Annual Treasury Management Review 2016/17

Purpose

This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2016/17. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

During 2016/17 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 12/02/2016)
- a mid-year (minimum) treasury update report (Council 12/12/2016)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Treasury Management Panel before they were reported to the full Council.

Executive Summary

During 2016/17, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	2015/16 Actual £000	2016/17 Budget £000	2016/17 Actual £000
Capital expenditure			
• **General Fund**	17,897	2,930	2,224
• **HRA**	6,949	11,538	11,255
• **TOTAL**	**24,846**	**14,468**	**13,479**
Capital Financing Requirement:			
• **General Fund**	40,666	38,910	39,310
• **HRA**	44,750	44,750	44,750
• **TOTAL**	**85,416**	**83,660**	**84,060**
Gross borrowing	**80,795**	**74,833**	**77,758**

Prudential and treasury indicators	2015/16 Actual £000	2016/17 Budget £000	2016/17 Actual £000
External debt	**65,360**	**64,830**	**64,830**
Investments • Longer than 1 year • Under 1 year • Total	 505 20,037 **20,542**	 435 16,885 **17,320**	 1,435 20,377 **21,812**
Net Borrowing	**60,253**	**57,513**	**55,946**

Other prudential and treasury indicators are to be found in Appendix 1 of this report. The Section 151 Officer (S151) also confirms that statutory borrowing limit (the authorised limit) was not breached at any time.

The financial year 2016/17 continued the challenging investment environment of previous years, namely low investment returns.

Recommendations

The Council is recommended to:

1. Approve the actual 2016/17 prudential and treasury indicators in this report
2. Note the annual treasury management report for 2016/17

Introduction and Background

This report summarises the following:-

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed investment activity.

1. The Council's Capital Expenditure and Financing 2016/17

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

£m General Fund/HRA	2015/16 Actual £000	2016/17 Budget £000	2016/17 Actual £000
Capital expenditure			
Financed in year	24,846	14,468	13,479
Unfinanced capital expenditure	**0**	**0**	**0**

2. The Council's Overall Borrowing Need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2016/17 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements.

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2017/18) plus the estimates of any additional capital financing requirement for the current (2016/17) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to either borrow in advance of its immediate capital needs in 2016/17 or reduce its investments. The table below highlights the Council's gross borrowing position against the CFR.

	31 March 2016 Actual	31 March 2017 Budget	31 March 2017 Actual
Gross borrowing position	£80.795m	£74.833m	£77.758m
CFR	£85.416m	£83.660m	£84.060m

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2016/17 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2016/17
Authorised limit	£117m
Operational boundary	£107m
Average gross borrowing position	£67.446m
Financing costs as a proportion of net revenue stream	6.26%

3. Treasury Position as at 31 March 2017

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established through member reporting detailed in the summary. At the beginning and the end of 2016/17 the Council's treasury position was as follows:

TABLE 1	31 March 2016 Principal	Rate/Return	31 March 2017 Principal	Rate/Return
Fixed rate funding:				
-PWLB	£49.46m	3.66%	£48.93m	3.66%
-Market	£15.90m	4.00%	£15.90m	4.00%
-Temporary	-	-	-	-
Total debt	£65.36m	3.74%	£64.83m	3.74%
CFR	£85.42m		£84.06m	
Over / (under) borrowing	(£20.06m)		(£19.23)m	
Investments:				
- in house	£20.54m	0.65%	£21.81m	0.65%

4. The Strategy for 2016/17

The expectation for interest rates within the treasury management strategy for 2016/17 anticipated low but rising Bank Rate, (starting in quarter 1 of 2017), and gradual rises in medium and longer term fixed borrowing rates during 2016/17. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

During the year there was major volatility in PWLB rates with rates falling during quarters 1 and 2 to reach historically very low levels in July and August, before rising significantly during quarter 3, and then partially easing back towards the end of the year.

5. The Economy and Interest Rates

The two major landmark events that had a significant influence on financial markets in the 2016-17 financial year was the UK EU referendum on 23 June and the election of President Trump in the USA on 9 November. The first event had an immediate impact in terms of market expectations of when the first increase in Bank Rate would happen, pushing it back from quarter 3 2018 to quarter 4 2019. At its 4 August meeting, the Monetary Policy Committee (MPC) cut Bank Rate from 0.5% to 0.25% and the Bank of England's Inflation Report produced forecasts warning of a major shock to economic activity in the UK, which would cause economic growth to fall almost to zero in the second half of 2016. The MPC also warned that it would be considering cutting Bank Rate again towards the end of 2016 in order to support growth. In addition, it restarted quantitative easing with purchases of £60bn of gilts and £10bn of corporate bonds, and also introduced the Term Funding Scheme whereby potentially £100bn of cheap financing was made available to banks.

In the second half of 2016, the UK economy confounded the Bank's pessimistic forecasts of August. After a disappointing quarter 1 of only +0.2% GDP growth, the three subsequent quarters of 2016 came in at +0.6%, +0.5% and +0.7% to produce an annual growth for 2016 overall, compared to 2015, of no less than 1.8%, which was very nearly the fastest rate of growth of any of the G7 countries. Needless to say, this meant that the MPC did not cut Bank Rate again after August but, since then, inflation has risen rapidly due to the effects of the sharp devaluation of sterling after the referendum. By the end of March 2017, sterling was 17% down against the dollar but had not fallen as far against the euro. In February 2017, the latest CPI inflation figure had risen to 2.3%, above the MPC's inflation target of 2%. However, the MPC's view was that it would look through near term supply side driven inflation, (i.e. not raise Bank Rate), caused by sterling's devaluation, despite forecasting that inflation would reach nearly 3% during 2017 and 2018. This outlook, however, is dependent on domestically generated inflation, (i.e. wage inflation), continuing to remain subdued despite the fact that unemployment is at historically very low levels and is on a downward trend. Market expectations for the first increase in Bank Rate moved forward to quarter 3 2018 by the end of March 2017 in response to increasing concerns around inflation.

USA.
Quarterly growth in the US has been very volatile during 2016 but a strong performance since mid-2016, and strongly rising inflation, prompted the Fed into raising rates in December 2016 and March 2017. The US is the first major western country to start on a progressive upswing in rates. Overall growth in 2016 was 1.6%.

EU.
The EU is furthest away from an upswing in rates; the European Central Bank (ECB) has cut rates into negative territory, provided huge tranches of cheap financing and been doing major quantitative easing purchases of debt during 2016-17 in order to boost growth from consistently weak levels, and to get inflation up from near zero towards its target of 2%. These purchases have resulted in depressed bond yields in the EU, but, towards the end of 2016, yields rose, probably due at least in part to rising political concerns around the positive prospects for populist parties and impending general elections in 2017 in the Netherlands, France and Germany. The action taken by the ECB has resulted in economic growth improving significantly in the eurozone to an overall figure of 1.7% for 2016, with Germany achieving a rate of 1.9% as the fastest growing G7 country.

On the other hand, President Trump's election and promise of fiscal stimulus, which are likely to increase growth and inflationary pressures in the US, have resulted in Treasury yields rising sharply since his election. Gilt yields in the UK have been caught between these two influences and the result is that the gap in yield between US treasuries and UK gilts has widened sharply during 2016/17 due to market perceptions that the UK is still likely to be two years behind the US in starting on an upswing in rates despite a track record of four years of strong growth.

Japan struggled to stimulate consistent significant growth with GDP averaging only 1.0% in 2016 with current indications pointing to a similar figure for 2017. It is also struggling to get inflation up to its target of 2%, only achieving an average of -0.1% in 2016, despite huge monetary and fiscal stimulus, though this is currently expected to increase to around 1% in 2017. It is also making little progress on fundamental reform of the economy.

China and emerging market counties. At the start of 2016, there were considerable fears that China's economic growth could be heading towards a hard landing, which could then destabilise some emerging market countries particularly exposed to a Chinese economic slowdown and / or to the effects of a major reduction in revenue from low oil prices. These fears have largely subsided and oil prices have partially recovered so, overall, world growth prospects have improved during the year.

Equity markets. The result of the referendum, and the consequent devaluation of sterling, boosted the shares of many FTSE 100 companies which had major earnings which were not denominated in sterling. The overall trend since then has been steeply upwards and received further momentum after Donald Trump was elected President as he had promised a major fiscal stimulus to boost the US economy and growth rate.

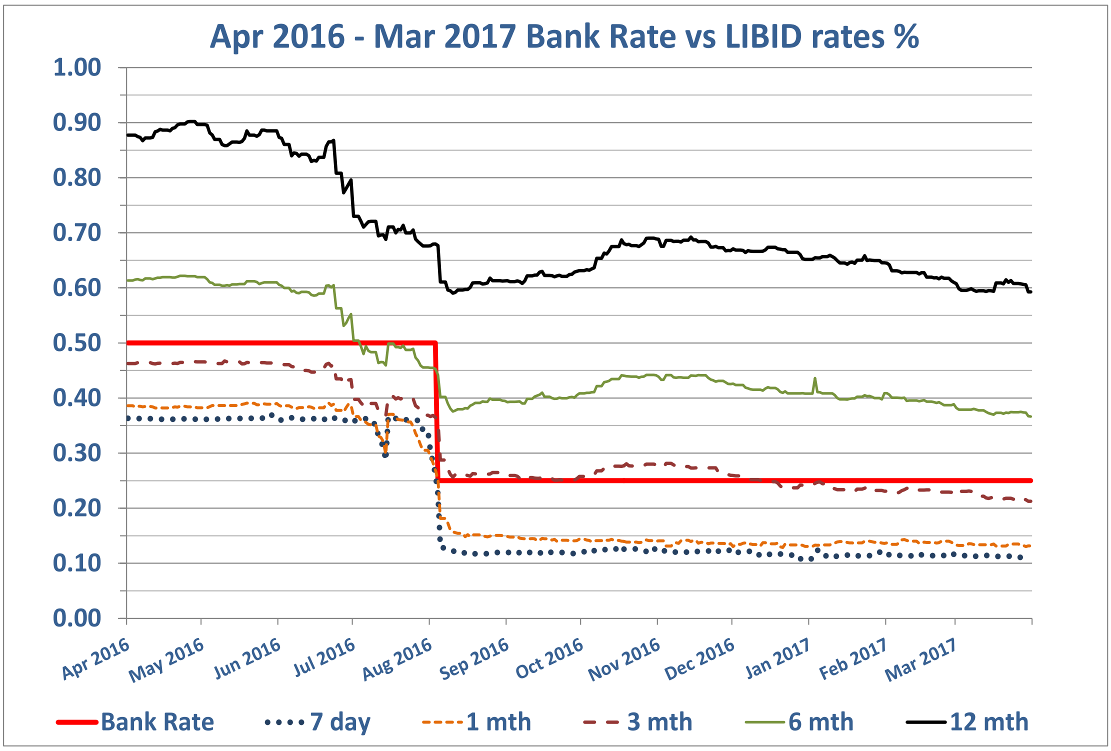
6. Borrowing Outturn for 2016/17

For 2016/17 the Council's actual debt management costs (borrowing) were £2,494,163 compared to a revised budget of £2,512,500, an under spend of £18,337. The weighted average rate on all loans for 2016/17 was 3.74% (2015/16 - 3.71%) on an average loan balance of £65.35m for the financial year.

The HRA repaid the General Fund £1.685m interest for the use of debt balances it holds.

No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

7. Investment Rates in 2016/17



After the EU referendum, Bank Rate was cut from 0.5% to 0.25% on 4 August and remained at that level for the rest of the year. Market expectations as to the timing of the start of monetary tightening started the year at quarter 3 2018, but then moved back to around the end of 2019 in early August before finishing the year back at quarter 3

2018. Deposit rates continued into the start of 2016/17 at previous depressed levels but then fell during the first two quarters and fell even further after the 4 August MPC meeting resulted in a large tranche of cheap financing being made available to the banking sector by the Bank of England. Rates made a weak recovery towards the end of 2016 but then fell to fresh lows in March 2017.

8. Investment Outturn for 2016/17

Investment Policy – the Council's investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council on 12th February 2016. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Type of Investments	Balance on 01/04/2016 £	Average Weighed Balance Held in 2016/17 £	Interest Earned in 2016/17 £	% Rate Achieved in 2016/17 %	Balance on 31/03/2017 £
Fixed Term Deposits	14,300,000	16,652,792	110,803	0.67%	21,000,000
Call Accounts & MMF's	5,660,000	8,100,225	21,114	0.30%	300,000
Policy Investments	140,000	102,171	1,611	1.50%	64,167

The Council maintained an average balance of £24.855m of internally managed funds during 2016/17. The internally managed funds earned an average rate of return of 0.54% (0.65% in 2015/16). The comparable performance indicator is the average 3 month LIBID rate which was 0.32% for the same period. The Council budgeted for £433,100 investment interest for 2016/17 but made an actual return of £434,543, a surplus of £1,443.

Net loans and investments budget for 2016/17 was a cost of £394,700 but made an actual return of £374,920, a surplus of £19,780.

9. Icelandic Bank Defaults

The Council had £11m deposited with three Icelandic Banks when the banking system in Iceland collapsed in October 2008.

At the current time, the process of recovering assets is still ongoing with the administrators. In the case of Kaupthing, Singer and Friedlander Ltd (KSF), the administrators have made a number of dividend payments to date, with further payments and updates anticipated during 2017/18. To date 84.25p in the pound has been recovered. It is estimated that total dividends will be between 86p to 86.5p in the pound. The outstanding liability now stands at £472k, however it is anticipated that the council will receive a further £59k in future creditor pay-outs. Interest accrued for KSF in 2016/17 totalled £2,440.

In June 2016 the Council participated in an auction to sell its Icelandic Krona held in a Glitnir Escrow account and was successful in receiving £627.9k in July 2016. No further monies are outstanding with Glitnir. The table below shows the detailed repayments in respect of the specific Icelandic investments held in administration:

Icelandic Deposits Held	**Original Deposits**	**Amount Received to date**	**Amount Owed**
	£	**£**	**£**
Kaupthing Singer & Friedlander	2,000,000	1,685,000	315,000
Kaupthing Singer & Friedlander	1,000,000	842,500	157,500
Glitnir	3,000,000	3,000,000	0
Landsbanki	2,000,000	2,000,000	0
Landsbanki	2,000,000	2,000,000	0
Landsbanki	1,000,000	1,000,000	0
TOTAL	**11,000,000**	**10,527,500**	**472,500**

Appendix 1: Prudential and treasury indicators

1. PRUDENTIAL INDICATORS	2015/16	2016/17	2016/17
Extract from budget and rent setting report	actual	revised	actual
	£'000	£'000	£'000
Capital Expenditure			
Non - HRA	17,897	2,930	2,224
HRA	6,949	11,538	11,255
TOTAL	**24,846**	**14,468**	**13,479**
Ratio of financing costs to net revenue stream			
Non - HRA	2.77%	3.93%	3.78%
HRA	7.77%	7.91%	7.92%
Gross borrowing requirement			
brought forward 1 April	£71,516	£71,516	£71,516
carried forward 31 March	£80,795	£74,833	£77,758
in year borrowing requirement	£9,279	£3,317	£6,242
CFR			
Non – HRA	£40,666	£38,910	£39,310
HRA	£44,750	£44,750	£44,750
TOTAL	£85,416	£83,660	£84,060
Incremental impact of capital investment decisions	£	£	£
Increase in council tax (band D) per annum *	£nil	£nil	£nil
Increase in average housing rent per week **	£nil	£nil	£nil
** Decisions on annual rent increases are subject to rent restructuring guidelines set by Central Government. As a consequence rent levels will only rise by RPI Index plus 0.5% and this should cover all additional capital expenditure.			

2. TREASURY MANAGEMENT INDICATORS	2015/16	2016/17	2016/17
	actual	revised	actual
	£'000	£'000	£'000
Authorised Limit for external debt -			
borrowing	£116,000	£117,000	£117,000
other long term liabilities	£0	£0	£0

TOTAL	£116.0000	£117,000	£117,000
Operational Boundary for external debt -			
borrowing	£106,600	£107,000	£107,000
other long term liabilities	£0	£0	£0
TOTAL	£106,600	£107,000	£107,000
Actual external debt	£65,360	£64,830	£64,830
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments :-	0-100 %	0-100 %	0-100 %
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments :-	0-100 %	0-100 %	0-100 %

Maturity structure of fixed rate borrowing during 2015/16	upper limit	lower limit
under 12 months	50%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%