



Audit Advisory Committee
26 June 2017

Report from the Chief Finance Officer

For Information

Wards Affected: ALL

2016-17 Treasury Management Outturn Report

1. INTRODUCTION

- 1.1 This report updates members on Treasury Management activity and confirms that the Council has complied with its Prudential Indicators for 2016/17.

2. RECOMMENDATION

- 2.1 The Committee is asked to consider the 2016/17 Treasury Management outturn report, which will be presented to the Cabinet and Council, in compliance with CIPFA's Code of Practice on Treasury Management (the Code).

3. BACKGROUND

- 3.1 The Council's treasury management activity is underpinned by the Code, which requires authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year.
- 3.2 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Investment Guidance.
- 3.3 The Council has borrowed money over the long term to support investment in the Council's infrastructure and also invests balances held for short periods. It 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 central to the Council's treasury management strategy.

Economic background

- 3.4 The recovery in the UK continued with steady, though slowing, economic activity and growth. Q1 2017 GDP showed year-on-year growth of 2% but quarterly growth of 0.2%. The only positive light in Q1 was solid manufacturing growth. Consumer Price Index (CPI) has increased to 2.9% since then, and is expected to grow due to the weakness of the pound. This imported inflation is part of the reason why the economy's inflation rate is expected to exceed the Bank of England's target for the coming year. While employment is currently at a record level of 74.8% of the working age population, pay is stagnant and there are widespread political unease around inequality and the low productivity of the UK.
- 3.5 Recent political events have given rise to a very uncertain environment, and it is very difficult to forecast what effect this will have on the way the UK economy develops. Much will depend on the actions and reactions of a wide range of individuals and organisations which are impossible to foresee

Gilt Yields and Money Market Rates

- 3.6 Gilt yields (the rate of interest on UK government borrowing) rose in the first quarter of 2016/17 and then fell in over the rest of the year. 10 year yields ended the year at 1.3% and 20 years at 1.95%, both slightly lower than the at the start of the year.
- 3.7 Interest rates on short term inter-bank lending remained below 1% through the year.

The Borrowing Requirement and Debt Management

- 3.8 The table below summarises the Council's borrowing activity during 2016/17. The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31/03/2017 was estimated to be £580m.

	Balance 01/04/201 6 (£m)	New Borrowing (£m)	Borrowing Repaid (£m)	Balance 31/03/201 7 (£m)	Average Rate (%)	Average Life (Years)
CFR	58			58		
Short Term Borrowing	0	0	0	0	0	
Long Term Borrowing	41	0	4	41	4.79	35.2

- 3.9 At 1 April 2016 the Council had £419 million of long-term borrowing, to finance its previous years' capital programmes. With short-term interest rates being much lower than long-term rates, it was more cost effective in the short-term to use internal resources rather than undertake further long-term borrowing. By doing so, the Council has been able to reduce net borrowing costs and reduced overall treasury risk, because overall borrowing has been reduced slightly. No temporary borrowing was required during the year. The average rate of 4.79% was higher than last year's rate of 4.76% and this was due to the redemption of £4m of PWLB loans that are paid back steadily over their lifetime. To repay the Council's loans would involve paying a premium to compensate PWLB for their inability to relend the money at the rate at which they have financed the loan. For example, the Council's most expensive loan is £3.05m at a rate of 8.875%, to repay it would cost £0.935m, a 30% premium on the value of the loan before the cost of re-financing. In short, the cost of re-financing our loans under the Government's punitive approach means is not economical. This analysis might change if interest rates returned to historically normal levels.
- 3.10 The Treasury Management Strategy approved by the Council in February 2016 states that the Council will maintain borrowing at the lowest level consistent with prudent management of the Council's finances. This implies that, at present discount rates, we will not undertake premature repayment of debt but that, in conjunction with our Treasury Management advisers, Arlingclose, we will remain abreast of developments and be prepared to borrow up to the level of CFR if a significant permanent rate rise appears likely. These circumstances did not arise during the year.
- 3.11 The Authority has £80.5m exposure to LOBO loans (Lender's Option Borrower's Option) of which £40.0m of these can be "called" within 2017/18. £15m of these were transformed into regular fixed rate loans in 2016/17.
- 3.12 LOBOs are so-called because lenders can exercise their rights at set times to amend the interest rate on the loan. At that point, the Borrower can accept the revised terms or reject them and repay the loan without penalty. LOBO loans present a potential refinancing risk to the Authority since the decision to call a LOBO is entirely at the lender's discretion, which was intended to be compensated for by a lower interest rate being paid in exchange for which the interest rate is lower than would be paid to the PWLB. This risk is mitigated by the fact that the Council's current cash holdings mean that any repayment could be accommodated by reducing deposits in a relatively short time and that it would financially advantageous to do so at current interest rates.
- 3.13 Any LOBOs called will be discussed with Arlingclose prior to acceptance of any revised terms. The default position will be the repayment of the LOBO without penalty i.e. the revised terms will not be accepted. It is considered a significant possibility that some LOBOs may be called over the next few years due to the

need for the commercial banks to comply with Basle III regulations for banks in 2019.

- 3.14. There are complex arguments made about LOBOs, by their supporters and by their detractors. The Council's position is simply that the LOBOs are part of its portfolio, and must therefore be managed as effectively as possible. There are no plans to enter into further LOBO contracts. However, it should be noted that the average rate of interest being paid on LOBOs is little different to that on PWLB debt (4.75% compared to 4.71% at 31 March) and the range of rates lower. The most expensive LOBO was at 6.234% on 31 March, compared with the most expensive PWLB at 8.875%.
- 3.15 HM Treasury (HMT) consulted on its proposal to subsume the functions of the PWLB into the Treasury during the year and published its response to comments. HMT feel that its proposals take into account the comments made and intend to proceed to seek legislation to implement them. Brent is unlikely to be adversely affected by the proposals as they involve little practical change to present arrangements

Investment Activity

- 3.16 Both CIPFA and the CLG Investment Guidance require the Council to invest prudently and have regard to the security and liquidity of investments before seeking the optimum yield. The table below summarizes investment activity during 2016/17.

Investments	Balance on 01/04/2016 (£m)	Investments made (£m)	Investments repaid (£m)	Balance on 31/03/2017 (£m)	Average Rate (%)
Fixed Term Deposits	91	582	522	151	0
Marketable instruments	50	103	153	0	
Money Market Funds and notice deposits	23	601	608	16	0
TOTAL INVESTMENTS	164	1286	1283	167	0

- 3.17 Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2016/17 which defined "high credit quality organisations" as those having a long-term credit rating of A- or higher that are domiciled in the UK or overseas where the sovereign rating is AA+ or higher.
- 3.18 The growth of bail-in risk gave rise to the decision to restrict the maximum maturity with market financial institutions to three months and use only marketable instruments issued by them. Bail-in means that long-term loans in financial institutions are converted into equity (shares) that are not easily convertible for many years, preventing Brent from accessing the resources, and potentially giving them a hefty cut in their value.
- 3.19 New investments with banks and Building Societies have been undertaken by means of marketable instruments and the Treasury bill market has also been used. Treasury bills have largely replaced the use of the UK Debt Management Office (the Bank of England's temporary borrowing team, who are effectively a deposit taker of last resort, borrowing at 0.1%) which has been used on rare occasions to invest large receipts at short notice. The risk of bail in has recently declined for many UK institutions, but investment decisions still need to be made on a case by case basis.

Credit developments and credit risk management

- 3.20 The Council assessed and monitored counterparty credit quality with reference to credit ratings, credit default swaps (a means of insuring loans), perceived credit-worthiness of the country in which the institution is registered and its share price. The minimum long-term counterparty credit rating determined by the Council for the 2016/17 treasury strategy was A- across rating agencies Fitch, S&P and Moody's. The mechanism for dealing with a failed bank, which was brought into effect through the Financial Services (Banking Reform) Act 2013, is now in operation. The Council continues to monitor risks, with advice from Arlingclose. The Council did not make any deposits with institutions in the Eurozone during the year.

Liquidity Management

- 3.21 Combining changes to the regulatory environment and our adoption of a mainly three month lending limit, investments with financial institutions are now normally by means of purchasing 3 month Certificates of Deposit (CDs). Longer maturities with less unattractive rates can be obtained from Local Authorities, though these will depend on being able to satisfy demand when it arises. At peak periods, mindful of the primacy of security as a criterion for decision making, substantial balances may be held in short term investments, particularly Money Market Funds. The use of short term borrowing at times of

lower cash balances is judged to maintain a prudent balance between maintaining security and liquidity and achieving a reasonable yield on investments, though this was only required for one week in 2016-17.

Yield

- 3.22 The UK Bank Rate dropped to 0.25% during the year. Short term money market rates also remained at low levels which continued to have a significant impact on investment income. The average 3-month LIBID rate during 2016/17 was 0.47%, the 6-month LIBID rate averaged 0.60% and the 1-year LIBID rate averaged 0.79%. The low rates of return on the Council's short-dated money market investments reflect prevailing market conditions and the Council's objective of optimising returns commensurate with the principles of security and liquidity.
- 3.23 The Council's budgeted investment income for the year had been estimated at £0.7m. The average cash balance during the year was £199m during the period and interest earned was £1.0m, an average return of .52%. The interest earned in 2015/16 was £0.9m on an average cash balance of £186m or 0.45%

Update on Investments with Icelandic Banks

- 3.24 The Council has now recovered 98% of its £10 million deposit with Heritable Bank. The administrators have not made any further estimate of final recoveries yet, though a further distribution is expected, subject to the outcome of a legal case.

Compliance

- 3.25 The Council confirms that it has complied with its Prudential Indicators for 2016/17, which were approved by the Council on 22 February 2016 as part of the Council's Treasury Management Strategy Statement.
- 3.26 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 2016/17. 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. Further information is set out in Appendix 2.

Investment Training

- 3.27 The needs of the Council's treasury management staff for training in investment management are kept under review and considered as part of the staff

appraisal process, and additionally when the responsibilities of individual members of staff change.

- 3.28 During 2016/17 staff attended training courses, seminars and conferences provided by Arlingclose and CIPFA and opportunities which may arise with other organisations are considered.

4. FINANCIAL IMPLICATIONS

- 4.1 Already noted within the report as this is the Treasury Management Outturn Report.

5. LEGAL IMPLICATIONS

- 5.1 None identified.

6. DIVERSITY IMPLICATIONS

- 6.1 None identified.

7. STAFFING IMPLICATIONS

- 7.1 None identified.

8. BACKGROUND INFORMATION

Treasury Management Strategy Report to Council – 22 February 2016
2016/17 Mid-Year Treasury Report to Council – 21 November 2016

9. CONTACT OFFICERS

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Appendix 1 - Debt and Investment Portfolio Position 31/3/2017

	31/3/2017 Actual Portfolio £m	31/3/2017 Average Rate %
External Borrowing:		
PWLB – Maturity	288	5.0
PWLB – Equal Instalments of Premium		
Fixed Rate Market Loans	32	2.6
LOBO Loans	15	4.3
Total External Borrowing	80	5.1
	415	4.8
Other Long Term Liabilities:		
PFI	30	9.5
Total Gross External Debt	445	5.0
Investments:		
Deposits	151	0.4
Money Market Funds	16	0.3
Total Investments	167	0.4
Net Debt	278	7.9

Appendix 2 – Prudential Indicators

(a) Capital Financing Requirement (CFR)

The Council's cumulative maximum external borrowing requirement for 2016/17 is shown in the table below:

Capital Financing Requirement	31/03/2017 Estimate £m	31/03/2017 Actual* £m
General Fund	459	439
HRA	137	141
Total CFR	596	580

*Uses provisional estimates from Draft Statement of Accounts

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of 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 is a key indicator of prudence.

Debt	31/03/2017 Estimate £m	31/03/2017 Actual £m
Borrowing	415	415
PFI liabilities	30	30
Total Debt	445	445
Borrowing in excess of CFR?	No	No

(b) Authorised Limit and Operational Boundary for External Debt

The Operational Boundary for External Debt is based on the Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt. It links directly to the Council's estimates of capital expenditure, the capital financing requirement and cash flow requirements and is a key management tool for in-year monitoring. Other

long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Council's debt.

The Authorised Limit for External Debt is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

The Director of Finance confirms that there were no breaches to the Authorised Limit and the Operational Boundary during 2016/17.

	Operational Boundary (Approved)	Authorised Limit (Approved)	Actual External Debt 31/03/2017
Borrowing			415
Other Long-term Liabilities			30
Total	750	850	445

(c) Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

This indicator is set to control the Council'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.

	Approved Limits for 2016/17 Proportion %	Maximum during 2016/17 Proportion %
Upper Limit for Fixed Rate Exposure	100	100
Compliance with Limits:	Yes	Yes
Upper Limit for Variable Rate Exposure	40	0
Compliance with Limits:	Yes	Yes

(d) 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 at 31/03/2017 £m	% Fixed Rate Borrowing at 31/03/2017	Compliance with Set Limits?
under 12 months	40	0	39	9	Yes
12 months and within 24 months	20	0	4	1	Yes
24 months and within 5 years	20	0	65	16	Yes
5 years and within 10 years	60	0	5	1	Yes
10 years and within 20 years	100	0	25	6	Yes
20 years and within 30 years	100	0	1	0	Yes
30 years and within 40 years	100	0	235	57	Yes
40 years and within 50 years	100	0	36	9	Yes
50 years and above	100	0	5	1	Yes

(e) Capital Expenditure

This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council tax and in the case of the HRA, housing rent levels.

Capital Expenditure	31/03/2017 Estimate £m	31/03/2017 Actual £m
Non-HRA	162.4	46.7
HRA	60.7	54.0
Total	223.1	100.7

(f) Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	31/03/2017 Estimate %	31/03/2017 Actual %
Non-HRA	7.97	7.16
HRA*	12.80	12.16
Total	8.76	8.04

(g) Adoption of the CIPFA Treasury Management Code

This indicator demonstrates that the Council adopted the principles of best practice.

The Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* in February 2013

(h) Upper Limit for Total Principal Sums Invested Over 364 Days

The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested.

	31/03/2017 Approved £m	31/03/2017 Actual £m
	20	0

(i) HRA Limit on Indebtedness

HRA Debt Cap (as prescribed by CLG)	£199m	
	31/03/2017 Estimate £m	31/03/2017 Actual £m
HRA CFR	137	141*

*Provisional Based on Draft Accounts