

# **Annual Treasury Management Review 2016/17**

## **1 Introduction**

- 1.1 The Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2016/17. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).
- 1.2 During 2016/17 the minimum reporting requirements were as follows:
  - an annual treasury strategy in advance of the year (Council 17 February 2016)
  - a mid year treasury update report (Governance & Audit Committee 22 November 2016)
  - an annual review following the end of the year describing the activity compared to the strategy (this report)
- 1.3 The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.
- 1.4 The Council confirms that it has complied with the requirement under the Code to give prior scrutiny to the annual treasury strategy by the Scrutiny Panel before it was reported to the full Council.
- 1.5 This report summarises:
  - Capital financing activity during the year;
  - Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
  - The actual prudential and treasury indicators;
  - The overall treasury position;
  - The Treasury Management Strategy for 2016/17;
  - The economy and interest rates;
  - Borrowing activity; and
  - Investment activity.

## **2 Capital expenditure and financing 2016/17**

- 2.1 The Council undertakes capital expenditure on long-term assets. These activities may either be:
  - Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
  - If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

- 2.2 The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

	2015/16	2016/17	2016/17
	Actual	Estimate	Actual
	£'000	£'000	£'000
General Fund capital expenditure	6,401	7,221	11,390
HRA capital expenditure	13,663	11,899	10,705
Total capital expenditure	20,064	19,120	22,095
Resourced by:			
· Capital receipts	2,585	6,859	4,782
· Capital grants	3,233	101	2,277
· Capital reserves	9,910	5,687	6,187
· Finance Leases	877	0	849
· Revenue	646	4,457	6,490
New borrowing requirement	2,813	2,016	1,510

### 3 ***The Council's overall borrowing need***

- 3.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2016/17 new borrowing requirement (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.
- 3.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the Capital Programme, the Accountancy team organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLb] or the money markets), or utilising temporary cash resources within the Council.
- 3.3 The Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP), to reduce the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need (there is no statutory requirement to reduce the HRA CFR). This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR. The total CFR can also be reduced by:
- the application of additional capital financing resources (such as unapplied capital receipts); or
  - charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).
- 3.4 The Council's 2016/17 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report on 17 February 2016.

- 3.5 The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.

	31-Mar-16	31-Mar-17	31-Mar-17
	Actual	Budget	Actual
CFR	£'000	£'000	£'000
Opening balance	151,168	154,138	153,563
Add unfinanced capital expenditure (as above)	2,813	2,016	1,510
Add on-balance sheet leasing schemes	877	0	849
Less MRP/VRP	1,295	1,264	1,325
Closing balance	153,563	154,890	154,597

- 3.6 Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.
- 3.7 In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2016/17. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31-Mar-16	31-Mar-17	31-Mar-17
	Actual	Budget	Actual
	£'000	£'000	£'000
Gross borrowing position	136,094	136,094	136,094
CFR	153,563	154,890	154,597

- 3.8 The **Authorised Limit** is the 'affordable borrowing limit' required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2016/17 the Council has maintained gross borrowing within its authorised limit.
- 3.9 The **Operational Boundary** is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.
- 3.10 The **actual financing costs as a proportion of net revenue stream** indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2015/16	2016/17
	£'000	£'000
Authorised limit	170,202	170,190
Maximum gross borrowing position	136,094	136,094
Operational boundary	147,651	143,530
Average gross borrowing position	136,094	136,094
Financing costs as a proportion of net revenue stream	10.30%	12.02%

#### 4 **Treasury position as at 31 March 2017**

- 4.1 The Council's debt and investment position is organised to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting (as detailed in the introduction), and through officer activity detailed in the Council's Treasury Management Practices. At the end of 2016/17 the Council's treasury position (excluding finance leases) was as follows:

	31-Mar-16 Principal £'000	Rate/ Return %	31-Mar-17 Principal £'000	Rate/ Return %
Fixed rate funding:				
PWLB	101,594	3.80%	101,594	3.80%
LOBO	14,500	4.04%	5,500	3.63%
Market	0	0.00%	9,000	4.28%
Stock Issue	20,000	8.79%	20,000	8.79%
<b>Total debt</b>	<b>136,094</b>	<b>4.56%</b>	<b>136,094</b>	<b>4.56%</b>
CFR	153,563		154,597	
Over/ (under) borrowing	(17,469)		(18,503)	
Investments - In house	37,376	0.59%	45,236	0.47%
<b>Total investments</b>	<b>37,376</b>	<b>0.59%</b>	<b>45,236</b>	<b>0.47%</b>

- 4.2 The maturity structure of the debt portfolio is shown below. It should be noted that for LOBO loans, the maturity date is deemed to be the next call date. They are therefore all shown as short-term debt:

	31-Mar-16 Actual £'000	31-Mar-17 Actual £'000
Under 12 months	14,500	5,500
12 months and within 24 months	0	0
24 months and within 5 years	20,000	20,000
5 years and within 10 years	700	700
10 years and within 20 years	10,500	10,500
20 years and within 30 years	30,400	36,000
30 years and within 40 years	36,294	35,694
40 years and within 50 years	23,700	18,700
Over 50 years	0	9,000
	<b>136,094</b>	<b>136,094</b>

- 4.3 All of the Council's investments were for a period of less than one year, and there was not any exposure to variable rates of interest.

- 4.4 The outturn position for the Central Loans and Investment Account (CLIA) is shown below. This shows the outturn position as being broadly on budget.

	Budget	Actual	Variance
CLIA	£'000	£'000	£'000
Total Interest Paid	6,658	6,670	12
Less: HRA recharge	(5,629)	(5,605)	24
<b>Total less HRA</b>	<b>1,029</b>	<b>1,065</b>	<b>36</b>
Total Investments	(232)	(268)	(36)
Less: Item 8 credit	30	29	(1)
<b>Total less HRA</b>	<b>(202)</b>	<b>(239)</b>	<b>(37)</b>
<b>Total CLIA</b>	<b>827</b>	<b>826</b>	<b>(1)</b>

- 4.5 The CLIA comprises the Council's borrowing costs and investment income. It is difficult to predict and can be affected by several factors. The majority of the Council's debt is on fixed rates reflecting the longer-term nature of the borrowing decisions. Investments are generally made for shorter periods, making returns more variable. This mix is generally more beneficial when interest rates are high or increasing. It is important to add that the exposure to interest rate movements is regularly monitored to minimise risks to changes in returns. The reasons that have contributed to the above variances include:
- The variance against interest income is as a result of a higher level of funds than was envisaged being available for investment, and the rates against some investments being greater than the budgeted figure.
  - Borrowing costs recharged to HRA include the impact of internal borrowing. The level of new HRA borrowing requirement for the year was less than the budgeted amount.

## 5 *The strategy for 2016/17*

- 5.1 The original expectation for interest rates within the treasury management strategy for 2016/17 anticipated low but rising Bank Rate (starting in quarter 2 of 2016) and gradual rises in medium and longer term fixed borrowing rates during 2016/17. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.
- 5.2 In this scenario, the treasury strategy was to continue to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk, by 'borrowing internally'.
- 5.3 The investment policy reflected the Council's low appetite for risk, emphasising the priorities of security and liquidity over that of yield. The main features of the policy were that the Council will apply minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties, which also enables diversification and avoidance of concentration risk. Investment decisions also applies the creditworthiness service provided by Capita Asset Services, which

combines data from credit rating agencies with credit default swaps and sovereign ratings.

- 5.4 The Council would only use approved counterparties from countries with a minimum credit rating of 'AA-'. The Council will consider longer-term deals if attractive rates are available within the risk parameters set by the Council. The suggested budgeted return on investments placed for periods up to 100 days during the year was 0.90%.
- 5.5 **Changes in strategy during the year** – the strategy adopted in the original Treasury Management Strategy for 2016/17 approved by the Council on 17 February 2016, was subject to revision during the year as part of the mid-year update report. The changes were as follows:
- A revised interest rate forecast to reflect PWLB rates falling during quarters 1 and 2 to reach historically very low levels in July and August.
  - Revision to the borrowing strategy to consider the long term saving resulting from borrowing at very low rates.
  - Amending the budgeted investment earnings for 2016/17 to 0.25% to reflect the lower rates available.
  - Changes to the Country limits to exclude the UK from the minimum sovereign debt limit to reflect ratings agency actions following the outcome of the EU referendum.
  - Revised accounting treatment for an element of the Council's long term debt, as the lender had decided to waive their right to change the applicable interest rate of two Lender Option/Borrower Option (LOBO) loans in the future.
  - A revision to the Council's MRP policy so that the historic element of MRP is paid on an equal instalment basis over a period of 50 years. This change would have the benefits of achieving savings over the medium-term, introducing a consistent level of charge, and ensuring that this element is eventually completely repaid.

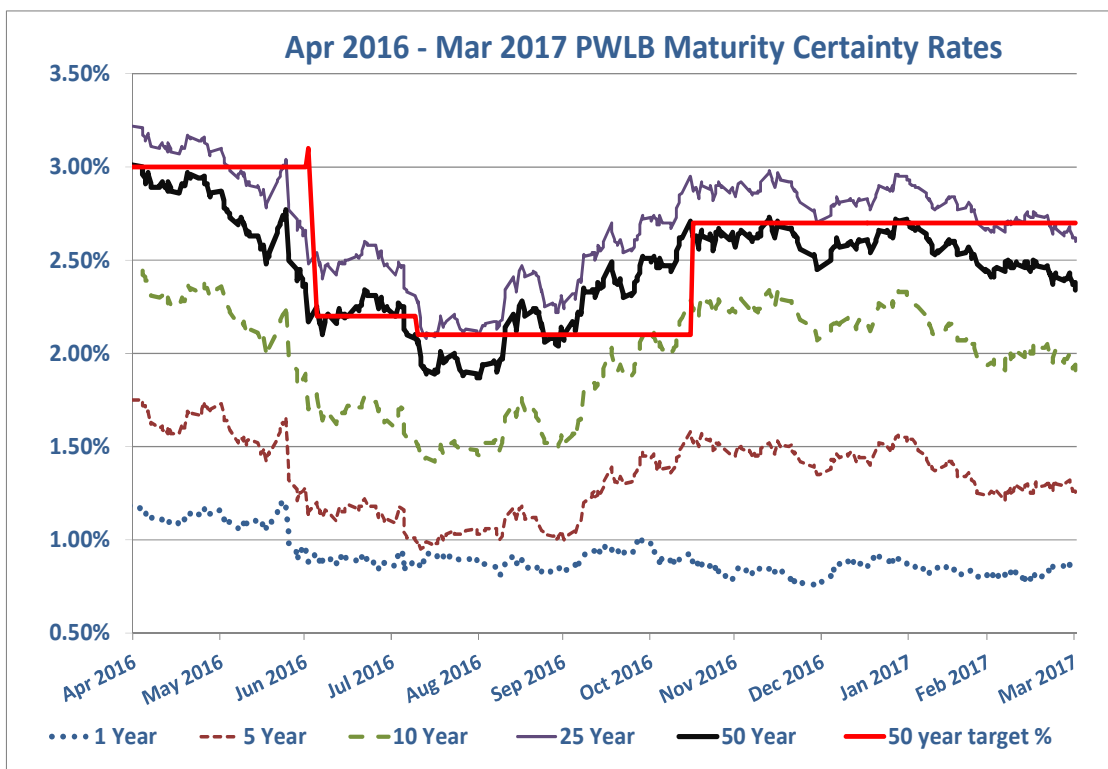
## **6 *The economy and interest rates***

- 6.1 The two major landmark events that had a significant influence on financial markets in the 2016-17 financial year were the UK EU referendum on 23 June and the election of President Trump in the USA on 9 November. The first event had an immediate impact in terms of market expectations of when the first increase in Bank Rate would happen, pushing it back from quarter 3 2018 to quarter 4 2019. At its 4 August meeting, the Monetary Policy Committee (MPC) cut Bank Rate from 0.5% to 0.25% and the Bank of England's Inflation Report produced forecasts warning of a major shock to economic activity in the UK, which would cause economic growth to fall almost to zero in the second half of 2016. The MPC also warned that it would be considering cutting Bank Rate again towards the end of 2016 in order to support growth. In addition, it restarted quantitative easing with purchases of £60bn of gilts and £10bn of corporate bonds, and also introduced the Term Funding Scheme whereby potentially £100bn of cheap financing was made available to banks.
- 6.2 In the second half of 2016, the UK economy confounded the Bank's pessimistic forecasts of August. After a disappointing quarter 1 of GDP growth, the three subsequent quarters of 2016 came in to produce an annual growth for 2016 that

was very nearly the fastest rate of growth of any of the G7 countries. Needless to say, this meant that the MPC did not cut Bank Rate again after August but, since then, inflation has risen rapidly due to the effects of the sharp devaluation of sterling after the referendum. By the end of March 2017, sterling was 17% down against the dollar but had not fallen as far against the euro. In February 2017, the latest CPI inflation figure had risen to 2.3%, above the MPC's inflation target of 2%. However, the MPC's view was that it would look through near term supply side driven inflation, (i.e. not raise Bank Rate), caused by sterling's devaluation, despite forecasting that inflation would reach nearly 3% during 2017 and 2018. This outlook, however, is dependent on domestically generated inflation, (i.e. wage inflation), continuing to remain subdued despite the fact that unemployment is at historically very low levels and is on a downward trend. Market expectations for the first increase in Bank Rate moved forward to quarter 3 2018 by the end of March 2017 in response to increasing concerns around inflation.

## 7 **Borrowing**

- 7.1 During 2016/17, PWLB rates fell from April to June and then gaining fresh downward impetus after the referendum and Bank Rate cut, before staging a partial recovery through to December and then falling slightly through to the end of March. The table for PWLB borrowing rates below shows, for a selection of maturity periods, the movement in rates during the course of the financial year.

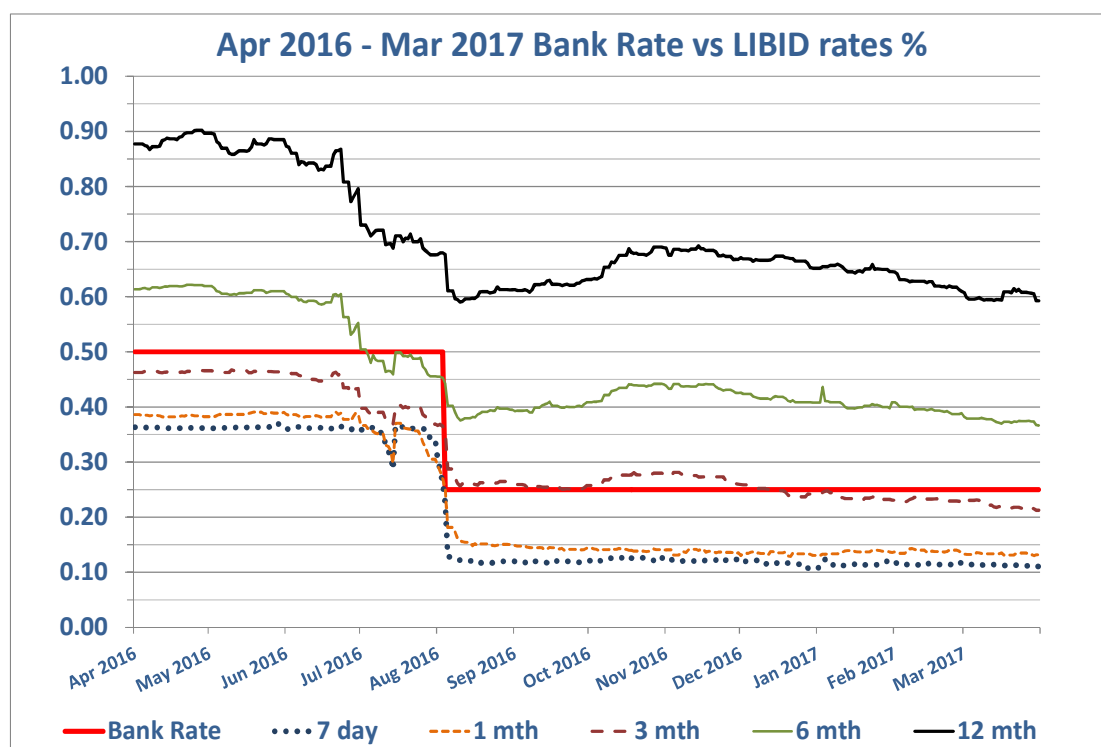


- 7.2 The Council's total debt outstanding at 31 March 2017 was £136.1m, which was unchanged from the figure at the end of the previous financial year. This means that the average interest rate on the Council's debt at the end of the year has remained at 4.56%.

- 7.3 The Council's approach during the year was to use cash balances to finance new capital expenditure so as to run down cash balances and minimise counterparty risk incurred on investments. This also maximised treasury management budget savings as investment rates were much lower than most new borrowing rates. No new short-term borrowing for cash flow purposes was undertaken during 2016/17.
- 7.4 No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

## 8 *Investments*

- 8.1 After the EU referendum, Bank Rate was cut from 0.5% to 0.25% on 4 August and remained at that level for the rest of the year. Market expectations as to the timing of the start of monetary tightening started the year at quarter 3 2018, but then moved back to around the end of 2019 in early August before finishing the year back at quarter 3 2018. Deposit rates continued into the start of 2016/17 at previous depressed levels but then fell during the first two quarters and fell even further after the 4 August MPC meeting resulted in a large tranche of cheap financing being made available to the banking sector by the Bank of England. Rates made a weak recovery towards the end of 2016 but then fell to fresh lows in March 2017.



- 8.2 The Council manages its investments in-house, and its cash balances comprise revenue and capital resources and cash flow monies. The Council's investment policy is governed by CLG investment guidance, which was implemented in the Annual Investment Strategy approved by the Council on 17 February 2016. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented



by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.)

- 8.3 The investment activity during the year conformed to the approved strategy, the Council had no liquidity difficulties, and no institutions in which investments were made during 2016/17 had any difficulty in repaying investments and interest in full.
- 8.4 The Council's internally managed funds earned an average rate of return of 0.47%. The comparable performance indicator is the average 3 month LIBID rate (London Interbank Bid Rate – the rate charged by one bank to another for a deposit) (uncompounded), which was 0.315%.

	2015/16	2016/17
Details	%	%
Temporary Investments	0.68	0.55
Overnight and Deposit Account	0.48	0.38
<b>Total</b>	<b>0.59</b>	<b>0.47</b>
Benchmark (3 month LIBID)	0.46	0.32
Return as a % of the Benchmark	129.4%	149.2%

The Council had temporary investments totalling £45.2m outstanding as at 31 March 2017. Of this, £32.5m relates to fixed-term deposits that are due to mature during 2016/17, £10.2m is held in a 'AAA' rated money market fund, and the remaining £2.5m is held in a 35 day notice account. All of the deposits were made in accordance with the 2016/17 Annual Investment Strategy. A full list of investments held as at 31 March 2017 is shown in **Appendix B** (confidential)