ANNEX

TREASURY MANAGEMENT ANNUAL REVIEW 2017/18

Purpose

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 the preceding year. 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 15/02/2017)
- a mid-year (minimum) treasury update report (Cabinet 03/10/2017)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

In addition, this Council has received quarterly treasury management update reports (Cabinet 11/07/2017 and 02/01/2018) as part of the budget monitoring process.

External Context

Economic background: 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 calendar 2017, the same level as in 2016. This was a far better outcome than the majority of forecasts following the EU Referendum in June 2016, 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 be 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 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 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, the minutes of the meeting suggested that an increase in May 2018 was highly likely.

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 calendar 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: 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 Council would will be dealing with once ring-fencing was

implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would look would actually look like, maturity limit for unsecured investments were scaled back. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

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). The Council expects most of the short-term MMFs to convert to the LVNAV structure and awaits confirmation from each fund.

Local Authority Regulatory Changes

Revised CIPFA Codes: CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The required changes from the 2011 Code will be incorporated into the Treasury Management Strategy and monitoring reports.

The 2017 Prudential Code introduces the requirement for a Capital Strategy which provides a high-level overview of the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for future financial sustainability. Where this strategy is produced and approved by full Council, the determination of the Treasury Management Strategy can be delegated to a committee. The Code also expands on the process and governance issues of capital expenditure and investment decisions.

In the 2017 Treasury Management Code the definition of 'investments' has been widened to include financial assets as well as non-financial assets held primarily for financial returns such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be discussed in the Capital Strategy or Investment Strategy. Additional risks of such investments are to be set out clearly and the impact on financial sustainability is be identified and reported.

MHCLG Investment Guidance and Minimum Revenue Provision (MRP): In February 2018 the MHCLG (Ministry of Housing, Communities and Local Government) published revised Guidance on Local Government and Investments and Statutory Guidance on Minimum Revenue Provision (MRP).

Changes to the Investment Guidance include a wider definition of investments to include non-financial assets held primarily for generating income return and a new category called "loans" (e.g. temporary transfer of cash to a third party, joint venture, subsidiary or associate). The Guidance introduces the concept of proportionality, proposes additional disclosure for borrowing solely to invest and also specifies additional indicators. Investment strategies must detail the extent to which service

delivery objectives are reliant on investment income and a contingency plan should yields on investments fall.

The definition of prudent MRP has been changed to "put aside revenue over time to cover the CFR"; it cannot be a negative charge and can only be zero if the CFR is nil or negative. Guidance on asset lives has been updated, applying to any calculation using asset lives. Any change in MRP policy cannot create an overpayment; the new policy must be applied to the outstanding CFR going forward only.

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 persons authorised to make investment decisions on behalf of the Council 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 persons have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The Council has met the conditions to opt up to professional status and has done so in order to maintain its quasi-MiFID II status prior to January 2018. The Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares, and to financial advice.

Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2017/18, which includes the Annual Investment Strategy, was approved by the Council on 15th February 2017. It sets out the Council's investment priorities as being:

1. **S**ecurity of Capital;
2. **L**iquidity; and
3. **Y**ield

Interest rates expectations within the 2017/18 strategy anticipated low but rising Bank Rate, with gradual rises in medium and longer term fixed borrowing rates. Short-term borrowing rates were expected to be the cheaper form of borrowing should funds have needed to be raised. Continued market risks promoted a cautious approach to investments, whereby options would continue to be dominated by low counterparty risk appetite, resulting in relatively low returns (when compared to borrowing rates) for low risk.

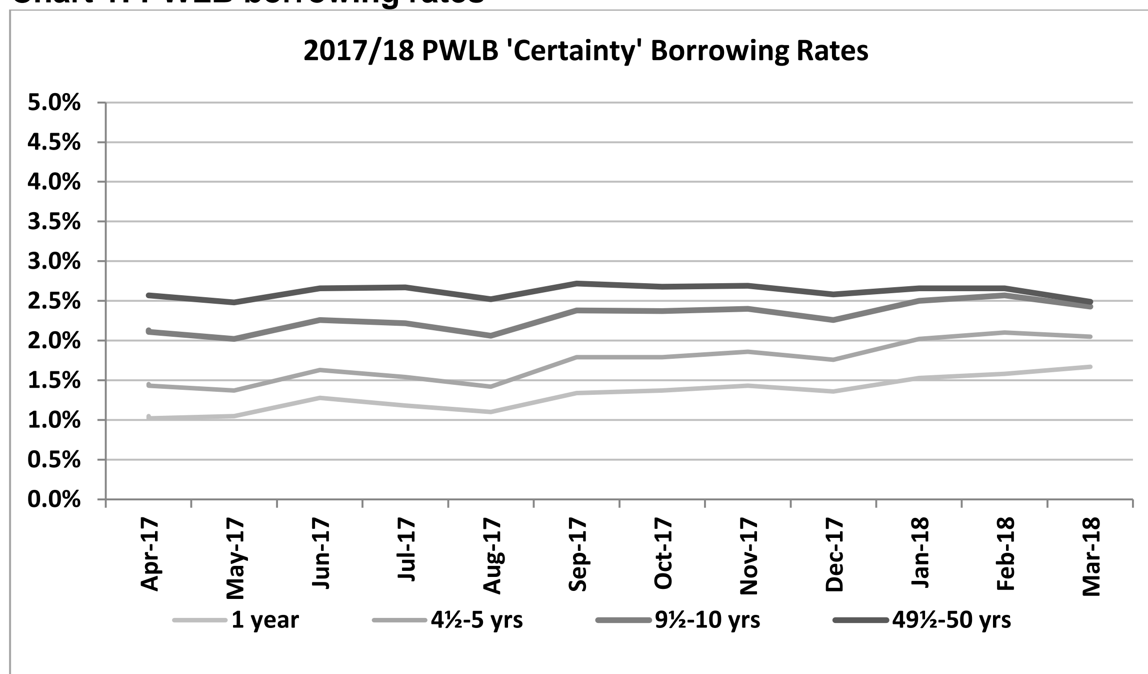
Borrowing

The Council's primary objective when borrowing is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should long-term plans change is a secondary objective.

During the year, existing Public Works Loans Board (PWLB) loan principal totalling £2.568m was repaid in line with loan agreements.

The chart below illustrates the movements in PWLB borrowing rates during the course of the year, less the 0.20% discount offered to qualifying Authorities.

Chart 1: PWLB borrowing rates



The table below sets out the profile of existing borrowing.

Table 1: Borrowing Profile at 31st March 2018

	Annuity	Maturity		TOTAL	
	Principal £m	No of loans	Principal £m	Principal £m	%
< 12 mths	2.666	2	6.469	**9.135**	**1.87**
1-2 yrs	2.768	2	11.178	**13.946**	**2.86**
2-5 yrs	8.952	6	17.904	**26.856**	**5.50**
5-10 yrs	17.348	12	53.000	**70.348**	**14.40**
>10 yrs	54.689	34	313.510	**368.199**	**75.37**
	86.423		**402.061**	**488.484**	**100.00**

Debt Restructuring

No debt rescheduling was undertaken during the year. Debt rescheduling opportunities have been limited due to the current economic climate and consequent structure of interest rates. Officers continue to monitor this position.

Investments

Counterparty Update: 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 deterioration in its financial position.

Moody's downgraded Rabobank's long-term rating due to its view on the bank's profitability and the long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment and the ratings of the large Australian banks on its view of the rising risks from their exposure to the Australian housing market and the elevated proportion of lending to residential property investors. S&P also upgraded the long-term rating of ING Bank to A+.

In February 2018, the Council's treasury advisors advised against lending to Northamptonshire County Council (NCC) for treasury purposes. 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 the Council's treasury advisors advised removing RBS plc and National Westminster Bank from its lending list. However, this did not reflect any change to the creditworthiness of either bank, but a tightening in recommended minimum credit rating criteria to A- from BBB+ for the 2018-19 financial year. The current long-term ratings of RBS and NatWest does not meet this minimum suggested criterion, although if following ring-fencing NatWest is upgraded, the bank would be reinstated on the Council's lending list. As the Council's corporate bankers, RBS/NatWest remain a key partner in providing banking services and there is no recommendation that this should change. Balances held in operational bank accounts will be kept to a minimum.

The table below summarises the investment maturity position at 31 March 2018:

Table 2: Investment Maturity Position at 31st March 2018

Term/Sector/Product	Product type/ Maturity	Amount	
		£	%
Instant Access	Money Market Funds	£76,035,000	48.45
	Bank Call Accounts	£15,141	0.01
		£76,050,141	**48.46**
Fixed Term – Other Local Authorities	9-12 months	£10,000,000	6.37
	12-24 months	£8,500,000	5.42
		£18,500,000	**11.79**
Tradable Instruments – Bank/B Soc Cert of Deposit	0-3 months	£32,500,000	20.70
	3-6 months	£5,000,000	3.19
		£37,500,000	**23.89**
Tradable Instruments – Covered Bonds/FRN	0-3 months	£5,179,868	3.30
	12-24 months	£4,000,000	2.55
		£9,179,868	**5.85**
Tradable Instruments – LA Property Fund	Ongoing	**£15,195,570**	**9.68**
Other Investments	Ongoing	**£510,496**	**0.33**
Total Investment Portfolio		**£156,936,075**	**100.00**

Investment balances bought forward at 31 March 2017 were £274.550m. Due to the front-loaded nature of various government funding streams and increased cash balances as a result of borrowing pending capital outlay, the average level of funds available for investment purposes during the year was £314.2m (£300.9m for Q4 2017-18).

Balances were forecast to fall to circa £150m by the financial year end as internal resources are applied to fund capital expenditure demands in lieu of further borrowing, effectively reducing the cost of carrying debt at higher cost than income generated through investment of balances and reducing exposure to counterparty risk. Actual balances at 31st March 2018 were £156.936m primarily due to delays & rephrasing of the capital programme.

Throughout the year, investments were placed with consideration to the significant Residual Waste Treatment Facility capital payment of £155m (inc' VAT) to ensure sufficient liquidity of cash funds. Original forecasts anticipated the capital expenditure to be incurred in September 2016 upon facility completion/handover. However, project delays meant that the Council held these funds throughout 2016/17 and the majority of 2017/18, with the impact of this taken into consideration in the Medium Term Financial Plan. Payment has now been made (March 2018), resulting in a significant drop in investment balances held.

The investment activity during the year conformed to the approved strategy, and the Council had no difficulties meeting liquidity demands.

The Council's investment return for 2017/18 was above target. Performance against benchmark return is shown below:

Table 3: Benchmark Performance

Benchmark	Benchmark Return	Council Performance
3 month LIBID	0.28%	0.68%

Projections for the financial year were reported through the Budget Monitoring process.

Other Non-Treasury Holdings

Although not classed as treasury management activities per se, the 2017 CIPFA Code now requires the Council to report on investments for policy reasons outside of normal treasury management. This includes service investments for operational and/or regeneration as well as commercial investments which are made mainly for financial reasons.

In 2012/13, the Council lent £31.6m to its wholly owned subsidiary company Milton Keynes Development Partnership (MKDP) LLP to finance the acquisition of assets from the Homes and Communities Agency (HCA). The balance outstanding at 31st March 2018 was £30.4m. MKDP plan to repay this debt to the Council through proceeds from the strategic sale of assets. The Council is funding the debt servicing costs of this loan until 31st March 2019 through New Homes Bonus grant to allow MKDP to develop sustainable income streams.

The Council has lent £0.5m in tranche payments to its 50% joint-owned partnership company YourMK LLP. YourMK is a partnership between the Council and Mears Group to deliver regeneration, management of council housing stock, and other development on council land and it is responsible for all Housing Land under the Council. At 31st March 2018, the Council's investment holding was valued at £0.510m which represents an unrealised gain through accruing compound interest. This investment generated £10,206 of investment income for the Council at an average rate of return of 3.52%. This is higher than the return earned on treasury investments but reflects the additional risks to the Council of holding such investments.

The Council holds a £5m principal investment (match-funded by external investment) in a National Homelessness Property Fund (the Fund). This investment was undertaken for service reasons to reduce the ongoing cost to the Council of providing temporary housing accommodation. At 31st December 2017 (latest available) the Net Asset Value of the Council's investment was £4,571,774, which represents an unrealised revaluation loss against principal of £428,226. The unrealised valuation loss is due to the basis of property asset valuation; the assets were acquired on an Open Market Value (OMV) basis, but have been revalued at

Existing Use Value (EUV) based on sub-market rental income streams to reflect the ongoing use as temporary accommodation. If the assets were sold to liquidise the Council's investment, it would be with vacant possession and thus the valuation method would revert back to OMV, so it is expected that the book loss would be fully recovered and with additional capital/housing market growth. No investment income dividends have been received to date, however the Fund has moved into a profitable position and expects to begin distributions in 2018. The Fund has provided 14,988 bed-nights during 2017/18 which has resulted in a saving of £45,000 against alternative temporary placement costs. This is equivalent to a 0.90% return on investment, which is higher than the return earned on treasury investments but reflects the additional risks to the Council of holding such investments. Annual savings are expected to increase in future years as a result of (a) higher bed-night numbers from full-year-effects of additional properties, and (b) profit income distribution from the Fund.

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) were approved alongside the TMSS on 15th February 2017.

During the financial year the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Statement.

The Prudential and Treasury Indicators are shown in Table 4 below.

Table 4: Prudential and Treasury Indicators

Prudential Indicator	2017/18 Indicator	2017/18 Actual
Authorised limit for external debt	----- £760.000m -----	
Operational boundary for external debt	----- £730.000m -----	
Gross borrowing	£488.478m	£488.484m
Capital Financing Requirement (CFR)	£711.119m	£707.504m *
Ratio of financing costs to net revenue streams: GF	9.71%	7.72% *
HRA	37.81%	37.16% *
Incremental impact of capital investment decisions:-		
a) Increase in council tax (band D) per annum.	-£69.63p	-£73.77p * **
b) Increase in average housing rent per week	£0.02p	£0.02p *
Limit of fixed interest rates based on net debt	£720.000m	£422.304m
Limit of variable interest rates based on net debt	£30.000m	-£90.756m
Principal sums invested > 364 days	£200.000m	£28.206m
Maturity structure of borrowing limits:-		
Under 12 months	Max. 15% Min. 0%	1.87%
12 months to 2 years	Max. 15% Min. 0%	2.86%

2 years to 5 years	Max. 50% Min. 0%	5.50%
5 years to 10 years	Max. 50% Min. 0%	14.40%
10 years and above	Max. 100% Min. 50%	75.37%

* subject to revision at final outturn.
** Impact of Residual Waste Treatment Facility scheme slippage.