APPENDIX A

Treasury Management Performance Report 2017/18

Introduction

In February 2011 the Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Council to approve a treasury management annual report after the end of each financial year.

This report fulfils the Council's legal obligation to have regard to the CIPFA Code.

The Council's treasury management strategy for 2017/18 was approved at the full council meeting of Isle of Wight Council on 15 March 2017. The Isle of Wight Council has borrowed and 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 Council's treasury management strategy.

External Context (Provided by Arlingclose Limited, based on data at 09/04/2018)

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, growing 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:

Credit Metrics

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 Council 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, 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 council 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 of 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).

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 Council 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 Council's lending list.

Local Council 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 are being incorporated into Treasury Management Strategies 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 person(s) 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 person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The Isle of Wight Council has met the conditions to opt up to professional status and has done so in order to maintain its erstwhile 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.

Local Context

On 31 March 2018, the Council had net borrowing of £150.9 million arising from its revenue and capital income and expenditure, an increase on 2017 of £23.6 million. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors and the year-on-year change are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.17 Actual £m	2017/18 Movement £m	31.3.18 Actual £m
Total CFR	**300.5**	**60.2**	**360.7**
Less: Other debt liabilities *	(85.6)	(16.5)	(102.2)
Borrowing CFR	**214.9**	**43.7**	**258.5**
Less: Usable reserves	(89.5)	(12.8)	(102.3)
Less: Working capital	1.9	(7.3)	(5.3)
Net Borrowing	**127.3**	**23.6**	**150.9**

* finance leases, PFI liabilities and transferred debt that form part of the Council's total debt

Net borrowing has increased due to an increase in the CFR as new capital expenditure was higher than the financing applied including minimum revenue provision; offset by an increase in usable reserves, especially due to £14.0 million in the Earmarked Reserves; and a reduction in working capital due to the timing of receipts and payments.

The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31 March 2018 and the year-on-year change is shown in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Rate %
Long-term borrowing	137.3	(9.2)	128.1	4.26%
Short-term borrowing	22.5	18.5	41.0	0.76%
Total borrowing	**159.8**	**9.3**	**169.1**	**3.53%**
Short-term investments	32.5	(14.3)	18.2	0.53%
Total investments	**32.5**	**(14.3)**	**18.2**	**0.53%**
Net borrowing	**127.3**	**23.6**	**150.9**	**3.90%**

Note: the figures in the table are from the balance sheet in the Council's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments

Due to the continued low interest rates the Isle of Wight Council has continued use short term borrowing rather than PWLB borrowing, where the rates are higher. The level of short-term investments has declined as the investments held at the end of the prior year have matured, and have not been reinvested.

Borrowing Activity

At 31 March 2018, the Council held £169.1 million of loans, an increase of £9.3 million on the previous year, as part of its strategy for funding previous years' capital programmes. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position

	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Rate %	31.3.18 WAM* years
Public Works Loan Board	132.3	(9.2)	123.1	4.43%	11.9
Banks (LOBO)	5.0	-	5.0	4.27%	23.7
Banks (fixed-term)	-	-	-	-	-
Local authorities (long-term)	-	-	-	-	-
Local authorities (short-term)	22.5	18.5	41.0	0.76%	0.8
Total borrowing	**159.8**	**9.3**	**169.1**	**3.53%**	**9.5**

*Weighted average maturity

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

In furtherance of these objectives, new borrowings were taken out to fund both capital expenditure and also to replace existing loans as they fell due during 2017/18. This strategy enabled the council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

For the majority of the year the "cost of carry" analysis performed by the Council's treasury management advisor Arlingclose did not indicate value in borrowing in advance for future years' planned expenditure and therefore none was taken.

The council continues to hold £5 million of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during 2017/18.

Other Debt Activity

Although not classed as borrowing, the council also raised £20.5 million of capital finance for Highway Improvements via Private Finance Initiative during the 2017/18 financial year. Total debt other than borrowing stood at £113.6 million on 31 March 2018, taking total debt to £282.7 million.

Investment Activity

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2017/18, the council's investment balance ranged between £9.1 and £49.5 million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change in show in table 4 below.

Table 4: Investment Position (Treasury Investments)

	31.3.17 Balance £m	2017/18 Movement £m	31.3.18 Balance £m	31.3.18 Rate %	31.3.18 WAM* days
Banks & building societies (unsecured)	4.0	(4.0)	-	-	-
Covered bonds (secured)	-	-	-	-	-
Government (incl. local authorities)	16.5	(9.3)	7.2	0.68%	246
Corporate bonds and loans	-	-	-	-	-
Money Market Funds	12.0	(1.0)	11.0	0.43%	1
Other Pooled Funds	-	-	-	-	-
Total investments	**32.5**	**(14.3)**	**18.2**	**0.53%**	**98**

*Weighted average maturity

Both the CIPFA Code and government guidance require the Council 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 Council'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 low returns from short-term unsecured bank investments, the Council reduced the value of investments in total. As a result, investment risk was lowered, while the average rate of return has increased by 0.19 percent to 0.53 percent. The progression of credit risk and return metrics for the Council's investments managed in-house are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 5 below.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	3.93	AA-	49%	75	0.34%
30.06.2017	4.11	AA-	51%	50	0.43%
30.09.2017	4.21	AA-	50%	102	0.34%
31.12.2017	4.17	AA-	37%	108	0.46%
31.03.2018	2.04	AA+	0%	98	0.53%
Similar LAs	**4.24**	**AA-**	**61%**	**68**	**0.58%**
All LAs	**4.24**	**AA-**	**55%**	**35**	**0.63%**

*Weighted average maturity

Financial Implications

The total of debt interest paid in 2017/18 was £5.8 million on an average debt portfolio of £154.4 million against a budgeted £8.5 million, on an average debt portfolio of £247.4 million, at an average interest rate of 4.43 percent, which is a saving of £2.7 million in interest paid.

This saving was as the result of the rates on new long term borrowing being lower than budgeted (£0.7 million), the budgeted commercial property not being acquired during this period

(£0.8 million) and the continued strategy of taking short-term borrowing rather than longer term loans (£0.4 million).

The total of investment income received in 2017/18 was £0.1 million on an average investment portfolio of £23.4 million against a budgeted £0.2 million on an average investment portfolio of £80 million at an average interest rate of 0.25 percent.

Performance Report

The Council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below.

Table 6: Performance

	Actual £m	**Budget £m**	**Over/ under**	**Actual %**	**Benchmark* %**	**Over/ under**
Total investment income	0.1	0.2	(0.1)	0.53%	0.58%	(0.05%)
Total cost of borrowing	(5.8)	(8.5)	2.7	3.10%	3.71%	0.61%
GRAND TOTAL	(5.7)	(8.3)	2.6	n/a	n/a	n/a

*Based on Arlingclose Investment and Debt Benchmarking scores for English unitary authorities

Compliance Report

The Director of Finance & S151 Officer is pleased to report that all treasury management activities undertaken during 2017/18 complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

The Authorised Limit for PFI and Finance leases was exceeded by £0.3 million due to rounding's, but as the Total Debt limit was not exceeded the Council considered itself compliant throughout the year.

Table 7: Debt Limits

	2017/18 Maximum £m	**31.3.18 Actual £m**	**2017/18 Operational Boundary £m**	**2017/18 Authorised Limit £m**	**Complied**
Borrowing	174.1	169.1	254.4	279.8	✓
PFI & finance leases	102.2	102.2	101.9	101.9	x
Total debt	**276.3**	**271.3**	**356.3**	**381.7**	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Table 8: Investment Limits

	2017/18 Maximum £m	31.3.18 Actual £m	2017/18 Limit £m	Complied
Any single organisation, except the UK Central Government	8.0	8.0	10.0	✓
Any group of organisations under the same ownership	8.0	8.0	8.0	✓
Any group of pooled funds under the same management	-	-	8.0	✓
Foreign countries per region	-	-	8.0	✓
Registered Providers	-	-	20.0	✓
Unsecured investments with Building Societies	-	-	20.0	✓
Money Market Funds	16.0	11.0	25.0	✓

Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators.

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.3.18 Actual	2017/18 Target	Complied
Portfolio average credit score	2.04	6.0	✓

Liquidity: The council addresses liquidity issues by restricting a significant proportion of its investment opportunities to short term and instant access deposits.

Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed was:

	31.3.18 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure	126.1	314.2	✓
Upper limit on variable interest rate exposure	24.8	186.4	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

	31.3.18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	25%	30%	0%	✓
12 months and within 24 months	4%	30%	0%	✓
24 months and within 5 years	11%	30%	0%	✓
5 years and within 10 years	22%	50%	0%	✓
10 years and above	37%	95%	0%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2017/18	2018/19	2019/20
Actual principal invested beyond year end	-	-	-
Limit on principal invested beyond year end	£28m	£44m	£72m
Complied	✓	✓	✓