Report to Audit Committee
Date of meeting 4 January 2017
By the Director of Corporate Resources
INFORMATION REPORT

Not exempt

Horshan District Council

Treasury Management and Prudential Indicators mid-year report 2016/17

Executive Summary

This report covers treasury activity and prudential indicators for the first half of 2016/17. During the period the Council complied with its legislative and regulatory requirements and the statutory borrowing limit, the Authorised Limit, was not breached. There was an instance when the single institution limit of £2.5m was breached by £80,000 for one day; otherwise all limits and indicators were within estimates.

At 30 September 2016, the Council's external debt was £4m (£4m at 31 March 2016) and its investments totalled £52.8m (£31.8m at 31 March 2016).

During the first half of 2016/17, the Council's cash balances were invested in accordance with the Council's treasury management strategy. Interest of £0.26m was earned on investments at an average return of 1.1% (0.8% full year 2015/16).

Recommendations

The Committee is recommended to:

i) Note the treasury management stewardship report at the mid-year 2016/17
ii) Note the mid-year prudential indicators for 2016/17

Reasons for Recommendations

i) This mid-year report is a requirement of the Council's reporting procedures
ii) This report meets the requirements of the relevant CIPFA Codes of Practice for Treasury Management and Prudential Indicators in Capital Finance.

Background Papers
"Treasury Management Strategy 2016-17" – A.A.G Committee 6 January 2016
"Budget 2016/17 and Medium Term Financial Strategy" – Council 24 February 2016

Consultation: Arlingclose Limited. Council's Treasury management advisors

Wards affected: All
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Background Information

1 Introduction

The purpose of this report

1.1 This report covers treasury management activity and prudential indicators for the first half of 2016/17. It 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. The Code recommends that members are informed of Treasury Management activities at least twice a year.

Background

1.2 In line with the CIPFA Prudential Code for Capital Finance in Local Authorities the Council adopts prudential indicators for each financial year and reports on performance relative to those indicators. This requirement is designed to show that capital spending is prudent, affordable and sustainable and that treasury practices adequately manage risk. The original indicators for 2016/17 together with Treasury Management Strategy 2016/17 were approved by Council on 24 February 2016. The Treasury Management Strategy 2016/17 had been recommended for approval by this Committee on 6 January 2016.

1.3 The economic background to treasury management remains challenging with fears over Brexit and global growth weighing on the economy and financial system which was still recovering from the 2008 financial crisis. Interest rates have again hit historic lows and positive news on UK growth is balanced by fears over Brexit and the global economy. Arlingclose Limited, the Council's treasury management advisors have provided a commentary on the year so far in Appendix 1.

1.4 At the end of 2015/16 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £13.2m, while usable reserves and working capital which are the underlying resources available for investment were £41m. The Council had £4m of borrowing and £31.8m of investment reflecting its use of internal resources rather than borrowing.

2 Treasury management

Borrowing strategy

2.1 On 30 September 2016, at the midpoint of the year, the Council's borrowing remained the single £4m PWLB loan at 3.38% as has been the case since 2009 . The Council does not expect to borrow in 2016/17.

Investment Activity

2.2 The treasury management position at 30 November 2016 is shown below. This is a snapshot rather than the cumulative returns.

	Principal £m	Average Interest Rate %
Call accounts	0.7	0.25
Money Market Funds	22.4	0.64
Short-term deposits	12.9	0.63
Long-term deposits	5.8	1.57
Pooled Funds	10.0	4.35*
Total Investments	**51.8**	**1.45**
Long-term PWLB loans	4.0	3.38
Total Borrowing	**4.0**	**3.38**
Net Investments	**47.8**	**1.29**

*Rates used are last full year

2.3 Investment income was £0.26m, well over the budget of £0.13m. The average return was 1.1% against a budget of 0.8% and the adopted yield benchmark 7 day LIBID of 0.37%. Cash balances ranged from £31.8m to £58.4m averaging £46m against a budgeted average balance of £33m. The comparative minimum and maximum balances last year were £24.7m and £45.3m. Although short term rates remain low the combination of extra cash and use of pooled funds, newly introduced in 2016/17, mean that the full year budgeted interest income could be in the region of £0.5m compared to budget of £0.275m.

2.4 Security of capital has remained the Council's main investment objective. Key to this is the counterparty policy as set out in its treasury management strategy. Counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

2.5 **Security benchmark** – The Council set a security benchmark rating of A-, which is the average credit rating for the investment portfolio. The average rating was A+ during the first half of the year.

2.6 **Liquidity benchmark** – The Council sets a benchmark to maintain a minimum of liquidity. The benchmark set was that £3m is available within a rolling three month period without additional borrowing. The Director of Corporate Resources can report that liquidity arrangements were well within benchmark during the year to date with overnight cash alone exceeding the £3m.

2.7 **Counterparty Update –** Arlingclose Limited, the Council's treasury management advisors, monitor the quality of potential counterparties and have provided a commentary on the developments in the first part of the year in Appendix 2. None of the changes affected the Council's existing investments.

Compliance with Prudential Indicators

2.8 The Council confirms compliance with its Prudential Indicators for 2016/17, which were set out in January 2016 as part of the Council's Treasury Management Strategy apart from a breach of the single institution limit of £2.5m for the Council's own bank

2.9 On 29th September the Council's balance with its own Bank NatWest was £2.58m which exceeded the limit of £2.5m. The Council had been expecting to make a large payment of just over £1.7m at the time so more was kept with the bank that usual in readiness. The payment was not made on that date, but balance was not reduced in time before the end of business for the day. This was rectified the next morning.

Treasury Management Indicators

2.10 **Interest rate exposures -** This indicator is set to control the Council's exposure to interest rate risk. The exposures to fixed and variable rate interest rates, expressed as an amount of net principal borrowed, were as the table below. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate. As investments count as negative borrowing the variable rate figure was negative during the period.

	Limit	Actual	Met?
Upper limit on fixed rate exposures	£15m	£4m	✓
Upper limit on variable rate exposures	£0m	£-32m	✓

2.11 **Maturity Structures Of Borrowing** – These gross limits are set in order to reduce the Council's exposure to large fixed rate loans - those instruments which carry a fixed interest rate for the duration of the instrument - falling due for refinancing. As the Council only has one such debt it has freedom to refinance the debt. The table below shows the estimates and current position.

	Upper Limit	Lower Limit	Actual	Met?
Under 12 months	100%	0	0	✓
12 months and within 24 months	100%	0	0	✓
24 months and within five years	100%	0	100%	✓
Five years and within 10 years	100%	0	0	✓
10 years and above	100%	0	0	✓

2.12 **Principal sums invested for periods longer than 364 days** – The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its long-term investments. The total principal sums invested to final maturities beyond the period end were:

	Original Indicator	Maximum Position
Maximum principal sums invested > 364 days	£8m	£5.8m

3 Prudential Indicators 2016/17

3.1 The Local Government Act 2003 requires the Council to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much it can afford to borrow. The objectives of the Prudential Code are to ensure that capital investment plans are affordable, prudent and sustainable. To demonstrate that the Council meets these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

3.2 **The Council's Capital Expenditure and Financing 2016/17 -** This is one of the required prudential indicators and shows total capital expenditure for the year and how this is financed. The estimated indicator is shown below.

2016/17	Original Estimate £000	Current projection £000
Total capital expenditure	19,247	10,178
Resourced by:		
Capital receipts and contributions	(6,860)	(5,010)
Capital grants	(442)	(513)
Revenue reserves	(2000)	(1,119)
Unfinanced capital expenditure (additional need to borrow)	9,945	3,536

3.3 The capital spend in 2016/17 has been under the budget. The final financing at the year-end will be well within the prudential indicator estimates.

3.4 **The Council's overall borrowing need -** The Council's underlying need to borrow is termed the Capital Financing Requirement (CFR). It represents the accumulated net capital expenditure which has not been financed by revenue or other resources. Part of the Council's treasury activities is to address this borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council.

3.5 The Council is required to make an annual revenue charge, the Minimum Revenue Provision (MRP), to reduce the CFR – effectively a repayment of the borrowing need. The Council's 2016/17 MRP Policy was approved on 24th February 2016 within the 2016/17 Budget report.

3.6 The Council's CFR for the year is shown below, and represents a key prudential indicator. There is a decrease in the expected CFR as unfinanced capital spend has been reduced or re-phased and thus is below estimate. No increase in borrowing is now projected in this financial year.

Capital Financing Requirement and External Debt Year end 2016/17	Original estimate £000	Current projection £000
CFR	22,019	15,958
External debt	9,000	4,000

3.7 External borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2016/17 and next two financial years. No difficulties are envisaged for the current or future years in complying with this Prudential Indicator.

3.8 **Borrowing limits** - The Council approved these Prudential Indicators as part of the 2016/17 Budget report.

3.9 **Operational boundary for external debt:** The operational boundary is based on the Authority's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

3.10 **Authorised limit for external debt:** The authorised limit 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.

	Limit	Actual	Met?
Operational boundary – borrowing	£9m	£4m	✓
Operational boundary – other long-term liability	£0m	£0m	✓
Operational boundary – TOTAL	£9m	£4m	✓
Authorised limit – borrowing	£14m	£4m	✓
Authorised limit – other long-term liability	£1m	£0m	✓
Authorised limit – TOTAL	£15m	£4m	✓

3.11 **The ratio of financing costs to net revenue stream -** This indicator identifies the trend in the cost of capital (financing costs net of interest and investment income) against the net revenue stream. The indicator for the year was 6% and the current estimate is approximately 4% mostly due to investment income being expected to exceed budget.

4 Outcome of consultations

4.1 Arlingclose Limited, the Council Treasury management advisors, have made comments which have been incorporated into the report.

5 Staffing consequences

5.1 There are no direct staff resourcing consequences. However, the risks in the investment environment highlights the continuing need for staff training and staff will take advantage of courses run by its advisors Arlingclose Limited.

6 Financial consequences

6.1 Interest earned is expected to be above budget improving the current year's financial performance. The outturn is forecast to be £0.225m above budget as a result of having higher cash balances and a better return from the pooled funds.

7 Other considerations

7.1 There are no consequences of any action proposed in respect of Risk; Crime & Disorder; Human Rights; Equality & Diversity and Sustainability.

Appendix 1

Economic background to the midpoint of 2016/17

The preliminary estimate of Q2 2016 GDP showed reasonably strong growth as the economy grew 0.7% quarter-on-quarter, as compared to 0.4% in Q1 and year/year growth running at a healthy pace of 2.2%. However the UK economic outlook changed significantly on 23rd June 2016. The surprise result of the referendum on EU membership prompted forecasters to rip up previous projections and dust off worst-case scenarios. Growth forecasts had already been downgraded as 2016 progressed, as the very existence of the referendum dampened business investment, but the crystallisation of the risks and the subsequent political turmoil prompted a sharp decline in household, business and investor sentiment.

The repercussions of this plunge in sentiment on economic growth were judged by the Bank of England to be severe, prompting the Monetary Policy Committee to initiate substantial monetary policy easing at its August meeting to mitigate the worst of the downside risks. This included a cut in Bank Rate to 0.25%, further gilt and corporate bond purchases (QE) and cheap funding for banks (Term Funding Scheme) to maintain the supply of credit to the economy. The minutes of the August meeting also suggested that many members of the Committee supported a further cut in Bank Rate to near-zero levels (the Bank, however, does not appear keen to follow peers into negative rate territory) and more QE should the economic outlook worsen.

In response to the Bank of England's policy announcement, money market rates and bond yields declined to new record lows. Since the onset of the financial crisis over eight years ago, Arlingclose's rate outlook has progressed from 'lower for longer' to 'even lower for even longer' to, now, 'even lower for the indeterminable future'.

The UK government followed the example set by the Bank of England in acting to mitigate an expected Brexit downturn and after six years of fiscal consolidation, the Autumn Statement on 23rd November shifted tack to bring in measures to support economic activity and confidence.

Market reaction: 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. The yield on the 10-year gilt fell from 1.37% on 23rd June to a low of 0.52% in August, a quarter of what it was at the start of 2016. It has since risen to 0.69% at the end of September. The yield on 2- and 3-year gilts briefly dipped into negative territory intra-day on 10th August to -0.1% as prices were driven higher by the Bank of England's bond repurchase programme. However both yields have since recovered to 0.07% and 0.08% respectively. The fall in gilt yields was reflected in the fall in PWLB borrowing rates, with rates for 50 year maturity loans going as low as 2.08%. Money market rates followed the Bank Rate down, most noticeably for very short-dated periods (overnight to 1 month) where rates fell to between 0.1% and 0.2%

In contrast, after an initial sharp drop, equity markets appeared to have shrugged off the result of the referendum despite warnings from IMF, Treasury and Bank of England on the impact on growth from 'Brexit' as investors counted on QE-generated liquidity to drive risk assets.

Appendix 2

Counterparty update

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 downgraded the UK's sovereign rating by one notch to AA from AA+, and Standard & Poor's downgraded its corresponding rating by two notches to AA from AAA. Fitch, S&P and Moody's have a negative outlook on the UK. S&P also downgraded the long-term ratings of the local authorities to which it assigns ratings as well as the long-term rating of the EU from AA+ to AA, the latter on the agency's view that it lowers the union's fiscal flexibility and weakens its political cohesion.

Moody's affirmed the ratings of nine UK banks and building societies but revised the outlook to negative for those that it perceived to be exposed to a more challenging operating environment arising from the 'leave' outcome.

There was no immediate change to Arlingclose's credit advice on UK banks and building societies as a result of the referendum result. Arlingclose believe there is a risk that the uncertainty over the UK's future trading prospects will bring forward the timing of the next UK recession.

The European Banking Authority released the results of its 2016 round of stress tests on the single market's 51 largest banks after markets closed on Friday 29th July. No bank was said to have failed the tests. The Royal Bank of Scotland was one of the worst performers as its ratios fell by some of the largest amounts, but from a relatively high base. Barclays Bank and Deutsche Bank ended the test with Common Equity Tier 1 (CET1) ratios below the 8% threshold, and would be required to raise more capital should the stressed scenario be realised.

At the end of November after the period being reported on the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies. Royal Bank of Scotland, Barclays and Standard Chartered Bank were found to be the weakest performers. Arlingclose did not changing its counterparty advice in response to the stress test results as the advised use of those banks was already quite cautious.

In July Arlingclose completed a review of unrated building societies' annual financial statements. Cumberland, Harpenden and Vernon Building Society were removed from Arlingclose's advised list, following a deterioration in credit indicators. The maximum advised maturity was also lowered for eleven societies from 6 months to 100 days due to the uncertainty facing the UK property market following the EU referendum.