Gateshead Council

**REPORT TO CABINET**
**19 June 2018**

**Title of Report:** **Treasury Annual Report 2017/18**

**Report of:** **Darren Collins – Strategic Director, Corporate Resources**

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## Purpose of the Report

1. Cabinet is asked to recommend to Council the attached Treasury Annual Report for 2017/18.

## Background

2. In line with what the Government defines as best practice and the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management, the Council must consider a Treasury Annual Report each year.

3. The attached Treasury Annual Report has been prepared taking into account the Local Government Act 2003, Ministry of Housing, Communities and Local Government's (MHCLG) Guidance on Local Government Investments, CIPFA's Prudential Code for Capital Finance and CIPFA's Code of Practice on Treasury Management. The document is also consistent with the Council's approved Treasury Management Policy and Strategy, which require an annual report to be presented to Council prior to the end of September each year.

4. The Audit and Standards Committee reviewed the Treasury Annual Report on 18 June 2018.

## Proposals

5. Cabinet is asked to recommend to Council the Treasury Annual Report attached at Appendices 2 and 3 in order to ensure that the Council fully complies with the requirements of good practice.

## Recommendation

6. Cabinet is asked to recommend to Council the Treasury Annual Report for 2017/18.

   For the following reason:

   To ensure that the Council fully complies with the requirements of Financial Regulations and good practice as recommended by the Chartered Institute of Public Finance and Accountancy (CIPFA) in its Code of Practice on Treasury Management.

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**APPENDIX 1**

## Policy Context

1. The proposals in this report are consistent with Council priorities and in particular the priority of ensuring a sustainable Gateshead through ensuring the best use of its resources. The proposals are consistent with the framework for achieving the Council's new strategic approach "Making Gateshead a Place Where Everyone Thrives". The Council recognises there are huge financial pressures on not just Council resources but those of partners, local businesses and residents.

## Background

2. The Council fully complies with the requirements of good practice as recommended by the Chartered Institute of Public Finance and Accountancy (CIPFA) in its Code of Practice on Treasury Management and its Prudential Code for Capital Finance and the Ministry of Housing, Communities and Local Government (MHCLG) Guidance on Local Authority Investments, which include the:
    a. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities;
    b. Creation and maintenance of Treasury Management Practice Statements which set out the manner in which the Council will seek to achieve those policies and objectives;
    c. Receipt by the Council of an annual strategy report for the year ahead and an annual review report of the previous year;
    d. 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; and
    e. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to Audit and Standards Committee and receipt of a mid-year review report to Council.

3. Comprehensive details of procedures in place to ensure compliance with the Code are included within the Council's Treasury Management Practices and these procedures are followed without exception.

4. Treasury Management in this context is defined as:

    "The management of the organisation's borrowing, 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 optimum performance consistent with those risks."

5. Taking into account the annual reporting requirements stipulated in the Code of Practice, this Annual Treasury Report covers:
    - The strategy for 2017/18 (including investment and borrowing strategies);
    - Treasury Management approach to risk;
    - Outturn 2017/18 performance measurement (including market interest rates, investment and borrowing performance and compliance with treasury limits set prior to the start of the financial year as Prudential Indicators);
    - Any restructuring and repayment; and
    - Summary of Treasury Management performance for the year 2017/18.

## Consultation

6. Consultation on the production of the Treasury Annual Report has taken place with the Council's treasury advisors Link Asset Services. The outcome of the consultation process, along with guidance issued by CIPFA, has informed the format and content of the annual report.

## Alternative Options

7. There are no alternative options, as the Treasury Annual Report is required in order to comply with CIPFA's Code of Practice on Treasury Management.

## Implications of Recommended Option

8. **Resources:**

   **a) Financial Implications** - The Strategic Director, Corporate Resources confirms that there are no direct financial implications associated with this report. The Annual Report sets out a financial summary of Treasury Management activity for the 2017/18 financial year end and compares this to budget.

   **b) Human Resources Implications** - There are no human resources implications arising from this report.

   **c) Property Implications -** There are no property implications arising from this report.

9. **Risk Management Implications**

   The Treasury Annual Report has been prepared to report on performance against the annual Treasury Policy and Strategy. These are prepared with the primary objective of safeguarding the Council's assets and a secondary objective of maximising returns on investments and minimising the costs of borrowing.

10. **Equality and Diversity Implications**

    There are no equality and diversity implications arising from this report.

11. **Crime and Disorder Implications**

    There are no crime and disorder implications arising from this report.

12. **Sustainability Implications**

    There are no sustainability implications arising from this report.

13. **Human Rights Implications**

    There are no human rights implications arising from this report.

14. **Area and Ward Implications**

    There are no direct area and ward implications arising from this report.

15. **Background Information:**

The following documents have been relied on in the preparation of the report:

- Local Government Act 2003
- CLG Guidance on Local Government Investments (2004)
- CIPFA's Prudential Code for Capital (2013)
- CIPFA's Code of Practice on Treasury Management (2011)
- Council's approved Treasury Policy & Strategy Statements 2017/18 to 2019/20
- Council's approved Treasury Management Practice Statements

**Appendix 2**

# Treasury Management Annual Report 2017/18

## The Strategy for 2017/18

1. The 2017/18 to 2019/20 Treasury Management Strategy was approved by Council on 16 March 2017.

2. The formulation of the 2017/18 to 2019/20 Treasury Management Strategy involved determining the appropriate borrowing and investment decisions with the primary objective of safeguarding the Council's assets and a secondary objective of maximising returns on investments and minimising the costs of borrowing.

3. The Treasury Management Strategy fully complies with the requirements of CIPFA's Treasury Management Code of Practice and covered the following:
    - prospects for interest rates;
    - treasury limits in force including prudential indicators;
    - the borrowing strategy;
    - the extent of debt rescheduling opportunities; and
    - the investment strategy.

## Investment Strategy

4. Part 1 of the Local Government Act 2003 relaxed the constraints under which local authorities can invest. These investment regulations came into force on 1 April 2004 and in conjunction with supplementary guidance are considered best practice.

5. Investments are managed in-house using counterparties listed in an approved lending list. Investments are placed over a range of periods and are dependent on the assessed security of the counterparty, the liquidity requirements of the cash flow, interest rate expectations and the interest rates actually on offer.

6 The expectation for interest rates within the Treasury Management Strategy for 2017/18 to 2019/20 anticipated a low, steady Bank Rate, with rate increases not expected until 2019. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

7 In this scenario, the Treasury Strategy was to delay borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

**Borrowing Strategy**

8. The borrowing strategy for 2017/18 was as follows:
    - When Public Works Loan Board (PWLB) rates fall back to or below 3.20% borrowing should be considered, with preference given to terms which ensure a balanced profile of debt maturity.
    - The use of short term borrowing (6 months to 18 months) will also be considered with the aim of minimising borrowing costs. This short-term borrowing will be replaced with longer term loans when rates are preferable.
    - Consideration will be given to borrowing market loans which are at least 20 basis points below the PWLB target rate.

9. Any potential opportunities for repaying debt before the maturity date to reduce borrowing costs was monitored and assessed throughout the year. However, the cost of premiums on any early repayment of debt was considered prohibitive for any debt restructuring.

**Treasury Management Approach to Risk**

10. The primary objective is to safeguard the Council's assets. Procedures have been put in place to ensure this takes place and these are fully documented in the Council's Treasury Management Practice Statements (TMPS), which are constantly kept under review. These procedures are followed without exception. The Internal Audit report of 14th November 2017 concluded that Treasury Management control systems and procedures are operating well. All funds were safeguarded in 2017/18.

**Outturn 2017/18 – Performance Measurement**

11. It should be noted that procedures in relation to the Prudential Code were effective from 1 April 2004 and continue to apply to this report on 2017/18 performance. However, in December 2017, CIPFA issued a revised Treasury Management Code of Practice and a revised Prudential Code. These revisions have particularly focused on non-treasury investments and especially on the purchase of property with a view to generating income. Full implementation of the revised Codes of Practice is not expected until the 2019/20 budget cycle across all authorities.

12. The performance, against limits in respect of borrowing set prior to the start of the financial year as Prudential Indicators, will be reported to Cabinet on 19 June 2018 as part of the Capital Monitoring process. None of the approved Prudential Indicators set for 2017/18 were breached in the year. For completeness the Prudential Indicators are shown at Appendix 4.

**Market Interest Rates**

13. Performance must be considered in conjunction with actual rate movements over the financial year which were as follows:

    - **Shorter-term interest rates** –The Monetary Policy Committee (MPC) at its quarterly Inflation Report meeting of 2nd November agreed to increase Base Rate to 0.50% and it remained at that level for the rest of the year.
    - **Longer-term interest rates** – The 7th February 2018 MPC meeting revealed warnings of a more imminent and faster pace of increases in Bank Rate than had previously been expected. Market expectations for increases in Bank Rate,

therefore, shifted considerably during the second half of 2017/18 and resulted in investment rates from 3 – 12 months increasing sharply during the spring quarter.

**Investment Performance**

14. The major issue for treasury management in 2017/18 has been ensuring the security of investments whilst generating a reasonable rate of return. Due to the difference between the cost of borrowing and investment interest and the reduction in suitable counterparties the Council has continued to use investment balances to temporarily fund the capital programme. This has delivered a saving on borrowing costs.

15. The Council's investment policy is governed by MHCLG guidance, which has been implemented in the annual investment strategy approved by the Council on 16th March 2017. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.) The investment activity during the year conformed to the approved strategy and the Council had no liquidity difficulties.

16. There has been a continued use of a range of investment instruments in order to increase flexibility, spread risk, maximise liquidity and obtain attractive rates. There has been an increased use of Notice Reserve accounts, and money market funds with high rated banks to maintain the security of the funds and enhance the rate of return on investments.

17. A summary of the year's activity is shown at Appendix 3. The investment interest earned in the year was £0.470m (2016/17 £0.413m) with an average interest rate of 0.51% (2016/17 0.55%). Interest earned on loans to third parties, agreed as part of the capital programme, increased total interest to £1.807m which was £0.345m more than the original budget of £1.462m. This includes £0.884m interest relating to Newcastle International Airport.

18. The overall return for the year of 0.51% exceeds the accepted benchmark for 2017/18, which was 0.22%. This benchmark is the 7-day London Interbank Bid Rate (LIBID), which is traditionally linked to the base rate.

19. Furthermore, the Council is a member of Link Asset Services Investment Benchmarking Group which assesses both the rate of return and the risk of the counterparty to calculate a weighted average rate of return. This is used for comparison across other local authorities who also subscribe to this service across a number of groups. The Council achieved an average return of 0.546% on its investments for Quarter 4 2017/18 which is slightly below the risk adjusted expectations (0.55% to 0.65%) defined in the Benchmarking Report for our group. This is due to the portfolios longer dated weighted average maturity of 151 days compared to the benchmark average of 95 days and the weighted average risk of the credit profile.

## Heritable Bank

20. The Council had a deposit of £2.792m at risk in Heritable Bank, a wholly owned subsidiary of an Icelandic bank, Landsbanki, when it entered administration in October 2008. The full deposit in Heritable was due to mature by the end of 2008/09 with interest.

21. To date dividends totalling £2.736m (98.00p in the £) have been received.

22. The most recent update from the administrators, Ernst and Young, in March 2018, provided detail of all dividends received to date and advised that no further dividend is expected until the administration is concluded. Ernst and Young intend to issue a further report early within the next accounting period.

## Borrowing Performance

23. The total external borrowing at 31 March 2018 was £650.341m, which was within the operational borrowing limit of £800.000m. This is a net increase of £40.153m from the opening figure of £610.189m. The increase is represented by £85.000m of new borrowing offset by £44.847m repayment of borrowing.

24. Investment returns/interest rates were low during 2017/18 and were well below long term borrowing rates. Therefore, value for money considerations indicated that best value could be obtained by delaying new external borrowing by using internal cash balances to finance new capital expenditure in the short term (this is referred to as internal borrowing). At the end of the financial year 2017/18 the Council had internal borrowing of £15.317m. Any short-term savings gained from adopting this approach was weighed against the potential for incurring additional long-term costs by delaying unavoidable new external borrowing until later years when PWLB long term rates are forecast to be higher.

25. The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). The CFR arises directly from the capital activity of the Council and the resources applied to fund the capital spend, as follows:

| | **31 March 2017 Actual £m** | **31 March 2018 Actual £m** |
|---|---|---|
| **Capital Financing Requirement for General Fund** | 301.792 | 320.153 |
| **Capital Financing Requirement for HRA** | 345.505 | 345.505 |
| **Total Capital Financing Requirement** | 647.297 | 665.658 |

26. The details of the borrowing taken during 2017/18 are as follows:

| Date | Term (years) | Amount £m | Interest Rate (%) | Source |
|---|---|---|---|---|
| 12/09/2017 | 48 | 5.000 | 2.26 | PWLB |
| 12/09/2017 | 46.5 | 5.000 | 2.26 | PWLB |
| 20/10/2017 | 48 | 5.000 | 2.43 | PWLB |
| 07/11/2017 | 48 | 10.000 | 2.41 | PWLB |
| 23/11/2017 | 50 | 5.000 | 2.38 | PWLB |
| 23/11/2017 | 50 | 5.000 | 2.38 | PWLB |
| 29/11/2017 | 49 | 5.000 | 2.38 | PWLB |
| 29/11/2017 | 49 | 5.000 | 2.38 | PWLB |
| 27/02/2018 | 50 | 5.000 | 2.48 | PWLB |
| 27/02/2018 | 50 | 5.000 | 2.48 | PWLB |
| 24/04/2017 | 6 months | 10.000 | 0.47 | Glasgow Council |
| 30/06/2017 | 7 months | 5.000 | 0.30 | Derby City Council |
| 25/07/2017 | 3 months | 10.000 | 0.23 | Middlesbrough Council |
| 16/10/2017 | 1 | 5.000 | 0.53 | London Borough of Havering |
| | | **85.000** | | |

27. At 31 March 2018 £525.341m of the total borrowing was from the PWLB and £125.000m was in the form of market loans. The average interest rate on borrowing has reduced from 4.37% in 2016/17 to 4.12% during 2017/18 which will reduce borrowing costs.

28. There was £30.000m of short-term borrowing taken during 2017/18 primarily to manage cashflow timing, with £25.000m being repaid prior to year-end. The majority of PWLB long term loans taken in 2017/18 were over 48 years which lengthens the life of the debt portfolio and provides long term security in terms of borrowing costs by securing loans at historically low rates.

29. The overall revenue cost of borrowing in 2017/18 was £26.174m. As a consequence of the level of capital expenditure and the application of the Treasury Management Strategy this was £1.016m less than the budget.

**Debt Restructuring & Repayment**

30. Due to the reintroduction of redemption rates on the early repayment of PWLB debt it was anticipated that there would be little scope to restructure PWLB debt.

31. The rates payable on the early redemption of debt was monitored throughout the year. The cost of early repayment outweighed any savings and therefore there was no early redemption of debt.

**Summary of Treasury Management Performance for the Year 2017/18**

32. Total interest income was £0.345m more than the budget, which was contributed to by the 0.25% increase in Base Rate on 2nd November 2017.

33. Borrowing costs were £1.016m less than budget due to a delay in taking borrowing and being taken at lower interest rates than estimated and the decision to temporarily fund the capital programme from cash balances.

34. There were no opportunities for restructuring debt during 2017/18.

35. Overall Treasury Management performance against budget for 2017/18 generated net savings of £1.361m, this is summarised in the following table:

| | | 2017/18 | |
|---|---|---|---|
| | **Budget £m** | **Actual £m** | **Saving £m** |
| Cost of Borrowing | 27.190 | 26.174 | (1.016) |
| Interest Income | (1.462) | (1.807) | (0.345) |
| **Net Position** | **26.016** | **24.617** | **(1.361)** |

36. Treasury Management remained challenging throughout 2017/18 with the continuation of the lowest bank interest rate in history for most of the year and continuing pressure on available counterparties.

**Appendix 3**

## Investment Activity

| | 2016/17 | 2017/18 |
|---|---|---|
| Number of investments made in 2015/16 maturing in 2016/17 | 14 | n/a |
| Number of investments made in 2016/17 maturing in 2016/17 | 41 | n/a |
| Number of investments made in 2016/17 maturing in 2017/18 | n/a | 14 |
| Number of investments made in 2017/18 maturing in 2017/18 | n/a | 23 |
| Total number of investments maturing in year | 52 | 37 |
| | | |
| Number of investments made in 2017/18 maturing in 2018/19 | n/a | 19 |
| Number of investments made in 2017/18 maturing in 2020/21 | n/a | 1 |
| | | |
| Average duration of investments (including overnight) | 4 days | 11 days |
| Average duration of investments (excluding overnight) | 84 days | 118 days |
| | | |
| Non-specified investments: | | |
| Rated non-high | | |
| Approved limit | 55% | 75% |
| Maximum level invested | 41% | 64% |
| | | |
| Not Rated | | |
| Approved limit | 0% | 0% |
| | | |
| Investments greater than 364 days | | |
| Approved limit | £15m | £15m |
| Maximum level Invested | £0m | £5m |

Outstanding amounts relating to the impaired investment with Heritable Bank are not included within this appendix.

**Appendix 4**

## Prudential Indicators 2017/18

The 2017/18 Prudential Indicators were agreed by Council on 23 February 2017 (column 1). This is now compared with the 2017/18 actual outturn position as at the 31 March 2018 (column 2).

Certain Treasury Management indicators must be monitored throughout the year on a regular basis in order to avoid breaching agreed limits. The capital expenditure and capital financing requirement indicators have been revised in line with the revised budget and none of the other approved Prudential Indicators set for 2017/18 have been breached.

| ***Capital Expenditure*** | | |
|---|---|---|
| | 2017/18<br>£000<br>Reported Indicator | 2017/18<br>£000<br>Actual |
| Non-HRA | 65,869 | 48,646 |
| HRA | 29,340 | 25,697 |
| **Total** | **95,209** | **74,783** |
| To reflect the reported capital monitoring agreed by Council during the year | | |

| ***Ratio of Financing Costs to Net Revenue Stream*** | | |
|---|---|---|
| | 2017/18<br>Reported Indicator | 2017/18<br>Actual |
| Non-HRA | 14.89% | 12.82% |
| HRA | 42.53% | 43.44% |

| ***Capital Financing Requirement*** | | |
|---|---|---|
| | 2017/18<br>£000<br>Reported Indicator | 2017/18<br>£000<br>Actual |
| Non-HRA | 340,885 | 320,153 |
| HRA | 345,505 | 345,505 |

There were no breaches to the Prudential Indicators set for 2017/18.

| Authorised Limit for External Debt | |
|---|---|
| | **2017/18<br>£000<br>Reported Indicator** |
| Borrowing | 825,000 |
| Other Long-Term Liabilities | 0 |
| **Total** | **825,000** |
| Maximum YTD £655.189m | |

| Operational Boundary for External Debt | |
|---|---|
| | **2017/18<br>£000<br>Reported Indicator** |
| Borrowing | £800,000 |
| Other Long-Term Liabilities | 0 |
| **Total** | **£800,000** |
| Maximum YTD £655.189m | |

The Council's actual external debt at 31 March 2018 was £650.341m. It should be noted that actual external debt is not directly comparable to the Authorised Limit and Operational Boundary, since the actual external debt reflects the position at one point in time.

***Estimated Incremental Impact on Council Tax and Housing Rents***

This indicator is set at the time the Council's budget is set. Therefore, there is no requirement for this Indicator to be monitored on a quarterly or annual basis.

**Adherence to CIPFA code on Treasury Management**

The Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Services.

| Upper Limit on Fixed and Variable Interest Rates Exposures | | |
|---|---|---|
| Range | 2017/18<br>£000<br>Reported Indicator | 2017/18<br>£000<br>Actual Position |
| Fixed Rate | Max 652,940<br>Min 424,015 | Actual 528,795<br>*Max 528,795*<br>*Min 499,731* |
| Variable | Max 160,751<br>Min (15,000) | Actual 30,000<br>*Max 44,000*<br>*Min 19,000* |
| All within agreed limits.<br>(Max and Min YTD) | | |

| Upper / Lower Limits for Maturity Structure of Fixed Rate Borrowing | | | | |
|---|---|---|---|---|
| | 2017/18<br>Reported Indicator | | 2017/18<br>Actual Position | |
| | Upper Limit | Lower Limit | Actual Percentage | Maximum YTD |
| Under 12 months | 25% | 0% | 2.99% | 9.66% |
| 12 months to 24 months | 25% | 0% | 6.28% | 6.39% |
| 24 months to 5 years | 50% | 0% | 17.08% | 20.84% |
| 5 years to 10 years | 50% | 0% | 9.45% | 9.45% |
| 10 years to 20 years | 50% | 0% | 10.72% | 14.71% |
| 20 years to 30 years | 50% | 0% | 1.20% | 1.25% |
| 30 years to 40 years | 50% | 0% | 19.10% | 19.39% |
| 40 years to 50 years | 60% | 0% | 28.57% | 29.67% |
| 50 years and above | 30% | 0% | 0.00% | 3.55% |
| All within agreed limits. | | | | |

On 8 March 2007, Council agreed to the placing of investments for periods of longer than 364 days in order to maximise investment income before forecast cuts in interest rates. An upper limit was set and agreed as a new Prudential Indicator.

| Upper Limit on amounts invested beyond 364 days | | | |
|---|---|---|---|
| | 2017/18<br>£000<br>Reported Indicator | 2017/18<br>£000<br>Actual Position | 2017/18<br>£000<br>Maximum YTD |
| Investments | **15,000** | **5,000** | **5,000** |