">Date By When Decision To Be Actioned:</td><td colspan="3"></td></tr>
<tr><td>Relevant Policy (ies):</td><td colspan="6">Financial Regulations, Treasury Management Policy</td></tr>
<tr><td>Within Policy:</td><td>Y</td><td colspan="4">Within Budget:</td><td>N/A</td></tr>
<tr><td>Contact Officer Name:</td><td colspan="2">Tel:</td><td colspan="2">Fax:</td><td colspan="2">Email:</td></tr>
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Background Papers used to prepare Report:

Treasury Management Policy Statement
CIPFA Code of Practice on Treasury Management and Cross Sectoral Guidance Notes
Advisor's Papers

Appendix A:

UK. The outcome of the EU referendum in June 2016 resulted in a gloomy outlook and economic forecasts from the Bank of England based around an expectation of a major slowdown in UK GDP growth, particularly during the second half of 2016, which was expected to push back the first increase in Bank Rate for at least three years. Consequently, the Bank responded in August 2016 by cutting Bank Rate by 0.25% to 0.25% and making available over £100bn of cheap financing to the banking sector up to February 2018. Both measures were intended to stimulate growth in the economy. This gloom was overdone as the UK economy turned in a G7 leading growth rate of **1.8% in 2016**, (actually joint equal with Germany), and followed it up with another **1.8% in 2017**, (although this was a comparatively weak result compared to the US and EZ).

During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year, growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this was the sharp increase in inflation, caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up in quarter 3 to 0.5% before dipping slightly to 0.4% in quarter 4.

Consequently, market expectations during the autumn rose significantly that the MPC would be heading in the direction of imminently raising Bank Rate. The **MPC meeting of 14 September** provided a shock to the markets with a sharp increase in tone in the minutes where the MPC considerably hardened their wording in terms of needing to raise Bank Rate very soon. The **2 November MPC quarterly Inflation Report meeting** duly delivered on this warning by withdrawing the 0.25% emergency rate cut which had been implemented in August 2016. Market debate then moved on as to whether this would be a one and done move for maybe a year or more by the MPC, or the first of a series of increases in Bank Rate over the next 2-3 years. The MPC minutes from that meeting were viewed as being dovish, i.e. there was now little pressure to raise rates by much over that time period. In particular, the GDP growth forecasts were pessimistically weak while there was little evidence of building pressure on wage increases despite remarkably low unemployment. The MPC forecast that CPI would peak at about 3.1% and chose to look through that breaching of its 2% target as this was a one off result of the devaluation of sterling caused by the result of the EU referendum. The inflation forecast showed that the MPC expected inflation to come down to near the 2% target over the two to three year time horizon. This all seemed to add up to cooling expectations of much further action to raise Bank Rate over the next two years.

However, GDP growth in the second half of 2017 came in stronger than expected while, in the new year, there was evidence that wage increases had started to rise. The **8 February MPC meeting** minutes therefore revealed another sharp hardening in MPC warnings focusing on a reduction in spare capacity in the economy, weak increases in productivity, higher GDP growth forecasts and a shift of their time horizon to focus on the 18 – 24 month period for seeing inflation come down to 2%. (CPI inflation ended the year at 2.7%

but was forecast to still be just over 2% within two years.) This resulted in a marked increase in expectations that there would be another Bank Rate increase in May 2018 and a bringing forward of the timing of subsequent increases in Bank Rate. This shift in market expectations resulted in **investment rates** from 3-12 months increasing sharply during the spring quarter. The May increase did not happen due to a sharp downturn in economic data in Qtr 1 but sentiment is that there will now be a rise in November 2018.

PWLB borrowing rates increased correspondingly to the above developments with the shorter term rates increasing more sharply than longer term rates. In addition, UK gilts have moved in a relatively narrow band this year, (within 25 bps for much of the year), compared to **US treasuries**. During the second half of the year, there was a noticeable trend in treasury yields being on a rising trend with the Fed raising rates by 0.25% in June, December and March, making six increases in all from the floor. The effect of these three increases was greater in shorter terms around 5 year, rather than longer term yields.

As for **equity markets**, the FTSE 100 hit a new peak near to 7,800 in early January before there was a sharp selloff in a number of stages during the spring, replicating similar developments in US equity markets.

The major UK landmark event of the year was the inconclusive result of the **general election** on 8 June. However, this had relatively little impact on financial markets. However, **sterling** did suffer a sharp devaluation against most other currencies, although it has recovered about half of that fall since then. Brexit negotiations have been a focus of much attention and concern during the year but so far, there has been little significant hold up to making progress.

The **manufacturing sector** has been the bright spot in the economy, seeing stronger growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, the manufacturing sector only accounts for around 11% of GDP so expansion in this sector has a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

EU. Economic growth in the EU, (the UK's biggest trading partner), was lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of quantitative easing to stimulate growth. However, growth eventually picked up in 2016 and subsequently gathered further momentum to produce an overall GDP figure for 2017 of 2.3%. Nevertheless, despite providing this massive monetary stimulus, the ECB is still struggling to get inflation up to its 2% target and in March, inflation was still only 1.4%. It is, therefore, unlikely to start an upswing in rates until possibly towards the end of 2019.

USA. Growth in the American economy was volatile in 2015 and 2016. 2017 followed that path again with quarter 1 at 1.2%, quarter 2 3.1%, quarter 3 3.2% and quarter 4 2.9%. The annual rate of GDP growth for 2017 was 2.3%, up from 1.6% in 2016. Unemployment in the US also fell to the lowest level for 17 years, reaching 4.1% in October to February, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has been the first major western central bank to start on an upswing in rates with six increases since the first one in December 2015 to lift the central rate to 1.50 – 1.75% in March 2018. There could be a further two or three increases in 2018 as the Fed faces a challenging situation with GDP growth trending upwards at a time when the recent Trump

fiscal stimulus is likely to increase growth further, consequently increasing inflationary pressures in an economy which is already operating at near full capacity. In October 2017, the Fed also became the first major western central bank to make a start on unwinding quantitative easing by phasing in a gradual reduction in reinvesting maturing debt.

Chinese economic growth has been weakening over successive years despite repeated rounds of central bank stimulus and, medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

Japan. GDP growth has been improving to reach an annual figure of 2.1% in quarter 4 of 2017. However, it is still struggling to get inflation up to its target rate of 2% despite huge monetary and fiscal stimulus, although inflation has risen in 2018 to reach 1.5% in February. It is also making little progress on fundamental reform of the economy.

Appendix B:

Statement of Accounts
Treasury Management

		2017/18	2017/18	2016/17
		Actual	Budget	Actual
		£	**£**	**£**
Employees		146,496	165,000	160,103
Transport	*1	2,002,811	1,514,310	1,537,011
Supplies & Services		199,711	205,000	199,815
Interest Paid	*2	10,398,779	10,791,945	9,924,698
Debt Management Expenses		30,947	6,000	0
Gross Expenditure		**12,778,744**	**12,682,255**	**11,821,627**
Interest Received	*3	67,066	0	140,032
Gross Income		**67,066**	**0**	**140,032**
Net Expenditure		**12,711,678**	**12,682,255**	**11,681,595**

Note 1: Transport relates to the cost of leasing/hire across the Authority and is included in the Treasury Management Statement of Accounts as leasing is classed as a Treasury Management activity.

Note 2: Supplies & Services: £138k dr/cr card charges, £38k bank charges

Note 3: A surplus of £67k on interest received was achieved as the Authority carried higher cash balances than expected during parts of the year.