This report will be made public on 11 July 2017

Folkestone
Hythe & Romney Marsh
Shepway District Council
www.shepway.gov.uk

Report Number **C/17/22**

To:	**Cabinet**
Date:	**19 July 2017**
Status:	**Non-Key Decision**
Head of Service:	**Pat Main, Interim Head of Finance**
Cabinet Member:	**Councillor Malcom Dearden, Finance**

SUBJECT: **TREASURY MANAGEMENT ANNUAL REPORT 2016/17**

SUMMARY: This report reviews the council's treasury management activities for 2016/17, including the actual treasury management indicators. The report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

REASONS FOR RECOMMENDATION:
Cabinet is asked to agree the recommendations set out below because:-

a) Both CIPFA's Code of Practice on Treasury Management in the Public Services and their Prudential Code for Capital Finance in Local Authorities, together with the Council's Financial Procedure Rules, require that an annual report on treasury management is received by the Council after the close of the financial year.

RECOMMENDATION:
1. To receive and note Report C/17/22.

1. INTRODUCTION

1.1 The annual treasury report is a requirement of the council's reporting procedures. It covers the treasury activity for 2016/17 compared to the approved strategy for the year. It also summarises the actual treasury management indicators for 2016/17 compared to those approved by Full Council.

1.2 The report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

1.3 Full Council approved the original Treasury Management Strategy for 2016/17 on 18 February 2016 (Report A/15/22 refers). On 19 October 2016 Cabinet received an update on the council's treasury management activities and projections against the approved treasury management indicators for 2016/17 (Report C/16/60 refers).

1.4 The council's formal treasury management reporting arrangements comply with the requirements of the CIPFA's Treasury Management Code and also provide the opportunity for proper scrutiny of the council's treasury management activities.

2. ECONOMIC COMMENTARY

(Commentary supplied by Arlingclose Ltd, the council's Treasury Advisor)

2.1. Economic Background

2.1.1 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.

2.1.2 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.

2.1.3 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.

2.1.4 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.

2.1.5 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%.

2.2 Financial Markets

2.2.1 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.

2.2.2 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.

2.2.3 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.

2.3 Credit Background

2.3.1 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.

2.3.2 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.

2.3.3 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.

3. TREASURY POSITION AT 31 MARCH 2017

3.1 On 31 March 2017, the Authority had net borrowing of £25.2m arising from its revenue and capital income and expenditure, a decrease on 2016 of £3.2m. 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	17.8	0.7	18.5
HRA CFR	47.4	-	47.4
Total CFR	**65.2**	**0.7**	**65.9**
Less: Usable reserves	(32.5)	(4.7)	(37.2)
Less: Working capital	(4.3)	0.8	(3.5)
Net borrowing	**28.4**	**(3.2)**	**25.2**

3.2 Net borrowing has decreased mainly due to an increase in usable reserves resulting from delays to the HRA capital programme. This has increased the balances to for the HRA General Reserve and the Major Repairs Reserve.

3.3 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 31 March 2017 and the year-on-year change in show in table 2 below.

Table 2: Treasury Management Summary

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m
Long-term borrowing	59.5	(1.7)	57.8
Short-term borrowing	0.6	1.1	1.7
Total borrowing	**60.1**	**(0.6)**	**59.5**
Long-term investments	(16.3)	9.4	(6.9)
Short-term investments	(14.5)	(8.0)	(22.5)
Cash and cash equivalents	(0.9)	(4.0)	(4.9)
Total investments	**(31.7)**	**(2.6)**	**(34.3)**
Net borrowing	**28.4**	**(3.2)**	**25.2**

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 is mainly due to the reprofiling of the Authority's capital expenditure programme between 2016/17 and 2017/18. As the table above shows, there has been a movement in investment funds from long term to short term. There are two main reasons for this switch. Firstly it ensures sufficient cash will be available to meet the Authority's planned expenditure in 2017/18. Secondly it reflects a strengthening of the Authority's investment counterparty criteria by using shorter durations, in particular with regards to the 'bail-in' requirements on banks and building societies.

4. BORROWING ACTIVITY 2016/17

4.1 At 31 March 2017, the Authority held £59.5m of loans, a small reduction of £0.6m on the previous year, as part of its strategy for funding previous years' capital programmes. Following the introduction of the Housing Revenue Account (HRA) Self-Financing regime in 2012 the Authority operates a two pool debt approach allocating its loans between the General Fund and HRA. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position – Two Pool Debt Approach

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %
General Fund				
Public Works Loan Board	8.4	-	8.4	5.56%
Local authorities (long-term)	0.5	-	0.5	2.32%
Local authorities (short-term)	0.6	(0.6)	-	-
Total General Fund borrowing	9.5	(0.6)	8.9	5.37%
Housing Revenue Account				
Public Works Loan Board	50.6	-	50.6	3.44%
Total HRA borrowing	50.6	-	50.6	3.44%
Total borrowing	**60.1**	**(0.6)**	**59.5**	**3.73%**

4.2 The weighted average maturity of the overall loans portfolio at 31 March 2017 is 14.4 years.

4.3 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.

4.4 In furtherance of these objectives no new borrowing was undertaken in 2016/17, while existing loans were allowed to mature without replacement. As outlined in section 3 of this report, the Authority’s CFR exceeded its gross borrowing position by £6.4m at 31 March 2017, i.e. it used internal borrowing from its cash surpluses to meet this difference. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

4.5 The “cost of carry” analysis performed by the Authority’s treasury management advisor Arlingclose did not indicate any value in borrowing in advance for future years’ planned expenditure and therefore none was taken.

4.6 **Debt Rescheduling** – Opportunities to undertake debt rescheduling were monitored throughout the year in conjunction with Arlingclose. However, as expected, PWLB interest rates did not reach a level where it would have been beneficial to undertake debt rescheduling to create a net saving in borrowing costs.

4.7 Temporary Borrowing

4.7.1 The Authority can borrow temporarily at times to meet cash outflows not covered by receipts and to finance capital expenditure which will ultimately be met from long term loans or grant receipts due. During 2016/17 the only activity was to repay a series of relatively small loans totalling £0.6m to Folkestone Town Council.

5. INVESTMENT ACTIVITY 2016/17

5.1 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 £33.4 and £54.1 million due to timing differences between income and expenditure. The Authority had an average investment balance of £42.9m during 2016/17 generating a return of 1.25% over the year. The year-end investment position and the year-on-year change in show in table 4 below. A list of the individual investments held at 31 March 2017 is shown in appendix 1 to this report.

Table 4: Investment Position

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m
Banks & building societies (unsecured)	12.5	0.5	13.0
Covered bonds (secured)	-	3.3	3.3
Government (incl. local authorities)	13.0	(5.0)	8.0
Money Market Funds	0.8	4.0	4.8
Other Pooled Funds	5.3	(0.1)	5.2
Total investments	**31.6**	**2.7**	**34.3**

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.

5.3 These objectives have been broadly met during the year. Although the level of unsecured lending to banks and building societies has risen by £0.5m over the year it should be noted that the duration around these investments has been reduced thereby reducing the risk of default over the longer term.

At the same time the Authority has started to diversify into more secure investment classes such as covered bonds.

5.4 The progression of 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)	Income Return
Shepway					
30.06.2016	3.98%	AA-	48%	200	1.39%
30.09.2016	4.41%	AA-	64%	168	1.26%
31.12.2016	4.29%	AA-	61%	107	1.18%
31.03.2017	4.36%	AA-	61%	141	1.35%
Shepway average	**4.26%**	**AA-**	**59%**	**154**	**1.30%**
Similar LAs	**4.27%**	**AA-**	**65%**	**133**	**1.17%**
All LAs	**4.28%**	**AA-**	**63%**	**53**	**0.92%**

5.5 The investment benchmarking, which is a snapshot at the end of each quarter, demonstrates the Authority had a similar risk profile as both its peer group and the wider local authority population in 2016/17 (measured against other Arlingclose clients only) and, pleasingly, achieved a higher income return than both.

5.6 The Authority's best performing investment in 2016/17 was its £5.2m externally managed pooled property fund. The CCLA Local Authorities' Property Fund generated a total net return of £241k or 4.6% compared to the average value of the fund during the year. The capital value of the Authority's investment in the fund fell by £82k over the year partly reversing previous gains of £269k. The reduction reflected a small anticipated downturn in commercial property values during the year. Because this fund has no defined maturity date, but is available for withdrawal after a notice period, its performance and continued suitability in meeting the Authority's investment objectives is regularly reviewed. In light of the fund's continued impressive income return and the Authority's latest cash flow forecasts, investment in this fund has been maintained for the year.

6. FINANCIAL SUMMARY

6.1 The following table summarises the council's net interest cost for its treasury management activities in 2016/17 and shows the outturn is in line with the approved estimate:

	2015/16 Actual	2016/17 Latest Estimate	**2016/17 Actual**	**2016/17 Variance Estimate to Actual**
	£'000	£'000	**£'000**	**£'000**
Interest Paid	*2,232*	2,220	**2,217**	**(3)**
Interest Received	*(543)*	(538)	**(536)**	**2**
Net Interest	*1,689*	1,682	**1,681**	**(1)**
<u>Net Impact</u>				
General Fund	*22*	50	**35**	**(15)**
H.R.A	*1,667*	1,632	**1,646**	**14**
	1,689	1,682	**1,681**	**(1)**

*It should be noted that the interest paid and received on treasury management activities features as part of the Financing and Investment Income disclosed in the Authority's draft Statement of Accounts for 2016-17.

7. COMPLIANCE WITH INVESTMENT LIMITS AND TREASURY INDICATORS

7.1 The Corporate Director for Organisational Change 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 and borrowing limits and Treasury Indicators is demonstrated in appendix 2 to this report.

8. LEGAL/FINANCIAL AND OTHER CONTROLS/POLICY MATTERS

8.1 Legal Officer's Comments (DK)
There are no legal implications arising directly out of this report other than those clearly stated in the report itself.

8.2 Finance Officer's Comments (LW)
This report has been prepared by Financial Services and relevant financial implications are included within it.

8.3 Diversities and Equalities Implications
The report does not cover a new service or policy or a revision of either and therefore does not require an Equality Impact Assessment.

9. CONTACT OFFICER AND BACKGROUND DOCUMENTS

Councillors with any questions arising out of this report should contact the following officer prior to the meeting:

Lee Walker, Group Accountant (Capital and Treasury Management)
Telephone: 01303 853593 Email: lee.walker@shepway.gov.uk

The following background documents have been relied upon in the preparation of this report:

Arlingclose Ltd – Model Treasury Management Annual Report Template

Appendices:
Appendix 1 – Investments held at 31 March 2017
Appendix 2 – Compliance with specific investment and borrowing limits and Treasury Indicators

APPENDIX 1 – INVESTMENTS HELD AT 31 MARCH 2017

Counterparty	Amount £	Terms	Interest Rate %
Banks and Building Societies (unsecured)			
Lloyds	2,000,000	1 Year Fixed to 06/07/2017	1.05
Royal Bank of Scotland	3,001,748	1 Year Certificate of Deposit to 12/05/2017	1.48
Santander	2,500,000	60 Day Notice Account to 09/06/17	0.50
Santander	2,500,000	60 Day Notice Account to 09/06/17	0.50
Lloyds	3,000,000	1 Year Fixed to 06/07/2017	0.90
Covered Bonds (Secured)			
Nationwide Building Society	1,001,908	Covered Floating Rate Note to 17/07/17	0.43
Nationwide Building Society	510,855	Covered Floating Rate Note to 17/07/17	0.53
Yorkshire Building Society	1,740,167	Covered Fixed Rate Bond to 12/04/2018	0.57
Government			
Peterborough City Council	3,000,000	2 Year Fixed Deposit to 29/09/17	0.92
Lancashire County Council	5,000,000	2 Year Fixed Deposit to 29/09/17	1.00
Money Market Funds			
Standard Life MMF	509,000	Money Market Fund instant access.	0.28
BNP Paribas MMF	4,341,000	Money Market Fund instant access.	0.30
Other Pooled Funds			
CCLA Property Fund	5,187,015	Commercial Property Fund	*4.60
Total Investments	**34,291,693**		
* Net of Fees			

APPENDIX 2 – COMPLIANCE WITH SPECIFIC INVESTMENT AND BORROWING LIMITS AND TREASURY INDICATORS

Compliance with specific investment limits is demonstrated in table 1 below.

Table 1: Specific Investment Limits

	2016/17 Maximum	31.3.17 Actual	2016/17 Limit	Complied
Any single UK organisation, except UK Government	£5m	£5m	£5m	✓
Any single non-UK organisation	£4m	-	£4m	✓
Individual foreign countries	£4m	-	£4m	✓
Foreign countries (maximum all non-UK investments)	£7m	-	£8m	✓
Any group of funds under the same management - UK	£5m	£5m	£5m	✓
Any group of funds under the same management – non-UK	-	-	£4m	✓
Non-specified investments	£16.2m	£6.9m	£17m	✓

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 2 below.

Table 2: Debt Limits

£m	2016/17 Maximum	31.3.17 Actual	2016/17 Operational Boundary	2016/17 Authorised Limit	Complied
Borrowing	60.1	59.5	64.0	66.5	✓
PFI & finance leases			-	-	✓
Total debt	**60.1**	**59.5**	**64.0**	**66.5**	✓

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. The total debt was not above the operational boundary during 2016/17.

<u>Treasury Management Indicators</u>

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

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. Compliance with the upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of interest payable and receivable is shown in table 3 below:

Table 3: Interest Rate Exposures

	31.3.17 Actual	2016/17 Limit	Complied
Upper limit on fixed interest rate exposure: Debt Investments	 99.9% 39.1%	 100% 100%	 ✓ ✓
Upper limit on variable interest rate exposure: Debt Investments	 0.1% 60.9%	 20% 80%	 ✓ ✓

Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. Compliance with the upper and lower limits on the maturity structure of fixed rate borrowing is shown in table 4 below:

Table 4: Maturity Structure of Borrowing

	31.3.17 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	2.9%	30%	0%	✓
12 months and within 24 months	3.2%	40%	0%	✓
24 months and within 5 years	6.2%	50%	0%	✓
5 years and within 10 years	35.3%	80%	0%	✓
10 years to 20 years	18.0%	100%	0%	✓
20 years to 30 years	6.1%	100%	0%	✓
30 years to 40 years	7.0%	100%	0%	✓
40 years to 50 Years	0%	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.

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. Compliance with the limits on the long-term principal sum invested to final maturities beyond the period end is shown in table 5 below:

Table 5: Principal Sums Invested for Periods Longer than 364 days

At 31.3.17	**2016/17**	**2017/18**	**2018/19**
Actual principal invested for longer than 364 days	£1.8m	-	-
Limit on principal invested beyond 364 days	£17m	£17m	£17m
Complied	✓	✓	✓