



Audit Committee
22 September 2016

Report from the Chief Finance Officer

Wards Affected:
ALL

2016/17 Mid-Year Treasury Report

1. Summary

1.1 This report updates Members on recent treasury activity.

2. Recommendation

2.1 The Committee is asked to note the 2016/17 mid-year Treasury report, which is to be forwarded to the Cabinet and Council.

3. Detail

Background

3.1 The Council's Treasury Management Strategy is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

3.2 The Code also recommends that Members are informed of Treasury Management activities at least twice a year. This report therefore ensures this authority is embracing best practice in accordance with CIPFA's recommendations.

3.3 Treasury Management is defined as: "The management of the local authority's investments 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."

3.4 In addition to reporting on risk management, the Code requires the Authority to report on any financial instruments entered into to manage treasury risks.

Economic Background

- 3.5 Growth rates have slowed across most developed economies in the past six months, though growth in the US continues to be solid. However, the largest uncertainty in the marketplace in the UK continues to be the vote to leave the European Union.
- 3.6 After an initial shock, most indicators seem to have remained reasonably steady, but the uncertainty caused makes it very difficult to foresee the course of events. In particular, business investment is vulnerable to a changing international trade environment.
- 3.7 The weakness of the pound is also likely to be a source of inflationary pressure and this would normally indicate rising interest rates. However, the Bank of England is committed to keep interest rates low to support economic activity. There are likely to be higher levels of volatility in the market until the future of the UK's relations with its major trading partners are resolved. It is widely assumed that interest rates will be lower and inflation higher previously thought.
- 3.8 Gilt yields have been significantly affected by the vote and have fallen to unprecedentedly low levels. Current borrowing rates are positive and the Governor of the Bank of England has expressed reluctance to lower the base rate to or below zero. The table below illustrates the significant change caused by the vote.

PWLB Rates

| Period | March 2016 | August 2016 |
|---------|------------|-------------|
| 1 year | 1.3% | 1.1% |
| 5 year | 1.8% | 1.2% |
| 10 year | 2.5% | 1.6% |

- 3.9 The interest rate the Council receives on money market funds has fallen since the vote and 12 month maturities with local authorities have fallen from 0.6% to 0.4%.

Debt Management

- 3.10 The Authority continues to qualify for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate). This is reviewed on an annual basis and has been confirmed as applying until 31 October 2016.
- 3.11 Alternative sources of long term funding to long-dated PWLB borrowing are available, but the Council will continue to adopt a cautious and considered approach to funding from the capital markets. The affordability, simplicity and ease of dealing with the PWLB represents a strong advantage but the Council, due to its prudent policies and strong balance sheet, is in a position to consider alternatives, and will start to do so in order to finance the investment strategy. However, no long term loans have been raised so far this year as can be seen in the table below:

| | Balance on 01/04/2016 £m | Debt repaid* £m | New Borrowing £m | Balance on 31/08/2016 £m |
|----------------------|--------------------------------|-----------------------|------------------------|--------------------------------|
| Short Term Borrowing | 0.0 | 0.0 | 0.0 | 0.0 |
| Long Term Borrowing | 419.3 | 1.6 | 0.0 | 417.7 |
| TOTAL BORROWING | 419.3 | 1.6 | 0.0 | 417.7 |
| Average Rate % | 4.76 | 2.57 | | 4.79 |

* £34.2m of the PWLB loans are referred to as EIP, whereby the Councils pays down the loans in half-yearly equal installments over the lifetime of the loan.

- 3.12 Affordability remains an important influence on the Council's borrowing strategy. Moreover, any borrowing undertaken ahead of need would need to be invested in the money markets at rates of interest significantly lower than the cost of borrowing and involve credit risk. If interest rates seemed likely to rise in the short-term then this approach might need to be reviewed.
- 3.13 The use of internal resources in lieu of borrowing has continued to be the most cost effective means of funding capital expenditure. This has lowered overall treasury risk by reducing external debt and temporary investments. However this position will not be sustainable over the medium term and the Council will need to give careful consideration to its future capital programme and how this is financed. Borrowing options and the timing of such borrowing will continue to be assessed in conjunction with the Council's treasury advisor, Arlingclose.
- 3.14 The persistence of low interest rates means that it would be uneconomic to reschedule debt, because early retirement of the loan would incur a heavy penalty, to compensate the PWLB for having to lend the money on at lower rates.

Investment Activity

- 3.15 The Council gives priority to security and liquidity and aims to achieve a yield commensurate with these principles.

| | Balance on 01/04/2016 £m | Investments Made £m | Investments Repaid £m | Balance on 31/08/2016 £m |
|---------------------------|--------------------------------|---------------------------|-----------------------------|--------------------------------|
| Short Term Investments | 164.0 | 583.3 | 541.7 | 205.6 |

- 3.16 There was a £42m movement in short-term investments. This was partially due to an additional Housing Benefit payment of £18m at the end of last year that led to a dip in the cash balance. £186m was the average amount of cash held in 2015/16. The rest of the movement between March 31st and August 31st 2016 was due to a steady flow of capital receipts that will be used to fund the Council's capital programme and the timing of payments and receipts.
- 3.17 Security of capital has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2016/17. New investments were made with the following classes of institutions:

A- rated banks;
AAA rated Money Market Funds;
Other Local Authorities;
The UK Debt Management Office.

- 3.18 Counterparty credit quality was assessed and monitored with reference to Credit Ratings (the Council's minimum long-term counterparty rating of A- (or equivalent) across rating agencies Fitch, Standard & Poor's and Moody's); credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; sovereign support mechanisms; potential support from a well-resourced parent institution; share price. There were two foreign banks on our Lending List, both Swedish (and, therefore, outside the Eurozone), conservatively run and with good ratings and strong financial figures.
- 3.19 All investments in banks and Building Societies are now undertaken by means of marketable instruments (Certificates of Deposit, CDs). This adds a measure of additional liquidity without sacrificing return, given our maturity limits.

Budgeted Income and Outturn

- 3.20 The Council's external interest budget for the year is £23.3m, and for investment income is £1.4m. The Council is unlikely to achieve the income figure, but this is likely to be compensated for by lower borrowing costs than budgeted. The average cash balances, representing the Council's reserves and working balances, were £184m during the period to 31 August 2016.
- 3.21 The UK Bank Rate has been reduced to 0.25% on 4 August, 2016. Short-term money market rates have remained at very low levels and do not, at the moment, appear likely to rise.

Icelandic Bank Investment Update

- 3.22 The Council received £0.4m in August 2016, which means that only £0.2m of the original £10m deposit now remains outstanding. It is expected that a further distribution will be made but this depends on the result of litigation currently under way regarding a property investment.

LOBOs (Lender Option Borrower Options)

- 3.23 Barclays released its lender option rights to alter the rate of interest, at no cost to the Council, in order to comply with Basle III regulations, coming in 2019. This has meant that £15m of LOBOs became fixed interest rate loans. Arlingclose have advised us that it is likely that many of our other lenders may also give up these rights. This has reduced our level of Treasury Management risk.

Compliance With Prudential Indicators

- 3.24 Officers confirm that they have complied with its Prudential Indicators for 2016/17, which were set in February 2016 as part of the Council's Treasury Management Strategy Statement (TMSS). Details can be found in Appendix 1.

Outlook

- 3.25 At the time of writing this activity report in August 2016, economic growth remains slow worldwide, though seems well established in the US. The UK had performed comparatively well with growth led by consumer spending, and investment beginning to grow.

- 3.26 Productivity remains low, though is showing some signs of improvement. However, the prospects for the UK economy are now extremely difficult to forecast. The period of uncertainty following the referendum is likely to last for at least the two year period of notice. It will depend on what terms can be negotiated with the EU, but also with other nations and trading blocs. As a major trading partner, the EU will continue to have a significant influence on the UK economy, however, other countries are likely to develop in importance.

Summary

- 3.27 In compliance with the requirements of the CIPFA Code of Practice, this report provides Members with a summary report of the treasury management activity during the first half of 2016/17. As indicated in this report, none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

4. Financial Implications

These are covered in the report.

5. Diversity Implications

None.

6. Staffing Implications

None.

7. Legal Implications

There are no direct legal implications.

8. Background Papers

Annual Treasury Strategy – Report to Full Council as part of the Budget Report – February 2016.

Contact Officers

Persons wishing to discuss the above should contact Gareth Robinson, Head of Finance, Treasury and Pension Investments Section, Finance, on 020 8937 6567 at Brent Civic Centre.

CONRAD HALL
Chief Finance Officer

Appendix 1

Capital Financing Requirement

Estimates of the Council's cumulative maximum external borrowing requirement for 2016/17 to 2018/19 are shown in the table below (excluding Private Finance Initiative schemes):

| | 31/03/2016 Draft* £m | 31/03/2017 Estimate £m | 31/03/2018 Estimate £m | 31/03/2019 Estimate £m |
|-----|----------------------------|------------------------------|------------------------------|------------------------------|
| CFR | 579 | 577 | 567 | 567 |

*The accounts have not been signed off as of yet, therefore the Draft number remains.

Usable Reserves

Estimates of the Council's level of Usable Reserves for 2016/17 to 2018/19 are as follows:

| | 31/03/2016 Draft £m | 31/03/2017 Estimate £m | 31/03/2018 Estimate £m | 31/03/2019 Estimate £m |
|-----------------|---------------------------|------------------------------|------------------------------|------------------------------|
| Usable Reserves | 97 | 88 | 85 | 84 |

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Prudential Indicator Compliance

Authorised Limit and Operational Boundary for External Debt

The Local Government Act 2003 requires the Council to set an Authorised Borrowing Limit. This is a statutory limit which should not be breached. The Council's Authorised Borrowing Limit was set at £850m for 2016/17. The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit. The Operational Boundary for 2016/17 was set at £750m. The Chief Finance Officer confirms that there were no breaches to the Authorised Limit or the Operational Boundary so far this year; borrowing at its peak was £419m.

Upper Limits for Fixed Interest Rate and Variable Interest Rate Exposure

These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

| | Limits for 2016/17 | Maximum during 2016/17 |
|--|--------------------|------------------------|
| Upper Limit for Fixed Rate Exposure | 100% | 100% |
| Upper Limit for Variable Rate Exposure | 40% | 0% |

Maturity Structure of Fixed Rate Borrowing

This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

| Maturity Structure of Fixed Rate Borrowing | Upper Limit % | Lower Limit % | Actual Fixed Rate Borrowing as at 31/08/16 £m | % Fixed Rate Borrowing as at 31/08/16 | Compliance with Set Limits? |
|--|---------------|---------------|---|---------------------------------------|-----------------------------|
| Under 12 months | 40 | 0 | 44 | 10 | Yes |
| 12 months and within 24 months | 20 | 0 | 14 | 3 | Yes |
| 24 months and within 5 years | 20 | 0 | 52 | 13 | Yes |
| 5 years and within 10 years | 60 | 0 | 7 | 2 | Yes |
| 10 years and above | 100 | 0 | 301 | 72 | Yes |

Net Debt and the CFR

This is a key indicator of prudence. In order to ensure that over the medium term net borrowing will only be for a capital purpose, the Authority should ensure that the net external borrowing does not exceed the total of the CFR in the preceding year plus the estimates of any additional increases to the CFR for the current and next two financial years.

The Authority had no difficulty meeting this requirement so far in 2016/17, nor are there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

Total principal sums invested for periods longer than 364 days

This indicator allows the Council to manage the risk inherent in investments longer than 364 days.

The limit for 2016/17 was set at £20m.

The Council's practice since the onset of the credit crunch in 2007 has generally been to keep investment maturities to a maximum of 12 months. At 31 August, the last maturity date in the deposits portfolio was 20 March, 2017.

Credit Risk

This indicator has been incorporated to review the Council's approach to credit risk. The Council confirms it considers security, liquidity and yield, in that order, when making investment decisions.

Credit ratings remain an important element of assessing credit risk, but they are not the sole feature in the Authority's assessment of counterparty credit risk. The authority

considers the following tools to assess credit risk, with advice and support from our advisers, Arlingclose:

- Published credit ratings of the financial institution and its sovereign;
- Sovereign support mechanisms;
- Credit default swaps (where quoted);
- Share prices (where available);
- Economic fundamentals, such as a country's net debt as a percentage of its GDP;
- Corporate developments, news, articles, markets sentiment and momentum.

The Council can confirm that all investments were made in line with a minimum long term credit rating of A- or equivalent, as set in the 2016/17 TMSS.

HRA Limit on Indebtedness

This purpose of this indicator is for the Council to report on the level of the limit imposed at the time of implementation of self-financing by the Department for Communities and Local Government.

| HRA Limit on Indebtedness | 31/03/2016 Draft* £m | 31/03/2017 Estimate £m | 31/03/2018 Estimate £m | 31/03/2019 Estimate £m |
|-------------------------------------|----------------------------|------------------------------|------------------------------|------------------------------|
| HRA CFR | 137 | 137 | 137 | 137 |
| HRA Debt Cap (as prescribed by CLG) | 199 | 199 | 199 | 199 |
| Difference | 62 | 62 | 62 | 62 |

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