Subject: 2016/17 TREASURY MANAGEMENT OUTTURN REPORT

Report to: Policy and Resources (13 June 2017),
Full Council 13 July 2017

Report by: Finance Director (Section 151 Officer)

SUBJECT MATTER/RECOMMENDATIONS

This report presents the treasury management activity for the 2016/17 financial year and includes:

- The overall treasury position for 2016/17
- The borrowing requirement and debt for 2016/17
- The borrowing outturn for 2016/17.

Recommendations:

1. Members are asked to approve the Treasury Management outturn report and indicators for 2016/17.

1. Introduction

1.1 This 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.

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

1.3 The Authority's treasury management strategy for 2016/17 was approved at a meeting of the Authority on 24th 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.

1.4 This Authority tendered the Treasury Management Contract and appointed new treasury advisors Arlingclose Ltd on 12th May 2017.

2. External Context

2.1 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.

2.2 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.

2.3 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.

2.4 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.

2.5 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%.

2.6 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.

2.7 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.

2.8 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.

2.9 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.

2.10 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.

2.11 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. It should be noted that as part of its creditworthiness research and advice, the Authority's new treasury advisor Arlingclose also 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.

3. Local Context

3.1 On 31st March 2017, the Authority had net borrowing of £84.2m arising from its revenue and capital income and expenditure, a decrease on 2016 of £2.7m. During 2016/17 the Authority received interest totalling £0.119m for the General Fund, and paid interest of £3.2m, of which £2.6m was a charge to the Housing Revenue Account. 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 £000	2016/17 Movement £000	31.3.17 Actual £000
General Fund CFR	44,643	1,649	46,292
HRA CFR	77,551	1,703	78,867
Total CFR	**122,194**	**3,352**	**125,159**
Less: Other debt liabilities *	978	63	1,041
Borrowing CFR	**123,172**	**3,415**	**126,200**
Less: Usable reserves	22,911	1,514	24,425
Less: Working capital	5,333	8,902	13,848
Net borrowing	**94,928**	**(7,001)**	**87,927**

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

3.2 Net borrowing has decreased despite a rise in the CFR mainly due to a rise in the working capital due to the timing of receipts and payments and an increase in usable reserves.

3.3 The Authority's current strategy is to maintain borrowing and investments below their underlying levels (the average investment during 2016/17 was £13m), sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31st March 2017 and the year-on-year change in show in table 2 below.

Table 2: Treasury Management Summary

	31.3.16 Balance £000	**2016/17 Movement £000**	**31.3.17 Balance £000**	**31.3.17 Rate %**
Long-term borrowing	81,889	0	81,889	3.66%
Short-term borrowing	13,039	7,000	6,039	0.65%
Total borrowing	**94,928**	**7,000**	**87,928**	
Long-term investments	0	0	0	-
Short-term investments	0	0	0	-
Cash and cash equivalents	8,060	4,292	3,768	0.36%
Total investments	**8,060**	**4,292**	**3,768**	
Net borrowing	**86,868**	**2,708**	**84,160**	

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

3.4 The decrease in net borrowing in table 1 has translated into a fall in investment balances due to the Authority's internal borrowing policy.

4. Borrowing Activity

4.1 At 31st March 2017, the Authority held £87.9m of loans, a decrease of £7m on the previous year, as part of its strategy for funding previous years' capital programmes. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position

	31.3.16 Balance £000	2016/17 Movement £000	31.3.17 Balance £000	31.3.17 Rate %
Public Works Loan Board	74,389	3,001	7,1388	3.95%
Banks (LOBO)	10,000	-	3,000	4.95%
Banks (fixed-term)	500	-	7,500	4.15%
Local authorities (long-term)	0	-	0	-
Local authorities (short-term)	10,039	4,000	6,039	0.65%
Total borrowing	**94,928**	**7,001**	**87,927**	

4.2 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.

4.3 In furtherance of these objectives, and due to a deferral of £20m of 2016/17 capital expenditure into 2017/18, new borrowing was kept to a minimum in 2016/17, primarily temporary loans borrowed from the market, while some existing loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

4.4 The Authority continues to holds £3m 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 Authority has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during 2016/17. However, Barclays Bank informed the Authority that it had revoked its right to exercise their options in future, and £7m has therefore been reclassified as fixed rate bank loans. Table 3 above reflects this reclassification.

4.5 There were no debt rescheduling opportunities in the economic climate of very low gilt yields that has continued to prevail and following the increase in the margin added to gilt yields for new PWLB loans which has been the case since October 2010.

5. Investment Activity

5.1 The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2016/17, the Authority's investment balance ranged between £3 and £21 million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change in show in table 4 below.

Table 4: Investment Position

	31.3.16 Balance £000	2016/17 Movement £000	31.3.17 Balance £000	31.3.17 Rate %
Banks & building societies (unsecured)	3,000	15	2,985	0.15%
Money Market Funds	5,105	5,105	0	0.36%
Total investments	**8,105**	**5,120**	**2,985**	

5.2 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.

6. Compliance Report

6.1 The Director of Finance 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 Maximum	31.3.17 Actual	2016/17 Limit	Complied
Banks 1 higher quality AA	£4m	£0	£4m	✓
Banks 1 medium quality AA	£4m	£0	£4m	✓
Banks 1 lower quality A-	£3m	£3,000	£3m	✓
Banks 2 - part nationalised	£4m (per group)	£0	£4m (per group)	✓
Limit 3 councils banker not meeting bank 1	£3m	£0	£3m	✓
DMADF (DMO) AAA	Unlimited	£7,965	Unlimited	✓
Local authorities	£3m	£0	£3m	✓
Money Market Funds AAA	£3m per fund	£3,000	£3m per fund	✓
Enhance money market funds AAA	£3m per fund	£0	£3m per fund	✓

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

Table 8: Debt Limits

	2016/17 Maximum	2016/17 Revised	31.3.17 Actual	2016/17 Operational Boundary	2016/17 Operational Boundary Revised	2016/17 Authorised Limit	2016/17 Authorised Revised Limit	Complied
Borrowing	117,700	99,800	87,927	150,000	135,000	155,000	138,000	✓
PFI & finance leases	600	600	903	2,000	2,000	2,000	2,000	✓
Total debt	**118,300**	**100,400**	**88,830**	**152,000**	**137,000**	**157,000**	**140,000**	✓

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.

7. Treasury Management Indicators

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

7.2 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	A	A	✓

Appendix 1, Credit score analysis

7.3 Liquidity: The Authority maintains a bank overdraft of £0.250m and liquid short term deposits of at least £1m liquidity available within a week's notice.

	31.3.17 Actual 000	2016/17 Target 000	Complied
Bank Overdraft	1,881	250	X
Liquid short term deposits	2,985	1,000	✓

There were two breaches where the Authority exceeded the overdraft in 2016/17; £2.1m on 03/05/16 was a direct debit payment that was taken after the daily banking analysis, this did not incur any interest as the Bank was notified and cancelled the interest, and £0.318m on the 2nd August 2016 an error was made and the incorrect amount was redeemed both breaches were brought to the attention of the Group Manager for Resources and Governance.

7.4 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 the proportion of net principal borrowed was:

	31.3.17 Actual	**2016/17 Limit**	**Complied**
Upper limit on fixed interest rate exposure	(100%)	(100%)	✓
Upper limit on variable interest rate exposure	(100%)	(100%)	✓

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.

7.5 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 000	**Upper Limit**	**Lower Limit**	**Complied**
Under 12 months	6,039	20%	0%	✓
12 months and within 24 months	3,500	40%	0%	✓
24 months and within 5 years	0	60%	0%	✓
5 years and within 10 years	11,383	80%	0%	✓
10 years and above	67,000	100%	0%	✓

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

Appendix 1

Credit Score Analysis

Long-Term Credit Rating	**Score**
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
Not rated	8