APPENDIX A

Treasury Management Performance Report 2018/19

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 2018/19 was approved at the full council meeting of Isle of Wight Council on 28 February 2018. 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 remains central to the council's treasury management strategy.

Treasury risk management at the council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the council to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

The CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code) was updated in December 2017, and it included a requirement for local authorities to provide a Capital Strategy, a summary document approved by full council covering capital expenditure and financing, treasury management and non-treasury investments. A statement published on the CIPFA website in early January 2018 recognised that authorities may require a lead-in period to create a capital strategy.

External Context (Provided by Arlingclose Limited, based on data at 09/04/2019)

Economic background: After spiking at over $85/barrel in October 2018, oil prices fell back sharply by the end of the year, declining to just over $50 in late December before steadily climbing toward $70 in April 2019. UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year/year, just above the consensus forecast but broadly in line with the Bank of England's February Inflation Report. The most recent labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

After rising to 0.6% in the third calendar quarter from 0.4% in the second, fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However, a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.

With the 29 March 2019, the original EU 'exit day' now been and gone, having failed to pass a number of meaningful votes in Parliament, including shooting down Theresa May's deal for the third time, MPs voted by a majority of one (313 to 312) to force the prime minister to ask for an extension to the Brexit process beyond 12 April in order to avoid a no-deal scenario. Recent talks between the Conservative and Labour parties to try to reach common ground on a deal which may pass a vote by MPs have yet to yield any positive results. The EU must grant any extension and its leaders have been clear that the terms of the deal are not up for further negotiation. The ongoing uncertainty continues to weigh on sterling and UK markets.

While the domestic focus has been on Brexit's potential impact on the UK economy, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to be show signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

Financial markets: December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE 100 and FTSE All share indices were both around 10% higher than at the end of 2018.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new year - the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate pushed up money markets rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury yields were lower than US 3 month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling by 1.8% year-on-year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China which despite some moderation in January does suggest that the International Monetary Fund's (IMF) and Organisation for Economic Co-Operation & Development's (OECD) forecasts for global growth in 2019 of 3.5% might need to be revised downwards.

Credit background: Credit Default Swap (CDS) spreads drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms. After hitting around 129 basis points in December 2018, the spread on non-ringfenced bank NatWest Markets plc fell back to around 96bps at the end of March, while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 33 and 79bps at the end of the period.

The ringfencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc) transferred their business lines into retail (ringfenced) and investment banking (non-ringfenced) entities.

In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty, following this move with the same treatment for UK banks and a number of government-related entities.

There were minimal other credit rating changes during the period. Moody's revised the outlook on Santander UK to positive from stable to reflect the bank's expected issuance plans which will provide additional protection for the its senior unsecured debt and deposits.

Local Context

On 31 March 2019, the council had net borrowing of £198.5 million arising from its revenue and capital income and expenditure. 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

	31.3.18 Actual £m	2018/19 Movement £m	31.3.19 Actual £m
Total CFR	**360.7**	**42.8**	**403.5**
Less: Other debt liabilities *	(101.8)	(5.4)	(107.2)
Borrowing CFR	**258.9**	**37.4**	**296.3**
External borrowing**	(169.1)	(92.8)	(261.9)
Internal (over) borrowing	**89.8**	**(55.4)**	**34.4**
Less: Usable reserves	(102.3)	9.7	(92.6)
Less: Working capital	(5.7)	0.5	(5.2)
(Investments) / New borrowing	**(18.2)**	**(45.2)**	**(63.4)**

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt
** shows only loans to which the council is committed and excludes optional refinancing

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; augmented by a decrease in usable reserves, especially due to £12.7 million reduction in capital receipts; 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 at 31 March 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.18 Balance £m	Movement £m	31.3.19 Balance £m	31.3.19 Rate %
Long-term borrowing	128.1	34.8	162.9	3.89%
Short-term borrowing	41.0	58.0	99.0	0.99%
Total borrowing	**169.1**	**92.8**	**261.9**	**3.53%**
Short-term investments	18.2	45.2	63.4	0.85%
Total investments	**18.2**	**45.2**	**63.4**	**0.85%**
Net borrowing	**150.9**	**47.6**	**198.5**	**3.43%**

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

The level of long-term borrowing has increased as the Isle of Wight council took advantage of the reducing PWLB rates, in order to reduce the reliance on short term borrowing. The level of short-term investments has increased as there were differences in the timing of the utilisation of borrowed funds.

Borrowing Strategy during the year

At 31 March 2019 the council held £261.9 million of loans, an increase of £92.8 million on the previous year, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31 March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	Net Movement £m	31.3.19 Balance £m	31.3.19 Rate* %	31.3.19 WAM** (years)
Public Works Loan Board	123.1	34.8	157.9	3.89%	15.90
Banks (LOBO)	5.0	-	5.0	4.27%	22.67
Local authorities (short-term)	41.0	58.0	99.0	0.99%	0.41
Total borrowing	**169.1**	**92.8**	**261.9**	**2.80%**	**10.17**

* Weighted average rate
** 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.

The council has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital. Having considered the appropriate duration and structure of the council's borrowing need based on realistic projections, it was decided to take a combination of short-term borrowing and longer-term Equal Instalment of Principal (EIP) loans. The council borrowed £40.0 million longer-term fixed rate loans, details of which are below. These loans provide some longer-term certainty and stability to the debt portfolio.

Table 4: Long-dated Loans borrowed 2018-19

	Amount £m	Rate %	Period (Years)
PWLB EIP Loan 1	15.0	2.35%	30
PWLB EIP Loan 2	15.0	2.34%	30
PWLB EIP Loan 3	10.0	2.20%	30
Total New long-dated loans	**40.0**		

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 2018/19.

Other Debt Activity

Although not classed as borrowing, the council also raised £16.9 million of capital finance for Highway Improvements via Private Finance Initiative during the 2018/19 financial year. Total debt other than borrowing stood at £121.7 million on 31 March 2019, taking total debt to £383.6 million.

Treasury Investment Activity

The council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2018/19, the council's investment balances ranged between £9.6 and £63.4 million due to timing differences between income and expenditure. During the year the council maintained balances of up to £8 million in the council's current bank account, in addition to the amounts invested. The investment position is shown in table 5 below.

Table 5: Treasury Investment Position

	31.3.18 Balance £m	Net Movement £m	31.3.19 Balance £m	31.3.19 Rate %	31.3.19 WAM* days
Banks & building societies (unsecured)	-	4.0	4.0	0.60%	1
Government (incl. local authorities)	-	28.8	28.8	0.87%	30
Isle of Wight Council Pension Fund	7.2	3.2	10.4	1.05%	230
Money Market Funds	11.0	9.2	20.2	0.77%	1
Total investments	**18.2**	**45.2**	**63.4**	**0.85%**	**53**

*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 treasury investments before seeking the optimum 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.

Given the increasing risk and low returns from short-term unsecured bank investments, the council has diversified into the more secure investment of lending to other local authorities as shown in table 5 above. As a result, investment risk was diversified. The average income return was 0.85 percent as compared with 0.53 percent in 2017-18.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 6 below.

Table 6: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2018	2.04	AA+	0%	98	0.53%
30.06.2018	4.21	AA-	51%	83	0.61%
30.09.2018	4.31	AA-	56%	73	0.75%
31.12.2018	3.73	AA-	10%	155	0.95%
31.03.2019	3.98	AA-	38%	53	0.84%
Similar LAs	**4.17**	**AA-**	**56%**	**53**	**0.86%**
All Las	**4.20**	**AA-**	**55%**	**29**	**0.85%**

*Weighted average maturity

Readiness for Brexit: With little by way of political clarity as to the exact date on whether there would be an agreed deal prior to leaving the EU and to be prepared for the outside chance of a particularly disruptive Brexit (such as last-minute no-deal) on 29 March, the council ensured there were enough accounts open at UK-domiciled banks and Money Market Funds to hold sufficient liquidity over the year end and that its account with the Debt Management Account Deposit Facility (DMADF) remained available for use in an emergency.

The council's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing was maintained.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the council as well as other non-financial assets which the council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The council also held £39.4 million of such investments in

- directly owned property £35.2 million
- shared ownership housing £3.7 million
- loans to local businesses £4.2 million

A full list of the council's non-treasury investments is available in the Isle of Wight Statement of Accounts 2018/19.

These investments generated £0.8 million of investment income for the council after taking account of direct costs, representing a rate of return of 2.24%.

Treasury Performance

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 7 below.

Table 7: Performance

	Actual £m	Budget £m	Over/ under	Actual %	Benchmark* %	Over/ under
Total investment income	0.1	0.2	(0.1)	0.85%	0.85%	-
Total cost of borrowing	(6.4)	(7.8)	1.4	3.18%	-	-
GRAND TOTAL	**(6.3)**	**(7.6)**	**1.3**	n/a	n/a	n/a

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

Compliance

The Director of Finance & Section 151 Officer reports that all treasury management activities undertaken during the year 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 8 below.

Table 8: Investment Limits

	2018/19 Maximum £m	31.3.19 Actual £m	2018/19 Limit £m	Complied?
Any single organisation, except the UK Government	8.0	8.0	8.0	✓
Any group of organisations under the same ownership	8.0	8.0	8.0	✓
Money Market Funds	20.2	20.2	25.0	✓

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 9 below.

The Authorised Limit for PFI and Finance leases was exceeded by £0.2 million due to roundings, but as the Total Debt limit was not exceeded the council considered itself compliant throughout the year.

Table 9: Debt Limits

	2018/19 Maximum £m	31.3.19 Actual £m	2018/19 Operational Boundary £m	2018/19 Authorised Limit £m	Complied?
Borrowing	261.9	261.9	324.8	357.4	✓
PFI and Finance Leases	107.2	107.2	107.0	107.0	x
Total debt	**281.3**	**369.1**	**431.8**	**464.4**	✓

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.

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.

	31.3.19 Actual	2018/19 Target	Complied?
Portfolio average credit score	3.98	4.25	✓

Liquidity: The council maintains detailed cash flow forecasts with a view to keeping minimum surplus cash balances. It 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 impact of a 1% rise or fall in the interest rates on the amount of net interest payable was:

	31.3.19 Actual £m	2018/19 Limit £m	Complied?
Upper limit on fixed interest rate exposure	157.9	357.3	✓
Upper limit on variable interest rate exposure	40.6	201.9	✓

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 all borrowing were:

	31.3.19 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	40%	30%	0%	x
12 months and within 24 months	2%	30%	0%	✓
24 months and within 5 years	7%	30%	0%	✓
5 years and within 10 years	14%	50%	0%	✓
10 years and above	36%	95%	0%	✓

Following the consideration of the risk of relative over exposure to short term borrowing, the Director of Finance and Section 151 Officer agreed to depart from the agreed limit.

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.

Throughout the majority of the year the council took out short-term borrowing in order to finance both capital investment and also to replace long-term borrowing as it matured. This was in accordance with the borrowing strategy in force at that time.

Principal Sums Invested for Periods Longer than 365 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:

	2018/19 £m	**2019/20 £m**	**2019/21 £m**
Actual principal invested beyond year end	Nil	Nil	Nil
Limit on principal invested beyond year end	35.0	40.0	45.0
Complied?	✓	✓	✓