Agenda Item No 10

WEST OXFORDSHIRE DISTRICT COUNCIL

FINANCE AND MANAGEMENT OVERVIEW AND SCRUTINY COMMITTEE WEDNESDAY, 5 JUNE 2019

TREASURY MANAGEMENT ACTIVITY AND PERFORMANCE – 2018/19

REPORT OF THE CHIEF FINANCE OFFICER

(Contact: Jenny Poole: - Tel (01993) 861171)

1. PURPOSE

To advise members of treasury management activity and the performance of internal and external fund managers for 2018/19.

2. RECOMMENDATIONS

(a) That treasury management and the performance of in-house and external fund managers' activity for 2018/19 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 two monitoring reports between 1 April 2018 and 31 March 2019 relating to investment activities, investment performance, this annual treasury management report plus the proposed Treasury Management Strategy Statement for 2019/20 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.

3.4. 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 authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 27 February 2019.

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: 22 May 2019

Appendix A

Annual Treasury Management Report

1. Economic Background

1.1 After spiking at over \$85/barrel in October 2018, oil prices fell back sharply by the end of the year, declining to just over \$50 in late December before steadily climbing toward \$70 in April 2019. 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%.

1.2 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.

1.3 The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However, a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.

1.4 With the 29th March 2019, the original EU 'exit day' now been and gone, having failed to pass a number of meaningful votes in Parliament, including shooting down Theresa May's deal for the third time, MPs voted by a majority of one (313 to 312) to force the prime minister to ask for an extension to the Brexit process beyond 12th April in order to avoid a no-deal scenario. Recent talks between the Conservative and Labour parties to try to reach common ground on a deal which may pass a vote by MPs have yet to yield any positive results. The EU must grant any extension and its leaders have been clear that the terms of the deal are not up for further negotiation. The ongoing uncertainty continues to weigh on sterling and UK markets.

1.5 While the domestic focus has been on Brexit's potential impact on the UK economy, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to be show signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

2. Financial Markets

2.1 December was a month to forget in terms of performance of riskier asset classes, most notably 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.

2.2 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.

2.3 Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury yields were lower than US 3 month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling by 1.8% year-on-year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China which despite some moderation in January does suggest that the International Monetary Fund's (IMF) and Organisation for Economic Co-Operation & Development's (OECD) forecasts for global growth in 2019 of 3.5% might need to be revised downwards.

2.4 The ring-fencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc) transferred their business lines into retail (ring-fenced) and investment banking (non-ring-fenced) entities.

2.5 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.

2.6 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. <u>Investment Activities</u>

3.1 The ring-fencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc) transferred their business lines into retail (ring-fenced) and investment banking (non-ring fenced) entities.

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 with the same treatment for UK banks and a number of government-related entities.

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.

3.4 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 2018/19. 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
- Local Authorities

<u>4. Investment Background</u>

4.1 The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2018/19, the Authority investment balance ranged between £26 million and £49 million.

4.2 The investment criteria and lending list limits which 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

4.3 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.

During 2018/19, after taking advice from Arlingclose and speaking with members of FMOS, two of the funds were sold. Both funds had a significant increase in capital value against the original investment. Additional cash of £304,015 was added to the capital gain of £695,985 enabling an additional pooled investment of £1,000,000. This increased the amount invested into pooled funds to £13m. It was decided that the funds would be invested into two new funds and one existing fund (M & G Strategic Bond fund) as can be seen from the tables below.

Pooled Funds- Sold

	Initial Investment	Capital Value 31st March 2018	Capital Value When sold	Dividends paid out in 2018/19	Gain / (Loss) for 2018/19	Gain / (Loss) to Initial Principal
Threadneedle – Equity	1,000,000	1,272,783	1,321,537	-	48,754	321,537
M&G Global - Equity	1,000,000	1,299,900	1,374,448	14,680	74,548	374,448
Total	**2,000,000**	**2,572,683**	**2,695,985**	**14,680**	**123,302**	**695,985**

Current Pooled Funds

Fund Manager	Bond Equity Liquidity	Original Investment £	Capital Value 31st March 2018 £	Capital Value 31st March 2019 £	Dividends Received £	2018/19 Gain/(Loss) £	Gain/(Loss) v Original Investment £
Threadneedle – Equity	E	1,000,000	1,272,783	0	0	48,754	321,537
M&G Global - Equity	E	1,000,000	1,299,900	0	14,680	74,548	374,448
Insight LPF	L	2,000,000	2,019,976	2,018,478	16,263	(1,498)	18,478
Payden & Rygel	L	2,000,000	2,037,998	2,036,000	18,446	(1,998)	36,000

Fund Manager	Bond Equity Liquidity	Original Investment £	Capital Value 31st March 2018 £	Capital Value 31st March 2019 £	Dividends Received £	2018/19 Gain/(Loss) £	Gain/(Loss) v Original Investment £
UBS	B/E	2,000,000	1,938,201	1,918,167	77,387	(20,034)	(81,833)
Royal London	L	2,000,000	1,986,610	1,982,006	29,864	(4,604)	(17,994)
Schroders	E	1,000,000	1,056,975	1,029,192	79,014	(27,783)	29,192
M & G Strategic	B	1,000,000	1,025,702	995,330*	36,694*	(30,372)	(4,670)
		12,000,000	**12,638,146**	**9,979,173**	**272,348**	**37,013**	**675,158**
Less Realised investments		(2,000,000)	(2,572,683)	0	N/A	(123,302)	(695,985)
Performance of funds net of realised investments		**10,000,000**	**10,065,463**	**9,979,173**	N/A	**(86,289)**	**(20,827)**
Investment in pooled funds in 2018/19 (£2,000,000 from realised investments + Capital Gain £695,985 + Additional Cash £304,105)							
M & G Strategic	B	1,000,000	0	995,330*	36,694*	(4,670)	(4,670)
Threadneedle – UK	E	1,000,000	0	957,791	32,487	(42,209)	(42,209)
CCLA Diversified	B/E	1,000,000	0	1,001,460	23,620	1,460	1,460
Totals		**13,000,000**	N/A	**12,933,754**	**365,149**	**(131,708)**	**(66,246)**

**Capital value and dividend apportioned according to original investment for simplicity*

4.4 The Pooled Funds' have performed well in producing dividends amounting to £365,149 against a budgeted figure of £314,500 returning 2.43% for the year on the £13m invested. However we saw the capital value of the existing Funds decrease by £131.7k compared to the same time as last year. The total funds value is now £66,246 less than the initial investments made (£13m). 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. When compared against the Council's original cash investment in pooled funds of £12.3m (£12m 2013/14 plus additional cash of £0.3 2018/19), overall the investments have increased in value by £629,649.

4.5 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 was invested with the CCLA Diversified Income Fund.

4.6 The investment income budget for 2018/19 was set at £607,300 assuming an average investment balance of £39.507m, achieving an overall return of 1.55%. Investment receipts exceeded budget by £110,120 with the overall level of return of 1.71% and with an average investment balance of £41.982m. The overall performance is shown in the table below:

Investment Performance: 1st April 2018 to 31st March 2019	Pooled Funds	In-House investments	Housing Association Bond	Total
Budget (£)	£314,500	174,000	£118,800	£607,300
Budgeted return (%)	2.39%	0.75%	4.75%	1.55%
Gross interest (£)	£365,149	£233,984	£118,287	£717,420
Gross rate of Return (%)	2.43%	0.88%	4.75%	1.71%

4.7 The In-house team were budgeted to achieve £174,000 for the year which included the loan to a Housing Association. The actual was £233,984, averaging a return of 0.88% from fixed term deposits and from Money Market Funds (MMFs). 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.

4.8 The Council's residual investment with the Icelandic Bank Kaupthing Singer and Friedlander (KSF) was £3,544 at 1st April 2018. One further repayment was received during the year, leaving a nil balance as at 31st March 2018.

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

<u>Movement of Cash Balances 1 April 2018 – 31 March 2019</u>

	Pooled Funds £	**In-House** £	**Bonds** £	**Housing Assoc.** £	**Total Cash** £
Opening value 1 April 2018	12,638,146	13,950,000	2,736,625	5,000,000	34,324,771
Cash Invest / (Withdraw) from Fund	304,015	100,000	0	(5,000,000)	(4,595,985)

	Pooled Funds	In-House	Bonds	Housing Assoc.	Total Cash
Increase/(Decrease) in Cash/Valuation during the period	(8,407)	0	(92,706)	0	(101,113)
Closing value/balance 31 March 2019	12,933,754	14,050,000	2,643,919	0	29,627,673

The cash investments for all funds as at 31 March 2019 are shown in Appendix B

5. Credit Risk / Liquidity and Yield

5.1 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)
31/03/2018	4.69	A+	4.94	A+	320
30/06/2018	5.19	A+	4.95	A+	202
31/12/2018	5.17	A+	5.12	A+	59
31/03/2019	4.56	A+	4.88	A+	217

5.2 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

Scoring:
-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

5.3 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. Both value and time weighted average credit risk scores of 4.56 and 4.88 respectively are within the Council's target score.

6. Financial Markets & Credit Background

6.1 December 2018 was a month to forget in terms of performance of riskier asset classes, most notably 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.

6.2 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.

6.3 Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury yields were lower than US 3 month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling by 1.8% year-on-year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China which despite some moderation in January does suggest that the International Monetary Fund's (IMF) and Organisation for Economic Co-Operation & Development's (OECD) forecasts for global growth in 2019 of 3.5% might need to be revised downwards.

6.4 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.

6.5 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.

6.6 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.

6.7 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.

7. Local Authority Regulatory Changes

7.1 CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The required changes from the 2011 Code were incorporated into Treasury Management Strategies from the 2019/2020 financial year. 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. The Code also expands on the process and governance issues of capital expenditure and investment decisions.

7.2 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.

8. Compliance with Prudential Indicators

8.1 The Council can confirm that it has complied with its Prudential Indicators for 2018/19, which was set in February 2018 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 2018/19. 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.

8.2 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

8.3 Appendix C reports the approved capital expenditure for 2018/19, 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 2018/19 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 2019

NAME OF COUNTERPARTY	VALUE DATE	NOMINAL AMOUNT (£)	MATURITY DATE	RATE OF INTEREST	Fitch Credit Rating
Federated Investors LLP	31.03.19	4,050,000	01.04.19	0.79%	AAA/MMF
Lloyds Bank	08.10.18	2,000,000	08.04.19	1.00%	A+
Rabobank International	18.10.18	1,000,000	17.10.19	0.99%	AA-
Lloyds Bank	30.11.18	3,000,000	31.05.19	1.00%	A+
Standard Chartered Bank	14.01.19	2,000,000	15.07.19	1.07%	A+
Aberdeen City Council	11.02.19	2,000,000	11.06.19	0.87%	UKLA
TOTAL IN-HOUSE INVESTMENTS		**14,050,000**			

BONDS

COUNTERPARTY	Book Cost (£)	Market Value (£)
A2D Bond (4.75%)	2,500,000	2,643,919

MANAGED FUNDS

COUNTERPARTY	As at:	NOMINAL VALUE (£)	MARKET VALUE (£)
Royal London Cash Plus Fund	31.03.19	2,000,000	1,982,006
Payden Sterling Reserve Fund	31.03.19	2,000,000	2,036,000
CCLA Diversified Income Fund	31.03.19	1,000,000	1,001,460
Threadneedle UK Equity Fund	31.03.19	1,000,000	957,791
Insight Liquidity Plus Fund	31.03.19	2,000,000	2,018,478
UBS Multi-Asset Income Fund	31.03.19	2,000,000	1,918,167
Schroders Income Maximiser Fund	31.03.19	1,000,000	1,029,192
M&G Strategic Bond Fund	31.03.19	2,000,000	1,990,660
TOTAL VALUE OF FUND		**13,000,000**	**12,933,754**

Appendix C

Capital Expenditure 2018/19

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	2018/19 Approved £	2018/19 Actual £
General Fund	8,769,072	4,347,605

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

Capital Financing	2018/19 Approved £	2018/19 Actual £
Capital receipts	2,128,100	477,389
Government Grants /Contributions	3,315,688	1,528,398
External borrowing	699,118	0
Internal borrowing	0	888,092
Revenue contributions	2,626,166	1,453,726
Total Financing	8,769,072	4,347,605

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	2018/19 Estimate %	2018/19 Actual %
General Fund	(1.04)	(2.75)

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