SWANAGE TOWN COUNCIL

Annual Treasury Report 2017/18

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1. Background

The Council's Treasury Management Strategy for 2017/18 is underpinned by having due regard to the Chartered Institute of Public Finance and Accountancy's Guidance for Smaller Public Organisations on the Application of the CIPFA Code of Practice for Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) and the Department for Communities and Local Government (CLG) *Guidance on Local Authority Investments,* issued March 2010. The Code recommends that members approve a treasury management annual report after the end of each financial year.

The Authority's Treasury Management Strategy for 2017/18 was approved by full Council on 23/01/2017 which can be accessed on http://www.swanage.gov.uk/Downloads.aspx.

The Authority has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

2. External Context

Economic commentary: 2017-18 was characterised by the push-pull from expectations of tapering of Quantitative Easing (QE) and the potential for increased policy rates in the US and Europe and from geopolitical tensions, which also had an impact.

The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in the 2017 calendar year, the same level as in 2016. This was a far better outcome than the majority of forecasts following the EU Referendum in June 2016, but it also reflected the international growth momentum generated by the increasingly buoyant US economy and the re-emergence of the Eurozone economies.

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 before falling back to 2.7% in February 2018. Consumers felt the squeeze as real average earnings growth, i.e. after inflation, turned negative before slowly recovering. 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 UK and the EU only reaching an agreement in March 2018 on a transition which will now span Q2 2019 to Q4 2020. The Withdrawal Treaty is yet to be ratified by the UK parliament and those of the other 27 EU member states and new international trading arrangements are yet to be negotiated and agreed.

The Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate by 0.25% in November 2017. It was significant in that it was the first rate hike in ten years, although in essence the MPC reversed its August 2016 cut following the referendum result. The February *Inflation Report* indicated that the MPC was keen to return inflation to the 2% target over a more conventional (18-24 month) horizon with 'gradual' and 'limited' policy tightening. Although in March two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates.

In contrast, economic activity in the Eurozone gained momentum and although the European Central Bank removed reference to an 'easing bias' in its market communications and had yet to confirm its QE intention when asset purchases end in September 2018, the central bank appeared some way off normalising interest rates. The US economy grew steadily and, with its policy objectives of price stability and maximising employment remaining on track, the Federal Reserve Open Market Committee (FOMC) increased interest rates in December 2017 by 0.25% and again in March, raising the policy rate target range to 1.50% - 1.75%. The Fed is expected to deliver two more increases in 2018 and a further two in 2019. However, the imposition of tariffs on a broadening range of goods initiated by the US, which has led to retaliation by China, could escalate into a deep-rooted trade war having broader economic consequences including inflation rising rapidly, warranting more interest rate hikes.

Financial markets: The increase in Bank Rate resulted in higher money markets rates: 1-month, 3-month and 12-month LIBID rates averaged 0.32%, 0.39% and 0.69% and at 31st March 2018 were 0.43%, 0.72% and 1.12% respectively.

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 rose to 1.65% by the end of March. 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 FTSE 100 had a strong finish to 2017, reaching yet another record high of 7688, before plummeting below 7000 at the beginning of 2018 in the global equity correction and sell-off.

Credit background:

<u>Credit Metrics</u>

In the first quarter of the financial year, UK bank credit default swaps reached three-year lows on the announcement that the Funding for Lending Scheme, which gave banks access to cheaper funding, was being extended to 2018. For the rest of the year, CDS prices remained broadly flat.

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. As there was some uncertainty surrounding which banking entities the Authority would be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would actually look like, in May 2017 Arlingclose advised adjusting downwards the maturity limit for unsecured investments to a maximum of 6 months. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non ring-fenced bank.

Money Market Fund regulation: The new EU regulations for Money Market Funds (MMFs) were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility Net Asset Value (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

Credit Rating developments

The most significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities.

Changes to credit ratings included Moody's downgrade of Standard Chartered Bank's long-term rating to A1 from Aa3 and the placing of UK banks' long-term ratings on review to reflect the impending ring-fencing of retail activity from investment banking (Barclays, HSBC and RBS were on review for downgrade; Lloyds Bank, Bank of Scotland and National Westminster Bank were placed on review for upgrade).

Standard & Poor's (S&P) revised upwards the outlook of various UK banks and building societies to positive or stable and simultaneously affirmed their long and short-term ratings, reflecting the institutions' resilience, progress in meeting regulatory capital requirements and being better positioned to deal with uncertainties and potential turbulence in the run-up to the UK's exit from the EU in March 2019. The agency upgraded Barclays Bank's long-term rating to A from A- after the bank announced its plans for its entities post ring-fencing.

Fitch revised the outlook on Nationwide Building Society to negative and later downgraded the institution's long-term ratings due to its reducing buffer of junior debt. S&P revised the society's outlook from positive to stable.

S&P downgraded Transport for London to AA- from AA following a deterioration in its financial position.

Other developments:
In February, Arlingclose advised against lending to Northamptonshire County Council (NCC). NCC issued a section 114 notice in the light of severe financial challenge and the risk that it would not be in a position to deliver a balanced budget.

In March, following Arlingclose's advice, the Authority removed RBS plc and National Westminster Bank from its counterparty list. This did not reflect any change to the creditworthiness of either bank, but a tightening in Arlingclose's recommended minimum credit rating criteria to A- from BBB+ for FY 2018-19. The current long-term ratings of RBS and NatWest do not meet this minimum criterion, although if following ring-fencing NatWest is upgraded, the bank would be reinstated on the Authority's lending list.

Local Authority Regulatory Changes

MiFID II: 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 which includes 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 Authority has not and does not plan to opt up to professional status because it does not meet the criteria set. This has had little overall impact upon the Council's investments to date. However, the Council has been notified that it will not be able to continue holding funds with the Federated MMF. The main protection in being a retail client is a duty on the firm to ensure that the investment is "suitable" for the Authority. It should be noted that local authorities' investments are not protected by the Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service regardless of whether they are retail or professional clients.

3. Local Context

At 31/03/2018 the Authority's underlying need to borrow for capital purposes was nil, while usable reserves which are the underlying resources available for investment were £5.74m. At

31/03/2018, the Authority had no borrowing and £5.9m of investments representing the Council's usable reserves and working capital.

4. Borrowing Strategy and Debt Management

The Authority is debt free. The 2017/18 capital expenditure plans and treasury strategy did not imply a need to borrow over the 3-year forecast period. Investments are forecast to fall to £3m by March 2021, as capital receipts and earmarked reserves are used to finance the capital programme.

5. Investment Activity

The Authority holds significant invested funds, representing reserves held. During the year the Authority's investment balances remained stable between £5.5m to £6m. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

Table 1: Investment Position

Investments	Balance on 01/04/2017 £	Investments Made £	Maturities/ Investments Sold £	Balance on 31/03/2018 £
Banks and building societies and other organisations - Short-term (minimum rating A-)	2,267,586	1,652,604	(2,700,585)	1,219,605
AAA-rated Money Market Funds	402,889	962	0	403,851
Loans to small businesses /other organisations	0	0	0	0
Investments in Pooled Funds	2,500,000	1,500,000	0	4,000,000
Commercial Paper, Corporate Bonds and other marketable instruments	379,080	0	(14,840)	364,240
TOTAL INVESTMENTS	**5,549,555**			**5,987,696**
Increase/(Decrease) in Investments				**438,141**

Government guidance requires the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Authority looked to further diversify into more secure and/or higher yielding asset classes during 2017/18. In 2016/17, £1.5m was identified as being available for long-term investment and was moved from bank deposits into pooled bond/equity funds, with a view to reduce bail-in risk and increase the return. Accounts were opened with M & G Investments and Investec Asset Management in 2016/17 and £500k and £1m were invested in each of the funds respectively in May 2017. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 2 below.

Table 2: Investment Benchmarking

Date	Credit Score	Credit Rating	No. of Counterparties/ Funds	Rate of Return (income only)
31/03/2017	4.69	A+	6	2.49%
30/06/2017	4.11	AA-	8	4.94%
30/09/2017	3.88	AA-	8	3.98%
31/12/2017	4.15	AA-	8	3.58%
31/03/2018	3.12	AA	8	4.06%

The Council held £1.2m in a Lloyds commercial call account at 31st March 2018, pending imminent expenditure on its capital programme. The investment and maturity values for banks in table 1 represent the general movement between accounts, with the removal of funds from the Council's Lloyds investment account due to a decrease in the interest rate to nil. The exception is the movement of £1.5m to long-term investments.

The Council's long-term investments have maintained a high income return during the year. Appendix 1, page 7, shows the overall performance of these investments for the 2017/18 financial year. The Council continued to hold £2.5m (market value £3.132m) with the CCLA LAMIT, an externally managed pooled property fund, which generated an income return of £143k, 4.8%. The market value of the investments with M&G and Investec at 31st March 2018 was £487k and £977k and with an income return of 3.51% and 3.76% respectively. As these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives is regularly reviewed.

6. Compliance

This report provides members with a summary report of the treasury management activity during 2017/18, having due regard to both the CIPFA Code of Practice and the CLG Guidance. A prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

The Authority can confirm that during 2017/18 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.

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Appendix 1

Extract: Arlingclose – Swanage Credit Profile 31/03/18

EXTERNAL FUND PORTFOLIO			SWANAGE				From: 31/03/2017		To: 31/03/2018	
FUND NAME	ASSET CLASS	No of Units Held in Period	Current Value £	Capital Growth £	Dividends Earned £	Holding Period (yrs)	Capital Return	Income Return	Total Return	Volatility
CCLA - LAMIT PROPERTY FUND	PROPERTY	1,053,526	3,132,449	142,015	143,591	1.0	4.75%	4.80%	9.55%	2.5%
INVESTEC DIVERSIFIED INCOME FUND	MULTI ASSET	940,645	977,695	-22,305	37,551	0.8	-2.23%	3.76%	1.52%	1.8%
M&G STRATEGIC CORPORATE BOND FUND	BOND	44,259	487,665	-12,335	17,544	0.8	-2.47%	3.51%	1.04%	2.5%
GRAND TOTAL			4,597,810	107,376	198,686	0.9	2.39%	4.42%	6.82%	1.8%
Capital gains and losses under one year are not annualised						Annualised Returns:	2.39%	4.66%	7.05%