

Essential Reference Paper B

# **East Herts District Council**

## **Annual Treasury Management Review**

**2017/18**

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## **ABBREVIATIONS USED IN THIS REPORT**

**ALMO:** an Arm's Length Management Organisation is a not-for-profit company that provides housing services on behalf of a local authority. Usually an ALMO is set up by the authority to manage and improve all or part of its housing stock.

**LAS:** Link Asset Services, Treasury solutions – the council's treasury management advisers.

**CE:** Capital Economics - is the economics consultancy that provides Link Asset Services, Treasury solutions, with independent economic forecasts, briefings and research.

**CFR:** capital financing requirement - the council's annual underlying borrowing need to finance capital expenditure and a measure of the council's total outstanding indebtedness.

**CIPFA:** Chartered Institute of Public Finance and Accountancy – the professional accounting body that oversees and sets standards in local authority finance and treasury management.

**CPI:** consumer price inflation – the official measure of inflation adopted as a common standard by countries in the EU. It is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

**ECB:** European Central Bank - the central bank for the Eurozone

**EU:** European Union

**EZ:** Eurozone -those countries in the EU which use the euro as their currency

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**Fed:** The Federal Reserve, often referred to simply as "the Fed," is the central bank of the United States. It was created by the Congress to provide the nation with a stable monetary and financial system.

**FOMC:** the Federal Open Market Committee – this is the branch of the Federal Reserve Board which determines monetary policy in the USA by setting interest rates and determining quantitative easing policy. It is composed of 12 members--the seven members of the Board of Governors and five of the 12 Reserve Bank presidents.

**GDP:** gross domestic product – a measure of the growth and total size of the economy.

**G7:** The group of seven countries that form an informal bloc of industrialised democracies--the United States, Canada, France, Germany, Italy, Japan, and the United Kingdom--that meets annually to discuss issues such as global economic governance, international security, and energy policy.

**Gilts:** Gilts are bonds issued by the UK Government to borrow money on the financial markets. Interest paid by the Government on gilts is called a yield and is at a rate that is fixed for the duration until maturity of the gilt, (unless a gilt is index linked to inflation); yields therefore change inversely to the price of gilts i.e. a rise in the price of a gilt will mean that its yield will fall.

**HRA:** Housing revenue account.

**IMF:** International Monetary Fund - the lender of last resort for national governments which get into financial difficulties.

**LIBID:** The London Interbank Bid Rate is a bid rate; the rate bid by banks on deposits i.e., the rate at which a bank is willing to borrow from other banks. It is the "other end" of the LIBOR (an offered, hence "ask" rate, the rate at which a bank will lend).

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**MHCLG:** The Ministry of Housing, Communities and Local Government - the Government department that directs local authorities in England.

**MPC:** The Monetary Policy Committee is a committee of the Bank of England, which meets for one and a half days, eight times a year, to determine monetary policy by setting the official interest rate in the United Kingdom, (the Bank of England Base Rate, commonly called Bank Rate), and by making decisions on quantitative easing.

**MRP:** minimum revenue provision -a statutory annual minimum revenue charge to reduce the total outstanding CFR, (the total indebtedness of a local authority).

**PFI:** Private Finance Initiative – capital expenditure financed by the private sector i.e. not by direct borrowing by a local authority.

**PWLB:** Public Works Loan Board – this is the part of H.M. Treasury which provides loans to local authorities to finance capital expenditure.

**QE:** Quantitative easing – is an unconventional form of monetary policy where a central bank creates new money electronically to buy financial assets, like government bonds, (but may also include corporate bonds). This process aims to stimulate economic growth through increased private sector spending in the economy and also aims to return inflation to target. These purchases increase the supply of liquidity to the economy; this policy is employed when lowering interest rates has failed to stimulate economic growth to an acceptable level and to lift inflation to target. Once QE has achieved its objectives of stimulating growth and inflation, QE will be reversed by selling the bonds the central bank had previously purchased, or by not replacing debt that it held which matures. The aim of this reversal is to ensure that inflation does not exceed its target once the economy recovers from a sustained period of depressed growth and inflation. Economic growth, and increases in inflation, may threaten to

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gather too much momentum if action is not taken to 'cool' the economy.

**RPI:** The Retail Price Index is a measure of inflation that measures the change in the cost of a representative sample of retail goods and services. It was the UK standard for measurement of inflation until the UK changed to using the EU standard measure of inflation – CPI. The main difference between RPI and CPI is in the way that housing costs are treated. RPI is often higher than CPI for that reason.

**TMSS:** the annual treasury management strategy statement report that all local authorities are required to submit for approval by the full council before the start of each financial year.

**VRP:** a voluntary revenue provision to repay debt, in the annual budget, which is additional to the annual MRP charge, (see above definition).

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# Annual Treasury Management Review 2017/18

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## 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 2017/18. 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 2017/18 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 01/03/2017)
- a mid-year (minimum) treasury update report (Council 13/12/2017)
- 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 Performance, Audit and Governance Scrutiny Committee before they were reported to the full Council.

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## 2. The Economy and Interest Rates

During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year which meant that growth was the slowest for the first half of any year since 2012. The main reason for this was the sharp increase in inflation caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up modestly in the second half of 2017. Consequently, market expectations during the autumn, rose significantly that the MPC would be heading in the direction of imminently raising Bank Rate. The minutes of the MPC meeting of 14 September indicated that the MPC was likely to raise Bank Rate very soon. The 2<sup>nd</sup> November MPC quarterly Inflation Report meeting duly delivered by raising Bank Rate from 0.25% to 0.50%. The 8<sup>th</sup> February MPC meeting minutes then revealed another sharp hardening in MPC warnings on a more imminent and faster pace of increases in Bank Rate than had previously been expected. Market expectations for increases in Bank Rate, therefore, shifted considerably during the second half of 2017-18 and resulted in **investment rates** from 3 – 12 months increasing sharply during the spring quarter.

**PWLB borrowing rates** increased correspondingly to the above developments with the shorter term rates increasing more sharply than longer term rates. In addition, UK gilts have moved in a relatively narrow band this year, (within 25 bps for much of the year), compared to **US treasuries**. During the second half of the year, there was a noticeable trend in treasury yields being on a rising trend with the Fed raising rates by 0.25% in June,

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December and March, making six increases in all from the floor. The effect of these three increases was greater in shorter terms around 5 year, rather than longer term yields.

The major UK landmark event of the year was the inconclusive result of the **general election** on 8<sup>th</sup> June. However, this had relatively little impact on financial markets.

*(Commentary provided by Link Asset Services)*

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### 3. Overall Treasury Position as at 31 March 2018

At the beginning and the end of 2017/18 the Council's treasury, (excluding borrowing by finance leases), position was as follows:

	<b>31<sup>st</sup> March 2017 Principal</b>	<b>Rate / Return</b>	<b>Average Life Yrs.</b>		<b>31<sup>st</sup> March 2018 Principal</b>	<b>Rate / Return</b>	<b>Average Life Yrs.</b>
<b>Total debt</b>	<i>£7.5m</i>	<i>8.83%</i>	<i>20.5</i>		<i>£7.5m</i>	<i>8.83%</i>	<i>19.5</i>
<b>CFR</b>	<i>(£23.1m)</i>				<i>(£23.1m)</i>		
<b>Over / (under) borrowing</b>	<i>£7.5m</i>				<i>£7.5m</i>		
<b>Total investments</b>	<i>£61.8m</i>	<i>1.61%</i>			<i>£65.9m</i>	<i>1.51%</i>	
<b>Net debt</b>	<i>(£54.3m)</i>				<i>(£58.4m)</i>		

## 4. The Strategy for 2017/18

The expectation for interest rates within the treasury management strategy for 2017/18 anticipated that Bank Rate would not start rising from 0.25% until quarter 2 2019 and then only increase once more before 31.3.20. There would also be gradual rises in medium and longer term fixed borrowing rates during 2017/18 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis 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.

In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

During 2017/18, longer term PWLB rates were volatile but with little overall direction, whereas shorter term PWLB rates were on a rising trend during the second half of the year.

*(Commentary provided by Link Asset Services)*

## 5. The Borrowing Requirement and Debt

The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

	<b>31<sup>st</sup> March 2017 Actual</b>	<b>31<sup>st</sup> March 2018 Budget</b>	<b>31<sup>st</sup> March 2018 Actual</b>
CFR General Fund (£m)	(23.1)	(21.0)	(23.1)

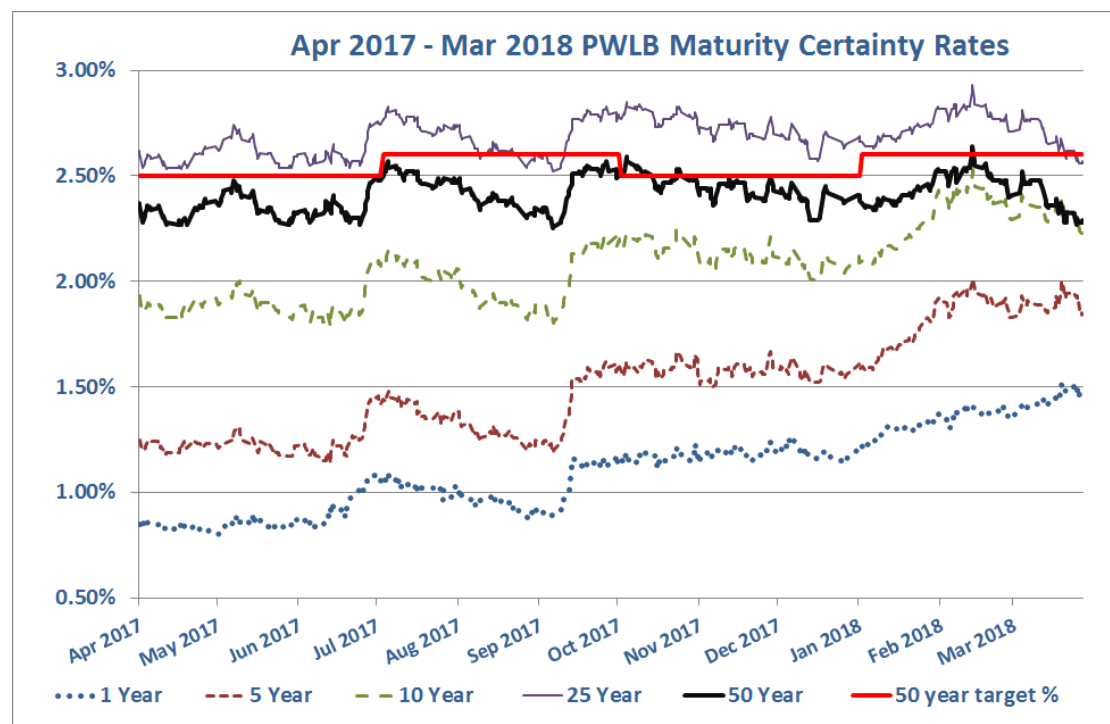
## 6. Borrowing Rates in 2017/18

### PWLB certainty maturity borrowing rates

As depicted in the graph and tables below and in Appendix 4, PWLB 25 and 50 year rates have been volatile during the year with little consistent trend. However, shorter rates were on a rising trend during the second half of the year and reached peaks in February / March.

During the year, the 50 year PWLB target (certainty) rate for new long term borrowing was 2.50% in quarters 1 and 3 and 2.60% in quarters 2 and 4.

The graphs and tables for PWLB rates show, for a selection of maturity periods, the average borrowing rates, the high and low points in rates, spreads and individual rates at the start and the end of the financial year.



*(Commentary and graph provided by Link Asset Services)*

## 7. Borrowing Outturn for 2017/18

### **Borrowing**

No borrowing was undertaken during the year.

### **Rescheduling**

No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

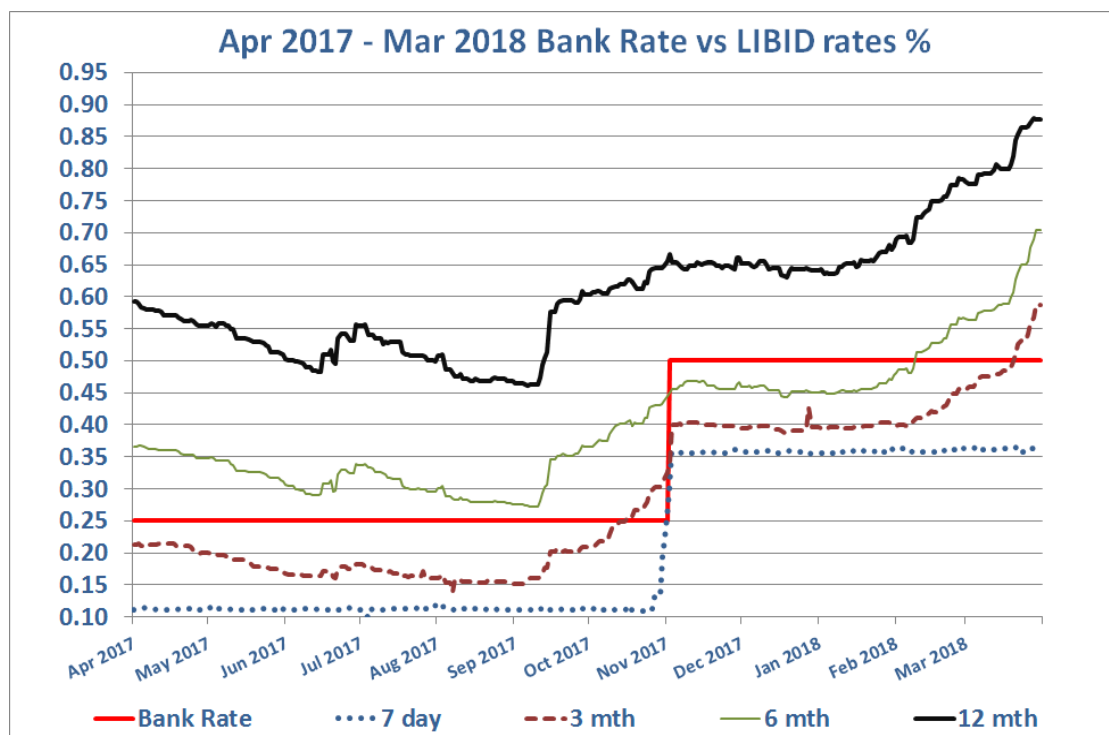
### **Repayments**

No repayments were made by the Council during the year.

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## 8. Investment Rates in 2017/18

Investment rates for 3 months and longer have been on a rising trend during the second half of the year in the expectation of Bank Rate increasing from its floor of 0.25%, and reached a peak at the end of March. Bank Rate was duly raised from 0.25% to 0.50% on 2.11.17 and remained at that level for the rest of the year. However, further increases are expected over the next few years. Deposit rates continued into the start of 2017/18 at previous depressed levels due, in part, to a large tranche of cheap financing being made available under the Term Funding Scheme to the banking sector by the Bank of England; this facility ended on 28.2.18.



*(Commentary and graph provided by Link Asset Services)*

## 9. Investment Outturn for 2017/18

**Investment Policy** – the Council's investment policy is governed by MHCLG guidance, which has been implemented in the annual investment strategy approved by the Council on 1<sup>st</sup> March 2017. 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.

**Investments held by the Council** - the Council maintained an average balance of £49.1m of internally managed funds. The internally managed funds earned an average rate of return of 0.51%. This exceeds comparable performance indicators detailed in the table below:

Average Internal Investments	Return	Benchmark		
		7 day LIBID	1 Month	3 Month
£49.1m	0.51%	0.2145%	0.2331%	0.2861 %

**Investments held by Property Funds** – the Council approved the use of property funds up to a value of £20m, at the time of investment. Working with our advisors at Capita Asset Services, two funds were chosen, Lothbury Property Trust and Hermes Property Unit Trust. Both funds had waiting lists to invest. The invitation to invest in the Lothbury fund arose in June 2015 and the Hermes fund in December 2015. The performances of these funds for 2017/18 are detailed below:

<b>Property Fund</b>	<b>Investments Held</b>	<b>Average Net Return</b>
Lothbury Property Trust	£10m	3.36 %
Hermes Property Unit Trust	£10m	3.92 %

The 2017/18 budget for interest was increased to £1,084,000 from £920,000. Consistent low interest returns meant that the outturn came in just under budget at £1,033,000.

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## 10. Other Issues

### 1. Revised CIPFA Codes

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued a revised Treasury Management Code and Cross Sectoral Guidance Notes, and a revised Prudential Code.

A particular focus of these revised codes was how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the Authority at a much higher level than can be attained by treasury investments. One recommendation was that local authorities should produce a new report to members to give a high level summary of the overall capital strategy and to enable members to see how the cash resources of the Authority have been apportioned between treasury and non-treasury investments. Officers will report to members when the implications of these new codes have been assessed as to the likely impact on this Authority.

### 2. Markets in Financial Instruments Directive II (MiFID II)

The EU set the date of 3<sup>rd</sup> January 2018 for the introduction of regulations under MIFID II. These regulations govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This has had little effect on this Authority apart from having to fill in forms sent by each institution dealing with this Authority and for each type of investment instrument we use, apart from for cash deposits with banks and building societies.

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## Appendix 1: Prudential and Treasury Indicators

During 2017/18, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Actual prudential and treasury indicators	2016/17 Actual £000	2017/18 Original £000	2017/18 Actual £000
Capital expenditure	2,813	3,386	2,389
Capital Financing Requirement	(23,079)	(20,935)	(23,079)
Gross borrowing	0	0	0
External debt	7,500	7,500	7,500
Investments	61,806	60,000	65,918*
Net borrowing	(54,306)	(54,500)	(58,418)

*\*Year-end investment balances finished higher than originally estimated due to increased preserve right to buy receipts and capital programme slippage.*

**Gross borrowing and 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 allows the Council some flexibility to borrow in advance of its immediate capital needs in 2017/18.

**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 2017/18 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 is 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.

	2017/18
Authorised limit	£11.7m
Maximum gross borrowing position	£7.5m
Operational boundary	£7.5m
Average gross borrowing position	£7.5m
Financing costs as a proportion of net revenue stream	4.57%

## Overall Treasury Position as at 31 March 2018

At the beginning and the end of 2017/18 the Council's treasury (excluding borrowing by finance leases) position was as follows:

	31 <sup>st</sup> March 2017 Principal	Rate/ Return	Average Life Yrs.		31 <sup>st</sup> March 2018 Principal	Rate/ Return	Average Life Yrs.
Fixed rate funding:							
-PWLB	£1.5m	8.875%	38		£1.5m	8.875%	37
-Market	£6m	8.785%	3		£6m	8.785%	2
Variable rate funding	None				None		
<b>Total debt</b>	<b>£7.5m</b>				<b>£7.5m</b>		
<b>CFR</b>	<b>(£23.1m)</b>				<b>(£23.1m)</b>		
<b>Over/ (under) borrowing</b>	<b>£7.5m</b>				<b>£7.5m</b>		
<b>Total investments</b>	<b>£61.8m</b>				<b>£65.9m</b>		
<b>Net debt</b>	<b>(£54.3m)</b>				<b>(£58.4m)</b>		

The maturity structure of the debt portfolio was as follows:

	31 March 2017 actual	2017/18 original limits	31 March 2018 actual
Under 12 months	£0m	£0m	£0m
12 months and within 24 months	£0m	£0m	£0m
24 months and within 5 years	£6m	£6m	£6m
5 years and within 10 years	£0m	£0m	£0m
10 years and within 20 years	£0m	£0m	£0m
20 years and within 30 years	£0m	£0m	£0m
30 years and within 40 years	£1.5m	£1.5m	£1.5m
40 years and within 50 years	£0m	£0m	£0m

The maturity structure of the investment portfolio was as follows:

	<b>2016/17 Actual £000</b>	<b>2017/18 Original £000</b>	<b>2017/18 Actual £000</b>
Investments			
Longer than 1 year	20,000	20,000	20,000
Under 1 year	41,806	40,000	45,918
<b>Total</b>	<b>61,806</b>	<b>60,000</b>	<b>65,918</b>

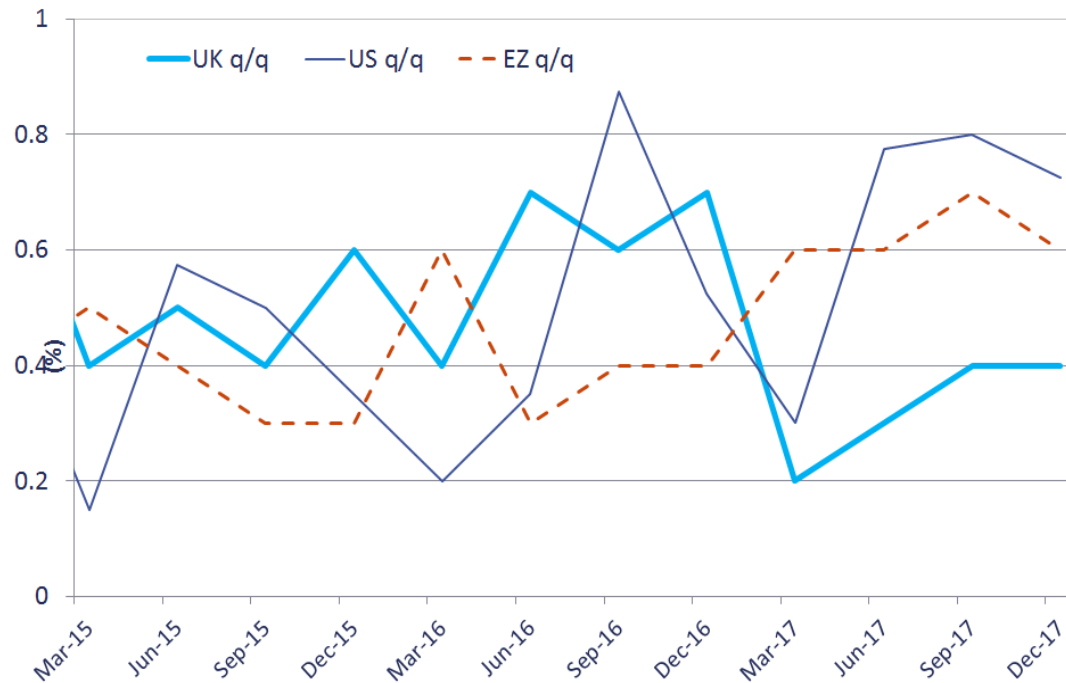
The exposure to fixed and variable rates was as follows:

	<b>31<sup>st</sup> March 2017 Actual £000</b>		<b>31<sup>st</sup> March 2018 Actual £000</b>
Fixed rate (principal or interest) based on net debt	100%		100%
• Debt	50%		50%
• Investments			
Variable rate (principal or interest) based on net debt	0%		0%
• Debt	50%		50%
• Investments			

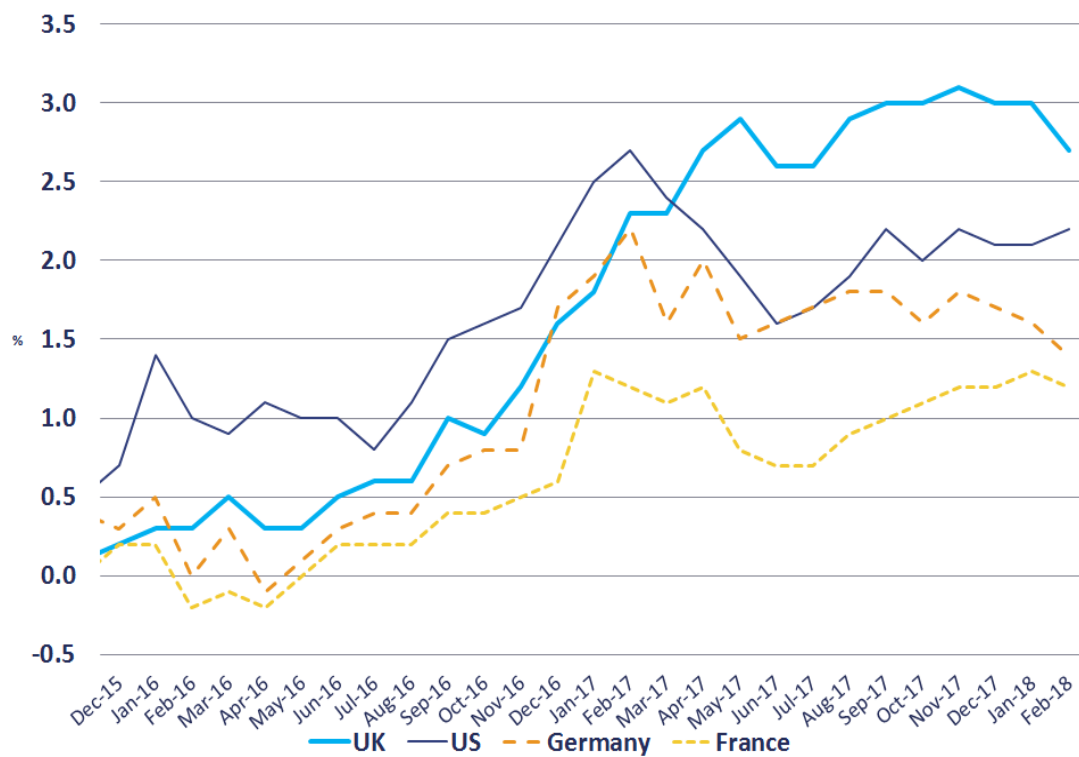
## Appendix 3: Graphs

Please find below graphs provided by Link Asset Services.

### UK, US and EZ GDP growth



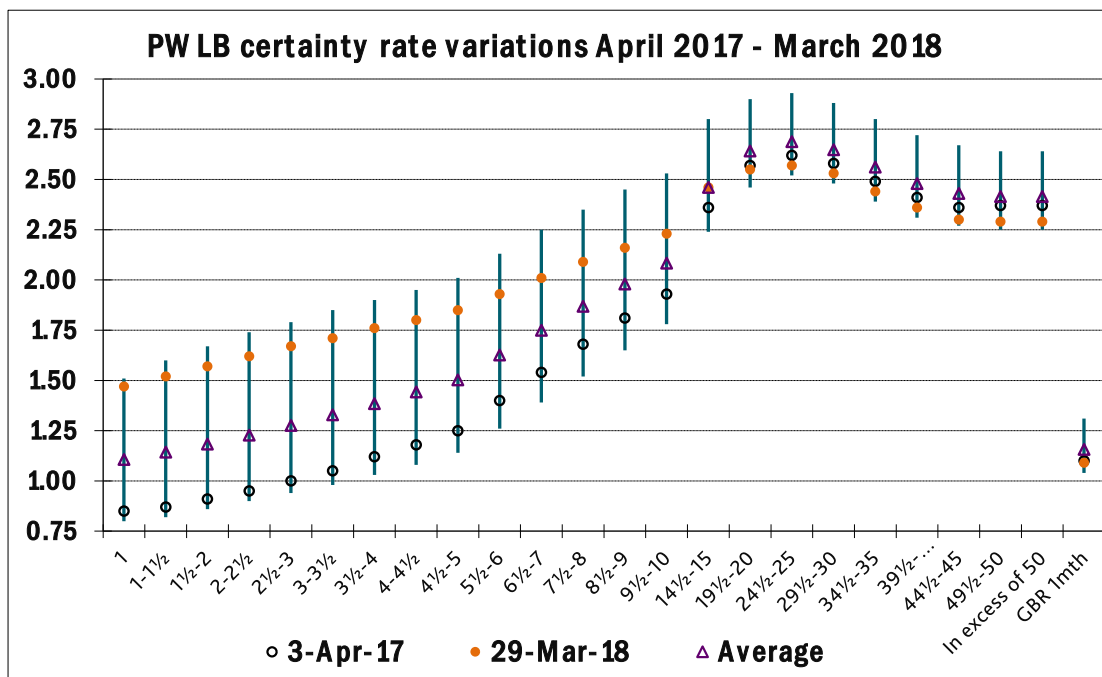
### Inflation UK, US, Germany and France



# Appendix 4: Borrowing and investment rates

Please find below supplementary graphs and tables provided by Link Asset Services.

## 1. PWLB borrowing rates



	1	1-1.5	2.5-3	3.5-4	4.5-5	9.5-10	24.5-25	49.5-50	1 month variable
3/4/17	0.850%	0.870%	1.000%	1.120%	1.250%	1.930%	2.620%	2.370%	1.100%
29/3/18	1.470%	1.520%	1.670%	1.760%	1.850%	2.230%	2.570%	2.290%	1.090%
High	1.510%	1.600%	1.790%	1.900%	2.010%	2.530%	2.930%	2.640%	1.310%
Low	0.800%	0.820%	0.940%	1.030%	1.140%	1.780%	2.520%	2.250%	1.040%
Average	1.107%	1.143%	1.276%	1.384%	1.503%	2.083%	2.688%	2.415%	1.157%
Spread	0.710%	0.780%	0.850%	0.870%	0.870%	0.750%	0.410%	0.390%	0.270%
High date	21/03/2018	21/03/2018	21/03/2018	21/03/2018	15/02/2018	15/02/2018	15/02/2018	15/02/2018	21/03/2018
Low date	03/05/2017	03/05/2017	30/05/2017	15/06/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017	04/04/2017

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/17	0.85%	1.25%	1.93%	2.62%	2.37%
31/3/18	1.47%	1.85%	2.23%	2.57%	2.29%
Low	0.80%	1.14%	1.78%	2.52%	2.25%
Date	03/05/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017
High	1.51%	2.01%	2.53%	2.93%	2.64%
Date	21/03/2018	15/02/2018	15/02/2018	15/02/2018	15/02/2018
Average	1.11%	1.50%	2.08%	2.69%	2.41%

## 2. Money market investment rates 2017/18

	7 day	1 month	3 month	6 month	1 year
1/4/17	0.111	0.132	0.212	0.366	0.593
31/3/18	0.364	0.386	0.587	0.704	0.878
High	0.366	0.390	0.587	0.704	0.879
Low	0.099	0.122	0.140	0.273	0.461
Average	0.215	0.233	0.286	0.401	0.606
Spread	0.267	0.268	0.447	0.432	0.418
High date	27/2/18	22/3/18	29/3/18	29/3/18	28/3/18
Low date	4/7/17	10/8/17	7/8/17	7/9/17	6/9/17