Appendix 2

FLINTSHIRE COUNTY COUNCIL

DRAFT TREASURY MANAGEMENT

ANNUAL REPORT 2017/18

1.00 INTRODUCTION

1.01 The Council approved the Treasury Management Strategy (Strategy) 2017/18 including key indicators, limits and an annual investment strategy on 14th February 2017.

1.02 The Strategy was produced based on the 2011 edition of the CIPFA Treasury Management in the Public Services: Code of Practice.

1.03 The purpose of this report is to review the outcomes from 2017/18 treasury management operations and compare these with the Strategy.

1.04 Treasury management comprises the management of the local authority's 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.

2.00 ECONOMIC & INTEREST RATE REVIEW 2017/18

This Provided by Arlingclose Ltd the Council's Treasury Management advisors.

Economic commentary

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.

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

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 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.

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.

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.

Financial markets:

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.

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.

3.00 BORROWING REQUIREMENTS AND DEBT MANAGEMENT

3.01 PWLB (Public Works Loans Board) Certainty Rate

The Council again qualified for the PWLB Certainty Rate, allowing the authority to borrow at a reduction of 20 basis points on the Standard Rate for a further 12 months from 1st November 2017.

3.02 Borrowing Activity in 2017/18.

The total long term borrowing outstanding, brought forward into 2017/18 totalled £252.6 million.

	Balance 01/04/2017 £m	**Debt Maturing £m**	**New Debt £m**	**Balance 31/03/2018 £m**
Capital Financing Requirement	**305.3**	5.5	27.8	**327.6**
Short Term Borrowing	10.0	(10.0)	52.1	52.1
Long Term Borrowing	252.6	(1.6)	3.1	254.1
TOTAL BORROWING	262.6	(11.6)	55.2	306.2
Other Long Term Liabilities	6.0	(0.6)	0.00	5.4
TOTAL EXTERNAL DEBT	**268.6**	**(12.2)**	**55.2**	**311.6**
Increase/(Decrease in Borrowing (£m)	-	-	43.0	

3.03 At 31st March 2018, loans with the Public Works Loans Board were in the form of fixed rate (£220.4m) and variable rate (£10m), £18.95m was variable in the form of LOBO's (Lender's Option, Borrower's Option) and £4.37m were interest free loans from the Government, available for specific schemes. The Council's average rate for long term borrowing was 5.00%.

3.04 The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31st March 2018 was £327.6m. The Council's total external debt was £311.6m.

3.05 Loans at Variable Rates

The Council has £10m of PWLB variable rate loans, at an average rate of 0.48%

which mitigate the impact of changes in variable rates on the Council's overall treasury portfolio (the Council's investments are deemed to be variable rate investments due to their short-term nature). This strategic exposure to variable interest rates will be regularly reviewed and, if appropriate, reduced by switching into fixed rate loans.

3.06 Internal Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the borrowing strategy was to minimise debt interest payments without compromising the longer-term stability of the portfolio. With short term interest rates lower than long term rates, it was more cost effective in the short term to either use internal resources, or to borrow short term instead.

The use of internal resources has been the most cost effective means of funding in previous years. This lowered overall treasury risk by reducing both external debt and temporary investments. However, the position was not sustainable for the whole year and the Council had always expected it would need to borrow for capital purposes from 2017/18 onwards.

The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant at around 2.58%.

3.07 Short Term Borrowing

Short term borrowing was undertaken as necessary in accordance with the 2017/18 borrowing strategy. The total short term (temporary) borrowing as at 31st March 2018 was £52.1m with an average rate of 0.68%.

3.08 Lender's Option Borrower's Option Loans (LOBOs)

The Council holds £18.95m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. All of these LOBOS had options during the year, none of which were exercised by the lender.

3.09 Debt Rescheduling

Options for debt rescheduling were explored and the following is a summary of the results of work undertaken in conjunction with our treasury management advisors:

PWLB Loans

The premium charged 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.

LOBOs

The Council explored the option to repay LOBOs early and received valuations for the LOBO loans from the bank. Following a review it has been established that the premium would cost £11.7m, which is 62% of principal amount of the LOBOs. Therefore, to repay the loans the Council would need to repay the principal of £18.95m and the premium of £11.7m, a total of £30.65m. This reflected the expected prolonged low interest rate environment. FMS (the lender of the Lobos) did not offer any discounts on the premium cost.

Given the valuations offered by FMS and the Council's financial position, costs were unlikely to be lower due to the need to refinance both the principal and premium. The Council was advised not to repay unless FMS agrees a lower valuation of the loans and decided at this time not to refinance.

While the Council could reduce its exposure to the optionality contained within the loans, i.e. uncertain refinancing risk, this risk is very low in the short to medium term.

The Corporate Finance Manager, in conjunction with the Council's treasury advisors will continue to review any potential opportunities for restructuring the Council's debt in order to take advantage of potential savings as interest rates change and to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility).

3.10 Loan to NEW Homes

In May 2016 Cabinet approved a loan to the Council's wholly owned company, NEW Homes Ltd, to build 62 homes on The Walks site in Flint for rent at affordable levels. To enable the funding of this loan, Council approved an increase in the Council's borrowing limit in June 2016.

£3.7m of this loan was drawn down during 2017/18 and was funded by short term borrowing. The total amount drawn down as at 31st March 2018 was £7.106m

The loan to NEW Homes does not meet the definition of an investment and is not therefore included in the Council's investment figures below. It is classed as capital expenditure.

4.00 INVESTMENT ACTIVITY

4.01 The Welsh Government's Investment Guidance gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

4.02 Investment Activity in 2017/18

Summary of investments as at 31st March 2018.

Country	Total	<1 month	1 –12 months	>12 months
	£m	%	£m	£m
UK BANKS				
UK BUILDING SOCIETIES	4.0	4.0		
OVERSEAS				
MMF's				
LOCAL AUTHORITIES	3.0	3.0		
DMO	26.4	26.4		
TOTAL	**33.4**	**33.4**	**0.00**	**0.0**

As none of these investments were greater than three months they are classified as cash in the Council's Balance Sheet.

4.03 Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Strategy for 2017/18. Investments during the year included:

- Deposits with the Debt Management Office
- Deposits with other Local Authorities
- Investments in AAA-rated Constant Net Asset Value Money Market Funds
- Call accounts and deposits with Banks and Building Societies
- Certificates of Deposit

4.05 Credit Risk

The Authority assessed and monitored counterparty credit quality with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP and share price. The minimum long-term counterparty credit rating determined by the Authority for the 2017/18 treasury strategy was A-/A-/A3 across rating agencies Fitch, S&P and Moody's.

4.06 Counterparty Update

Credit Metrics

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.

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 Council 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 the Council's Treasury Management advisors 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.

Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non ring-fenced bank.

Money Market Fund regulation: 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). The Council's treasury management advisors expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

Credit Rating developments

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.

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).

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.

Fitch revised the outlook on Nationwide Building Society to negative and later downgraded the institution's long-term ratings due to its reducing buffer of junior debt. S&P revised the society's outlook from positive to stable.

S&P downgraded Transport for London to AA- from AA following a deterioration in its financial position.

<u>Other developments:</u>
In February, the Council's Treasury Management advisors advised against lending to Northamptonshire County Council (NCC). NCC issued a section 114 notice in the light of severe financial challenge and the risk that it would not be in a position to deliver a balanced budget.

In March, following the Council's Treasury Management advisor's advice, the Council removed RBS plc and National Westminster Bank from its counterparty list. This did not reflect any change to the creditworthiness of either bank, but a tightening in recommended minimum credit rating criteria to A- from BBB+ for FY 2018-19. The current long-term ratings of RBS and NatWest do not meet this minimum criterion, although if following ring-fencing NatWest is upgraded, the bank would be reinstated on the Council's lending list.

4.07 Liquidity

In keeping with the WG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds and call accounts.

4.08 Yield

The UK Bank Rate began the year at 0.25% with a rise in November to 0.5% where it has since stayed. Short term money market rates also remained at very low levels which continued to have a significant impact on investment income. The low rates of return on the Authority's short-dated money market investments reflect prevailing market conditions and the Authority's objective of optimising returns commensurate with the principles of security and liquidity.

The Authority's budgeted investment income for the year had been estimated at £45k The average cash balance was £16.6m during the period and interest earned was £57k, at an average interest rate of 0.31%.

4.09 Local Authority Regulatory Changes

Revised CIPFA Codes: 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.

The Council's Capital Strategy and Asset Management Plan will be updated during 2018/19 to support the current and emerging longer term Council priorities and to meet the investment needs of new or readopted business models. The new Strategy will be more ambitious and will be an evidence base to support the leverage of national funds to meet Council priorities.

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.

Changes to the Investment Guidance include a wider definition of investments to include non-financial assets held primarily for generating income return and a new category called "loans" (e.g. temporary transfer of cash to a third party, joint venture, subsidiary or associate). The Guidance introduces the concept of proportionality, proposes additional disclosure for borrowing solely to invest and also specifies additional indicators. Investment strategies must detail the extent to which service delivery objectives are reliant on investment income and a contingency plan should yields on investments fall.

The definition of prudent MRP has been changed to "put aside revenue over time to cover the CFR"; it cannot be a negative charge and can only be zero if the CFR is nil or negative. Guidance on asset lives has been updated, applying to any calculation using asset lives. Any change in MRP policy cannot create an overpayment; the new policy must be applied to the outstanding CFR going forward only.

There have been no moves yet by Welsh Government on proposed changes to the Guidance on Local Authority Investments. The Council is however aware of the MHCLG's changes to the Investment Guidance for English authorities.

Amendments to Capital Finance Legislation:

The Welsh Government published the Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2018 in March 2018. It amends and clarifies erstwhile regulations so that investments in corporate bonds and shares in FCA (Financial Conduct Authority) approved UCITS (Undertakings for the Collective Investment of Transferable Securities) funds, Real Estate Investment Trusts (REITs) and investment schemes approved by HM Treasury are no longer treated as capital expenditure. This legislation came into effect in the 2017/18 financial year. It enables the Council to invest in these instruments, if appropriate for the council's circumstance and objectives, without the potential revenue cost of MRP (Minimum Revenue Provision) and without the proceeds from sale being considered a capital receipt.

MiFID II:

As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could "opt up" to professional client status, providing certain criteria was met which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a year's relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The Council has met the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. The Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

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5.00 COMPLIANCE

5.01 The Council can confirm that it has complied with its Prudential Indicators for 2017/18. These were approved by Council as part of the Treasury Management Strategy on 14th February 2017.

5.02 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.

5.03 On one occasion, the Council exceeded its limits for investing with other local authorities as detailed in the Treasury Management Policy Schedules. Flintshire invested 5m with the London Borough of Bexley – exceeding the prescribed policy limit by 2m for a total of 10 days. This was due to human error and the decision to not call back the deal was taken due to the investment being with another local authority. The credit risk exposure was minimal and the early redemption premium would have incurred an extra cost to the Council.

5.04 Apart from the breach reported in paragraph 5.03, the treasury function operated within the limits detailed in the Treasury Management Policy and Strategy Statement 2017/18.

6.00 OTHER ITEMS

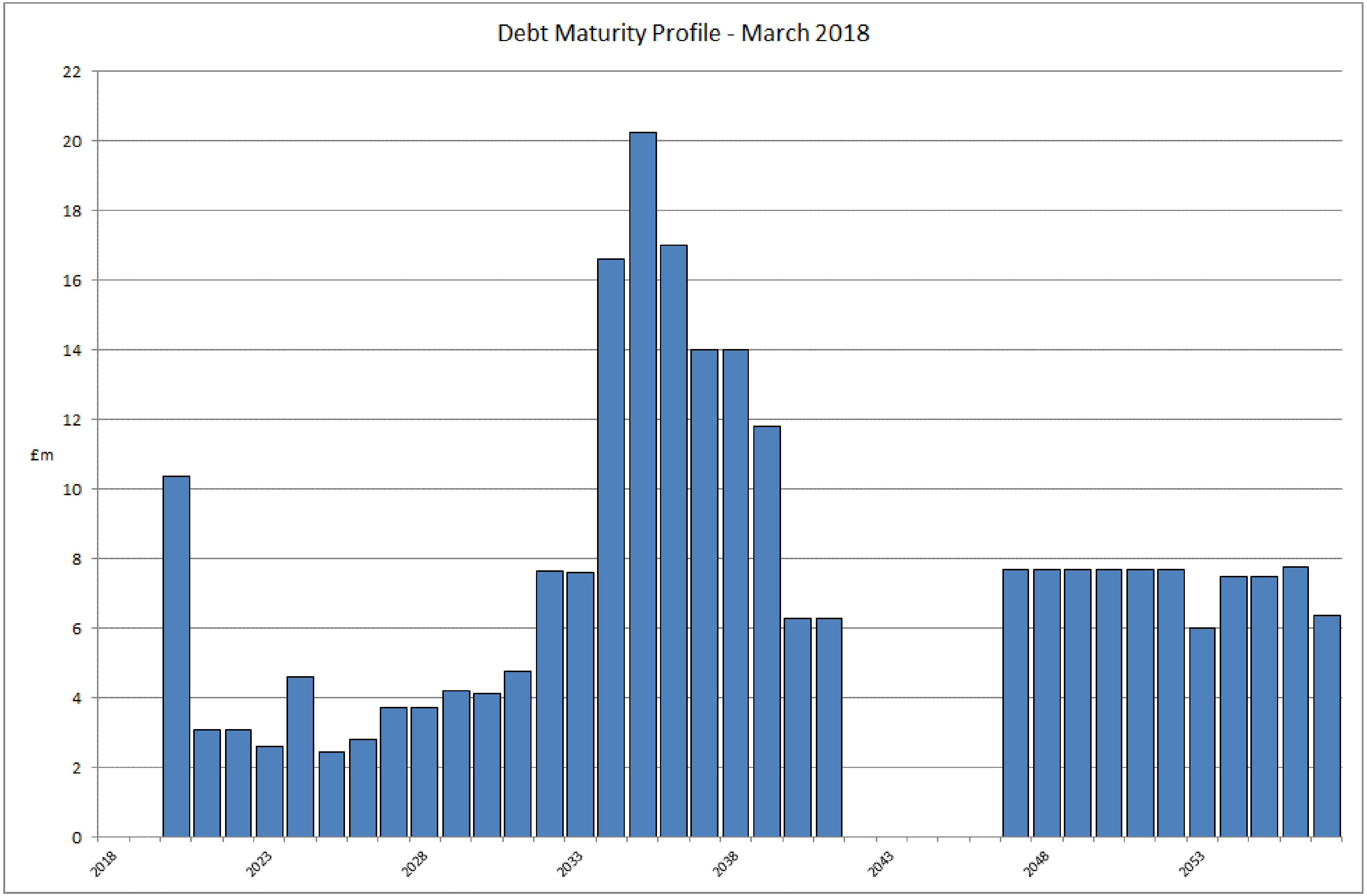
6.01 The following were the main treasury activities during 2017/18:

- The Council received a Mid-Year Report on 30th January 2018.
- Quarterly update reports were presented to the Audit Committee.
- The 2018/19 Investment Strategy Statement was approved by Council on 20th February 2018.
- The Council continues to be an active member of the CIPFA Treasury Management Network.
- The Council's cash flow was managed on a daily basis. During the year the Council acted both as a borrower and as a lender and was a net borrower over the year in question. The maximum investments the Authority had on deposit at any one time was £33.4m and the maximum long-term borrowing at any one time was £254.1m.

7.00 CONCLUSION

7.01 The treasury management function has operated within the statutory and local limits detailed in the 2017/18 Treasury Management Strategy.

7.02 The Policy was implemented in a pro-active manner with security and liquidity as the focus.



Debt Maturity Profile - March 2018
£m
0
2
4
6
8
10
12
14
16
18
20
22
2018
2023
2028
2033
2038
2043
2048
2053