Agenda Item No. 9

WEST OXFORDSHIRE DISTRICT COUNCIL

FINANCE AND MANAGEMENT OVERVIEW AND SCRUTINY COMMITTEE WEDNESDAY, 6 JUNE 2018

TREASURY MANAGEMENT ACTIVITY AND PERFORMANCE – 2017/2018

REPORT OF THE CHIEF FINANCE OFFICER

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1. PURPOSE

To advise members of treasury management activity and the performance of internal and external fund managers for 2017/18.

2. RECOMMENDATION

That treasury management and the performance of in-house and external fund managers' activity for 2017/18 are noted.

3. BACKGROUND

3.1. The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to annually produce a Treasury Management Strategy Statement and the associated Prudential Indicators. The Code also recommends that members are informed of treasury management activities at least twice a year. This committee has received six reports between 1 April 2017 and 31 March 2018 relating to investment activities, investment performance, this annual treasury management report plus the proposed Treasury Management Strategy Statement for 2018/19 onwards.

3.2. Treasury management 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 those activities; and the pursuit of the optimum performance consistent with those risks."

3.3. The overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

4. ALTERNATIVES/OPTIONS

Not applicable.

5. FINANCIAL IMPLICATIONS

5.1. The annual report for Treasury Management includes:

- a review of the economic background and its impact on the financial markets;
- details of the controls in place for the Council in its use of investment counterparties (credit risk);
- details of the Council's investments and their performance;
- confirmation that the Council has complied with the prudential indicators it set as part of its investment strategy.

5.2 All these factors are reported within Appendix A, B and C to this report.

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Chief Finance Officer
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Date: 23 May 2018

Appendix A

Annual Treasury Management Report

1. Economic Background

1.1 2017/18 was characterised by the push-pull from expectations of tapering of Quantitative Easing (QE) and the potential for increased policy rates in the US and Europe and from geopolitical tensions, which also had an impact.

1.2 The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in calendar 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.

1.3 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 4.3% in January 2018. The inherent weakness in UK business investment was not helped by political uncertainty following the surprise General Election in June and by the lack of clarity on Brexit, the UK and the EU only reaching an agreement in March 2018 on a transition which will now be span Q2 2019 to Q4 2020. 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.

1.4 The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 0.25% in November 2017. It was significant in that it was the first rate hike 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.

1.5 In contrast, economic activity in the Eurozone gained momentum and although the European Central Bank removed reference to an 'easing bias' in its market communications and had yet to confirm its QE intention when asset purchases end in September 2018, the central bank appeared some way off normalising interest rates. The US economy grew steadily and, with its policy objectives of price stability and maximising employment remaining on track, the Federal Reserve Open Market Committee (FOMC) increased interest rates in December 2017 by 0.25% and again in March, raising the policy rate target range to 1.50% - 1.75%. The Fed is expected to deliver two more increases in 2018 and a further two in 2019. However, the imposition of tariffs on a broadening range of goods initiated by the US, which has led to retaliation by China, could escalate into a deep-rooted trade war having broader economic consequences including inflation rising rapidly, warranting more interest rate hikes.

2 Investment Activities

2.1 Both the CIPFA and the CLG's Investment Guidance require the Authority to invest prudently and have regard to the security and liquidity of investments before seeking the optimum yield. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2017/18. Investments during the year included:

- Investments in AAA-rated Stable Net Asset Value Money Market Funds
- Call accounts and deposits with Banks and Building Societies systemically important to UK banking system
- Pooled funds (collective investment schemes) meeting the criteria in SI 2004 No 534 and subsequent amendments
- Housing Associations
- Corporate Bonds

Investment Background

2.2 The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2017/18, the Authority investment balance ranged between £29 million and £43 million.

The criteria and lending list limits the Council adopted within its Treasury Management Strategy included specified and non-specified investments (i.e. investments up to one year and more than one year). The full counterparty list is maintained and updated by Arlingclose on a monthly basis in accordance with the Council's investment strategy; although amendments are informed to Officers immediately as they occur.

Externally Managed Funds

2.3 During the 2013/14 financial year the authority decided to invest £12m over several pooled funds. The performance of each of the Pooled Funds can be seen in the table below.

The funds were originally invested in a broad split of £4m short dated liquidity funds; £4m medium dated bond funds; £4m equity income funds. This was intended to give a balanced approach to liquidity and risk.

<u>Pooled Funds</u>

Fund Manager	Investment	31st March 2017	31st March 2018	Dividends Received 2017/18	2017/18 Gain/(Loss)	Gain/(Loss) v Original Investment
	£	£	£	£	£	£
Insight LPF (L)	2,000,000	2,020,017	2,019,976	9,771	(41)	19,976
Payden & Rygel (L)	2,000,000	2,045,356	2,037,998	14,132	(7,358)	37,998
UBS (B/E)	2,000,000	2,004,981	1,938,201	78,565	(66,780)	(61,799)
Royal London (L)	2,000,000	2,000,224	1,986,610	22,953	(13,614)	(13,390)
Schroders (E)	1,000,000	1,086,168	1,056,975	78,097	(29,193)	56,975
Threadneedle (E)	1,000,000	1,379,098	1,272,783	47,716	(106,315)	272,783
M&G Global (E)	1,000,000	1,349,619	1,299,900	38,650	(49,719)	299,900
M&G Strategic (B)	1,000,000	1,030,971	1,025,702	36,900	(5,269)	25,702
	12,000,000	**12,916,434**	**12,638,146**	**326,784**	**(278,289)**	**638,145**

(L = Liquidity ; B= Bond; E= Equity)

2.4 The Pooled Funds' have performed well in producing dividends amounting to £326,784 against a budgeted figure of £249,300 returning 2.72% for the year on the original £12m invested. However we saw the capital value of the Funds decrease by £278k compared to the same time as last year. The total funds value is still £638k more than the initial investments made (£12m). The nature of these funds is that values can fluctuate from one year to another. Their performance and suitability in meeting the Authority's investment objectives are monitored and discussed with Arlingclose on a regular basis.

2.5 At FMOS, the Members were supportive of realising the capital gain made on the M&G Global Dividend Fund and the Threadneedle Global Equity Income Fund. These have now been sold and re-invested into the Columbia Threadneedle UK Equity Income Fund (£1m) and M&G Strategic Corporate Bond Fund (£1m). A further £1m is to be invested with the CCLA Diversified Income Fund.

2.6 The investment income budget for 2017/18 was set at £607,300 assuming an average investment balance of £35.545m, achieving an overall return of 1.70%. Investment receipts exceeded budget by £100,700 with the overall level of return of 1.74% and with an average investment balance of £40.652m. The overall performance is shown in the table below:

Investment Performance: 1st April 2017 to 31st March 2018	Pooled Funds	In-House investments	Housing Association Bond	Total
Budget (£)	£249,300	239,200	£118,800	£607,300
Budgeted return (%)	2.08%	1.00%	4.75%	1.70%
Gross interest (£)	£326,784	£262,689	£118,485	£707,958
Gross rate of Return (%)	2.72%	1.00%	4.75%	1.74%

2.7 The In-house team were budgeted to achieve £239,200 for the year which included the loan to a Housing Association. Their actual was £262,689, averaging a return of 1.40% from fixed term deposits and 0.25% from Money Market Funds (MMFs) an overall return of 1.00%. The In-house team are constrained by having to meet cash flow requirements to conduct the Council's business and consequently invested for short time periods especially with Money Market Funds.

2.8 The Council's residual investment with the Icelandic Bank Kaupthing Singer and Friedlander (KSF) was £23,330 at 1st April 2017. Two further repayments were received during the year, leaving a balance of £3,544 at 31st March 2018. It is anticipated that the Council will receive the final payments on this investment in 2018/19.

2.9 A summary of the movements in the Council's classes of investment during the year are as follows:

Movement of Cash Balances 1 April 2017 – 31 March 2018

	Pooled Funds £	**In-House** £	**Bonds** £	**Housing Assoc.** £	**Total Cash** £
Opening value 1 April 2017	12,916,435	12,265,000	2,790,667	5,000,000	32,972,102
Cash Invest / (Withdraw) from Fund	-	1,685,000	-	-	1,685,000
Increase/(Decrease) in Cash/Valuation during the period	(278,289)	-	(54,042)	-	(332,331)
Closing value/balance 31 March 2018	12,638,146	13,950,000	2,736,625	5,000,000	34,324,771

The cash investments for all funds as at 31 March 2018 are shown in Appendix B

3. Credit Risk / Liquidity and Yield

3.1 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Authority's minimum long-term counterparty rating is [A-] across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Counterparty credit quality as measured by credit ratings is summarised below:

<u>Credit Score Analysis</u>

Date	Value Weighted Average Credit Risk Score	Value Weighted Average Credit Rating	Time Weighted Average Credit Risk Score	Time Weighted Average Credit Rating	Average Life (days)
31/03/2016	4.81	A+	5.02	A+	460
30/06/2017	4.72	A+	4.90	A+	332
30/09/2017	4.68	A+	4.88	A+	270
31/12/2017	5.05	A+	4.92	A+	265
31/03/2018	4.69	A+	4.94	A+	320

3.2 The value weighted average reflects the credit quality of investments according to the size of the deposit. The time weighted average reflects the credit quality of investment according to the maturity of the deposit.

Long-Term Credit Rating	Score
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
BBB+	8
BBB	9
BBB-	10

<u>Scoring:</u>
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 26
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

3.3 The Council aimed to achieve a score of 7 or lower, to reflect the Council's overriding priority of security of monies invested and the minimum credit rating of threshold of A- for investment counterparties.

4. Financial Markets

4.1 The increase in Bank Rate resulted in higher money markets rates: 1-month, 3-month and 12-month LIBID rates averaged 0.32%, 0.39% and 0.69% and at 31st March 2018 were 0.43%, 0.72% and 1.12% respectively. Gilt yields displayed significant volatility over the twelve-month period with the change in sentiment in the Bank of England's outlook for interest rates. The yield on the 5-year gilts which had fallen to 0.35% in mid-June rose to 1.65% by the end of March. 10-year gilt yields also rose from their lows of 0.93% in June to 1.65% by mid-February before falling back to 1.35% at year-end. 20 year gilt yields followed an even more erratic path with lows of 1.62% in June, and highs of 2.03% in February, only to plummet back down to 1.70% by the end of the financial year.

4.2 The FTSE 100 had a strong finish to calendar 2017, reaching yet another record high of 7688, before plummeting below 7000 at the beginning of 2018 in the global equity correction and sell-off.

4.3 In the first quarter of the financial year, UK bank credit default swaps reached three-year lows on the announcement that the Funding for Lending Scheme, which gave banks access to cheaper funding, was being extended to 2018. For the rest of the year, CDS prices remained broadly flat.

4.4 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 Authority would will be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non-ring-fenced entities would look would actually 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.

4.5 The new EU regulations for Money Market Funds (MMFs) were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility Net Asset Value (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

4.6 The most significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities.

4.7 Changes to credit ratings included Moody's downgrade of Standard Chartered Bank's long-term rating to A1 from Aa3 and the placing of UK banks' long-term ratings on review to reflect the impending ring-fencing of retail activity from investment banking (Barclays, HSBC and RBS were on review for downgrade; Lloyds Bank, Bank of Scotland and National Westminster Bank were placed on review for upgrade).

4.8 Standard & Poor's (S&P) revised upwards the outlook of various UK banks and building societies to positive or stable and simultaneously affirmed their long and short-term ratings, reflecting the institutions' resilience, progress in meeting regulatory capital requirements and being better positioned to deal with uncertainties and potential turbulence in the run-up to the UK's exit from the EU in March 2019. The agency upgraded Barclays Bank's long-term rating to A from A- after the bank announced its plans for its entities post ring-fencing.

5. Local Authority Regulatory Changes

5.1 CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The required changes from the 2011 Code are being incorporated into Treasury Management Strategies and monitoring reports. 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 full Council, 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.

5.2 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

6. Compliance with Prudential Indicators

6.1 The Council can confirm that it has complied with its Prudential Indicators for 2017/18, which was set in February 2017 as part of the Council's Treasury Management Strategy. In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2017/18. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

6.2 The Prudential Indicators include:

- Authorised and Operational Boundary for External Debt
- Upper limits for fixed interest rate exposure and variable interest rate exposure
- Upper limit for total principal sums invested over 364 days

6.3 Appendix C reports the approved capital expenditure for 2017/18, the actual year-end figures, how the capital programme has been funded, and the impact it has on the Ratio of Financing Costs to the Net Revenue Stream. The accounts for 2017/18 are being prepared for review by the Council's external auditor and may be subject to some minor change. Should the final figures change, it is not anticipated this will impact on full compliance with Prudential Indicators.

Appendix B

SCHEDULE OF CASH INVESTMENTS OUTSTANDING AT 31 MARCH 2018

NAME OF COUNTERPARTY	VALUE DATE	NOMINAL AMOUNT (£)	MATURITY DATE	RATE OF INTEREST	Fitch Credit Rating
Deutsche Global Asset MMF	31.03.18	2,950,000	01.04.18	0.44%	AAA/MMF
Hanover Housing Association	24.07.13	5,000,000	24.07.18	3.35%	A
Birmingham City Council	28.04.17	2,000,000	27.04.18	0.65%	AA
Rabobank International	06.09.17	1,000,000	05.09.18	0.41%	AA-
Rabobank International	19.10.17	1,000,000	18.10.18	0.72%	AA-
Goldman Sachs International Bank	03.01.18	2,000,000	03.04.18	0.50%	A
TOTAL IN-HOUSE INVESTMENTS		**13,950,000**			
ICELANDIC BANK DEPOSIT					
Kaupthing Singer Friedlander (KSF)	02.07.07	3,544	02.07.09	6.59%	

BONDS

COUNTERPARTY	Book Cost (£)	Market Value (£)
A2D Bond (4.75%)	2,500,000	2,736,625

MANAGED FUNDS

COUNTERPARTY	As at:	NOMINAL VALUE (£)	MARKET VALUE (£)
Royal London Cash Plus Fund	31.03.17	2,000,000	1,986,610
Payden Sterling Reserve Fund	31.03.17	2,000,000	2,037,998
M&G Global Dividend Fund	31.03.17	1,000,000	1,299,901
Threadneedle Global Equity Fund	31.03.17	1,000,000	1,272,783
Insight Liquidity Plus Fund	31.03.17	2,000,000	2,019,976
UBS Multi-Asset Income Fund	31.03.17	2,000,000	1,938,201
Schroders Income Maximiser Fund	31.03.17	1,000,000	1,056,975
M&G Strategic Bond Fund	31.03.17	1,000,000	1,025,702
TOTAL VALUE OF FUND		**12,000,000**	**12,638,146**

Appendix C

Capital Expenditure 2017/18

1. Capital Expenditure – this indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits, and, in particular, to consider the impact on council tax.

Capital Expenditure	2017/18 Approved £	2017/18 Actual £
General Fund	10,335,115	6,115,486

2. Capital expenditure has been and will be financed or funded as follows:

Capital Financing	2017/18 Approved £	2017/18 Actual £
Capital receipts	2,225,011	500,000
Government Grants /Contributions	953,877	828,464
External borrowing	4,595,900	0
Internal borrowing	0	4,269,544
Revenue contributions	2,560,327	517,478
Total Financing	10,335,115	6,115,486

3. Ratio of Financing Costs to Net Revenue Stream – this is an indicator of affordability and highlights the revenue implications of existing capital expenditure by identifying the proportion of the revenue budget required to meet financing costs. The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2017/18 Estimate %	2017/18 Actual %
General Fund	-10%	-7.8%

As the Council is in a net investment position the ratio is showing negative results, indicating that investment income exceeds borrowing costs.