ANNUAL REPORT ON TREASURY MANAGEMENT ACTIVITIES FOR 2018/19

July 2019

PLYMOUTH
CITY COUNCIL

Introduction

The Chartered Institute of Public Finance and Accountancy's Treasury Management (the CIPFA Code) requires the Council to report on the performance of the treasury management function after the financial year end).

The Council's Treasury Management Strategy for 2018/19 was approved by Council on 26 February 2018. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

External Context

Economic background (as at April 2019): 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%.

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.

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.

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.

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.

Financial markets: 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.

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.

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.

Credit background: 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.

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.

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.

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.

Local Authority Regulatory Changes: Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

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 in February 2019.

Local Context

On 31st March 2019, the Council had net borrowing of £350m arising from its revenue and capital income and expenditure, an increase on 2018 of £101m. 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	460	100	560
Less: Other debt liabilities *	-121	0	-121
Borrowing CFR	**339**	**100**	**439**
Less: Usable reserves	-60	3	-57
Less: Working capital	-30	-2	-32
Net borrowing	**249**	**101**	**350**

* *finance leases, PFI liabilities and transferred debt that form part of the Council's total debt*

Net borrowing has increased due to a rise in the CFR as new capital expenditure was higher than the financing applied including minimum revenue provision; together with a small decrease in usable reserves and a fall in working capital due to the timing of receipts and payments.

Borrowing Activity

At 31st March 2019, the Council held £461m of loans, (an increase of £103m on 31/03/2018) as part of its strategy for funding previous years' capital programmes. See table 2 below.

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 Council's long-term plans change being a secondary objective.

Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have started to rise with the likelihood of further rises over the next 12 months.

The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with this 'cost of carry' and breakeven analysis. Temporary and short-dated loans borrowed from the markets, predominantly from other local authorities, also remained affordable and attractive.

The Council's Treasury Management Board has determined it was more cost effective in the short-term to borrow short-term loans instead of fixing in at higher long term rates. The Council reviews the situation on a regular basis and also takes advice from it Treasury Management advisors.

Table 2: Borrowing Activity

	Balance on 01/04/2018 £m	Movement £m	Balance on 31/03/2019 £m	Avg Rate %
Public Works Loan Board	44	0	44	5.76%
Banks - LOBOs	82	(18)	64	4.34%
Other Loans	18	12	30	
Short Term Borrowing	214	109	323	1.04%
TOTAL BORROWING	358	103	461	
Other Long Term Liabilities	121	0	121	-
TOTAL EXTERNAL DEBT	479	103	582	-
Increase/ (Decrease) in Borrowing £m			103	

LOBO (Lender's Option Borrower's Option)

During the year the Council refinance £18m LOBOs and now holds £64m (£82m in 2017) of LOBO loans where the lender has the option to propose an increase in the interest rate at set dates. The Council then has the option to either accept the new rate or to repay the loan at no additional cost. During the year £15m of our LOBOs had options, none of which were exercised by the lender.

LGA Bond Agency

UK Municipal Bonds Agency (MBA) plc. was established in 2014 by the Local Government Association as an alternative to the PWLB with plans to issue bonds on the capital markets and lend the proceeds to local authorities. In early 2016 the Agency declared itself open for business, initially only to English local authorities. The Council has analysed the potential rewards and risks of borrowing from the MBA and has approved and signed the Municipal Bond Agencies framework agreement which sets out the terms upon which local authorities will borrow, including details of the joint and several guarantee.

As at 31st March 2019 no bonds have been issued by the Municipal Bonds Agency.

Debt Rescheduling

The PWLB continued to operate a spread of approximately 1% between "premature repayment rate" and "new loan" rates so the premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

Other Long Term Liabilities

Although not classified as borrowing, the Council has other capital finance from Private Finance Initiatives and Finance Leases etc. and as at 31st March 2018 this amounted to £125m.

The liability for the PFI scheme has increased our requirement for finance and therefore we increased our Operational Boundary and Authorised limit to allow for this.

Minimum Revenue Provision (MRP)

MRP is a charge to the revenue budget that is made each year for monies to repay the Council's borrowing.

Under regulation 27 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 SI 2003/146, as amended, local authorities are required to charge to their revenue account, for each financial year, MRP for the cost of their unfinanced capital expenditure.

Following changes in advice from CIPFA the Council changed it MRP calculations method in 2015/16 to use the annuity method. Prior years involved detailed calculations which were very prescriptive but these were replaced with a requirement that local authorities calculate an amount or MRP which they consider to be prudent.

The Council matches the economic benefits from its assets with the life of those assets. Therefore the Council changed its calculation method to the annuity method which not only spreads the cost of the borrowing over the life of the assets but it also takes into account the time value of money.

The Council's previous method of calculating MRP was to spread the cost of borrowing in a straight line over a maximum of 25 years. The current council tax payers would therefore pay a relative higher charge than council tax payers in the future. For example if an asset cost of £20m to build and has a life of 20 years then there would have been a £1m charged each year on the straight line basis. The annuity method takes into account the time of value because £1m today has a higher value (NPV) that £1m in 20 years' time.

<u>Investment Activity</u>

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 and cash balances ranged between £70 and £100 million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change in show in table 3 below.

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

Table 3: Investment Activity in 2017/18

Investments	Balance on 01/04/2018 £m	Movement £m	Balance on 30/03/2019 £m	Avg Rate/Yield (%)
Short term Investments (call accounts etc.)	18	3	21	0.91%
Covered Bonds and Loans	11	(8)	3	1.08%
Money Market Funds	26	0	26	0.68%
Other Pooled Funds	25	10	35	3.34%
TOTAL INVESTMENTS	**80**	**5**	**85**	
Increase/ (Decrease) in Investments £m			5	

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.

During the year the Council invested £10m into the Schroder Income Maximiser Fund which offers higher rates of returns than the Council other short term investments.

The Council has £35m invested in externally managed pooled Funds with the CCLA and Schroder and this has generated a total return for the year of £1.479m (4.2%). Investment income return used to support services in year. Because these 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.

Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy.

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating is A across rating agencies Fitch, S&P and Moody's); for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Given the increasing risk and falling returns from short-term unsecured bank investments, the Council wants to diversify into higher yielding long term asset classes.

Other Non-Treasury Holdings and Activity

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority 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 Council held £164m of direct property investment under its Asset Investment Fund

These non-treasury investments generated £2.794m of investment income for the Council after taking account of direct costs, representing a net revenue return of 2.4% after allowing for payment to a void reserve and payment to a lifecycle maintenance reserve. The gross return is higher than the return earned on treasury investments but reflects the additional risks to the Council of holding such investments.

Treasury Management Outturn 2018/19

Budget Income and Expenditure

Treasury Management Outturn Position 2018/19

	2018/19 Budget	2018/19 Outturn	Year End Variance	
	£m	£m	£m	
Interest Payable	6.787			
LOBO and other long term loans		3.770		
PWLB (Public Works Loan Board)		2.550		
Temporary loans		1.378		
Other Interest and charges		(0.181)		
Recharge to Departments for Unsupported Borrowing (in accordance with business cases)	(7.979)	(7.855)		
Total Interest Payable	**(1.192)**	**(0.338)**	**0.854**	
Interest Receivable	(1.730)			
CCLA Pool Funds		(1.479)		
Money Market Fund		(0.148)		
Other Interest		(1.167)		
Total Interest Receivable	**(1.730)**	**(2.794)**	**(1.064)**	
Other Payments	0.130	0.116		
Debt Management	0.080	0.486		0.406
Amortised Premiums	0.497	0.537		
Total Other Charges	**0.707**	**1.139**	**0.433**	
Minimum Revenue Provision	7.079	5.999	(1.080)	
TOTAL	**4.864**	**4.006**	**(0.858)**	

The Council's Treasury Management Outturn for the year was an underspend of £0.858m. The Council has, however, continued to increase its borrowing to fund the capital programme which means it will pay increased loan interest and loan repayments (MRP) in the coming years while the investment returns remain very low.

The Treasury Management Outturn does not include the returns from the Council's investments in the purchasing of capital assets as this is included in the Place revenue outturn.

The Bank of England increased the Bank Rate by 0.50% to 0.75% in November 2018 and the Bank of England have indicated that there will a further two rises in the next twelve months.

The Treasury Management budget is a held as a separate budget under the Finance Department of the Council's General Fund. Whilst interest costs are slightly less than the budget there are a number of factors that contribute to the final position. Whilst the Council not only borrows to finance capital expenditure, it also has to maintain a daily net cash surplus position. The costs of borrowing to finance invest to save capital schemes is charged to departments. The figures above include the borrowing implications of decisions to utilise the Asset Investment Fund to acquire assets to earn a revenue return which is accounted for in directorate's budgets.

Externally Managed Funds

The Council also has investments in cash plus bond and property funds which allow the Council to diversify into asset classes other than cash with the need to own and manage the underlying investments. The funds which are operated on a variable net asset value (VNAV) basis offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short-term. All of the Council's pooled fund investments are in the respective fund's distributing share class which pay out the income generated.

Compliance with Prudential Indicators

The Council confirms compliance with its Prudential Indicators for 2017/18, which were set in February 2017.

The Following indicators are set and monitored each year:

- Estimates of Capital Expenditure;
- Estimates of Capital Financing Requirement;
- Gross Debt and the Capital Financing Requirement;
- Operation Boundary for External Debt;
- Authorised Limit for External Debt;
- Ratio of Financing Costs to Net Revenue Stream ;
- Incremental Impact of Capital Investment Decisions.

Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators.

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 proportion of net principal borrowed will be:

	2018/19 Limit	2018/19 Actual	Complied
Upper limit on fixed interest rate exposure	100%	28%	✓
Upper limit on variable interest rate exposure	100%	72%	✓

Fixed rate borrowings are those where the rate of interest is fixed for the whole financial year or more. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper Limit	Lower Limit	31.03.2019 Actual	Complied
Under 12 months	90%	0%	61%	✓
12 months and within 24 months	40%	0%	11%	✓
24 months and within 5 years	40%	0%	0%	✓
5 years and within 10 years	25%	0%	1%	✓
10 years and above	95%	0%	27%	✓

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 365 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. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2018/19	2019/20	2020/21
Limit on principal invested beyond year	£45m	£50m	£50m
Actual	£0m	£0m	£0m
Complied	✓	✓	✓

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.

	Target	Actual	Complied
Portfolio average credit rating	A	AA-	✓

Liquidity: The Council does not keep large amounts of cash in call accounts so that it reduces the cost of carrying excess cash. To mitigate the liquidity risk of not having cash available to meet unexpected payments the Council has access to borrow additional, same day, cash from other local authorities.

Investment Training

Officers have undergone the following training during the year:

Arlingclose – Changes to IFRS 9 Impairment of Financial Instruments.
Arlingclose – Principles of Treasury Management Workshop.
CIPFA – Implementing new Treasury Management Regulatory Framework
Arlingclose – Investments workshop 2018.

Arlingclose - Accounts closedown workshop 2018/19.

Grant Thornton - Accounts Closedown Workshops for Local Authority Accountants

Prudential Indicators 2018/19

The Local Government Act 2003 requires the Council to have regard to CIPFA's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

This report compares the approved indicators with the outturn position for 2018/19. Actual figures have been taken from or prepared on a basis consistent with, the Council's statement of accounts.

Capital Expenditure: The Council's capital expenditure and financing may be summarised as follows.

Capital Expenditure and Financing	2018/19 Actual £m
General Fund	134.005
Total Expenditure	**134.005**
Capital Receipts	2.325
Grants & Contributions	32.077
Reserves	0.712
Revenue	0.174
Borrowing	98.717
Total Financing	**134.005**

Capital Financing Requirement: The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31.03.19 Actual £m
General Fund	**559.870**
Total CFR	**559.870**

The CFR rose by £100m in the year to £560m (2018 £460m) from capital expenditure financed by debt outweighs resources put aside for debt repayment.

The increase in CFR shows that the Council is increasing its borrowing to pay for capital expenditure in the city.

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Actual Debt: The Council's actual debt at 31 March 2019 was as follows:

Debt	31.03.19 Estimate £m	31.03.19 Actual £m	Difference £m
Borrowing	517	461	56
PFI liabilities & other Finance leases	125	121	4
Total Debt	**642**	**582**	**60**

The actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt below.

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely (i.e. prudent, but not worst case) scenario for external debt. It links directly to the Council's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary	31.03.19 Boundary £m	31.03.19 Actual Debt £m	Complied
Borrowing	540	461	✓
Other long-term liabilities	140	121	✓
Total Debt	**680**	**582**	✓

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003

It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	31.03.19 Boundary £m	31.03.19 Actual Debt £m	Complied
Borrowing	675	461	✓
Other long-term liabilities	160	121	✓
Total Debt	**835**	**582**	✓

Recommendations

That Council **notes** the Treasury Management Annual Report 2018/19.