Somerset County Council
Cabinet – 9th July 2018

Annual Treasury Management Outturn Report 2017-18

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Report Sign off	**Seen by:**	**Name**	**Date**
	County Solicitor	Honor Clarke	14/6/18
	Monitoring Officer	Scott Wooldridge	25/6/18
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	Human Resources	Chris Squire	25/6/18
	Senior Manager	Kevin Nacey	25/6/18
	Cabinet Member	Cllr Mandy Chilcott	25/6/18
Forward Plan Reference:	FP/18/04/07		
Summary:	The Annual Treasury Management Outturn Report is a requirement of the CIPFA Treasury Management Code and covers the Treasury Management activity for 2017-18. This report: - ➢ Is prepared in accordance with the CIPFA Treasury Management Code and the Prudential Code. ➢ Gives details of the outturn position on treasury management transactions in 2017-18. ➢ Presents details of capital financing, borrowing, and investment activity. ➢ Reports on the risk implications of treasury decisions and transactions. ➢ Confirms compliance with treasury limits and Prudential Indicators or explains non-compliance.		
Recommendations:	**This is a formal report and the Cabinet is asked to approve it and submit it to Full Council on 18th July 2018.**		
Reasons for Recommendations:	The Local Government Act 2003 requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services. The Code requires Full Council to receive as a minimum, an annual strategy and plan in advance of the year, a mid-year review, and an annual report after its close. This is the full-year review for 2017-18.		
Links to Priorities and Impact on Service Plans:	Effective Treasury Management provides support to the range of business and service level objectives that together help to deliver the Somerset County Plan.		
Consultations undertaken:	Not Applicable		
Financial Implications:	None directly		
Legal Implications:	None		
HR Implications:	None		

Risk Implications:	There are no specific risks associated with this outturn report. The risks associated with Treasury Management are dealt with in the Annual Treasury Management Strategy, Annual Investment Strategy, and Treasury Management Practice documents.
Other Implications (including due regard implications):	None
Scrutiny comments / recommendation (if any):	The Audit Committee is the nominated body to provide scrutiny for Treasury Management and this report will be sent to Audit Committee members.

1. Background

1.1. The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance. A more detailed outline of these, including the Treasury Management Framework and Policy is given at appendix A.

1.2. Somerset County Council (SCC) has adopted the CIPFA Code of Practice for Treasury Management and operates its treasury management service in compliance with this Code and the requirements in appendix A. The Code requires as a minimum, a formal report on treasury activities and arrangements to Full Council mid-year and after the year-end. These reports enable those tasked with implementing policies and undertaking transactions to demonstrate they have properly fulfilled their responsibilities, and enable those with ultimate responsibility/governance of the treasury management function to scrutinise and assess its effectiveness and compliance with policies and objectives.

1.3. Whilst headline figures can be a useful guide to performance, they should not be viewed in isolation. It is important to also assess performance against the stated objectives and specific needs of SCC during the year, and to take a wider view in relation to timeframes and overall risk management. There are many factors and circumstances that affect treasury activity and performance that are not immediately apparent from statistical reports. Activities undertaken may be directly attributable to good risk management or preferred risk tolerances. Some limitations to purely statistical analysis are outlined in appendix B.

1.4. Useful comparison has been further eroded as some Local Authorities are investing in non-financial assets, with the primary aim of generating profit. Others are entering into very long-term investments or are providing loans to local enterprises or third sector entities as part of regeneration or economic growth projects. It is impossible to standardise and meaningfully compare returns, particularly for a given timeframe, and it is also extremely difficult to understand, quantify, and compare risks.

2. Treasury Activity and Outturn

2.1. Economic Background

The UK economy showed signs of slowing with March 2018 estimates showing GDP growing by 1.8% in 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. As well as domestic resilience, growth also reflected the re-emergence of the Eurozone economies and an increasingly buoyant US economy.

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 2017 before falling back to 2.7% in February 2018. Consumers felt the squeeze as real average earnings growth turned negative, before slowly recovering as inflation subsided.

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 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. The February 2018 Inflation Report indicated rate rises of a 'gradual' and 'limited' nature. In March however, two MPC members voted to increase policy rates immediately and the minutes of the meeting suggested that an increase in May 2018 was highly likely. Markets built in a probability of 90% for a May hike, although recent weak economic data has seen the MPC keep rates at 0.5% at the May meeting. Market rates have oscillated in tandem with prevailing sentiment.

In contrast to the UK, economic activity in the Eurozone gained momentum. The US economy grew steadily and increased interest rates in December 2017 by 0.25% and again in March, raising the policy rate target range to 1.50% - 1.75%.

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 2017 rose to 1.65% by the end of March 2018. 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 November 2017 increase in Bank Rate resulted in proportionately higher money markets rates. However, it was after the February meeting that rates rose significantly higher during the last 6-weeks of the year. Rates can be seen in the LIBID table in Appendix C. 1-month, 3-month, 6-month and 12-month LIBID rates averaged 0.23%, 0.28%, 0.40% and 0.60% respectively for 2017-18, and at 31st March 2018 were 0.39%, 0.59%, 0.70% and 0.88%.

A more detailed commentary on the year's events, and tables of relevant rates throughout the year is in Appendix C.

2.2. Summary of Performance

During the year, Council treasury management policies, practices, and activities remained compliant with relevant statutes and guidance, namely the CLG investment guidance issued under the Local Government Act 2003, and the CIPFA Treasury Management and Prudential Codes.

The Council can confirm that it has complied with its Prudential Indicators for 2017-18.

All Capital projects were funded from Capital Receipts and Grant allowances from central Government, and contributions and funds set aside to repay loans that have been re-profiled, thereby eliminating the need to borrow in 2017-18.

The SCC weighted average rate paid on total borrowings of £329.55m was 4.66%, the same as 2016-17 as there was no change in portfolio.

Security of capital remained the Council's main investment objective. This was achieved by following the counterparty policy as set out in the Annual Investment Strategy, and by the approval method set out in the Treasury Management Practices. SCC has continuously monitored counterparties, and all ratings of proposed counterparties have been subject to verification on the day, immediately prior to investment.

The biggest macro influence on banks' ratings was that 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.

Moody's downgraded the UK sovereign rating in September from Aa1 to Aa2 bringing it in line with the other two rating agencies. It also downgraded the long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment, and the ratings of the large Australian banks.

As there was some uncertainty surrounding which UK banking entities the Council would be dealing with once ring-fencing was implemented, and in response to the above, the Council reduced the duration for unsecured investments to UK banks, to a maximum of 6 months and suspended RBS. It also reduced its' duration limits with Canadian Banks to 6-months from 13-months. Australian Banks already had a limit of 6-months.

An account of issues and any restrictions implemented throughout the year can be found in appendix G.

Liquidity. In keeping with the CLG guidance, the Council maintained a sufficient level of liquidity through the use of call accounts, Money Market Funds, and short-term deposits. SCC did not need to borrow short-term money during the year.

CCLA Property Fund. In May 2017, the Council placed a £10m investment in the CCLA Property Fund. This Fund has been in existence for more than 25 years and is only available to Local Authorities. It is an actively managed, diversified portfolio of UK Commercial Property with a stated investment objective "to provide investors with a high level of income and long-term capital appreciation".

Yield (Ex-Property). Interest of £1.36m was earned on cash investments during 2017-18. The decrease on the comparator figure for 2016-17 of £2.08m is largely due to reduced average balances of £36.3m, subdued rates, and a reduction in investment duration. When compared with average cash rates for the year, the ex-property yield of 0.56% was only 0.04% less than the average 12-month LIBID rate, on a portfolio with an average duration of less than 5-months.

Property Fund. To 31st March the CCLA Property Fund delivered an average net income yield of 4.46%, £371,841 cash.

Yield (Inc-Property). Interest of £1.73m was earned on total investments during 2017-18. When compared to the average 6-month risk-free deposit rate of approximately 0.16% offered by the Government Debt Management Office (DMO) throughout the year, the benefit of the SCC investment strategy across the average SCC investment balance of £249.1m for the year was just over £1.3m (£1.7m in 2016-17).

Security and liquidity have been achieved with the income return of 0.69% achieved for the year, being 0.09% above the average 12-month LIBID rate.

During the year, SCC received 2 further dividends totalling, £128,936.64 from Kaupthing, Singer & Friedlander. A total of £8,819,266.46 has now been received.

In total, as at 31st March 2018 £23,215,519.30 had been recovered on all Icelandic claims. More detail of the current position is in Appendix G.

2.3. The Portfolio Position as at 31st March 2018

The portfolio position as at 31st March 2018 and a comparison with the beginning of the year can be found in Appendix D.

2.4. Temporary Borrowing

Temporary borrowing has not been necessary at all during 2017-18. Further details can be found in Appendix E.

2.5. Long-Term Borrowing

The overall level of borrowing remained the same during the year, at £329.55m. The cost of rescheduling or repaying PWLB debt early varied significantly during the year as Gilt yields fell yet again. In March 2017 the total premium stood at £103m. During 2017-18, a year-high premium of £104m would have been payable in June, a low of £87m in mid-February, ending the year in March at £99m. Any decision to reschedule or repay debt would need to be taken in this dynamic environment. The weighted average rate paid on all debt was 4.66%. All details of long-term borrowing activity during the year can be found in Appendix F.

2.6. Cash managed on behalf of others

During 2017-18 SCC provided treasury management services to the Police and Crime Commissioner for Avon and Somerset, after winning a full competitive tender to provide Treasury Management services for 3 years from April 2015. An extension to April 2019 has been given during this financial year. Funds continue to be lent on a segregated basis, with PCC funds lent in its own name.

SCC continues to manage cash on behalf of other not-for-profit organisations including Exmoor National Park Authority (ENPA), and South West Councils (SWRC) via service level agreements and the Comfund vehicle. These balances were just under £8.6m at year-end.

In addition, during 2017-18, SCC was retained to manage the Local Enterprise Partnership (LEP) Growth Deal Grant on behalf of the other Enterprise Partners. A grant of £36.6m was received on 11th April 2017, and an average balance in excess of £50m was managed.

All treasury management activities, including a fee for the management of the LEP money, brought in income and benefits of approximately £204,000 during the year.

2.7. Lending

The average daily balance of the Council's investments during 2017-18 was £249.1m, down £36.3m from the previous year.

The weighted investment return of 0.69% was 0.09% better than the average 12-Month LIBID rate for the financial year. A more detailed commentary on activity and analysis of performance for the year can be found in Appendix G.

2.8. Comparison against other Local Authorities clients of Arlingclose

2017-18 was the ninth complete year that SCC had the services of retained Treasury advisors, Arlingclose. It would therefore seem appropriate to look at SCC performance compared with other Authorities that use Arlingclose, i.e. that share much of the same investment advice, particularly regarding counterparties. However, many of the caveats mentioned in appendix B may apply. Furthermore, it has become apparent that some Authorities have been investing in non-financial assets, and entering into very long-term investments or providing loans to local enterprises or third sector entities as part of regeneration or economic growth projects within their Treasury portfolios. With this in mind, a more equitable comparator, figures for internally managed investments only, has been used. The Arlingclose report compares quarter-end figures only, and comparisons can be seen below.

	Average Rate		Average Balance	
	SCC	Others	SCC	Others
June 2017	0.53%	0.51%	£258m	£70m
September 2017	0.53%	0.48%	£246m	£73m
December 2017	0.60%	0.54%	£218m	£73m
March 2018	0.68%	0.63%	£205m	£67m
Average	**0.59%**	**0.54%**	**£232m**	**£71m**

Using this methodology, SCC performance has been above that of comparators. This has been achieved with an average investment balance of more than 3 times that of the average for the universe.

From a risk perspective, both SCC and Other Authorities' average credit rating score was AA- throughout the year. (To give this some perspective, the United Kingdom Government is rated one notch above at AA). When comparing the average days to maturity with that of other County Councils, the SCC average of 116 days is a full **2 years** below the 879 days for other County Councils. This in part reflects the fact that SCC is holding circa £50m of LEP money on behalf of its partners, so needs to retain more liquidity, and that a much more cautious approach is taken with regard to interest rate risk, i.e. more funds are available sooner to invest in an anticipated rising rate market. This performance relative to risk can be seen in two graphs along with more general detail in appendix G.

2.9. Prudential Indicators

The Council can confirm that it has complied with its Prudential Indicators for 2017-18. Indicators that were set for the 2017-18 year, and the year-end position for each are set out in Appendix H.

2.10. Non-Financial Assets, Regulatory Changes, & Risk Management

Some Local Authorities have been investing in non-financial assets, with the primary aim of generating profit. Others have entered into very long-term investments or providing loans to local enterprises or third sector entities as part of regeneration or economic growth projects. Some recent 'non-financial investments' by other Local Authorities are highlighted in Appendix B.

The National Audit Office and the Public Accounts Committee raised a number of concerns about Local Authority (investment) behaviour. These are: -

- Local Authorities are exposing themselves to too much financial risk through borrowing and investment decisions
- There is not enough transparency to understand the exposure that LA's have as a result of borrowing and investment decisions
- Members do not always have sufficient expertise to understand the complex transactions that they have ultimate responsibility for approving

As a result of esoteric investments, and the subsequent review, Statutory Guidance on Local Government Investments has been revised, effective from 1st April 2018. The CIPFA Treasury Management and Prudential Codes have also been reviewed and updated. An overview is provided in Appendix I.

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. This included 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. As a result, the Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

SCC has continuously monitored counterparties, and all ratings of proposed counterparties have been subject to verification on the day, immediately prior to investment. Other indicators taken into account have been:-

- Credit Default Swaps and Government Bond Spreads.
- GDP and Net Debt as a Percentage of GDP for sovereign countries.
- Likelihood and strength of Parental Support.
- Banking resolution mechanisms for the restructure of failing financial institutions i.e. bail-in.
- Share Price.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.

The biggest macro influence on banks' ratings was that the rules for UK banks' ring-fencing were finalised by the Prudential Regulation Authority and banks began the implementation process ahead of the statutory deadline of 1st Jan 2019.

Moody's downgraded the UK sovereign rating in September from Aa1 to Aa2 bringing it in line with the other two rating agencies. It also downgraded the long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment, and the ratings of the large Australian banks.

As there was some uncertainty surrounding which UK banking entities the Council would be dealing with once ring-fencing was implemented, and in response to the above, the Council, reduced the duration for unsecured investments to UK banks, to a maximum of 6 months and suspended RBS. It also reduced its' duration limits with Canadian Banks to 6-months from 13-months. Australian Banks already had a limit of 6-months.

At year-end maximum durations per counterparty were as follows: -

- Nat West– **Operational use only;**
- Barclays, Goldman Sachs International, and Standard Chartered – **100 days;**
- HSBC, Bank of Scotland, Lloyds, Nationwide BS, Santander UK, OP Corporate, Landesbank Hessen-Thuringen and all Australian and Canadian banks – **6-months;**
- Nordea, Rabobank, Svenska Handelsbanken, and all Singaporean banks – **13-months;**

There was no audit during 2017-18, so the Audit report dated 28th September 2015 remains the latest one. It awarded the best possible outcome, as quoted below.

> "I am able to offer substantial assurance as the areas reviewed were found to be adequately controlled. Internal controls are in place and operating effectively and risks against the achievement of objectives are well managed".

SCC has continuously proactively assessed and implemented mitigation for the risks that have materialised in the new investment environment. Controls/procedures are constantly being assessed and introduced/adapted where needed, and embedded into practices to further mitigate risks to SCC investment and borrowing portfolios. Details of risk management and governance can be found in Appendix I.

Arlingclose has been retained Treasury Advisors throughout the period.

During the year Treasury staff have continued to attend regular courses and seminars provided through its membership of the CIPFA Treasury Management Forum (TMF), its advisors, Arlingclose, and other ad hoc events.

3. Options considered and reasons for rejecting them

3.1. Not Applicable

4. Consultations undertaken

4.1. None

5. Financial, Legal, HR and Risk Implications

5.1. There are no direct financial implications arising from this paper. There are no Legal, HR, or other direct risk implications from this report.

6. Other Implications

6.1. None

7. Background papers

7.1. Treasury Management Strategy Statement 2017-18 and appendices. These were approved by Full Council at the meeting on 15th February 2017. The full papers can be found under the 6th February 2017 Cabinet meeting at

http://democracy.somerset.gov.uk/documents/s1825/Item%209%20Treasury%20Management%20Strategy%20Statement%202017-18.pdf

http://democracy.somerset.gov.uk/documents/s1826/Item%209%20TMSS%20Appendix%20A%202017-18.pdf

http://democracy.somerset.gov.uk/documents/s1827/Item%209%20TMSS%20Appendix%20B%202017-18.pdf

http://democracy.somerset.gov.uk/documents/s1828/Item%209%20TMSS%20Appendix%20C%202017-18.pdf

http://democracy.somerset.gov.uk/documents/s1829/Item%209%20Appendix%20D.pdf