

Treasury Management Outturn Report 2016/17

Introduction

In March 2012 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.

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

The Authority's treasury management strategy for 2016/17 was approved at a meeting of the Authority on 2 March 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.

Local Context

On 31st March 2017, the Authority had net borrowing / investments of £25m arising from its revenue and capital income and expenditure, an increase on 2016 of £14m. 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	11,685	0	11,685
HRA CFR	78,358	2,081	76,277
Total CFR	90,043	2,081	87,962
Less: Usable reserves	(46,010)	10,918	(56,928)
Less: Working capital	(4,920)	801	(5,721)
Net borrowing	39,113	13,800	25,313

Net borrowing has decreased due to a fall in the CFR as new capital expenditure was lower than the financing; together with an increase in usable reserves, especially due to £17m in the capital receipt reserve; and a rise in working capital due to the timing of receipts and payments.

The Authority's current strategy is to maintain borrowing and investments below their underlying levels, 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	87,669	(2,154)	85,515	3.39
Short-term borrowing	2,086	4,068	6,154	0.40
Total borrowing	89,755	1,914	91,669	
Short-term investments	34,452	21,252	55,704	0.50
Cash and cash equivalents	16,190	(5,538)	10,652	0.50
Total investments	50,642	15,714	66,356	
Net borrowing	(39,113)	13,800	(25,313)	

The decrease in net borrowing in table 1 has translated into a rise in investment balances due to the Authority's internal borrowing policy. The increase in investment balances is mainly due to a capital receipt of £7.6m received in March 2017.

Borrowing Activity

At 31st March 2017, the Authority held £92m of loans, an increase of £2m 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	86,756	(2,087)	84,669	3.39
Banks (LOBO)	3,000	0	3,000	4.75
Banks (fixed-term)	0	0	0	
Local authorities (long-term)	0	0	0	
Local authorities (short-term)	0	4,000	4,000	0.40
Total borrowing	89,756	1,913	91,669	

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.

The Authority continues to hold £3m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at 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.

Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2016/17, the Authority's investment balance ranged between £55.7 and £66.7 million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change is shown 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)	39,182	12,737	51,919	0.48
Covered bonds (secured)	0	0	0	
Government (incl. local authorities)	1,910	3,000	4,910	0.85
Corporate bonds and loans	0	0	0	
Money Market Funds	9,550	(23)	9,527	0.32
Other Pooled Funds	0	0	0	
Total investments	50,642	15,714	66,356	

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 is looking to further diversify into more secure and/or higher yielding asset classes during 2017/18. The progression of risk and return metrics are shown in the extracts from Arlingclose’s quarterly investment benchmarking in table 5 below. The potential benefits of future diversification can be seen by comparison to other local authorities (LAs) below.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2016	4.22	AA-	66%	53	0.71%
30.06.2016	4.21	AA-	64%	57	0.69%
30.09.2016	4.30	AA-	66%	54	0.60%
31.12.2016	4.33	AA-	64%	50	0.52%
31.03.2017	4.30	AA-	60%	47	0.61%
Similar LAs	4.18	AA-	58%	137	1.68%
All LAs	4.30	AA-	60%	47	1.14%

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)	Actual %	Benchmark %	Over/ (under)
Interest received	342	329	13	0.50	0.32	0.18
Interest payable	3,021	3,020	1	3.39	3.39	0

Compliance Report

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, with the minor exception of £9.5m being held in the Standard Life Investments Money Market Fund for two full days only, following a capital receipt from the sale of land at Aylesham (29th - 31st March 2017). 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
Operating Bank (NatWest)	£14.3m	£1.1m	£20m	✓
Unsecured investments with other UK banks	£8m	£8m	£8m	✓
Investments held in a broker's nominee account	£8m	£1.9m	£8m	✓
Unsecured investments with Building Societies	£8m	£5m	£8m	✓
Money Market Funds	£9.5m	£8m	£8m	*
Individual Local Authorities	£3m	£3m	100%	✓

* exceeded for two days only, as previously described, otherwise £8m or less with any MMF at any time.

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

Table 8: Debt Limits

	2016/17 Maximum £000	31.3.17 Actual £000	2016/17 Operational Boundary £000	2016/17 Authorised Limit £000	Complied
Borrowing	92,000	91,913	333,000	338,500	✓
Total debt	92,000	91,913	333,000	338,500	✓

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. Total debt was above the operational boundary for 0 days during 2016/17.

Treasury Management Indicators

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

Security: For 2016/17 our approved creditworthiness policy was to follow the Capita Asset Services creditworthiness service using credit ratings from the three main credit rating agencies (Fitch, Moody's and Standard and Poor's), overlaid with credit default swap spreads, sovereign ratings for countries, and other data, as laid out in the 2016/17 TMSS. The policy was complied with throughout the year.

Liquidity: The Authority seeks to maintain a bank overdraft facility of £0.5m and to maintain liquid short term deposits of at least £1m available with a week’s notice. This minimum was maintained, including by borrowing £4m from another local authority from 22nd March 2017 to 21st April 2017 to meet expected payments. The receipt of £7.6m from the sale of land at Aylesham on 29th March 2017 meant that funds were, in fact, higher than expected.

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 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	0%	30%	✓

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 £000	Upper Limit	Lower Limit	Complied
Under 12 months	9,729	50%	0	✓
12 months and within 24 months	3,373	50%	0	✓
24 months and within 5 years	7,243	50%	0	✓
5 years and within 10 years	13,695	100%	0	✓
10 years and above	61,282	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.