Somerset County Council

Cabinet
– 8th July 2019

Annual Treasury Management Outturn Report 2018-19

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Division and Local Member: All
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Report Sign off	**Seen by:**	**Name**	**Date**
	County Solicitor	Honor Clarke	04-06
	Monitoring Officer	Scott Wooldridge	13-06
	Corporate Finance	Stephen Morton	24-05
	Human Resources	Chris Squire	05-06
	Senior Manager	Sheila Collins	24-05
	Cabinet Member	Cllr Mandy Chilcott	13-06
Forward Plan Reference:	FP/19/05/11		
Summary:	The Annual Treasury Management Outturn Report is a requirement of the CIPFA Treasury Management Code and covers the Treasury Management activity for 2018-19. 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 2018-19. ➢ 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 17th July 2019.		
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 2018-19.		
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 Outturn and Performance

2.1. Economic Background

Financial markets are constantly changing, both proactively in anticipation of upcoming scenarios and events, and reactively, in response to news and outcomes. Whilst it is important to review and report on performance, it must be borne in mind that Treasury decisions are made in dynamic conditions. It is important therefore to give some background and context to Treasury performance.

UK GDP rose to 0.6% in the third calendar quarter from 0.4% in the second, but fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend.

UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year on year, just above the consensus forecast but broadly in line with the Bank of England's February Inflation Report.

Labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However, a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.

With 29th March 2019, the original EU 'exit day' now been and gone, an extension to the Brexit process has been agreed. Whilst the EU insists that the terms of the deal are not up for further negotiation, the ongoing uncertainty continues to weigh on sterling and UK markets.

The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with the EU. The EU itself appeared to show signs of a rapid slowdown in economic growth with Germany and France both suffering downturns in manufacturing.

Financial markets: December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE 100 and FTSE All share indices were both around 10% higher than at the end of 2018.

Gilt yields continued to display significant volatility over the period. After rising in October, gilts regained their safe-haven status throughout December and into the new year. The 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The August increase in Bank Rate pushed up money markets rates over the year, and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

During March the US yield curve inverted (10-year Treasury yields were lower than US 3-month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations.

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

2.2 The Treasury Position as at 31st March 2019

The Treasury position as at 31st March 2019 and a comparison with the previous year is shown in the table below. More detail behind the figures is given in Appendix D.

	31st March 2018 £m	**31st March 2019 £m**	**Change £m**
Borrowing – Long-term			
Public Works Loan Board	159.05	159.05	0.00
Rate (%)	4.59	4.59	0.00
Market loans	170.5	165.5	-5.00
Rate (%)	4.72	4.74	+0.02
Sub-total	**329.55**	**324.55**	**-5.00**
Rate (%)	**4.66**	**4.66**	**0.00**
Short-Term Borrowing			
External Borrowing	0.0	0.0	**0.0**

Total Borrowings	**329.55**	**324.55**	**-5.00**
Cash Managed on behalf of others			
ENPA / SWC	0.22	0.11	-0.11
Organisations in the Comfund	8.36	7.48	-0.88
LEP	49.80	35.25	-14.55
Total	**58.38**	**42.84**	**-15.54**
Lending/Investments			
Revenue Lending	16.89	34.93	+18.04
Rate (%)	0.49	0.79	+0.30
Comfund Investment	179.68	151.15	-28.53
Rate (%)	0.69	1.02	+0.33
CCLA Property Fund	10.00	10.00	0.00
(Nominal)	4.22	4.35	+0.13
Rate (%)			
Total Lending	**206.57**	**196.08**	**-10.49**
Rate (%)	**0.84**	**1.15**	**+0.31**

Capital projects identified were to be funded using a combination of grant, capital receipts, and contributions. Although timing of capital expenditure is never totally predictable, it was envisaged that borrowing of up to £40m may have been necessary. As the differential between investment earnings and debt costs remained negative during 2018-19, a passive borrowing strategy, borrowing funds as they were required was prudent. With capital spending less than anticipated, no new borrowing was undertaken.

In December an opportunity arose to repay a £5m LOBO (Lender Option Borrower Option) loan. This type of loan gives the lender the option (at specified dates) to raise the interest rate, but the borrower then has the option to accept the new rate or to repay the loan. SCC policy is to repay any optioned loans. In this particular case however, the lender was going to sell the LOBO via a bidding process, and SCC was invited to bid. In conjunction with TM advisors Arlingclose, SCC chose to participate in the bidding process, and were successful with the bid. The loan was prepaid on 6th December.

A premium of £1.142m was paid, but this will be written off over the life of the loan (original maturity 2043) at £46k per annum. With a gross interest saving of £68.5k in 2018-19, and a net £172k saving annually thereafter, both in-year and long-term revenue savings were achieved, whilst reducing refinancing risk posed by the LOBO.

Total lending as at 31st March 2019, including unspent LEP money, stood at over £196m, a decrease of £10.5m from 2018. It should be noted that £20m of extra grant from Central Government was received during 2018-19.

The total lending figure of £196m as at 31 March 2019 in the table above includes all of the cash managed on behalf of others, as a result the £10.5m reduction in total lending over the financial year is a result of the lower balances held on behalf of the LEP. SCC balances (not including 3rd parties) increased by £5m during the year.

The change in balance of investments between revenue lending and Comfund is the result of regular decisions taken by the Treasury team to ensure liquidity to meet cash flow requirements and shouldn't be interpreted as a change in strategy.

2.3 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 2018-19.

At year-end, with a £5m LOBO repaid and no new debt taken, total debt stood at £324.55m, with an average rate paid on total borrowings of 4.66%, similar after rounding to 2017-18.

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.

There were few credit rating changes during the period for overseas counterparties, Moody's upgrading the ratings of Canadian banks being the notable change.

The ringfencing of the big four UK banks and the subsequent re-rating by the agencies resulted in some notable changes to the ring-fenced entities. Changes put RBS and Nat West above minimum criteria across the 3 agencies and made them eligible for consideration for investments again.

The average Credit Rating of the SCC investment portfolio (Excluding CCLA Property Fund) as at 31st March 2019 was AA-. To give this some perspective, this is one notch below the rating for the UK Government of AA.

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. SCC maintained a £10m investment in the CCLA Property Fund, initially invested in May 2017. 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 £1.69m was earned on cash investments during 2018-19. The increase on the comparator figure for 2017-18 of £1.35m is largely due to higher rates but was achieved on reduced average balances of £36.5m, and a reduction in investment duration. When compared with average cash rates for the year, the ex-property yield of 0.83% was 0.04% above the average 6-month LIBID rate, and 0.11% 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 £10m investment in the CCLA Property Fund delivered an average net income yield of 4.25%.

Yield (Inc-Property). Interest of £2.12m was earned on total investments during 2018-19. When compared to the average risk-free deposit rate of approximately 0.42% 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 £214m for the year was just over £1.2m (£1.3m in 2017-18).

Security and liquidity have been achieved with the income return of 0.99% achieved for the year, being 0.05% above the average 12-month LIBID rate.

During the year, SCC received a further dividend of £25,787 from Kaupthing, Singer & Friedlander. A total of £8,845,053.79 has now been received from KSF. In total, as at 31st March 2018 £23,241,306.63 had been recovered on all Icelandic claims. More detail of the current position is in Appendix G.

2.4 Temporary Borrowing

Temporary borrowing has not been necessary at all during 2018-19.

2.5 Long-Term Borrowing

The borrowing strategy for 2018-19 recognised that borrowing of up to £40m may have been necessary. As the differential between investment earnings and debt costs remained negative during 2018-19, a passive borrowing strategy, borrowing funds as they were required was pursued. With capital spending less than anticipated, no new borrowing was undertaken.

During 2018-19, there were no scheduled debt maturities, but the opportunity to repay a LOBO was taken. The debt portfolio therefore reduced to £324.55m during the year. 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 2018-19 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 (+ optional 2 years extra) from April 2015. An extension to April 2020 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 £7.5m at year-end.

In addition, during 2018-19, SCC was retained to manage the Local Enterprise

Partnership (LEP) Growth Deal Grant on behalf of the other Enterprise Partners. A grant of £10.5m was received on 20th April 2018, and an average balance in excess of £40m was managed.

All treasury management activities, including a fee for the management of the LEP money, brought in income in excess of £167k during the year.

2.7 Lending

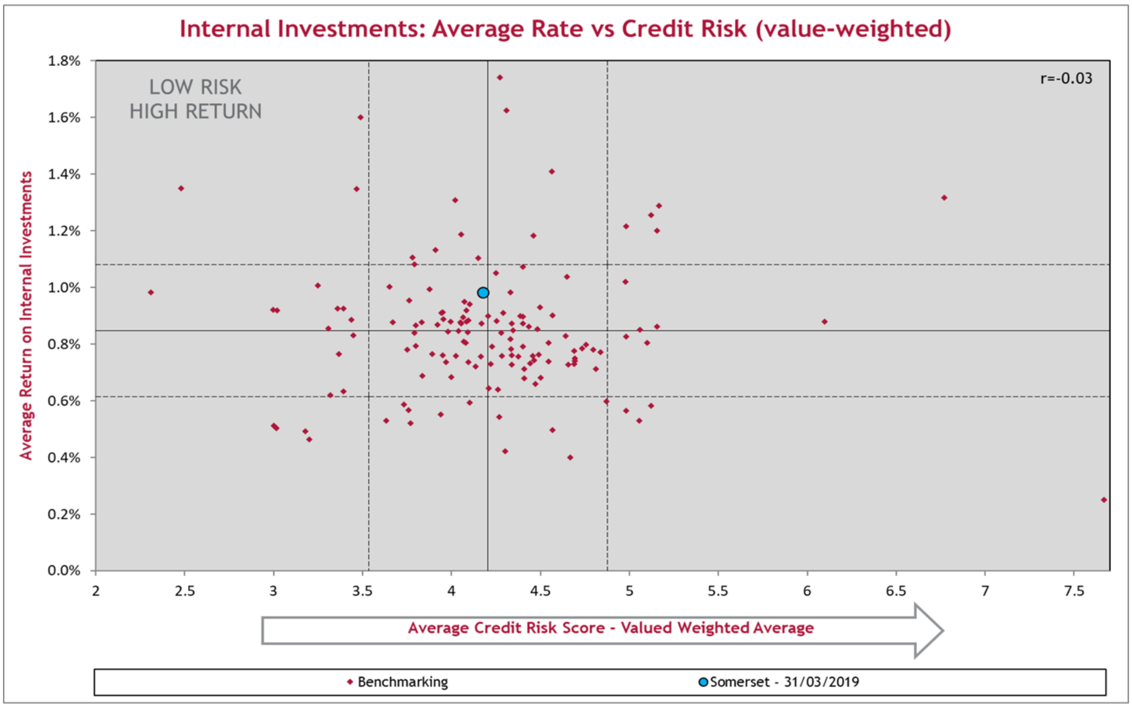
The average daily balance of the Council's investments during 2018-19 was £214.4m, down £36.5m from the previous year.

The weighted investment return of 0.99% was 0.04% better than the average 6-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

2018-19 was the tenth 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 results can be seen in the graph below.

This graph clearly shows that SCC is in a healthy position comparatively, being below the average credit risk score, but with a return that is better than the average.



When comparing the average days to maturity with that of other County Councils, the SCC average of 111 days is a full 1.6 years below the 692 days for other County Councils. This in part reflects the fact that the passive borrowing strategy pursued meant investments of shorter duration were held, another factor being that SCC was holding circa £40m of LEP money on behalf of its partners, so needed to retain more liquidity for payments. Performance relative to risk can be seen in the 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 2018-19. Indicators that were set for the 2018-19 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. As SCC is currently looking into the feasibility of alternative investments it is appropriate to highlight the main thrust of changes introduced and an overview is provided in Appendix I.

The Council has continued to meet the conditions to maintain professional status as prescribed by MiFID II. (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 authorised personnel have the expertise, experience and knowledge to make investment decisions and understand the risks involved). 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.

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.

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 Brexit and other global economic concerns, the Council reduced the duration for unsecured investments to UK banks, to a maximum of 6 months. It also reduced its' duration limits with all other existing counterparties to 6-months, with the exception of Singaporean Banks.

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

- Barclays, Goldman Sachs International Bank, Nat West, and RBS – **100 days;**
- Bank of Scotland, Close Brothers, Handelsbanken Plc, HSBC Bank Plc, Lloyds Bank, Nationwide BS, Santander UK, Standard Chartered, DZ Bank, Landesbank Hessen-Thuringen, Nordea, OP

Corporate, Rabobank and all Australian and Canadian banks – **6-months;**
- ➢ DBS Bank, OCBC, and UOB (Singaporean banks) – **13-months.**

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.

There was no audit during 2018-19, 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 2018-19 and appendices. These were approved by Full Council at the meeting on 21st February 2018. The full papers can be found under the 12th February 2018 Cabinet meeting at

http://democracy.somerset.gov.uk/documents/s5914/Treasury%20Management%20Strategy%20Statement%202018-19.pdf

http://democracy.somerset.gov.uk/documents/s5915/Treasury%20Management%20Strategy%20Statement%202018-19%20Appendix%20A.pdf

http://democracy.somerset.gov.uk/documents/s5916/Treasury%20Management%20Strategy%20Statement%202018-19%20Appendix%20B.pdf

http://democracy.somerset.gov.uk/documents/s5917/Treasury%20Management%20Strategy%20Statement%202018-19%20Appendix%20C.pdf

http://democracy.somerset.gov.uk/documents/s5918/Treasury%20Management%20Strategy%20Statement%202018-19%20Appendix%20D.pdf