Council Report

Ward(s) affected: all

Report of Chief Finance Officer

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Capital and Investment outturn report 2017-18

Executive Summary

Following the new capital and investment strategy for 2018-19, this annual treasury management report now encompasses capital and non-treasury investments, to meet the requirements of the revised Prudential and Treasury Codes of Practice and the Ministry of Housing, Communities, and Local Government (MHCLG) updated Investment Guidance.

<u>Capital programme</u>
In total, expenditure on the General Fund capital programme was £13.9 million. This was less than the revised budget by £20.2 million. Details of the revised estimate and actual expenditure in the year for each scheme are given in **Appendix 3**.

The budget for Minimum Revenue Provision (MRP) was £1.229 million and the outturn was £573,852. This was due to slippage in the capital programme in 2016-17.

<u>Non-treasury investments</u>
The Council's investment property portfolio stood at £147.4 million at the end of the year. Our rental income was £9.17 million, and our income return 6.59% against the benchmark of 4.2%.

<u>Treasury management</u>
The Council's cash balances have built up over a number of years, and reflect our strong balance sheet, with considerable revenue and capital reserves. Officers carry out the treasury function within the parameters set by the Council each year in the Capital and Investment Strategy. As at 31 March 2018, the Council held £133.6 million in investments, £43.5 million of short term borrowing so net investments of £90.1 million.

The Council considers, security, liquidity and yield when making treasury investment decisions. The most important part of making investments is the security of capital – ensuring we get our money back. Next, we consider liquidity – getting our money back when we need it. Once we are comfortable with both the security and liquidity of the investment, we review the return on the investment.

For borrowing, we borrow short-term from other local authorities for cash flow purposes and ensure there is no cost of carry on this. We undertake longer-term borrowing in line with our liability benchmark and the capital programme. The Council had £241.6 million borrowing at 31 March 2018, of which £43.5 million was short-term borrowing for cash purposes.

This report (section 8) confirms that the Council complied with its prudential indicators, treasury management policy statement and treasury management practices (TMPs) for 2017-18. The policy statement is included and approved annually as part of the Capital and Investment Strategy, and the TMPs are approved under delegated authority.

The treasury management performance over the last year, compared to estimate, is summarised in the table below. The report highlights the factors affecting this performance.

	Estimate %	**Actual %**	**Estimate (£000)**	**Actual (£000)**
General fund Capital Financing Requirement (CFR)			368,251	75,781
Housing Revenue Account CFR			197,024	197,024
Total CFR			**565,275**	**272,805**
Return on investments	1.71	1.23	1,473	1,853
Interest paid on external debt		2.23	6,112	5,261
Total net interest paid			**4,639**	**3,408**

There was slippage in the capital programme, which resulted in a lower CFR than estimated (more information in **Appendix 1**, section 3).

Interest paid on debt was lower than budget, due to the variable loan rate being reset lower than expected.

The yield returned on investments was lower than estimated, but the interest received was higher due to more cash being available to invest in the year – a direct result of the capital programme slippage.

Officers have been reporting higher interest receivable and payable and a lower charge for MRP during the year as part of the budget monitoring when reported to councillors during the year.

Detailed information on the return on investments, and interest paid on external debt can be found in section 7 of this report.

This report has been considered by the Corporate Governance and Standards Committee and the Executive at their respective meetings held on 14 and 19 June 2018. They were both happy to endorse the recommendation below

Recommendation to Council:

(1) That the treasury management annual report for 2017-18 be noted.

(2) That the actual prudential indicators reported for 2017-18, as detailed in **Appendix 1** to this report, be approved.

Reason for Recommendation:
To comply with the Council's treasury management policy statement, the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on treasury management and the CIPFA Prudential Code for Capital Finance in Local Authorities.

1. Purpose of Report

1.1 The Local Government Act 2003 states that the Council has a legal obligation to have regard to both the CIPFA code of practice on treasury management and the MHCLG investment guidance.

1.2 The CIPFA treasury management code of practice, and the MHCLG investment guidance requires public sector authorities to produce an annual capital strategy (incorporating capital expenditure, non treasury investments and treasury management activity), and as a minimum, report to councillors on treasury activity mid-year and after the year-end.

1.3 This report covers the activity of the treasury management function in 2017-18. It also covers the requirement to report on the prudential and treasury indicators for the year. The position of the Council's investment property portfolio is also presented along with progress on the capital programme.

1.4 The Council borrows and invests 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. This report covers treasury activity and the associated monitoring and control of risks. The Council holds a substantial amount of investment property and has a large capital programme, all of which have risk.

1.5 Treasury management is a highly complex, technical and regulated aspect of local government finance. We have included a glossary of technical terms (**Appendix 10**), to aid the reading of this report.

2. Strategic Priorities

2.1 Treasury management and capital expenditure are key functions in enabling the Council to achieve financial excellence and value for money. It underpins the achievement of all the Corporate Plan 2018-2023 themes.

2.2 This report details the activities of the treasury management function and the effects of the decisions taking in the year in relation to the best use of its resources. It also presents the outturn position for the year of the capital programme, and the performance on non-treasury investments.

3. Background

3.1 Treasury management is defined by CIPFA as:

"the management of the council's investments, borrowing 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"

3.2 The Council has overall responsibility for treasury management. Treasury management contains a number of risks. The effective identification and management of those risks are integral to the Council's treasury management objectives, as is ensuring that borrowing activity is prudent, affordable and sustainable.

3.3 The Council has a statutory requirement, under the Local Government Act 2003, to adopt the CIPFA Prudential Code and produce prudential indicators.

3.4 The objectives of the prudential code are to ensure, within a clear framework, that capital investment plans are affordable, prudent and sustainable, and the treasury management decisions are taken in accordance with good professional practice.

3.5 The Council has a large capital programme and a large investment property portfolio on its balance sheet. These, together with treasury management, are the management of the Council's cash and assets.

3.6 The Council operates its treasury management function in compliance with this Code and the statutory requirements.

3.7 This annual report, and the appendices attached to it, set out:

- a summary of the economic factors affecting the approved strategy and counterparty updated (sections 4 and 5 with details in **Appendix 5**)
- a summary of the approved strategy for 2017-18 (section 6)
- a summary of the treasury management activity for 2017-18 (section 7 with detail in **Appendix 1**)
- compliance with the treasury and prudential indicators (section 8 with detail in **Appendix 1**)
- non-treasury investments (section 9)
- capital programme (section 10)
- risks and performance (section 11)
- Minimum Revenue Provision (MRP) (section 12)
- details of external service providers (section 13)
- details of training (section 14)

4. Economic Environment

4.1 This section includes the key points of the economic environment for 2017-18, to show the treasury management activity in context. **Appendix 5** contains more detail.

- US and Eurozone economies gaining momentum
- US raised their policy rate a number of times

- UK economy slowing with GDP increasing at the same level as in 2016
- Year-on-year CPI rose due to the price of Sterling falling
- Real earnings growth became negative
- Unemployment fell to 4.3% in January 2018
- General election in June 2017 resulted in a lot of political uncertainty
- Unclear Brexit negotiations – transition will now span Q2 2019 and Q4 2020
- Bank of England base rate increased by 0.25% to 0.50% in November 2017
- Gilt yields were volatile with the change in sentiment in the Bank of England's outlook for interest rates

4.2 The key points relevant to investment property are:

- Brexit uncertainty – unclear economic growth therefore investors remain with a cautious outlook over all sectors
- Risk aversion is the overriding theme
- Inward movement of prime yields for the logistics sector
- Downward pressure on the multi let sector
- Property remains a safe haven for capital preservation, and demand for prime, secure investments continues
- A shortage of prime stock is leading investors to seek secure income in alternative assets

5. Counterparty update

5.1 This section provides the key points of the changes in the counterparties on the Council's lending list during the year. These changes can have a direct impact on our treasury management activities in that recommended durations and counterparties can change, as can yields on new investments.

- UK's rules on banks' ring-fencing were finalised with an implementation date of 1 January 2019, causing uncertainty over which banking entities the Council would be dealing with once implemented. Arlingclose reduced the duration of unsecured investments to six months
- Moody's made the following credit rating changes
    - UK Sovereign downgraded from Aa1 to Aa2 in September 2017, sub sovereigns followed (including the Council)
    - Standard Chartered downgraded from Aa3 to A1
    - Downgraded Rabobank, the major Canadian banks and the large Australian banks
- S&P made the following changes
    - Upgraded Barclays when it announced its ringfencing plans
    - Downgraded Transport for London following a deterioration in its financial position
    - Upgraded ING Bank
- Fitch downgraded Nationwide Building Society

5.2 In February 2018, 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. They have subsequently been re-added to our lending list.

6. Regulatory Changes

6.1 CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The required changes were introduced as part of the 2018-19 Capital and Investment Strategy, approved by Council in February.

6.2 In the 2017 Treasury Management Code, the definition of 'Investments' now includes 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 strategy. Additional risks of these investments are to be clearly set out and the impact on financial sustainability is to be identified and reported.

6.3 In February 2018, the MHCLG published revised guidance on Local Government Investments and Statutory Guidance on Minimum Revenue Provision (MRP).

6.4 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" (for example temporary transfer of cash to a third party, joint venture, subsidiary or associate). The Guidance introduced 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.

6.5 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 new 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.

6.6 MiFID II: As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3 January 2018, local authorities were automatically treated as retail clients but could "opt-up" to professional client status (our default status prior to the introduction of MiFID II), providing certain criteria were met which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a year's relevant professional experience. In addition, the regulated financial service firms to whom this directive applies, have had to assess that the person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

6.7 The 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.

7. Approved strategy and budgets for 2017-18 – a summary

7.1 Council approved the treasury management strategy for 2017-18 in February 2017.

7.2 The strategy showed an underlying need to borrow in 2017-18 for the General Fund (GF) capital programme of £87.1 million.

7.3 The strategy set out how we would manage our cash. It allowed for internally managed investments for managing cash flow and externally managed and longer-term investments for our core cash (cash not required in the short or medium term). See **Appendix 9** for background.

7.4 It highlighted the need to continue to diversify our investment portfolio to reduce credit risk. The approved strategy set the minimum long-term credit rating of A- (or equivalent) for investments in counterparties to be determined as 'high credit' using the lowest denominator principal for the three main credit rating agencies.

8. Treasury management activity in 2017-18

8.1 The treasury position at 31 March 2018, compared to the previous year is:

		31 March 2017 (£'000)	Average Rate	31 March 2018 (£'000)	Average Rate
Fixed Rate Debt	PWLB	148,355	3.22%	148,125	3.22%
	Market	0	0.00%	0	0.00%
Variable Rate Debt	PWLB	45,000	0.57%	45,000	0.66%
	Market	0	0.00%	0	0.00%
Long-term	LAs	10,000	1.35%	5,000	1.29%
Temporary borrowing	LAs	30,000	0.39%	43,500	0.42%
Total Debt		**233,355**	**2.26%**	**241,625**	**2.23%**
Fixed Investments		(87,060)	0.90%	(91,132)	0.94%
Variable Investments		(17,294)	0.51%	(22,260)	0.58%
Externally managed		(22,563)	3.53%	(20,245)	3.30%
Total Investments		**(126,917)**	**1.21%**	**(133,637)**	**1.23%**
Net Debt / (Investments)		**106,438**		**107,988**	

8.2 PWLB is the Public Works Loans Board and is a statutory body operating as an executive of HM Treasury. Its function is to lend money from the National Loans Fund to local authorities and other prescribed bodies.

8.3 The above table shows investments have increased by £6.7 million and loans by £8.2 million. Therefore, net debt has increased by £1.5 million. Short-term borrowing has increased, partly replacing the long-term local authority loan that matured in the year. We sold one of our externally managed funds, and invested in more long-term investments.

8.4 We budgeted a return of 1.71% for the year and achieved 1.23%. Our return is lower because the BoE cut the base rate and investments yields were lower.

8.5 The Council's budgeted investment income was £1.474 million, and actual interest was £1.853 million (£379,000 higher). We had been projecting higher interest receipts throughout the financial year. This is because we had more cash available to invest than we had budgeted, and we hold some longer higher yielding secure investments. Our external funds returned £165,000 more than budgeted, and cash investments £214,000.

8.6 Our budgeted debt interest payable was £6.112 million. £5.14 million relates to the HRA. The outturn was £5.261 million (£5 million for the HRA). We assumed we would borrow long-term for the GF capital programme but slippage in the schemes meant that we did not need to and therefore realised a saving in the debt interest payable against budget.

8.7 All our external funds are distributing funds, and they achieved an overall weighted average return of 3.3%, split as follows:

Fund	**Balance at 31 March £000**	**Average return**	**Type of fund**
M&G	2,571,638	2.86%	Equity focussed
Schroders	884,202	7.38%	Equity focussed with at least 80% on FTSE all share companies
SWIP	0	1.21%	Fixed income focussed
Funding Circle	490,323	7.54%	Investments in SMEs up to a max of £2,000
UBS	2,336,174	3.92%	Multi asset
City Financials	2,303,351	3.26%	Multi asset
Payden	5,007,350	0.69%	Cash plus
CCLA	6,652,274	4.83%	Property

8.8 Our external fund portfolio is now very diverse and we invest in a range of products and markets. The capital value of the funds can go up as well as down. Across all funds, there was a capital loss of £90,000, the biggest contributor being the City Financial fund losing £165,000, M&G fund lost £98,000, and UBS fund lost £80,000 in the year. The CCLA property fund increased over the year by £302,000. We decreased our exposure to the Funding circle by £421,000 to reduce potential risks moving forward of the impact on Brexit on small businesses and the SWIP fund by the balance of £1.8 million because we felt the fund had not performed as we had anticipated in either income or capital value so decided to sell the exposure.

8.9 The Council also invested more in our subsidiaries and now holds £1.803 million of equity investment in Guildford Holdings Ltd and £2.698 million in North Downs Housing Ltd.

8.10 The Council agreed an interest rate of base rate plus 5% (currently 5.50%) on the investment in North Downs Housing Ltd. This is higher than the treasury investments held as it reflects the risk associated with holding such investments.

8.11 The equity investment in Guildford Holdings will be subject to a dividend if a profit is achieved.

Capital programme

8.12 The actual underlying need to borrow for the year, and the amount of internal borrowing actually taken, for the GF capital programme was £7.17 million, which is lower than budgeted of £87.7 million because of slippage in the capital programme. We will continue to support service managers with the scheduling of schemes in the capital programme to ensure it is kept up to date when project timescales change.

8.13 The Council must charge a Minimum Revenue Provision (MRP) on its internal borrowing which is setting aside cash from council tax to repay the internal borrowing. MRP charged to the revenue account for the year was £573,852, against an original budget of £1,228,584.

8.14 Our overall underlying need to borrow, as measured by the Capital Financing Requirement (CFR) was £273.445 million (£76.78 million relates to the GF).

Benchmarking and performance indicators

8.15 The Council is a member of the CIPFA treasury management benchmarking club.

8.16 Arlingclose also provide benchmarking data across their clients. It highlights the effect of changes in our investment portfolio and compares the basis of size of investment, length of investment and the amount of credit risk taken.

8.17 The benchmarking shows a snapshot of our average running yield on all investments, also split between internally managed and externally managed. The latest benchmarking data (at 31 March 2018), shows our average rate of investments for our total portfolio as being 1.28% against the client universe of 1.08%. The table shows that we have outperformed our internally managed investments of the client universe by quite some margin.

Benchmark	Guildford	Client Universe
Internally managed return	0.99%	0.63%
Externally managed (return only)	3.23%	3.22%
Total Portfolio	1.28%	1.08%
% of investments subject to bail in	25%	55%
No. of counterparties/funds	45	15

8.18 The difference in our return as part of the benchmarking and our own return is due to a different calculation in the way Arlingclose put the benchmarking return together.

8.19 The table above shows how far the Council has come to mitigate bail in risk – closing the year at 25% of investments subject to bail in. This percentage will change during the course of the year depending on the level of cash we have and what we are invested in.

8.20 One of our key areas in our treasury strategy has been to increase diversification in the portfolio. The number of counterparties and funds we are investing in are far higher than the client universe and shows that we have achieved our aim. Again, this level of diversification will change at different points in the year.

8.21 We set our own performance indicators:

Indicator	Target	Actual	Variance
Cashflow investment returns above base rate	0.65%	0.29%	-0.36%
Long-term investment returns above base rate	0.94%	0.77%	-0.17%
Externally managaged funds above base rate	2.63%	2.94%	0.31%
Combined funds above base rate	1.03%	0.87%	-0.16%
% of daily balances within the range +/- £50,000	70.00%	74.79%	4.79%
The daily current account bal to be +/- £50,000	+/-£50,000	£29,605	

8.22 Overall performance was slightly below target in most areas.

8.23 The Council's daily bank balance target was +/- £50,000 for 70% of days. The average balance in the year was £29,605 and 74.79% of days were +/- £50,000, so we were well within our target.

9. Non-treasury investments

9.1 **Appendix 2** sets out Council investment property fund portfolio report for 2017-18. The key points are summarised below.

9.2 Investment in property has been more subdued but there remains a demand for prime assets and secure income streams.

9.3 Guildford remains in a strong position going forward, with solid economic and property fundamentals. The town was placed 6th in Lambert Smiths Hampton's 2018 UK Vitality Index with top ten placements in the sections for highly educated and fastest growing towns.

9.4 The key themes for the Thames Valley area office market over the last year have been:

- the rise of the tech market;
- increase in co working spaces;
- non-existent grade c stock and
- average transaction sizes falling

9.5 In Guildford, most of the larger corporates are focussed on working more efficiently and reducing the space they occupy. Guildford office supply increased from 260,000 sq ft in 2010 to 337,000 sq ft in 2017. New supply is being delivered by refurbishment of existing buildings, with the proportion of grade A space increasing from 0% in 2011 to 65% in 2017.

9.6 There is now an increased reliance on the SME companies for new demand. Guildford has a wide base of SME occupiers and an increasing tech sector. This mixed economic base provides stability and will maintain activity in the market, despite a lack of larger requirements. Demand will focus on high-spec interior refurbished and new buildings in the town centre.

9.7 Retail remained one of the worst performing sectors in the investment market last year. There is a common belief that the uncertainty over Brexit and the ceiling for on-line sales will mean that the market will continue the trend of flexible leases, with shorter terms, break clauses and also increasingly trying to secure turnover rents. Many retailers will also continue to rationalise with a rolling programme of closures and downsizings, counterbalanced by selective re-locations and strategic new openings.

9.8 Due to the historic High Street and lack of out-of-town development, Guildford remains a resilient prime affluent retail market and retains its attraction for investors and occupiers alike with its quality of catchment.

9.9 Industrial investment was the strongest performer across the commercial sectors in 2017. Going forward, prime and secondary industrial are generally expected to see near term rent increases across the UK. This is expected in Guildford because of the low supply of existing stock across all size ranges.

9.10 The current portfolio is:

Sector	**No. of assets**	**Sub-category**	
Office	8		
Industrial	129		
Retail	10	Shops Shopping Centres Supermarkets	7 2 1
Leisure	6	Restaurants Nightclubs	5 1
Other Commercial	11	Educational Theatres Barns Petrol Stations Sui Generis Car Parks Water Treatment Works	3 2 2 1 1 1 1
Total Investment Properties	**164**		

9.11 Fund statistics are:

Rental income	Industrial	Office	All Retail	Other	All
2015-16	2,679,571	1,831,900	1,750,254	885,636	7,147,361
2016-17	3,057,302	1,858,638	1,447,672	1,062,137	7,425,749
2017-18	3,493,405	3,186,048	1,426,317	1,070,786	9,176,556

Capital value	Industrial	Office	All Retail	Other	All
2015-16	39,077,755	19,227,500	34,270,000	11,233,500	103,808,755
2016-17	42,922,450	25,915,000	25,908,500	15,963,500	110,709,450
2017-18	51,509,000	49,574,000	26,065,000	17,471,500	144,619,500

Income return	Industrial	Office	All Retail	Other	All
2015-16	8.03%	7.46%	5.60%	7.52%	6.84%
2016-17	7.12%	7.17%	5.59%	6.65%	6.71%
2017-18	7.96%	7.39%	5.23%	5.76%	6.59%

Benchmark retu	Industrial	Office	All Retail	Other	All
2015-16	6.10%	4.70%	5.40%	4.70%	5.23%
2016-17	5.40%	4.10%	5.00%	5.50%	4.80%
2017-18	7.90%	3.90%	2.50%	2.50%	4.20%

9.12 The performance shows that our portfolio has performed better than our benchmark.

10. Capital programme

10.1 **Appendix 3** sets out the actual expenditure on capital schemes, compared to the updated estimates, together with reasons for variances. Overall, we spent £86.06 million (86%) less on capital schemes than we originally estimated and £6.3 million (31%) less than the revised estimate, the majority of which related to SARP, Walnut Bridge, and Spectrum CHP although there are significant variations on other approved schemes as detailed in Appendix 3.

10.2 The table below summarises our capital expenditure and variances in the year:

	Revised estimate (£m)	Actual (£m)	Variance (£m)
Non-housing approved programme	14.717	9.885	(4.832)
Non-housing provisional programme	0.019	0.019	(0)
Schemes financed from reserves	4.442	3.305	(1.137)
Projects financed from s106 receipts	0.439	0.09	(0.349)
Private sector and affordable housing grants	0.665	0.645	(0.02)
Total	**20.282**	**13.944**	**(6.338)**

10.3 We significantly re profiled schemes during the year, and under spent by £6.3 million on the revised estimate.

11. Compliance with treasury and prudential indicators

11.1 The CIPFA prudential code and treasury management code of practices require local authorities to set treasury and prudential indicators.

11.2 The objectives of the Prudential Code, and the indicators calculated in accordance with it, provide a framework for local authority capital finance that will ensure:

- capital expenditure plans are affordable
- all external borrowing and other long-term liabilities are within prudent and sustainable limits
- treasury management decisions are taken in accordance with professional good practice and
- in taking the above decisions, the Council is accountable by providing a clear, transparent framework

11.3 The prudential code requires the Council to set a number of prudential indicators for the following and two subsequent financial years, and to monitor against the approved indicators during the year. We can revise these indicators during the year but need full Council approval.

11.4 Officers can confirm that the Council has complied with its prudential indicators for 2017-18, (see **Appendix 1** for the outturn figures), its treasury management policy statement and its treasury management practices.

11.5 Section 6 outlines the approved treasury management strategy. We have adhered to the strategy by:

- financing of capital expenditure from government grants, usable capital resources, revenue contributions and cash flow balances rather than from external borrowing
- taking a prudent approach in relation to the investment activity in the year, with priority given to security and liquidity over yield
- maintaining adequate diversification between counterparties
- forecasting and managing cash flow to preserve the necessary degree of liquidity

12. Risk and performance

12.1 The Council considers security, liquidity and yield, in that order, when making investment decisions.

12.2 The Council has complied with all the relevant statutory and regulatory requirements, which limit the level of risk associated with its treasury management activities. In particular, its adoption and implementation of both the prudential code and treasury management code of practice means our capital expenditure is prudent, affordable and sustainable, and our treasury practices demonstrate a low risk approach.

12.3 Short-term interest rates and likely movements in these rates, along with our projected cash balances, determine our anticipated investment return. These returns can be volatile and whilst, loss of principal is minimised through the annual investment strategy, accurately forecasting future returns can be difficult.

12.4 We set a target return of 1.71% and returned 1.23%. This shows that we did not increase the level of risk taken over what we had budgeted for.

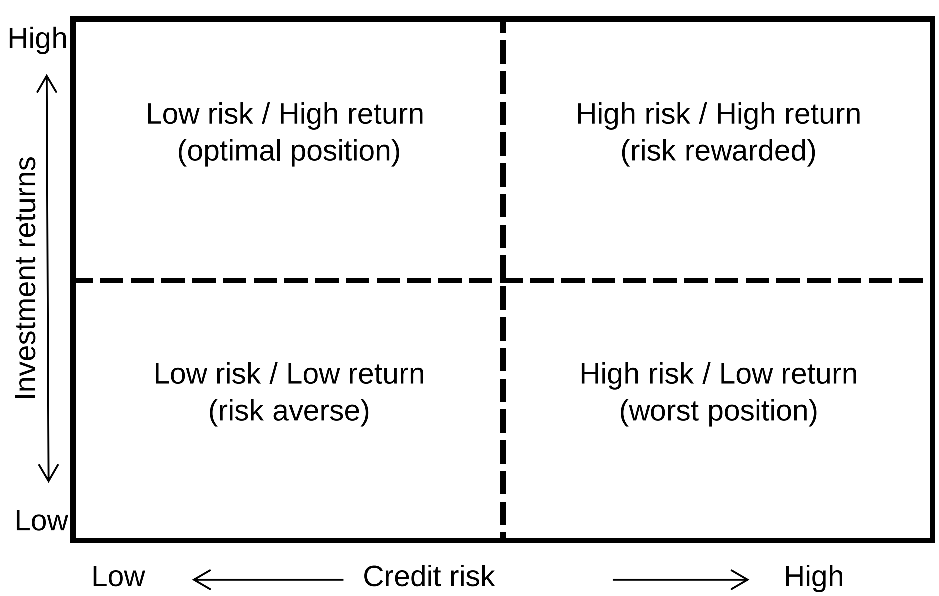
12.5 If the Council were to lose any of its investments, the GF will carry the loss, even if the cash lost is HRA cash. Therefore, to compensate the GF for this, we apply a credit risk adjustment to the rate of interest we apply on the HRA balances and reserves and SPA reserves. Therefore, a lower interest rate is applied than the weighted average investment return for the year.

12.6 The council invests in externally managed funds. These are more volatile than cash investments, but can come with a higher return. Officers continually review our funds to ensure they still have a place in the portfolio. We view most of our funds over a three to five year time horizon to take account of their potential volatility – they are not designed to be short-term investments, despite being able to get the money from them quickly.

Credit developments and credit risk management during the year

12.7 Security of our investments is our key objective when making treasury decisions. We therefore manage credit risk through the limits and parameters we set in our annual treasury management strategy. One quantifiable measure of credit quality we use is to allocate a score to long-term credit ratings. **Appendix 8** explains the scoring in more detail.

12.8 This is a graphical representation used in the Arlingclose benchmarking.



12.9 Typically we should aim to be in the top left corner of the chart where we get a higher return for lower risk. In the actual benchmarking, for average rate versus credit risk (value weighted) we were above the average of all clients and were in the top left box towards the middle vertical line. For time weighted, we are well within the top left box (see **Appendix 6** for the two charts).

12.10 We set our definition of high credit quality as a minimum long-term credit rating of A-, which attracts a score of 7. The lower the score, the higher the credit quality of the investment portfolio.

12.11 The table below shows that at each quarter date, the weighted average score of our investment portfolio, on a value weighted and a time weighted basis is well within our definition of high credit quality, ending the year at 3.86 (AA-) and 2.63 (AA).

Date	Value Weighted Avg Credit Risk Score	Value Weighted Avg Credit Rating	Time Weighted Avg Credit Risk Score	Time Weighted Avg Credit Rating	Average Life (days)
31-03-17	3.47	AA	2.34	AA+	417
30-06-17	3.67	AA-	2.57	AA	353
30-09-17	3.83	AA-	2.93	AA	370
31-12-17	3.76	AA-	2.85	AA	390
31-03-18	3.86	AA-	2.63	AA	302

12.12 We have maintained security throughout the year within the portfolio. We also have a lower risk score on both elements than the Arlingclose client universe (4.24/AA- and 4.03/AA-). We do, however, have a much longer duration (ours is 302 days compared to the universe of 35 days) and this is due to the addition of covered bonds in the portfolio, which can be sold on the secondary market if required. The longer duration is with AAA rated covered bonds so this has enhanced the security of the portfolio.

13. Minimum Revenue Provision (MRP)

13.1 The Local Authorities (Capital Financing and Accounting) (England) (Amendment) Regulations 2008 (SI No 414 of 2008) place a duty on local authorities to make a prudent provision for debt redemption. Making an MRP reduces the Capital Financing Requirement (CFR) and leaves cash available to replenish reserves used for internal borrowing or making external debt repayments. There are three options for applying MRP available to us:

- asset life method
- depreciation method
- any other prudent method

13.2 Any other prudent method means we can decide on the most appropriate method depending on the capital expenditure.

13.3 The revised MRP policy was approved by Council in February 2017. It stated that:

- the Council will use the asset life method as its main method, but will use annuity for investment property
- in relation to expenditure on development, we may use the annuity method starting in the year after the asset becomes operational
- where we acquire assets ahead of a development scheme, we will charge MRP based on the income flow of the asset or as service benefit is obtained, and will not charge MRP during construction, refurbishment or redevelopment
- where expenditure is incurred pending receipt of an alternative source of finance we will not charge MRP
- we will use 75-years for freehold land purchased for development purposes, and any new buildings or similar structures on that land
- where loans are made to other bodies for their capital expenditure, no MRP will be charged
- we will apply a 100-year life for investments in shares classed as capital expenditure

13.4 The unfinanced capital expenditure in 2017-18 of £7.17 million related mainly to Spectrum roof, Guildford Park car park and SARP.

13.5 The MHCLG MRP guidance has suggested some limits and as such we need to amend our policy going forward. This only applies from 2019-20 budget year and will be reported, along with the implications, as part of the Capital and Investment Strategy 2019-20 to 2023-24.

14. External service providers

14.1 The Council reappointed Arlingclose as our treasury management advisers in March 2015. The contract is for a period of 7 years. The Council is clear what services it expects and what services Arlingclose will provide under the contract.

14.2 The Council is clear that overall responsibility for treasury management remains with the Council.

15. Training

15.1 CIPFA's revised treasury management code of practice suggests that best practice is achieved by all councillors tasked with treasury management responsibilities, including scrutiny of the treasury management function, receiving appropriate training relevant to their needs and that they should fully understand their roles and responsibilities.

15.2 The MHCLG's revised investment guidance also recommends that a process is in place for reviewing and addressing the needs of the Council's treasury management staff for training in investment management.

15.3 Following the revised CIPFA code of practice and the stated requirement that a specified body be responsible for the implementation and regular monitoring of the treasury management policies, we use the Corporate Governance and

Standards Committee to scrutinise the treasury management activity of the Council.

15.4 Officer training is undertaken on a regular basis, by attending workshops held by Arlingclose, and seminars or conferences held by other bodies, such as CIPFA. On the job training and knowledge sharing are undertaken when required. Those involved in treasury management are either a fully qualified accountant, or AAT qualified. The main post holder responsible for the treasury management function holds the 'Certificate in International Treasury Management for Public Finance' qualification, which is a joint qualification between the ACT (Association of Corporate Treasurers) and CIPFA.

15.5 Certain officers of the Council are deemed professional by the financial industry and therefore demonstrate the level of skill and expertise in the treasury function to ensure the Council remains professional status under the MiFID II regulations.

16. Consultations

16.1 Officers have consulted with the Lead Councillor for Finance and Asset Management about the contents of this report.

17. Equality and Diversity Implications

17.1 There are no equality and diversity implications

18. Financial Implications

18.1 The detailed financial implications are summarised above and in **Appendix 1**.

19. Legal Implications

19.1 A variety of professional codes, statutes and guidance regulate the council's treasury management activities. These are:

- the Local Government Act 2003 ("the Act") provides the powers to borrow and invest. It also imposes controls and limits on these activities
- the Act permits the Secretary of State to set limits on either the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken. The HRA debt cap is the only restriction that applied in 2017-18
- The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (SI No 3146 of 2003 - "The SI"), as amended, develops the controls and powers within the Act
- the SI requires the Council to undertake any borrowing with regard to the prudential code. The prudential code requires indicators to be set – some of which are limits – for a minimum of three forthcoming years
- the SI also requires the Council to operate the treasury management function with regard to the CIPFA treasury management code of practice
- under the terms of the Act, the Government issued "investment guidance" to structure and regulate the Council's investment activities. The emphasis of the guidance is on the security and liquidity of investments.

20. Human Resource Implications

21.1 There are no human resource implications arising from this report other than the training discussed in section 15, which is already in place.

21. Summary of Options

21.1 We could have invested in lower credit quality investments, but this would have increased our risk exposure.

21.2 We could have borrowed longer-term for our capital programme, but would have suffered a cost of carry due to the slippage in the programme.

22. Conclusion

22.1 The Council has complied with the objectives of the CIPFA treasury management code of practice by maintaining the security and liquidity of its investment portfolio.

22.2 We maintained the security of our investment portfolio, and did not borrow long-term in advance of need.

22.3 We have also complied with the requirements of the prudential code by setting, monitoring and staying within the prudential indicators set, except the variable limit on net investments due to higher investment balances than when the indicator was set.

23. Background Papers

- CIPFA Treasury Management in the Public Services – Code of Practice and Cross Sectoral Guidance Notes (2017 edition)
- CIPFA Treasury Management in the Public Services – Guidance Notes for Local Authorities including Police Authorities and Fire Authorities (2011 edition)
- CIPFA the Prudential Code for Capital Finance in Local Authorities (2017 edition)
- CIPFA the Prudential Code for Capital Finance in Local Authorities – Guidance Notes for Practitioners (2013 edition)
- Treasury management annual strategy report 2017-18

24. Appendices

Appendix 1: Treasury management activity, treasury and prudential indicators 2017-18
Appendix 2: Investment property fund portfolio report 2017-18
Appendix 3: Capital Programme
Appendix 4: Schedule of Investments at 31 March 2018
Appendix 5: Economic Background – a commentary from Arlingclose
Appendix 6: Benchmarking graphs
Appendix 7: Credit score analysis
Appendix 8: Credit rating equivalents and definitions
Appendix 9: Background to externally managed funds
Appendix 10: Glossary