Annexes B & C to this Appendix are not for publication as they contain exempt information of the description in Paragraphs 14 and 21 of Schedule 12A of the Local Government Act 1972.

Cardiff Council
Treasury Management Annual Report 2017/18

Introduction

1. Treasury management activities are the management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

2. The Council carries out its treasury management activities in accordance with a code developed for public services and updated in 2017 by the Chartered Institute of Public Finance and Accountancy (CIPFA).

3. On 25th February 2010, Council approved policies and adopted the four clauses of the treasury management code which are replicated in **Annexe A** for information. Council received a report in February 2017 on the Council's Treasury Management Strategy for 2017/18 and a mid-year review in November 2017.

4. This report provides members with an annual report for the Council's Treasury Management activities for 2017/18. It covers:-

   - the economic background to treasury activities
   - treasury investment strategy and outturn for 2017/18
   - borrowing strategy and outturn for 2017/18
   - debt rescheduling
   - compliance with treasury limits and prudential indicators
   - treasury management issues for 2018/19

5. Council requires the scrutiny of the accounting, audit and commercial issues of its Treasury Management Strategy and practices to be undertaken by the Council's Audit Committee. A number of reports were submitted to the Committee to note and review during the year, with each committee receiving a report on the position and performance of treasury investments and borrowing. Member training has also been undertaken to support Members' scrutiny role.

Economic Background

Growth at the start of the year remained weak as a result of inflation caused by increases in the cost of imported goods feeding through into prices and consequently impacting on consumer disposable income. Market speculation about the timing of increases in UK base rate continued during the year given the series of increases in the United States. The Monetary Policy Committee (MPC) increased bank rate from 0.25% to 0.50% in November 2017 and the Bank of England ended the term funding scheme in February 2018 which had been a cheap source of funds to Banks.

The increase in base rate resulted in increases in investment deposit rates primarily for longer periods. The increase in base rate has also increased shorter term borrowing rates, however longer term rates, whilst volatile, ended the year where they started.

Investments and Outturn

6. The Council's treasury investments include those arising from its own temporary cash balances as well as balances held from activities of Joint Committees for which it is the accountable body.

7. The management of the day-to-day cash requirements of the Council is undertaken in-house with credit advice from Link Asset Services, the Council's Treasury Management advisors. This may involve temporary borrowing pending receipt of income/long-term funds or the temporary lending of surplus funds. These fluctuate daily and arise from a number of sources including differences in timing of revenue and capital cash flows, reserves, provisions and other balances held for future use.

8. The Council invests with institutions listed on the Council's approved lending list and in accordance with investment guidelines established by the Welsh Government as reflected in the Council's investment strategy. Lending to these institutions is subject to the time and size limits laid down on that list. The categories, names, periods and size limits on this list can be extended, varied or restricted at any time by the Section 151 Officer under delegated powers and are monitored closely in conjunction with the Council's treasury advisors.

9. From January 2018, the Council was required to comply with the Markets and Financial Instruments Directive II (MIFID II). Under these regulations, which govern the relationship between the Council and financial institutions we lend to and borrow from, the Council elected for 'professional' status. Whilst this increased administration, this had little impact on the Council.

10. An extract from the investment strategy approved by Council in February 2017 is shown below.

> *Given the likelihood of internal borrowing and the interest rate forecasts identified above, longer-term investments above one year will be unlikely. The Debt Management Agency Deposit Facility will be used only as a last resort.*

11. At 31 March 2018, investments stood at £59.1 million, with a short term investment strategy employed for most of the year. The Council's choice of investments maintained an approach of security where the amount invested is that repayable. **Annexe B** shows with whom these investments were held.

12. A selection of performance indicators and benchmarking charts in relation to investments is included in **Annexe C.** The main areas to highlight at 31 March 2018 are as follows:-

    - Counterparty exposure against the maximum allowed directly with an organisation. This shows that at 31 March 2018 no exposure limits set were breached. This was also the case during the course of the year.
    - Investments held with different institutions as a percentage of the total shows that investments are diversified over a number of organisations and this was a strategy applied where possible during the course of the year.

- The geographic spread of investments as determined by the country of origin of relevant organisations. All investments are in sterling and countries are rated AA and above as per our approved criteria.

13. Using historic data adjusted for current financial market conditions, the probability of any default is low at circa 0.01% of the investments outstanding, £5,905.

14. All investments held at 31 March 2018 are deemed recoverable. Accordingly, no impairment losses are reflected in the Council's 2017/18 Statement of Accounts arising from the Council's treasury management activities.

15. The overall level of interest receivable from treasury investments totalled £366,000 in 2017/18. The average returns achieved compared to industry benchmarks are shown in the table below.

	Return on Investment 2016/17		**Return on Investment 2017/18**	
	Benchmark 7day / 3month (%)	**Achieved (%)**	**Benchmark 7day / 3month (%)**	**Achieved (%)**
In-house	0.20/ 0.32	0.62	0.22/ 0.29	0.44

16. The benchmarks are the average of the 7 day London Interbank Bid Rate (LIBID) and 3 month LIBID respectively. These represent the average rate during the course of the year for investments for those periods. Performance exceeded benchmarks, due to availability of notice accounts offering higher deposit rates and undertaking longer term deposits where appropriate.

Borrowing and Outturn

17. Long term borrowing is undertaken to finance the Council's capital programme. The main sources of borrowing are currently the Public Works Loan Board (PWLB) and the Money Markets.

18. At 31 March 2018, the Council had £693 million of external borrowing. This was predominantly fixed interest rate borrowing payable on maturity.

31 March 2017			**31 March 2018**	
£m	**Rate (%)**		**£m**	**Rate (%)**
617.2		Public Works Loan Board	631.8	
51.0		Market (Lender Option Borrower Option)	51.0	
3.0		Welsh Government	4.6	
2.8		Other	5.9	
674.0	**4.74**	**Total External Debt**	**693.3**	**4.64**

19. Total interest payable on external debt during 2017/18 was £31.8 million of which £11.8 million was payable by the Housing Revenue Account (HRA). In total £35.4 million was set aside from General Fund and HRA revenue budgets in line with the Councils approved policy on provision for debt repayment.

20. Extracts from the borrowing strategy approved by Council in February 2017 are shown below.

The Council will aim to manage its debt portfolio on a long-term basis with a high regard to the effects on current and future Council Tax and Rent Payers.
The Council's Borrowing Strategy for 2017/18 and the capital financing revenue budgets included in the MTFP will consider all options to meet the long-term aims of: • *Promoting revenue cost stability to aid financial planning and avoid a stop-start approach to service delivery, although it is recognised that this may have a financial impact.* • *Pooling borrowing and investments to ensure the whole Council shares the risks and rewards of treasury activities.* • *Reduction over time in the average rate of interest on overall Council borrowing* • *Ensuring any refinancing risk is manageable each financial year, using opportunities to re-profile borrowing where cost effective to do so both in the short and long term.* • *Ensuring borrowing plans are aligned to known capital expenditure spending plans, the useful life of assets created, financial reserve levels and consistent with the prudent provision for the repayment of any such expenditure paid for by borrowing.*

<u>External verses internal borrowing</u> *Whilst interest rates for borrowing are greater than interest rates the Council receives for investments (the cost of carry), it makes financial sense to use any internal cash balances held in the short-term to pay for capital expenditure and minimise costs (Internal Borrowing), rather than undertake external borrowing. However, there is a risk that the Council may have to borrow at higher rates when it does actually need to borrow in future and so this position is kept under continuous review.*
The forecast level of internal borrowing at 31 March 2018 in relation to the CFR is deemed manageable. However, based on the current forecasts of future capital expenditure plans and high level analysis of the sustainability of internal borrowing from the Council's balance sheet position for future years, external borrowing will be required to be undertaken in the medium term.

21. During 2017/18 borrowing of £25.0 million was undertaken. This comprised borrowing of £20 million from PWLB at an average rate of 2.38% and average maturity of 41 years,

also £5.0 million of interest free loans from Welsh Government and Salix for specific capital schemes. Together with the natural maturity of £5.7 million of primarily PWLB loans, the overall effect of new borrowing during the year was to reduce the average rate on the Council's borrowing to 4.64% at 31 March 2018.

22. As part of its loan portfolio, the Council has 6 Lender Option Borrower Option (LOBO) loans totalling £51 million. These are where the lender can request a change in the rate of interest payable by the Council on pre-determined dates. The Council at this point has the option to repay the loan. Apart from the option to increase rates these loans are comparable to PWLB and have no other complications such as variation in interest rates or complex terms.

23. Interest rates on the LOBO's held range between 3.81% and 4.35% which are not unreasonable and are below the Council's average rate of interest payable. Details of the loans are shown in the table below.

24. None of the LOBO's had to be repaid during 2017/18. £24 million of the LOBO loans are subject to the lender having the right to change the rate of interest payable during the next financial year. The Council has the right to refuse the change, triggering early repayment and the need to re-finance. This is a manageable refinancing risk as LOBO's form a relatively low proportion of the Council's overall borrowing at 7.36%.

£m	Rate	Potential Repayment Date	Option Frequency	Full Term Maturity
6	4.28%	21/05/2018	6 months	21/11/2041
6	4.35%	21/05/2018	6 months	21/11/2041
6	4.06%	21/05/2018	6 months	23/05/2067
6	4.08%	01/09/2018	6 months	23/05/2067
22	3.81%	21/11/2020	5 years	23/11/2065
5	4.10%	15/01/2023	5 years	17/01/2078

25. In accordance with the strategy, the Council has been undertaking internal borrowing which is when it uses temporary cash balances it holds in the short term instead of undertaking external borrowing. This is confirmed by a comparison of the Council's external level of debt and Capital Financing Requirement at 31 March 2018 as shown later in this report.

Debt Rescheduling

26. No debt rescheduling or early repayment of debt was undertaken during 2017/18. The main obstacle remains the level of premium (penalty) that would be chargeable on early repayment by the PWLB. The premium payable on the balance of PWLB loans at 31 March 2018, which are eligible for early repayment (£421 million) is £345 million. This premium is payable primarily because:-

- Interest rates on loans of equivalent maturities compared to those held are currently lower

- A penalty rate or lower early repayment rate was introduced by HM Treasury in November 2007, which increased the cost of premiums and reduced flexibility of Local Authorities to make savings. This has been a significant thorn in the ability of local authorities to manage debt more effectively.

27. Whilst the cost of Premiums can be spread over future years, options for restructuring that have been considered previously, but result in an adverse Net Present Value (NPV). Whilst there may have been short terms savings, these were outweighed by potentially longer term costs and not deemed cost effective.

Compliance with treasury limits and prudential indicators

28. During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the annual Treasury Management Strategy. The actual outturn for 2017/18 Prudential Indicators is shown in the following paragraphs and compared to the original estimates contained in the 2017/18 Budget Report. Future year's figures are taken from the Budget Report for 2018/19 and will be updated in the Budget Report for 2019/20.

Capital Expenditure

29. The "Prudential Code" requires the Council to estimate the capital expenditure that it plans to incur over the Medium Term. The actual capital expenditure incurred in 2017/18 and reported in the Outturn Report to Cabinet in July 2018 and estimates of capital expenditure for the current and future years as set out in the Budget Report of February 2018 are as follows:-

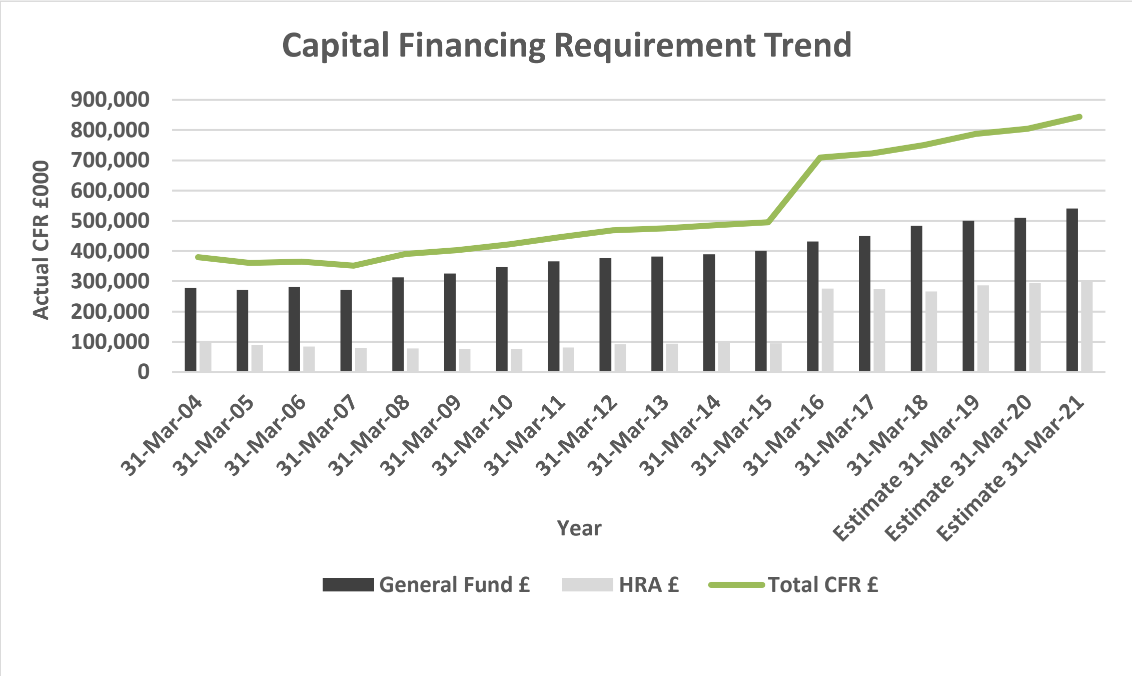
Capital Expenditure					
	2017/18 Actual £m	**2017/18 Original Estimate £m**	**2018/19 Estimate Month 4 £m**	**2019/20 Estimate £m**	**2020/21 Estimate £m**
General Fund	113	113	106	96	131
HRA	25	30	43	30	39
Total	**138**	**143**	**149**	**126**	**170**

Capital Financing Requirement (CFR) – The Borrowing Requirement (Excluding Landfill Provision)

30. Where capital expenditure has been incurred without a resource to pay for it immediately e.g. via capital receipts, grants or other contributions, this will increase what is termed the Council's Capital Financing Requirement (CFR) or its need to undertake borrowing. The Council is required to make an annual prudent provision for the repayment of historic capital expenditure from its revenue budget and set at a level that considers previous and future borrowing commitments as well as the period over which the benefits of capital expenditure are expected. This reduces the CFR. Calculation of the CFR is summarised in the following table and results in the need to borrow money.

	Opening Capital Financing Requirement (CFR)
+	Capital expenditure incurred in year
-	Grants, contributions, reserves and receipts used to pay for capital expenditure
-	Prudent Minimum Revenue Provision & Voluntary Repayment
=	*Closing Capital Financing Requirement (CFR)*

The historic trend in the CFR is shown below, with the increase in 2015/16 reflecting the Housing Revenue Account subsidy buyout as reported previously.



31. The CFR as at 01 April 2017 was £724 million. The actual CFR as at 31 March 2018, estimates for current and future years (estimated in the February 2018 budget) are shown in the table below and exclude non cash backed provisions in relation to Landfill after care provision:-

Capital Financing Requirement (Excludes landfill provision)					
	31.03.2018 Actual £m	**31.03.2018 Original Estimate £m**	**31.03.2019 Estimate £m**	**31.03.2020 Estimate £m**	**31.03.2021 Estimate £m**
General Fund	484	476	500	510	541
HRA	267	282	287	294	303
Total CFR	**751**	**758**	**787**	**804**	**844**
External Debt	**693**				
Over / (Under) Borrowing	**(58)**				

32. By comparing the CFR at 31 March 2018 (£751 million) and the level of external debt at the same point in time (£693 million), it can be seen that the Council is temporarily using circa £58 million of internal cash balances to finance the Capital Programme at 31 March 2018 (£50 million at 31 March 2017).

33. As set out in the February 2018 Budget Report, the CFR is forecast to increase over the next three years due to additional borrowing for investment in existing assets, new housing, 21st century schools and invest to save schemes. Forecasts will be updated in the 2019/20 Budget Report.

34. The Housing Revenue Account CFR at 31 March 2018 is £267 million. As part of the Housing Finance Reform voluntary agreement with Welsh Government and HM Treasury in 2015/16, a debt cap of £316 million is in place.

Actual External Debt

35. The Code requires the Council to indicate its actual external debt at 31 March 2018 for information purposes. This was £693 million as shown in the earlier paragraphs.

Affordable Borrowing Limit

36. The Council has a statutory duty under section 3 of the Local Government Act 2003 and supporting regulations to determine and keep under review how much it can afford to borrow and to enter into credit arrangements (the "Affordable Borrowing Limit"). This cannot be breached without Council approval. Council must have regard to the Prudential Code when setting this limit which is intended to ensure that total capital investment remains within sustainable limits and that the impact upon future council tax/rent levels is affordable.

37. During 2017/18 the Council remained within the authorised limit of £776 million set for that year.

Operational Boundary

38. The operational boundary is the estimated level of external borrowing and is subject to the timing of borrowing decisions. The boundary was originally estimated at £758 million to match the forecast for the CFR when setting the 2017/18 budget. The actual level of external debt equalled £693 million reflecting the strategy to utilise internal borrowing in the short term.

Maturity Structure of Fixed Rate Borrowing

39. The maturity structure remains within the limits below approved as part of the 2017/18 strategy below. These limits are set to avoid having large amounts of debt maturing in a short space of time, thus being exposed to significant liquidity risk and interest rate risk.

	31-Mar-17		Upper limit	31-Mar-18			
				Loans to Maturity		Loans if LOBO's Paid Early	
	%	£m	%	%	£m	%	£m
Under 12 months	0.9	6.0	10	0.7	4.5	4.1	28.5
12 months and within 24 months	0.6	4.0	10	0.5	3.3	0.5	3.3
24 months and within 5 years	1.5	9.9	15	1.9	12.9	5.8	39.9
5 years and within 10 years	3.6	24.2	20	5.1	35.4	5.1	35.4
10 years and within 20 years	22.6	152.2	30	22.4	155.5	22.4	155.5
20 years and within 30 years	24.5	165.0	35	23.9	166.0	22.2	154.0
30 years and within 40 years	30.9	208.7	35	30.4	210.7	30.4	210.7
40 years and within 50 years	12.9	87.0	35	14.4	100.0	9.5	66.0
50 years and within 60 years	1.8	12.0	15	0.7	5.0	0.0	0.0
60 years and within 70 years	0.7	5.0	5	0.0	0.0	0.0	0.0

40. The maturity profile of the Council's borrowing as at 31 March 2018 is also shown in a chart in **Annexe D**. Unless the Council's LOBO loans are repaid early, very little debt matures within the next 10 years. In the medium to long term, efforts will be made to restructure loans maturing in 2056/57 and to review LOBO maturities in order to reduce refinancing risk. Benchmarking undertaken during the year has demonstrated that the Council's maturity profile is not inconsistent with other local authorities where information is available.

Ratio of financing costs to net revenue stream

41. This indicator identifies the percentage of the net revenue stream that is subsumed each year in servicing debt. Financing costs include, interest payable on borrowing and receivable on treasury investments, prudent revenue budget provision for repayment of capital expenditure paid for by borrowing and re-imbursement of borrowing costs from directorates in respect of Invest to Save schemes.

42. For the General Fund, net revenue stream is the sum of non-specific WG Grants and Council Tax, whilst for the HRA it is the amount to be met from rent payers.

Ratio of financing costs to Net Revenue Stream					
	2017/18 Original Estimate %	**2017/18** Actual %	**2018/19** Estimate %	**2019/20** Estimate %	**2020/21** Estimate %
General Fund – Net Capital Financing Budget	5.77	5.84	5.76	5.79	5.81
General Fund – Gross Capital Financing Budget	n/a	7.47	7.53	7.69	7.95
HRA	30.53	32.63	31.53	33.58	33.10

43. Whilst the net indicator is required by the Prudential Code, it has a number of limitations:

- it does not take into account the fact that some of the Council's budget is outside of its direct control
- it is impacted by transfers in and out of the settlement.
- it includes investment income which is unpredictable, particularly in future years.
- it does not reflect gross capital financing costs for schemes where additional borrowing is undertaken to be repaid from within directorate budgets. From 2018/19, this has been addressed by calculating a gross ratio. Comparators will then be available for future years.

44. Although there may be short term implications, invest to save schemes are intended to be net neutral on the capital financing budget. However there are risks that the level of income, savings or capital receipts anticipated from such schemes will not materialise and would have a detrimental long term consequence on the Revenue budget. This requires careful monitoring when considering future levels of additional borrowing.

45. Accordingly an additional local indicator is calculated for the general fund to support decision making and is shown in the table below for the period up to 2022/23. These indicators, which will be updated in the budget proposals report for 2019/20, show capital financing costs of the Council as a percentage of its controllable budget and excludes treasury investment income on temporary cash balances:-

Capital Financing Costs as percentage of Controllable Budget									
	2011/12 Actual %	2017/18 Original Estimate %	2017/18 Actual %	2018/19 Estimate %	2019/20 Estimate %	2020/21 Estimate %	2021/22 Estimate %	2022/23 Estimate %	Difference 11/12-22/23 %
Net	13.47	14.77	14.59	13.87	14.49	15.11	16.46	16.65	23.61
Gross	15.17	19.44	18.60	18.07	19.21	20.56	23.38	24.62	62.29

46. An increasing percentage indicates that a greater proportion of the controllable budget is required for capital financing costs which are committed in the long term. The requirement to meet these additional costs can only come from future savings or from increases in Council Tax. This clearly limits the scope for additional borrowing in future years and reduces the Council's overall flexibility when making decisions on the allocation of revenue resources. The percentages take into account the significant level of savings having to be found in 2018/19 and over the medium term. Careful monitoring of these indicators will be required over the life of the Capital Programme and the Medium Term Financial Plan.

<u>Principal Invested for over 364 days</u>

47. An upper limit for principal invested over 364 days was set at £60 million and this was not breached during the year, primarily due to the strategy adopted of minimising the period for which investments were made during 2017/18.

Treasury Management issues for 2018/19

48. Whilst this report is primarily backward looking in relation to Treasury Activities for 2017/18, some key issues for 2018/19 are :-

- The timing of external borrowing
- Implementing CIPFA Treasury Management Code updates into the Treasury Management Strategy and Policy for 2019/20.

The code was updated primarily as a result of increasing commercialisation activities undertaken by local authorities e.g. investment in property, shares, loans specifically for the purpose of generating a financial surplus. The Code therefore broadens the definition of investments to include treasury as well as non treasury investments and requires that all investments have an appropriate risk management framework. This includes making it explicit in any decision making:-

- the powers under which investment is made
- the governance process including arrangements in place to ensure appropriate due diligence to support decision making
- the extent to which capital invested is placed at risk
- the impact of potential losses on financial sustainability
- the methodology and criteria for assessing performance and monitoring process
- how knowledge and skills in managing such investments is arranged and that these are monitored, reported and highlighted explicitly in the decision making process and due diligence.

49. In accordance with the Council's Treasury Management Policy, Council will receive a further update on Treasury Management issues as part of the 2018/19 Mid-Year Treasury Management report in November 2018.

Christine Salter
Corporate Director Resources
05 September 2018

The following Annexes are attached:-
Annexe A – Treasury Management Policy and Four Clauses of Treasury Management
*Annexe B – Investments at 31 March 2018
*Annexe C – Investment charts at 31 March 2018
Annexe D – Maturity analysis of debt as at 31 March 2018

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