Treasury Management Outturn Report 2016/17

Introduction

In April 2002 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) which requires the Authority to approve a treasury management annual report after the end of each financial year.

The Authority's treasury management strategy for 2016/17 was approved by full Council on 18 February 2016. The Authority 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 Authority's treasury management strategy.

External Context

Economic background: Politically, 2016/17 was an extraordinary twelve month period which defied expectations when the UK voted to leave the European Union and Donald Trump was elected the 45th President of the USA. Uncertainty over the outcome of the US presidential election, the UK's future relationship with the EU and the slowdown witnessed in the Chinese economy in early 2016 all resulted in significant market volatility during the year. Article 50 of the Lisbon Treaty, which sets in motion the 2-year exit period from the EU, was triggered on 29th March 2017.

UK inflation had been subdued in the first half of 2016 as a consequence of weak global price pressures, past movements in sterling and restrained domestic price growth. However the sharp fall in the Sterling exchange rate following the referendum had an impact on import prices which, together with rising energy prices, resulted in CPI rising from 0.3% year/year in April 2016 to 2.3% year/year in March 2017.

In addition to the political fallout, the referendum's outcome also prompted a decline in household, business and investor sentiment. The repercussions on economic growth were judged by the Bank of England to be sufficiently severe to prompt its Monetary Policy Committee (MPC) to cut the Bank Rate to 0.25% in August and embark on further gilt and corporate bond purchases as well as provide cheap funding for banks via the Term Funding Scheme to maintain the supply of credit to the economy.

Despite growth forecasts being downgraded, economic activity was fairly buoyant and GDP grew 0.6%, 0.5% and 0.7% in the second, third and fourth calendar quarters of 2016. The labour market also proved resilient, with the ILO unemployment rate dropping to 4.7% in February, its lowest level in 11 years.

Following a strengthening labour market, in moves that were largely anticipated, the US Federal Reserve increased rates at its meetings in December 2016 and March 2017, taking the target range for official interest rates to between 0.75% and 1.00%.

Financial markets: Following the referendum result, gilt yields fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. After September there was a reversal in longer-dated gilt yields which moved higher, largely due to the MPC revising its earlier forecast that Bank Rate would be dropping to near 0% by the end of 2016. The yield on the 10-year gilt rose from 0.75% at the end of September to 1.24% at the end of December, almost back at pre-referendum levels of 1.37% on 23rd June. 20- and 50-year gilt yields also rose in Q3 2017 to

1.76% and 1.70% respectively, however in Q4 yields remained flat at around 1.62% and 1.58% respectively.

After recovering from an initial sharp drop in Q2, equity markets rallied, although displaying some volatility at the beginning of November following the US presidential election result. The FTSE-100 and FTSE All Share indices closed at 7342 and 3996 respectively on 31st March, both up 18% over the year. Commercial property values fell around 5% after the referendum, but had mostly recovered by the end of March.

Money market rates for overnight and one week periods remained low since Bank Rate was cut in August. 1- and 3-month LIBID rates averaged 0.36% and 0.47% respectively during 2016-17. Rates for 6- and 12-months increased between August and November, only to gradually fall back to August levels in March, they averaged 0.6% and 0.79% respectively during 2016-17.

Credit background: Various indicators of credit risk reacted negatively to the result of the referendum on the UK's membership of the European Union. UK bank credit default swaps saw a modest rise but bank share prices fell sharply, on average by 20%, with UK-focused banks experiencing the largest falls. Non-UK bank share prices were not immune, although the fall in their share prices was less pronounced.

Fitch and Standard & Poor's downgraded the UK's sovereign rating to AA. Fitch, S&P and Moody's have a negative outlook on the UK. Moody's has a negative outlook on those banks and building societies that it perceives to be exposed to a more challenging operating environment arising from the 'leave' outcome.

None of the banks on the Authority's lending list failed the stress tests conducted by the European Banking Authority in July and by the Bank of England in November, the latter being designed with more challenging stress scenarios, although Royal Bank of Scotland was one of the weaker banks in both tests. The tests were based on banks' financials as at 31st December 2015, 11 months out of date for most. As part of its creditworthiness research and advice, the Authority's treasury advisor Arlingclose regularly undertakes analysis of relevant ratios - "total loss absorbing capacity" (TLAC) or "minimum requirement for eligible liabilities" (MREL) - to determine whether there would be a bail-in of senior investors, such as local authority unsecured investments, in a stressed scenario.

On the advice of Arlingclose, new investments with Deutsche Bank and Standard Chartered Bank were suspended in March 2016 due to the banks' relatively higher credit default swap (CDS) levels and disappointing 2015 financial results. The Authority's deposits with Standard Chartered Bank matured in May 2016. Standard Chartered was reintroduced to the counterparty list in March 2017 following its strengthening financial position, but Deutsche Bank was removed altogether from the list.

Local Context

On 31st March 2017, the Authority had net borrowing of £144.18m arising from its revenue and capital income and expenditure, an increase on 2016 of £10m. 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

	31.3.16 Actual £m	2016/17 Movement £m	31.3.17 Actual £m
General Fund CFR	29.6	0	29.6
HRA CFR	155.1	0	155.1
Total CFR	**184.7**	**0**	**184.7**
Less: Usable reserves	-46.9	3	-43.9
Less: Working capital	-4.0	2	-2
Net Worth	**133.8**	**5**	**138.8**

Table 2: Treasury Management Summary

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %
Long-term borrowing	185.5	0	185.5	2.97
Total borrowing	**185.5**	**0**	**185.5**	
Short-term investments Cash and cash equivalents	37.7 14.0	-12.7 2.3	25.0 16.3	0.37 0.27
Total investments	**51.7**	**-10.4**	**41.3**	
Net Borrowing	**133.8**	**-10.4**	**144.2**	

Note: the figures in the table are from the balance sheet in the Authority's statement of accounts.

Net borrowing has increased due to falls in usable reserves and working capital. As investment balances were used to fund the capital programme no additional borrowing was required.

The Authority's current strategy is to maintain a minimum investment balance of £10m with a view to borrowing to fund the rest of the house building programme probably later in 2017. The treasury management position as at 31st March 2017 and the year-on-year change in show in table 2 above.

Borrowing Activity

At 31st March 2017, the Authority held £185.5m of loans, this has remained static over the year as slippage in the capital programme has meant the need to borrow has not materialised. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %	31.3.17 WAM* years
Public Works Loan Board	185.55	0	185.55	2.97	19.95

*Weighted average maturity

The Authority'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 Authority's long-term plans change being a secondary objective.

In furtherance of these objectives, no new borrowing was undertaken in 2016/17, as the capital programme has been funded using available internal resources. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

Investment Activity

The Authority holds significant invested funds, representing balances and reserves held. During 2016/17, the Authority's investment balances have been falling due to funding the capital programme. The year-end investment position and the year-on-year change in show in table 4 below.

Table 4: Investment Position

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %	31.3.17 WAM* days
Banks & building societies (unsecured)	21.7	-5.4	16.3	0.42	124.5
Government (incl. local authorities)	18.5	-3.5	15.0	0.33	137.4
Money Market Funds	11.5	-1.5	10.0	0.27	1.0
Other Pooled Funds					
Total investments	**51.7**	**-10.4**	**41.3**	**0.34**	**94.74**

*Weighted average maturity

Both the CIPFA Code and government guidance require the Authority 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 Authority'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 falling returns from short-term unsecured bank investments, the Authority has kept investment balances short term in line with the cash flow so as to enable funds to be available when required by operational and capital requirements.

Risk and return metrics 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
31.03.2016	3.80	AA-	66%	53	1.04%
30.06.2016	3.89	AA-	64%	57	0.99%
30.09.2016	4.03	AA-	66%	54	0.88%
31.12.2016	3.96	AA-	64%	50	0.79%
31.03.2017	3.97	AA-	60%	47	0.99%
All LAs	**4.01**	**AA-**	**58%**	**137**	**1.31%**

*Weighted average maturity.

The table above shows how the Council is performing with its investments, and as can be seen performance is commensurate with other Local Authorities, with the exception of the Rate of Return. This is due to this Council keeping investments shorter, 47 days invested against other Local Authorities 137 days, which gives rise to lower interest rates received.

The Council set itself targets of 7 or below for the credit score and A- or higher for the credit rating and the table above shows both these targets were achieved.

Performance Report

The Authority 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 £'000	Budget £'000	Over/ Under £'000	Actual %	Benchmark %
Temporary Loans Interest	(156.9)	(178.1)	21.2	0.50	0.57
Money Market Funds Interest	(62.3)	(57.8)	(4.5)	0.58	0.48
Total investment income	**(219.2)**	**(235.9)**	**16.7**	**0.52**	**0.55**
Fixed Rate Loans Interest	5,348.0	5,348.0	**0.0**	3.48	3.48
Variable Rate Loans Interest	183.1	214.0	**(30.9)**	0.58	0.67
Total debt expense	**5,531.1**	**5,562.0**	**(30.9)**	**2.97**	**3.00**
GRAND TOTAL	**5,311.9**	**5,326.1**	**(14.2)**	n/a	n/a

Temporary loan interest receivable has under achieved over the year. This is because the Council has been investing for shorter periods as cash is being used to support the capital programme. The variable rate of loan interest is more favourable as the benchmark is set based upon the previous years actual and any subsequent falls in the rate from the lender are borne in this year.

Compliance Report

The Director of Resources is pleased to report that all treasury management activities undertaken during 2016/17 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	2016/17 Limit	31.3.17 Actual	Complied
Any single organisation, except UK Government	£5m	£5m (Lloyds and Santander)	✓
UK Central Government	**Unlimited**	**£15m**	✓
Any group of funds under the same management	**£5m per group**	**£5m (Lloyds)**	✓
Any group of pooled funds under the same management	**£5m per manager**	**Nil**	✓
Negotiable instruments held in a broker's nominee account	**£15m per broker**	**£11m ICAP and £4m BGC**	✓
Foreign countries	**£5m per country**	**Nil**	✓
Registered Providers	**£5m in total**	**Nil**	✓
Unsecured investments with Building Societies	**£5m in total**	**Nil**	✓
Loans to unrated corporates	**£5m in total**	**Nil**	✓
Money Market Funds	**£15m in total**	**£10m**	✓

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 8: Debt Limits

	31.3.17 Actual	2016/17 Operational Boundary	2016/17 Authorised Limit	Complied
Borrowing	£185.55m	£230.00m	£240.00m	✓

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

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating 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.

	31.3.17 Actual	2016/17 Target	Complied
Portfolio average credit rating	AA-	A-	✓

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month without additional borrowing.

	31.3.17 Actual	2016/17 Target	Complied
Total cash available within 3 months	£26m	£15m	✓

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

	31.3.17 Actual	2016/17 Limit	Complied
Upper limit on fixed interest rate exposure on debt	82.86%	100%	✓
Upper limit on fixed interest rate exposure on investments	(71.43%)	(100%)	✓
Upper limit on variable interest rate exposure on debt	17.14%	25%	✓
Upper limit on variable interest rate exposure on investments	(28.57%)	(75%)	✓

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 Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

	31.3.17 Actual £m	Lower limit	Upper Limit	Complied
Under 12 months	0%	0%	100%	✓
12 months and within 24 months	0%	0%	100%	✓
24 months and within 5 years	0%	0%	100%	✓
5 years and within 10 years	0%	0%	100%	✓
10 years and above	100%	0%	100%	✓

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 Authority'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:

	2016/17	2017/18	2018/19
Actual principal invested beyond year end	£0m	£0m	£0m
Limit on principal invested beyond year end	£15m	£5m	£5m
Complied	✓	tbc	tbc