Annual Treasury Management Strategy 2018/2019 Outturn Report

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ATTACHMENTS

The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly. This report therefore ensures Cornwall Council is implementing best practice in accordance with the code.

1 – Economic Background

After weak economic growth early in the year, growth then picked up before cooling off in the final quarter – to be expected given all the uncertainties over Brexit. However, some recovery in the rate of growth is expected going forward. The annual growth came in at 1.4% y/y confirming that the UK was the third fastest growing individual country in the G7.

After the Monetary Policy Committee raised Bank Rate from 0.5% to 0.75% in August 2018, it is little surprise that they have abstained from any further increases since then. It is unlikely the MPC will take any further action until the uncertainties over Brexit become clear. If there were a disorderly exit, it is likely that Bank Rate would be cut to support growth.

Nevertheless, the MPC does have concerns over the trend in wage inflation which in 2018 peaked at a new post financial crisis high of 3.5%, (excluding bonuses). British employers ramped up their hiring at the fastest pace in more than three years in the three months to January as the country's labour market defied the broader weakness in the overall economy as Brexit approached. The number of people in work surged by 222,000, helping push down the unemployment rate to 3.9 percent, its lowest rate since 1975.

As for CPI inflation itself, this has been on a falling trend, reaching 1.8% in January before rising marginally to 1.9% in February. However, in the February Bank of England Inflation Report, the latest forecast for inflation over both the two and three year time horizons remained marginally above the MPC's target of 2%.

The rise in wage inflation and fall in CPI inflation is good news for consumers as their spending power is improving i.e. a real terms increase. Given the UK economy is very much services sector driven, this is likely to feed through into providing some support to the overall rate of economic growth in the coming months.

Brexit - The Conservative minority government has, so far, been unable to muster a majority in the Commons over its Brexit deal. If another form of Brexit, other than the current deal, does get a majority – and within EU deadlines - then it is likely there will need to be a long delay to Brexit to allow time for negotiations with the EU.

It appears unlikely that there would be a Commons majority which would support a disorderly Brexit or revoking article 50, (cancelling Brexit). There would also need to be a long delay if there is no majority for any form of Brexit. If that were to happen, then it increases the chances of a general election in 2019; this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA - President Trump's massive easing of fiscal policy in 2018 fuelled a (temporary) boost in consumption in 2018 which generated an upturn in the strong rate of growth. The annual rate came in at 2.9% for 2018, just below President Trump's aim for 3% growth.

The strong growth in employment numbers has fed through to an upturn in wage inflation which hit 3.4% in February, a decade high point. However, CPI inflation overall fell to 1.5% in February, a two and a half year low, and looks to be likely to stay around that number in 2019 i.e. below the Fed's target of 2%.

The Fed increased rates another 0.25% in December to between 2.25% and 2.50%, this being the fourth increase in 2018 and the ninth in the upward swing cycle. However, the Fed now appears to be edging towards a change of direction and admitting there may be a need to switch to taking action to cut rates over the next two years. Financial markets are now predicting two cuts of 25 bps by the end of 2020.

Eurozone - The annual rate of growth for 2018 was 1.8% but is expected to fall to possibly around half that rate in 2019. The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which means that the central banks in the US, UK and EU have all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt.

However, the downturn in growth in the second half of 2018 and into 2019, together with inflation falling well under the upper limit of its target range 2%, has prompted the ECB to take new measures to stimulate growth. However, with its refinancing rate already at 0.0% and the deposit rate at -0.4%, it has probably reached the bottom of cutting rates.

At its March meeting it said that it expects to leave interest rates at their present levels "at least through the end of 2019", but that is of little help to boosting growth in the near term. Consequently, it announced a third round of 'targeted longer term refinancing operations' (TLTROs); this will now continue to provide banks with cheap borrowing every three months from September 2019 until March 2021, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending.

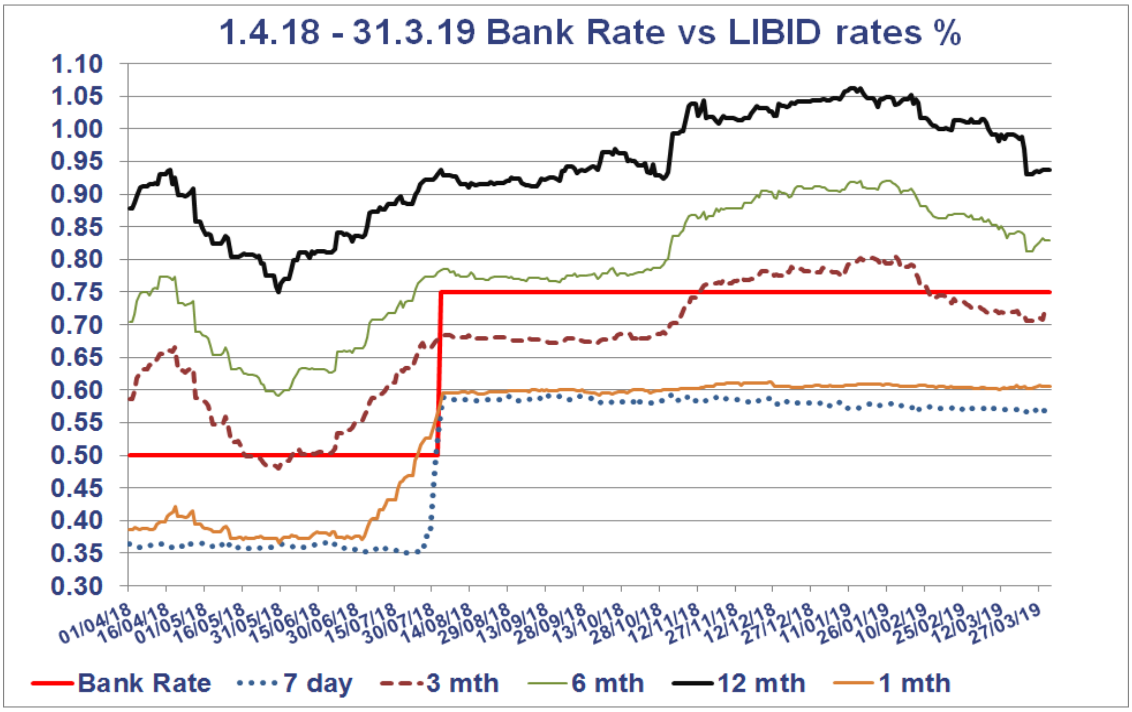
China - Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

Japan - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

Interest Rates 2018/19 and Forecast

Longer term investment rates were on a rising trend for most of the year until they started falling in December/January.

The flow of generally positive economic statistics earlier in the year meant that the MPC came to a decision on 2 August to make the first rise in Bank Rate above 0.5% since the financial crash to 0.75%. However, the MPC also emphasised again that future increases would be gradual (indeed even estimated that this would be around 2.5% in ten years' time) and it is of no surprise that the rate has since remained unchanged for the rest of the year.



The Council's treasury advisor, Link Asset Services, has provided the following interest rate forecast based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012. The underlying trend shows forecast interest rates are set to gradually increase but, compared to historical levels, will remain extremely low for the next few years:

	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)			
		5 year	10 year	25 year	50 year
Jun-2019	0.75	1.90	2.30	2.80	2.60
Sep-2019	1.00	2.00	2.40	2.90	2.70
Dec-2019	1.00	2.10	2.50	3.00	2.80
Mar-2020	1.00	2.20	2.60	3.10	2.90
Jun-2020	1.25	2.30	2.60	3.20	3.00
Sep-2020	1.25	2.30	2.70	3.20	3.00
Dec-2020	1.25	2.40	2.80	3.30	3.10
Mar-2021	1.50	2.50	2.90	3.40	3.20
Jun-2021	1.50	2.50	2.90	3.40	3.20
Sep-2021	1.75	2.60	3.00	3.50	3.30
Dec-2021	1.75	2.60	3.00	3.50	3.30
Mar-2022	2.00	2.70	3.00	3.60	3.40

[The above forecast is based on a central assumption that there will be an agreement on a reasonable form of Brexit. In view of the current lack of any majority in the House of Commons for a single option for Brexit, forecasts will likely need amending to take account of the existing impasse if that were continue. This could mean that the start of increases in Bank Rate may need to be pushed back]

- Gilt yields and PWLB rates

The general expectation is for volatility in bond yields to endure as investor fears and confidence ebb and flow between favouring relatively more "risky" assets i.e. equities, or the "safe haven" of government bonds. The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently, although there are likely to also be periods of sharp volatility from time to time.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Brexit – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- Bank of England monetary policy takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than is currently anticipated.
- A resurgence of the Eurozone sovereign debt crisis.
- An increasingly fragile political state impacting across Europe, with challenges developing from a strong and growing anti-immigration movement and with many vulnerable minority EU governments dependent

on coalitions which could prove fragile. This could put considerable pressure on the cohesion of the EU and could spill over into impacting the euro, EU financial policy and financial markets.

- There are concerns around the level of US corporate debt which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their dent into junk ratings, increasing the cost of financing and further negatively impacting on profits and cash flow.
- Weak capitalisation of some European banks.
- Rising interest rates in the US, combined with a potential trade war between the USA and China, sparked major volatility in equity markets during 2018/19. Some emerging market countries, that have borrowed heavily in dollar denominated debt, could be particularly exposed to investor fights from equities to safe havens e.g. UK gilts.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

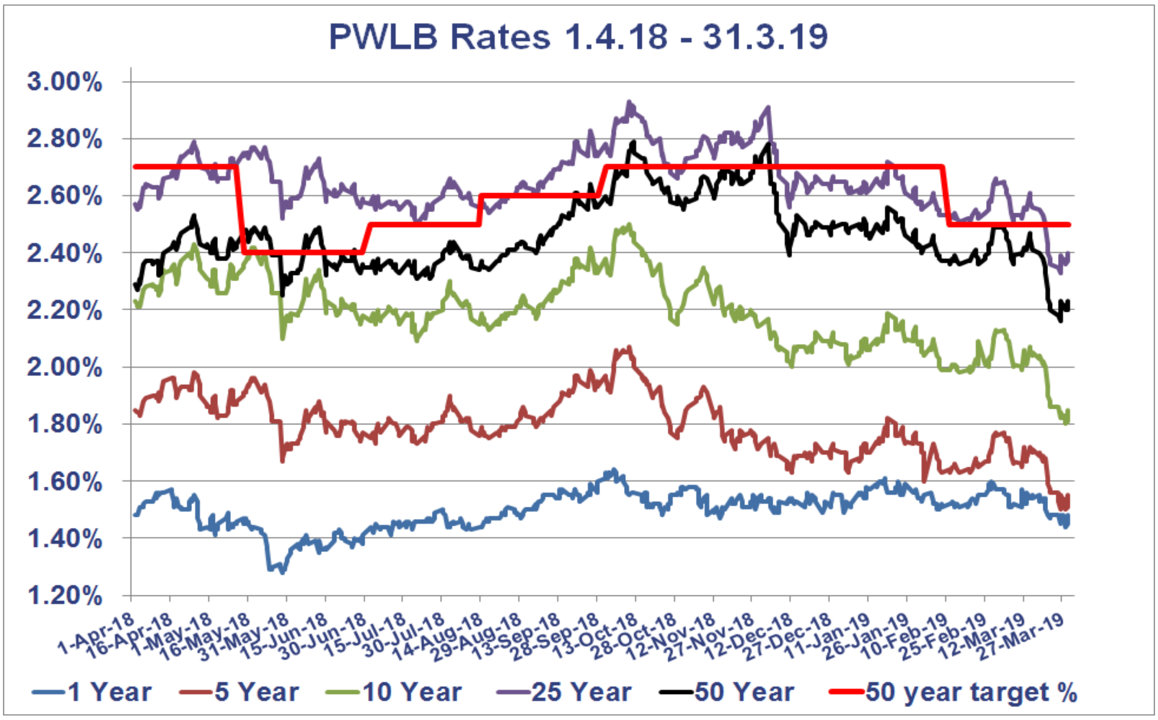
The potential for upside risks to current forecasts for UK gilt yields and PWLB rates include:

- Brexit – if both sides were to agree a compromise that removed all threats of economic and political disruption.
- The Federal Reserve causes a sudden shock in financial markets by misjudging the pace and strength of increases in its Federal Funds Rate and in the pace and strength of reversal of Quantitative Easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than is currently expected.
- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Borrowing Rates in 2018/19

As depicted in the graph below, since PWLB rates peaked during October, most rates have been on a general downward trend since then and reached lows for the year at the end of March.

During the year, the 50 year PWLB target (certainty) rate for new long term borrowing varied between 2.4% and 2.7% during this period.



2 – Annual Investment Strategy

The Annual Treasury Management Strategy (ATMS) for 2018/19, which includes the Annual Investment Strategy, was approved by the Council on 20 February 2018. It set out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the year.

Investment rates available in the market have continued at historically low levels. The average level of investments during the year was £408m. The level of cash available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

At 31 March 2019 the Council's investment portfolio stood at £341m. Average investment returns to 31 March were 1.33%, which is 0.82% above the benchmark, the Average 7 day LIBID, which stood at 0.51%. The average 12 month LIBID was 0.94%.

3 – New borrowing

As outlined in the Treasury Strategy, the Council continues to follow a policy of utilising internal cash balances i.e. liquid investments to finance capital expenditure, thereby deferring the need to actually borrow externally. As a result the Council is currently significantly underborrowed against its Capital Financing Requirement.

This is unsustainable in the long term and means that – at some stage - the Council will need to undertake additional long term borrowing.

In 2018/19 interest rates have been extremely volatile, largely as a result of the ongoing uncertainty surrounding Brexit. The Section 151 Officer has continued to monitor closely financial markets for any opportunities; and in December 2018, following a sharp fall in the market, undertook additional long term borrowing totalling £135m from the Public Works Loan Board. This was structured in three different loans for a period of between 40 and 50 years, limiting the openness to future refinancing risk on maturity in any single year:

- £40m maturing in 40 years at a fixed rate of 2.42%
- £50m maturing in 43 years at a fixed rate of 2.40%
- £45m maturing in 50 years at a fixed rate of 2.39%

Other short Term borrowing (less than 12 months) was undertaken as part of normal day to day treasury activities to facilitate cash flow movements.

The Council has not borrowed in advance of need during the year to 2018/19.

4 – Debt Rescheduling

In 2018/19 the Council undertook to redeem and refinance two Royal Bank of Scotland inverse floating LOBOs for a total principal value of £85m. Further information can be found at the following:
https://democracy.cornwall.gov.uk/mgIssueHistoryHome.aspx?IId=84035&Opt=0

It should be noted that the Council currently holds 34% (£235m) of its long term debt in LOBOs.

5 – Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved ATMS.

During the financial year 2018/19 the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators are shown in tables 1 and 2.

TABLE 1: Prudential Indicators as at 31 March 2019

Prudential Indicators	2018/19 Strategy £m	Mid-Year Forecast £m	Outturn £m
Capital expenditure:			
General Fund	211.7	268.1	209.7
HRA	11.5	21.7	20.8
Total	**223.2**	**289.9**	**230.5**
This indicator is a summary of the Council's Capital Expenditure Plans for the financial year (including Housing Development Programme). The outturn is lower than previously expected mainly as a result of slippage in the programme including most significantly the Investment Programme (£15m), Highways and Transport initiatives (inc Growth Deal) (£9m), Tamar Bridge and Torpoint Ferry works (£4m) and vehicle relacement (£5m).			
Capital Financing Requirement (CFR):			
General Fund	945.0	940.6	876.6
HRA	109.2	108.6	109.6
Total	**1054.2**	**1049.2**	**986.2**
Annual change in CFR:			
General Fund	59.9	83.4	19.4
HRA	-1.0	-1.0	0.0
Total - In year borrowing requirement	**58.9**	**82.4**	**19.4**
The CFR is the total historic outstanding Capital Expenditure which has not yet been paid for from either revenue or capital resources. It has increased by £19m from last year, mostly a result of additional capital spend incurred this year to be funded from borrowing (£45m) less MRP charged this year to revenue (c£26m). The outturn is lower than previously forecast, reflecting small changes/slippage in the capital programme but more significantly the removal of Housing Development Programme which, for technical accounting reasons, has been excluded from CFR calculations. [Note: the CFR includes certain technical adjustments e.g. pfi, for which the Council will not undertake any additional external borrowing. By excluding these adjustments, the actual underlying borrowing need as at 31 March 2019 is circa £827m]			
Ratio of financing costs to net revenue stream:			
General Fund	9.21%	9.26%	8.72%
HRA	9.41%	9.45%	7.40%
This indicator identifies the trend in the cost of capital (borrowing costs net of investment income) against the Council's net budget. The capital financing budget, as a proportion of the overall net budget (general fund), reduced significantly as a result of the in year transfer of £3m resource for adults transformation.			
a) Increase / (decrease) in council tax (band D change) per annum	£(13.33)	£(11.81)	£(27.49)
a) Increase / (decrease) in average housing rent per week	£(0.12)	£1.01	£(0.51)
This indicator identifies the increase/(decrease) in Band D and weekly housing rent that would occur as a result of the Council's Capital Expenditure plans financed by borrowing.			

TABLE 2: Treasury Indicators as at 31 March 2019

Treasury Indicators	**2018/19 Strategy £m**	**Mid-Year Forecast £m**	**Outurn £m**
Authorised limit for external debt	950	950	950
Operational boundary for external debt	900	900	900
The authorised limit represents a statutory limit, set or revised by Full Council, beyond which external debt is prohibited. The operational boundary is the limit which external debt is not normally expected to exceed. These indicators remain unchanged from the Strategy and actual debt levels have been managed within these limits throughout the year (see Diagram 1).			
Gross external debt	710	710	791
Investments	*330*	*310*	341
Net Debt	*380*	*400*	450
Gross external debt is the total level of Council debt outstanding at the end of the financial year. The Council's net debt is significantly higher than previously forecast at mid year and a result of the debt redemption and refinancing subsequently undertaken.			
Maturity structure of fixed rate borrowing - upper and lower limits *(first option dates in brackets)*			
Under 12 months	0% - 40%	5% - 15%	12%
		(15% - 25%)	*(19%)*
12 months to 10 years	0% - 40%	0% - 10%	0%
		(30% - 40%)	*(23%)*
10 years and above	0% - 100%	85% - 95%	88%
		(40% - 50%)	*(58%)*
The Council's fixed rate maturity structure is in line with the strategy with nearly 90% of the Council's debt falling due in the next 10 years to 60 years (see Diagram 2)			
Upper limit of fixed interest rates based on net debt	100%	100%	100% *(actual 89%)*
Upper limit of variable interest rates based on net debt	50%	50%	50% *(actual 11%)*

Diagram 1; Actual external debt 2018/19

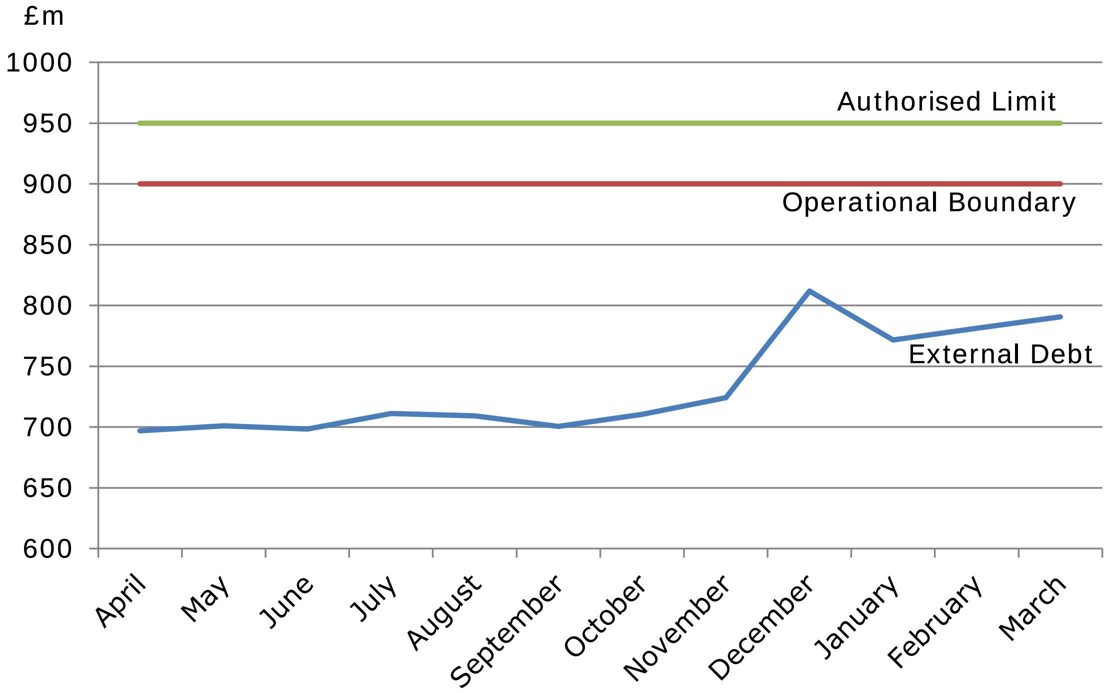


Diagram 2; maturity profile of fixed rate borrowing

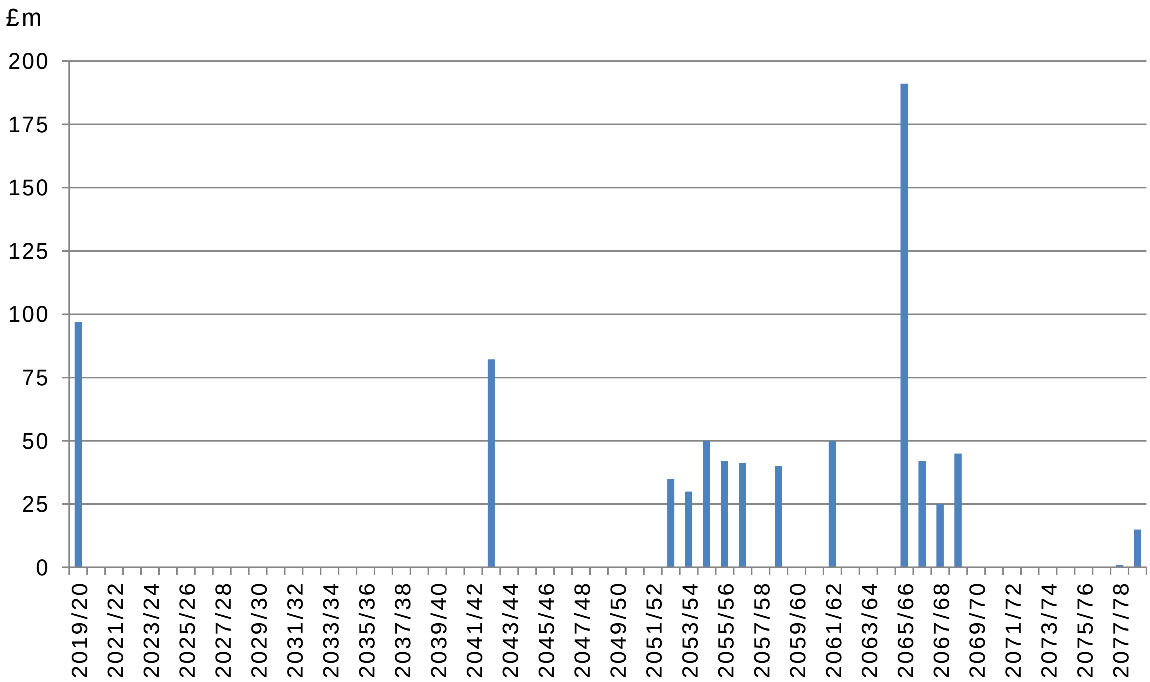


TABLE 3: Summary of Cornwall Council Net Debt at 31 March 2019

	£m	
Total Borrowing	**791**	
Long Term		
Public Works Loan Board (PWLB)	**374**	**47%**
UK:	**251**	**32%**
Barclays (fixed term)	80	
Dexia*	158	
KBC*	13	
Germany: Bayerische Landesbank GIR*	**15**	**2%**
Ireland: DEPFA*	**49**	**6%**
Sub-Total	690	
Short Term		
Temporary Borrowing: Local Authorities	**101**	**13%**

* indicates LOBO (totalling £235m)

	£m	
Total Investments	**341**	
UK:	**311**	**91%**
Local Authorities	181	
Prime Rate	50	
RBS	34	
Goldman Sachs	20	
Handelsbanken	17	
Aldermore Bank	10	
Australia: Commonwealth Bank of Australia	20	**6%**
Netherlands: Rabobank	10	**3%**

	£m
Net Debt	**450**

ATTACHMENT 1

Glossary of Terms

- **Annuity** – method of repaying a loan where the payment amount remains uniform throughout the life of loan, therefore the split varies such that the proportion of the payment relating to the principal increases as the amount of interest decreases.

- **Bail-In** – previously, in response to the banking crisis, some governments used taxpayer funds to support banks in danger of failing. The European Union's Banking Recovery and Resolution Directive (BRRD) requires that, in future, 'bail in' will be applied in such a scenario; this means that after shareholders' equity, depositors' funds comprising balances over c£85k will be used to support the bank at risk. The £85k threshold is not available to local authorities and therefore all unsecured deposits with banks and building societies will be at risk of 'bail in'.

- **Base Rate** – minimum lending rate of a bank or financial institution in the UK

- **Bond** – a government or public company's document undertaking to repay borrowed money usually with a fixed rate of interest.

- **Capital Expenditure** – spend on major items e.g. land and buildings, which adds to and not merely maintains the value of existing fixed assets

- **Capital Grants** – specific targeted grants to cover capital spend

- **Capital Receipts** – the proceeds from the disposal of land or other assets. Capital receipts can be used to fund capital expenditure but cannot be used to finance revenue.

- **CIPFA** – the Chartered Institute of Public Finance and Accountancy, is the professional body for accountants working in Local Government and other public sector organisations, also the standard setting organisation for Local Government Finance.

- **Counterparty** – an institution (e.g. a bank) with whom a borrowing or investment transaction is made.

- **Credit Rating** – an opinion on the credit-worthiness of an institution, based on judgements about the future status of that institution. It is based on any information available regarding the institution: published results, Shareholders' reports, reports from trading partners, and also an analysis of the environment in which the institution operates (e.g. its home economy, and its market sector). The main rating agencies are Fitch, Standard and Poor's and Moody's. They analyse credit worthiness under four headings:

    - **Short Term Rating** – the perceived ability of the organisation to meet its obligations in the short term, this will be based on measures of liquidity.

- **Long Term Rating** – the ability of the organisation to repay its debts in the long term, based on opinions regarding future stability, e.g. its exposure to 'risky' markets.
- **Individual/Financial Strength Rating** – a view of the likelihood, in the case of a financial institution failing, that its obligations would be met, in whole or part, by its shareholders, central bank or national government.
- **Legal Support Rating** - a view of the likelihood, in the case of a financial institution failing, that its obligations would be met, in whole or part, by its shareholders, central bank, or national government.

The rating agencies constantly monitor information received regarding financial institutions, and will amend the credit ratings assigned as necessary.

- **DMADF and the DMO** – The DMADF is the 'Debt Management Account Deposit Facility'; this is highly secure fixed term deposit account with the Debt Management Office (DMO), part of Her Majesty's Treasury.

- **EIP** – Equal Instalments of Principal, a type of loan where each payment includes an equal amount in respect of loan principal is eroded, and so the total amount reduces with each instalment.

- **Gilts –** the name given to bonds issued by the UK Government (i.e. the loan instrument by which the Government borrows). Gilts are issued bearing interest at a specified rate, however they are then traded on the markets like shares and their value rises or falls accordingly. The Yield on a gilt is the interest paid divided by the Market Value of that gilt, e.g. a 30 year gilt is issued in 1994 at £1, bearing interest of 8%. In 1999 the market value of the gilt is £1.45.

  The yield on that gilt is calculated as 8%/1.45 = 5.5%.

- **Lender Option Borrower Option (LOBO)** - LOBOs are a long term borrowing instrument commonly used by banks. It is an alternative lender option to the Government's Public Works Loan Board. In simple terms the instrument gets its name because the lender has an option to set revised interest rates at predetermined dates, and at which point the borrower has the option to accept the revised rates or pay the debt in full without penalty.

- **LIBID** – The London Interbank Bid Rate, the rate which banks would have to bid to borrow funds from other banks for a given period. The official rate is published by the Bank of England at 11am each day based on trades up to that time. The average 7 day rate is the benchmark the Council uses for its own investment performance.

- **Liquidity** – Relates to the amount of readily available, or short term, investment money which can be used for either day to day or unforeseen expenses. For example Call Accounts allow instant daily access to invested funds.

- **Market –** The private sector institutions e.g. banks, building societies

- **Maturity** - Type of loan where only payments of interest are made during the life of the loan, with the total amount of principal falling due at the end of the loan period.

- **Minimum Revenue Provision (MRP) –** A statutory amount charged to the Council's revenue account for the provision to repay the loan principal on debt undertaken to finance the Capital Programme. For the Council this is done on a straight line basis in-line with the asset life and commences the financial year after the asset is operational.

- **Monetary Policy Committee (MPC)** – group that sets the bank base rate for the Bank of England.

- **Money Market Fund (MMF)** – A highly diversified pooled investment vehicle whose assets mainly comprise of short term instruments.

- **Multilateral Development Banks (MDB)** – these are supranational institutions set up by sovereign states, which are their shareholders (e.g. European Investment Bank). Their remits reflect the development aid and cooperation policies established by these states.

- **Policy and Strategy Documents** – Documents required by the CIPFA Code of Practice on Treasury Management in Local Authorities. These set out the framework for treasury management operations during the year.

- **Public Works Loans Board (PWLB)** – a central government agency providing long and short term loans to Local Authorities. Rates are set daily at a margin over the Gilt yield (see Gilts above). Loans may be taken at fixed or variable rates and as an Annuity, Maturity, or EIP loans (see separate definitions) over periods of up to fifty years. Financing is also available from the money markets, however because of its nature the PWLB is generally able to offer better terms.

- **Yield** – The amount in cash (in percentage terms) that returns to the owners of an investment e.g. interest earned from a deposit.