City of BRADFORD METROPOLITAN DISTRICT COUNCIL

Report of the Director of Finance to the meeting of Governance and Audit to be held on 28 June 2019

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Subject:

Annual Treasury Management Report 2018-19

Summary statement:

This report shows the Council's Treasury Management activities for the year ending 31 March 2019

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Portfolio: Corporate Services

Overview & Scrutiny Area:

Corporate Services

1. Introduction

This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2018-19. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code).

During 2018-19 the minimum reporting requirements were that the full Council should receive the following reports:

- An annual treasury strategy in advance of the year (Council 19/03/2019).
- A mid-year treasury update report (Council 16/10/2018).
- An annual review following the end of the year describing the activity compared to the strategy (this report).

The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Governance and Audit Committee before they were reported to the full Council. Member training on treasury management issues was undertaken during the year on 14/03/2019 in order to support Members' scrutiny role.

2. Overall Treasury Position as at 31 March 2019

At the beginning and the end of 2018-19 the Council's treasury, (including borrowing by PFI and finance leases), position was as follows:

	31 March 2018 Principal £'m	Rate/ Return	31 March 2019 Principal £'m	Rate/ Return
Fixed rate funding:				
-PWLB	278.8		275.8	
-Market	41.4	5.5%	36.2	5.4%
PFI and other finance leases	178.0		170.0	
Total debt	**498.2**		**482.0**	
CFR	669.5		700.1	
Over / (under) borrowing	(171.3)		(218.1)	
Total investments	35.0	0.4%	56.9	0.74%
Net debt	**463.2**		**425.1**	

3. Prudential Indicators

3.1 Capital Expenditure

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

	2017-18 Actual £'m	**2018-19 Estimate £'m**	**2018-19 Actual £'m**
Capital expenditure	**72.9**	**151.0**	**84.3**
Financed in year	55.9	76.0	52.7
Unfinanced capital expenditure	**17.0**	**75.0**	**31.6**

3.2 The Council's Overall Borrowing Need

The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's indebtedness and so the underlying borrowing need. Any capital expenditure above, which is not immediately paid for through a revenue or capital resource, will increase the CFR.

In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2017-18) plus the estimates of any additional capital financing requirement for the current (2018-19) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2018-19. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2018 Actual £'m	**31 March 2019 Budget £'m**	**31 March 2019 Actual £'m**
Capital Financing Requirement	669.5	740.0	700.1
Gross borrowing position	498.2	541.0	482.0

	31 March 2018 Actual £'m	31 March 2019 Budget £'m	31 March 2019 Actual £'m
(Under) / over funding of CFR	**(171.3)**	**(199.0)**	**(218.1)**

3.3 Treasury Indicators

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2018-19 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream.

	2018-19
Authorised limit	£640m
Maximum gross borrowing position during the year	£482m
Operational boundary	£600m
Financing costs as a proportion of net revenue stream	9.0%

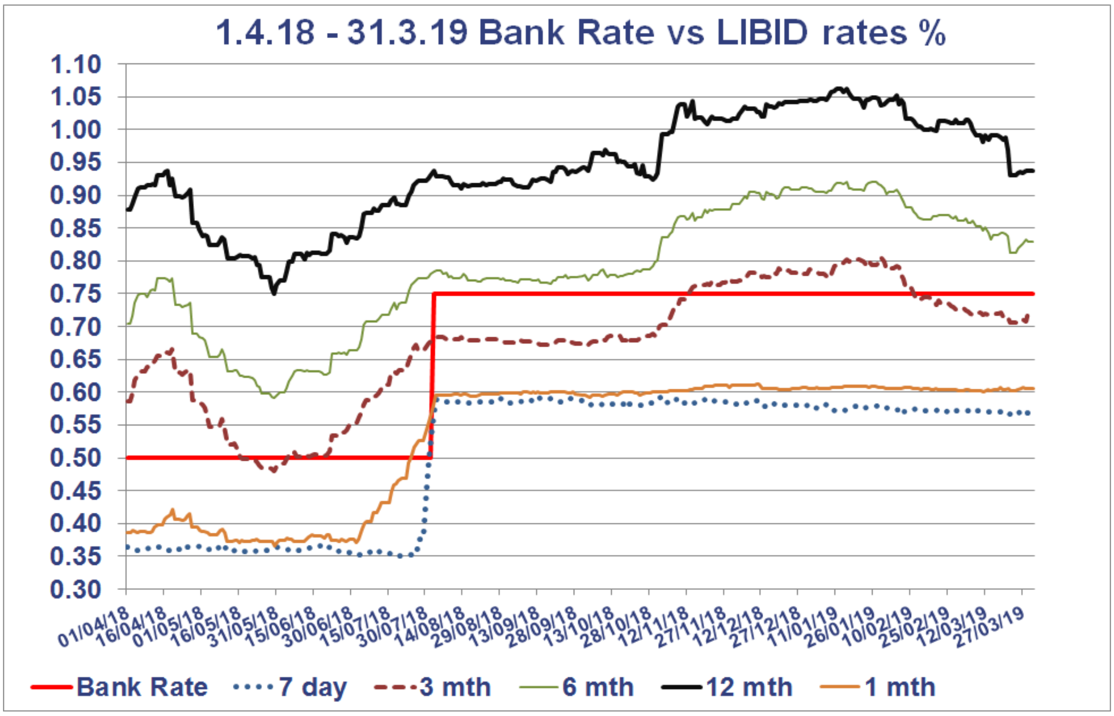
The maturity structure of the debt portfolio was as follows:

	31 March 2018 Actual £'m	31 March 2019 Actual £'m
Under 12 months	9.5	17.1
12 months and within 24 months	17.1	1.8
24 months and within 5 years	22.8	27.5
5 years and within 10 years	65.1	58.7
10 years and within 20 years	61.9	61.9
20 years and within 30 years	0	0
30 years and within 40 years	95.2	95.2
40 years and within 50 years	48.6	49.8

4 The Strategy for 2018-19

4.1 Investment strategy and control of interest rate risk

Investment returns remained low during 2018-19. The expectation for interest rates within the treasury management strategy for 2018-19 was that Bank Rate would rise from 0.50% to 0.75%. At the start of 2018-19, and after UK GDP growth had proved disappointingly weak in the first few months of 2018, the expectation for the timing of this increase was pushed back from May to August 2018. Investment interest rates were therefore on a gently rising trend in the first half of the year after April, in anticipation that the MPC would raise Bank Rate in August. This duly happened at the MPC meeting on 2 August 2018. During this period, investments were, therefore, kept shorter term in anticipation that rates would be higher later in the year.



It was not expected that the MPC would raise Bank Rate again during 2018-19 after August in view of the fact that the UK was entering into a time of major uncertainty with Brexit due in March 2019. Value was therefore sought by placing longer term investments after 2 August where cash balances were sufficient to allow this.

Investment rates were little changed during August to October but rose sharply after the MPC meeting of 1 November was unexpectedly hawkish about their perception of building inflationary pressures, particularly from rising wages. However, weak GDP growth data after December, plus increasing concerns generated by Brexit, resulted in investment rates falling back again.

Continued uncertainty in the aftermath of the 2008 financial crisis has 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.

4.2 Investment Outturn 2018-19

The Council's investment position at the end of 2018-19 is summarised below.

INVESTMENT PORTFOLIO	Actual 31.3.18 £m	Actual 31.3.18 %	Actual 31.3.19 £m	Actual 31.3.19 %
Treasury investments				
Banks	22.1	63	29.4	52
Building Societies - rated	4	11	5.0	9
Money Market Funds	8.9	26	22.5	39
Total managed in house	**35.0**	**100**	**56.9**	**100**

The maturity structure of the investment portfolio was as follows:

	2018-19 Actual £'m	2018-19 Actual £'m
Investments		
Longer than 1 year	£0m	£0m
Up to 1 year	35.0m	56.9m

Investments held by the Council - The Council maintained an average balance of £54.7m of internally managed funds. The internally managed funds earned an average rate of return of 0.74%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.506%.

4.3 Investment Policy

The Council's investment policy is governed by MHCLG investment guidance, which has been implemented in the annual investment strategy approved by the Council on 19th March 2019. 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.

5 Borrowing strategy and control of interest rate risk

Borrowing is undertaken to fund net unfinanced capital expenditure and naturally maturing debt and also to maintain cash flow liquidity requirements. During 2018-19, the Council maintained an under-borrowed position. This means that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when the Council may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Director of Finance monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks:

- If it had been felt that there was a significant risk of a sharp FALL in long and short term rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding into short term borrowing would have been considered.

- If it had been felt that there was a significant risk of a much sharper RISE in long and short term rates than initially expected, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position would have been re-appraised. Most likely, fixed rate funding would have been drawn whilst interest rates were lower than they were projected to be in the next few years.

Interest rate forecasts expected only gradual rises in medium and longer term fixed borrowing rates during 2018-19 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

Below are Links forecasts for interest rates set at 12/2/18.

Link Asset Services Interest Rate View	12.2.18												
	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.50%
5yr PWLB Rate	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%
10yr PWLB Rate	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%

Since PWLB rates peaked during October 2018, most PWLB rates have been on a general downward trend, though longer term rates did spike upwards again during December, and, (apart from the 1 year rate), reached lows for the year at the end of March. There was a significant level of correlation between movements in US Treasury yields and UK gilt yields -which determine PWLB rates. The Fed in America increased the Fed Rate four times in 2018, making nine increases in all in this cycle, to reach 2.25% –

2.50% in December. However, it had been giving forward guidance that rates could go up to nearly 3.50%. These rate increases and guidance caused Treasury yields to also move up. However financial markets considered by December 2018, that the Fed had gone too far, and discounted its expectations of further increases. Since then, the Fed has also come round to the view that there are probably going to be no more increases in this cycle.

The issue now is how many cuts in the Fed Rate there will be and how soon, in order to support economic growth in the US. But weak growth now also looks to be the outlook for China and the EU so this will mean that world growth as a whole will be weak. Treasury yields have therefore fallen sharply during 2019 and gilt yields / PWLB rates have also fallen.

5.1 Borrowing Outturn 2018-19

The Council repaid two maturing PWLB loans in the year totally £9.48m with an average rate of interest of 7.63%. The maturity of these loans results in an annual saving of 724k interest.

A new PWLB loan was drawn in December from the PWLB for 48 years at a rate of 2.77% to finance the repayment of a LOBO loan.

Summary of debt transactions – management of the debt portfolio resulted in a fall in the average interest rate of 0.15%, representing net General Fund savings of £782k per year.

5.2 Borrowing in advance of need

The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

5.3 Rescheduling

In December 2018 the Council entered a competitive bidding process to purchase one of its LOBO loans. The Council was successful with the bid and the loan valued at £5.2m was purchased. The interest rate on this loan was 4.5% and it was replaced as part of the £6.4m PWLB loan at 2.77%. This means that even with a premium payments of £1.145m the Council makes an annual revenue saving.

6 Other considerations

6.1 None

7 Changes to the Treasury Policy

At present the Council only uses Moody’s for its long term credit rating in the Treasury Policy’s. This raises the issue that there are a few banks including ring fenced banks which use the other two main credit rating agencies but not Moody’s. This means at present we would not be able use these banks.

Due to the issue raised above it is proposed to make the following changes to the Treasury Policy.

The present criteria are:

Any Bank or a Building Society with a Moody's rating of Aa3 or better, a Fitch short-term credit rating of at least F1and a Standard & Poor (S & P) rating of A-1 a limit of £30 million.

Any Bank or a Building Society with a Moody's rating of A1 or better, a Fitch short-term credit rating of at least F1and a S & P rating of A-1 a limit of £20 million.

New criteria

Any Bank or a Building Society with a Moody's rating of Aa3 or better,(Fitch AA- if not available) a Fitch short-term credit rating of at least F1and a S & P rating of A-1 a limit of £30 million.

Any Bank or a Building Society with a Moody's rating of A1 or better,(Fitch A+ if not available) a Fitch short-term credit rating of at least F1and a S & P rating of A-1

8 Options

8.1 None

9 Financial and Resources Appraisal

9.1 The financial implications are set out in section 1,2,3, 4 and 5.

10 Risk Management

10.1 The principal risks associated with treasury management are:

Risk: Loss of investments as a result of failure of counterparties.
Mitigation: Limiting the types of investment instruments used, setting lending criteria for counterparties, and limiting the extent of exposure to individual counterparties.

Risk: That the council will commit too much of its investments in fixed term investments and might have to recall investments prematurely resulting in possible additional costs or new borrowing (Liquidity risk).
Mitigation: Ensuring that a minimum proportion of investments are held in short term investments for cashflow purposes.

Risk: The level of investments and surplus cash is higher than needed to fund short term timing differences.
Mitigation: Cash flow forecasting and capital expenditure monitoring.

Risk: Increase in the net financing costs of the Council due to borrowing at high rates of interest.

Mitigation: Planning and undertaking borrowing and lending in light of assessments of future interest rate movements, and by undertaking mostly long term borrowing at fixed rates of interest (to reduce the volatility of capital financing costs).

Risk: Higher interest rates increase borrowing making it more difficult to self-finance capital schemes. Debt servicing becomes less affordable and less sustainable and crowds out revenue spend.
Mitigation: To pause, delay or defer capital schemes. Also review opportunities to borrow in the future at current interest rates.

Risk: Return on non-treasury investments lower than expected.
Mitigation: Review and analysis of risk prior to undertaking non-treasury investments.

Risk: The Council's Minimum Revenue Policy charges an insufficient amount to the Revenue Estimates to repay debt.
Mitigation: Align the Minimum Revenue Policy to the service benefit derived from the Council's assets.

Risk: Associated with cash management, legal requirements and fraud.
Mitigation: These risks are managed through:

- Treasury Management Practices covering all aspects of Treasury management procedures including cashflow forecasting, documentation, monitoring, reporting and division of duties.
- All Treasury management procedures and transactions are subject to inspection by internal and external auditors.

The Council also employs external financial advisors to provide information on market trends, credit rating alerts, lending criteria advice and investment opportunities.

11 Legal Implications

11.1 Any relevant implication considerations are set in the report.

12 Other Implications

12.1 Equal Rights implications – no direct implications
12.2 Sustainabilty implications – no direct implications
12.3 Green house Gas Emissions Impact- no direct implications
12.4 Community safety implications- no direct implications
12.5 Human Rights Act – no direct implication
12.6 Trade Unions – no direct implications
12.7 Ward Implications – no direct implications

13 Not for publications documents

13.1 None

14 Recommendations

14.1 That the report be noted and referred to Council at its meeting on the 16th July 2019 for adoption.

15 Appendices

Appendix 1: Prudential and treasury indicators

Appendix 2: Borrowing and investment rates

16 Background Documents

Treasury Management Schedules
Treasury Management Practices
Treasury Policy

Appendix 1: Prudential and treasury indicators

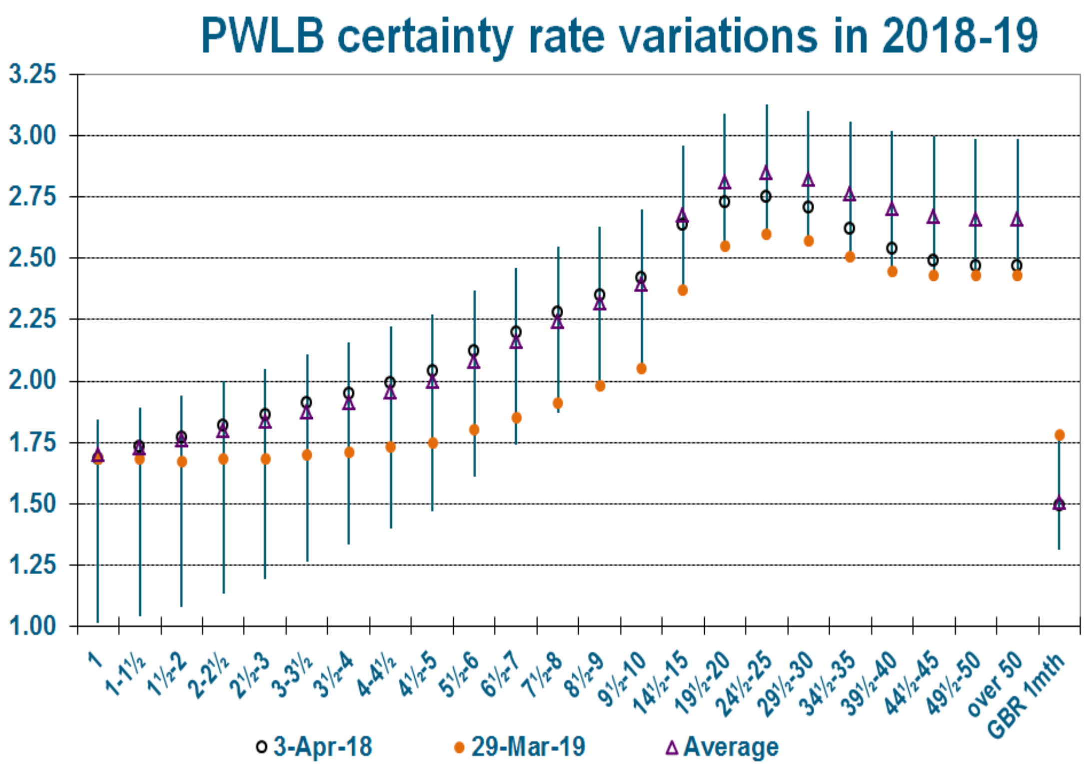
1. PRUDENTIAL INDICATORS	2017/18 Actual £'000	2018/19 Estimate £'000	2018/19 Actual £'000
Capital Expenditure	72,900	151,000	84,343
Ratio of financing costs to net revenue stream	15.8%	9.9%	9.0%
Gross borrowing requirement General Fund	320,000	363,000	312,000
Capital Financing Requirement	669,000	740,000	700,124

2. TREASURY MANAGEMENT INDICATORS	**2017/18 Actual £'000**	**2018/19 Original £'000**	**2018/19 Actual £'000**
Authorised Limit for external debt -			
borrowing	320,000	420,000	312,000
other long term liabilities	178,000	220,000	169,000
TOTAL	**498,000**	**640,000**	**481,000**
Operational Boundary for external debt -			
borrowing	320,000	400,000	312,000
other long term liabilities	178,000	200,000	169,000
TOTAL	**498,000**	**600,000**	**481,000**
Actual external debt	320,000		312,000

Maturity structure of fixed rate borrowing during 2018-19	upper limit	lower limit
under 12 months	20%	0%
12 months and within 24 months	20%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	50%	0%
10 years and within 20 years	90%	0%
20 years and within 30 years	90%	0%
30 years and within 40 years	90%	0%
40 years and within 50 years	90%	0%
Maturity structure of investments during 2018-19	upper limit	lower limit
Longer than 1 year	£20m	£0m

Appendix 2: Borrowing and investment rates

a) PWLB borrowing rates



	1 Year	5 Year	10 Year	25 Year	50 Year
02/04/2018	1.48%	1.85%	2.23%	2.57%	2.29%
29/03/2019	1.48%	1.55%	1.85%	2.40%	2.23%
Low	1.28%	1.50%	1.80%	2.33%	2.16%
Date	29/05/2018	26/03/2019	28/03/2019	26/03/2019	26/03/2019
High	1.64%	2.07%	2.50%	2.93%	2.79%
Date	04/10/2018	10/10/2018	10/10/2018	10/10/2018	12/10/2018
Average	1.50%	1.80%	2.20%	2.66%	2.47%

b) Money market investment rates and forecasts 2018/19

	Bank Rate	7 day	1 mth	3 mth	6 mth	12 mth
01/04/2018	0.50	0.36	0.39	0.59	0.70	0.88
31/03/2019	0.75	0.57	0.61	0.72	0.83	0.94
High	0.75	0.59	0.61	0.81	0.92	1.06
High Date	02/08/2018	01/11/2018	10/12/2018	29/01/2019	15/01/2019	11/01/2019
Low	0.50	0.35	0.37	0.48	0.59	0.75
Low Date	01/04/2018	19/07/2018	30/05/2018	30/05/2018	30/05/2018	30/05/2018
Average	0.67	0.51	0.54	0.68	0.79	0.94
Spread	0.25	0.24	0.25	0.33	0.33	0.31