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TO BE HELD ON

11 SEPTEMBER 2018</td></tr>
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Forward Plan Ref No 4

Cabinet Portfolio Holder Cllr Mallory</td></tr>
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REPORT OF DIRECTOR (NE) – 18/197

WARDS AFFECTED: All

SUBJECT: TREASURY MANAGEMENT OUT-TURN FOR 2017/2018

RECOMMENDATION(S):

Cabinet is recommended to receive this report and note the out-turn position of the Council's Treasury Management function for the 2017/2018 financial year.

REASON FOR RECOMMENDATIONS:

(i) To comply with the CIPFA Code of Practice of Treasury Management in Local Authorities (the Code) by informing the relevant internal bodies of the Council's treasury management activities before 30 September following the end of the financial year that the report relates;

(ii) To keep Members informed of Treasury Management activities and performance.

HIGHLIGHTED RISKS

The Council does not comply with the Code of Practice of Treasury Management in Local Authorities, which may result in adverse comment from both internal and external auditors.

1. INTRODUCTION

1.1 Treasury Management in Local Government is regulated by the CIPFA Code of Practice on Treasury Management in Local Authorities (the Code), which this Council formally adopted and complies with; together with the CIPFA Code for Capital Finance in Local Authorities (the Prudential Code).

1.2 The primary requirements of the Code are:

- The creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury activities;

- The creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives;

- Reporting to Cabinet and/or Council of both the expected treasury activities for the forthcoming financial year (the annual treasury strategy statement) and subsequently the results of the Council's treasury management activities in that year (this annual treasury report);

- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions;

- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body which in this Council is the Audit Committee.

1.3 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is therefore important in that respect, as it provides details of the out-turn position for treasury activities and highlights compliance with the Council's previously approved policies. It is accepted good practice for the out-turn report to be subject to Audit Committee scrutiny prior to being presented to Cabinet by the end of September.

1.4 Treasury Management in this context is defined as:

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

1.5 In December 2017, CIPFA issued a revised Treasury Management Code and Cross Sectoral Guidance Notes, and a revised Prudential Code.

A particular focus of these revised Codes was how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income at a much higher level than can be attained by treasury investments. One recommendation was that local authorities should produce a new report to Members giving a high level summary of the overall capital strategy and to enable Members to see how the cash resources of the Council have been apportioned between treasury and non-treasury investments. Officers will report to Members when the implications of these new Codes have been assessed as to the likely impact on this Council.

2. CORPORATE AIMS AND PRIORITIES

2.1 This report potentially affects all of the Council's Corporate Objectives as treasury management activities, especially capital borrowing, underpin the financial affordability in meeting these objectives.

3. BACKGROUND AND ISSUES

3.1 Investment and Borrowing Portfolios as at 31 March 2018

3.1.1 The Council's investment and borrowing position at the beginning and end of the financial year was as follows:

	31 March 18 Principal	Rate %	31 March 17 Principal	Rate %
Borrowings				
Fixed Rate Funding	11,842,150	3.3399	11,896,419	3.3977
Variable Rate Funding	0	0	0	0
Total Borrowing	**11,842,150**	**3.3399**	**11,896,419**	**3.3977**
Investments				
In-house	20,000,000	0.4841	16,000,000	0.5782
Total Investments	**20,000,000**	**0.4841**	**16,000,000**	**0.5782**

3.1.2 The level of external borrowing is within the Authorised Limits established by the Treasury Management Prudential Indicators reported to Cabinet on 14 February 2017 (17/44) and Full Council on 10 March 2017 as part of the Financial Strategy for the 2017/2018 financial year.

3.2 The Strategy for 2017/2018

3.2.1 The treasury strategy for 2017/2018 was based on:

- Bank Rate would not start rising from 0.25% until Q2 2019;
- Bank Rate would only increase once more (to 0.75%) before the end of Q1 2020;
- Gradual rises in medium and long term fixed borrowing rates during 2017/2018, and the two subsequent financial years;

- ➢ Variable, or short term rates, would be the cheaper form of borrowing over the period;
- ➢ Investments would continue to be dominated by low counterparty risk considerations; and
- ➢ Low investment returns compared to borrowing rates.

3.2.2 The Council would continue to maintain an under-borrowed position; using internal resources in lieu of external borrowing as the most cost effective means of financing capital expenditure. This would also avoid holding higher level of investments, thus reducing counterparty risk. The Strategy recognised that the short term savings to the General Fund by avoiding new long term borrowing has to be weighed against the potential for incurring additional long term extra costs by delaying unavoidable new external borrowing until later years when Public Works Loan Board (PWLB) rates may be significantly higher.

3.2.3 The Council's expansive capital programme for the forthcoming years identified that new external borrowing would be required at a future date. Any new borrowing would only take place in advance of need if the rates available were so favourable that the long term benefits significantly exceeded the short term costs.

3.2.4 Opportunities for the cost effective repayment or rescheduling of existing borrowing were to be constantly monitored and would be exploited if they emerged and were of favourable terms.

4. CONSULTATION

4.1 In accordance with best practice and internal governance arrangements the treasury out-turn position was presented to the Audit Committee on 26 July 2018 (18/163) for scrutiny. Following this scrutiny, the Audit Committee resolved that the report be presented to Cabinet's September meeting to comply with the CIPFA Code of Practice.

5. ASSESSMENT

5.1 Economic Out-turn for 2017/2018

5.1.1 During the 2017 calendar year there was a major shift in expectations in financial markets as to 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 due in the main to the sharp increase in inflation caused by the devaluation of sterling after the EU referendum.

5.1.2 Consequently, market expectations during the autumn rose significantly that the MPC would imminently raise Bank Rate. At the November meeting the MPC increased Bank Rate by 0.25% to 0.50%, in effect reversing the emergency rate cut which had been implemented in August 2016.

5.1.3 Market debate then moved on as to whether this would be a one and only move for maybe a year or more, or the first in a series of increases in Bank Rate over the next 2-3 years.

5.1.4 The MPC minutes from the November meeting implied there was little pressure to raise rates by much over that time period. 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. 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 during the spring quarter.

5.1.5 PWLB borrowing rates increased correspondingly to the above developments with the shorter term rates increasing more sharply than longer term rates.

5.2 Investment Out-turn for 2017/2018

5.2.1 The Council's investment policy is governed by the Ministry of Housing, Communities and Local Government guidance, which has been implemented in the Annual Investment Strategy approved by Full Council on 10 March 2017 as part of the Financial Strategy. This policy sets out the approach for selecting counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks and credit default swaps).

5.2.2 The Council manages its investments in-house and invests with the institutions that meet the minimum creditworthiness criteria approved by Full Council. During the year, as well as using short term instruments, the Council invested in fixed term deposits up to 6 month duration with strong rated institutions, including those benefiting from the UK Government's sovereign rating. The selection of period and type of instrument is dependent on the Council's cashflows, its interest rate view and the interest rates on offer.

5.2.3 The Council can, dependant on cash levels, invest for periods greater than 1 year, but given the economic instability this was not considered a prudent approach. In addition to making investments to generate interest the in-house team must also ensure that the Council's day-to-day cashflow requirements are aligned to support the Capital Strategy and revenue expenditure.

5.2.4 The investment activity during the year conformed to the approved Strategy, and the Council had no liquidity difficulties.

5.2.5 In applying stringent credit criteria, which has reduced the number of counterparties available, the Council demonstrated its adherence to the overriding principles of security and liquidity which are the cornerstone of its investment policy and objective. The Council accepted the diminution in investment return from investing with highly rated counterparties as an acceptable risk-reward trade-off. Due to the limited counterparties available, the Council had increased the maximum investment limits with certain institutions and public authorities, which enabled greater flexibility in implementing the investment Strategy.

5.2.6 The uncompounded 7-day LIBID rate investment benchmark for the year was 0.2145% and the 3-month LIBID uncompounded was 0.2861%. The Council achieved an investment return of 0.4841%, against a budget forecast of 0.35%. This does not take account of the savings (£354k) achieved through paying 3 years pension fund contribution in one payment (£5.27 million) in April 2017.

5.2.7 No institutions in which investments were made had any difficulty in repaying investments and interest in full during the year. The list of institutions in which the Council invests was kept under continuous review throughout the year.

5.3 Borrowing Out-turn for 2017/2018

5.3.1 At the beginning of the financial year the Council had £11.986 million in external borrowing spread over three loans as detailed beneath:

Principal £	Lender	Date Taken	Type of Loan	Rate %	Loan Period (Years)
4,000,000	Barclays	15 Sept 2003	Maturity	4.45	40
4,000,000	PWLB	2 February 2015	Maturity	2.59	15
3,986,419	PWLB	2 March 2015	Annuity	3.15	40

5.3.2 Two of the loans are with the PWLB, with the other being a £4.00 million fixed rate maturity with Barclays Capital.

5.3.3 The annuity loan has a fixed annual repayment amount over the duration of the loan (40 years) which incorporates an amount for principal as well as interest. Over the course of the 2017/2018 financial year £54,269 of principal has been repaid. As an element of principal is being repaid with each instalment the interest payable on debt outstanding reduces annually throughout the loan term.

5.3.4 No opportunities of rescheduling any of the existing loans arose during the financial year.

5.3.5 No new long term external borrowing was taken during the financial year, despite an assumed borrowing need of £10.50 million being identified in the 2017/2018 financial strategy. Borrowing became unnecessary in the year because of slippage in the capital programme and draw down of grants in advance of expenditure.

6. RISK MANAGEMENT

6.1 The much publicised events of recent years surrounding the difficulties faced by Sovereign nations and individual financial institutions illustrate the risks associated with investment and borrowing activity and these are addressed within the Council's Treasury Management Strategy which is reviewed each year by Council. That report also refers to the controls that are operated on a daily basis and are designed to mitigate the risks associated, particularly with investment institutions.

6.2 Clearly for borrowing decisions the nature of risk is different in that the Council owes money to institutions rather than the reverse scenario. Nonetheless, there are risks in that decisions made could have an adverse effect upon the overall financial position of the Council such as choosing to borrow, restructure or repay debt at an inopportune time.

6.3 To mitigate the possibility of erroneous judgement the Council employs Capita Asset Services (CAS) to provide specialist advice to support such decisions. On 8th December 2016 Capita plc announced its intention to sell CAS as it is no longer considered core to Capita plc's strategy of focusing on technology enabled outsourcing solutions. CAS was purchased by the Link Group (Link) in June 2017.

6.4 The Council's contract with CAS expired on 31 March 2017. However, their contract was extended to enable a joint procurement exercise to be conducted with other District Councils within North Yorkshire. The procurement process was conducted through an Eastern Shires Purchasing Organisation (ESPO) Agreement Framework Issue 5 – Consultancy Services.

6.5 Following the procurement exercise Link were appointed on 1 October 2017 to provide treasury consultancy to the Council for a period of three years, with a two year extension option.

6.6 The Council's treasury activities were subject to an external audit by Mazars, and an internal audit review during the financial year, resulting in an opinion of High Assurance.

7. MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II (MiFID II)

7.1 On 3 January 2018 a revision of the Markets in Financial Instruments Directive (MiFID) was introduced. MiFid is the EU legislation that regulates firms who provide services to clients linked to 'financial instruments' and has been revised to offer greater protection to investors and inject more transparency into all asset classes.

7.2 All Local Authorities will be classified as retail clients unless they opt-up to professional status. Being classed as a retail client may result in a wide range of financial institutions and/or investment instruments not being available to the Council.

7.3 The Council therefore sought to opt-up to professional status under MiFid II with money market brokers and the appointed treasury adviser. The Council had to complete Qualitative and Quantitative Questionnaires as part of the opt-up process to demonstrate that the loss of protection is understood and that the Council has the skills and experience to understand the nature of investments and manage the risks associated. The Council has been accepted as a professional client with those organisations it applied to opt-up with.

7.4 A large number of banks and building societies, where the only transaction is cash deposits, have determined there is no requirement for local authorities to opt-up.

8. RING FENCING

8.1 The largest UK banks (those with more than £25bn of retail / SME deposits) are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as “ring-fencing”.

8.2 Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

8.3 Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure.

8.4 In general, simpler, activities offered from within a ring-fenced bank (RFB) will be focussed on lower risk, day-to-day core transactions, whilst more complex and “riskier” activities are required to be housed into a separate entity – a non-ring-fenced bank (NRFB). This is intended to ensure that an entity’s core activities are not adversely affected by the acts or omissions of other members of its group.

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8.5 The Ring-Fencing Transfer Scheme (RTFS) is a provision under Part VII of the Financial Services and Markets Act 2000, which created an additional form of transfer of business. It enables banking groups that will include an RFB to restructure their business to comply with the ring-fencing requirements.

8.6 In order for an RFTS to be sanctioned, an application must be made to The High Court of England and Wales (the ‘Court’). To aid the Court in its decision as to whether to sanction the transfer, the Court must be provided with a scheme report. If the Prudential Regulation Authority (PRA) is satisfied, they may consent to the firm’s application to the Court. The Court may not sanction an RFTS unless the PRA has certified that the receiving entity possesses (or will possess, in the case of a newly formed entity) adequate financial resources.

8.7 There are currently 5 UK banks that hold retail/SME deposits over £25bn; Barclays, The Royal Bank of Scotland, Lloyds, HSBC and Santander. These banks are at different stages of the process, with each aiming to be compliant by the due date. Each of the entities will be assigned ratings, at which stage the Council will evaluate them against the creditworthiness criteria approved by Full Council.

9. IMPLICATIONS

9.1 Policy

9.1.1 The content of this report is within the Council's policy and financial framework.

9.2 Financial

9.2.1 This report does not have any financial implications.

9.3 Legal

9.3.1 This report fulfils the requirement to inform Members of the Council's treasury management activities in accordance with the CIPFA Code of Practice on Treasury Management in Local Authorities.

9.4 Risk

9.4.1 A risk matrix is attached as Appendix A.

9.5 Communications

9.5.1 The treasury out-turn position has been presented to the Council's Audit Committee, which has governance responsibility for scrutinising treasury management activities.

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Background Papers:
CIPFA Code of Practice on Treasury Management in Local Authorities
Prudential Code for Capital Finance

APPENDIX A

Risk Matrix

Risk Ref	Date	Risk	Consequences	Mitigation	Current Risk Score	Target Score	Service Unit Manager/ Responsible Officer	Action Plan
1	July 2018	The Council does not comply with the Code of Practice of Treasury Management in Local Authorities.	It may lead to a detrimental comment from the external auditors.		B2	A1	Asset & Risk Manager	This report is to be presented to the Audit Committee and Cabinet prior to the 30 September 2018.