Report to Audit Committee

25 July 2017
By the Director of Corporate Resources
INFORMATION REPORT

Not exempt

Horsham District Council

Treasury Management Activity and Prudential Indicators 2016/17

Executive Summary

This report covers treasury activity and prudential indicators for 2016/17. At 31 March 2017, the Council's external debt was £4m (£4m at 31 March 2016) and its investments totalled £50.1m (£31.8m at 31 March 2016) including call accounts and Money Market Funds.

During 2016/17 the Council's cash balances were invested in accordance with the Council's treasury management strategy. Interest of £0.605m (£0.288m in 2015/16) was earned on investments, an average return of 1.2% (0.8% in 2015/16). There was one instance when the single institution limit of £2.5m was breached overnight; otherwise all limits and indicators were within estimates.

Recommendations

The Committee is recommended to:

i) Note the Treasury Management stewardship report for 2016/17.
ii) Note the actual prudential indicators for 2016/17.

Reasons for Recommendations

i) The annual treasury report is a requirement of the Council's reporting procedures.
ii) This report also covers the actual Prudential Indicators for 2016/17 in accordance with the requirements of the relevant CIPFA Codes of Practice.

Background Papers

"Treasury Management Strategy 2016/17" - AAG Committee 6 January 2016
"Budget 2016/17 and MTFS to 2019/20" - Council 24 February 2016
"Treasury Management Activity and Prudential Indicators 2015/16 and request for revision of the 2016/17 Treasury Management Strategy " - AAG Committee 13 September 2016
"Budget for 2017/18 and Council Tax" - Council 15 February 2017

Consultation: Arlingclose Ltd – the Council's Treasury Management advisers

Wards affected: All

Contact: Julian Olszowka, Group Accountant (Technical), 01403 215310

Background Information

1 Introduction

1.1 This report covers treasury management activity and prudential indicators for 2016/17. It meets the requirements of the 2011 editions 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.

1.2 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 demonstrate that capital spending is prudent, affordable and sustainable and that treasury management decisions are taken in accordance with good professional practices. This report compares the approved indicators with the outturn position for 2016/17. Actual figures have been taken from or prepared on a basis consistent with, the Council's statement of accounts.

1.3 The original prudential indicators for 2016/17 together with Treasury Management Strategy 2016/17 were agreed by Council on 24 February 2016 having been approved by this Committee on 6 January 2016. The strategy was amended by Council on 19 October 2016 after approval by this Committee on 13 September 2016. The amendments were to increase limits on long term and pooled fund investments.

2 The Council's Capital Expenditure and Financing 2016/17

2.1 This is one of the required prudential indicators and shows total capital expenditure for the year and how this was financed. The estimates include revisions to the original indicators approved by the Council on 15 February 2017 as a part of budget report.

2016/17	Actual £000	Estimate £000	Variance £000
Total capital expenditure	9,344	10,201	-857
Resourced by:			
Capital receipts and third party contributions	(4,311)	(5,033)	722
Capital grants	(689)	(513)	(176)
Revenue reserves*	(770)	(1,119)	349
Unfinanced capital expenditure (additional need to borrow)	**3,574**	**3,536**	38

* Includes use of New Homes Bonus

2.2 The capital spend in 2016/17 was under the budget as revised in the 2017/18 budget report and well below the original 2016/17 budget which was £19m. The underspend resulted in a reduced need for financing when compared with the estimate.

3 The Council's Overall Borrowing Need

3.1 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.

3.2 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 (as required by DCLG Guidance) was approved on 24 February 2016 as a part of the 2016/17 Budget report.

3.3 The Council's CFR for the year is shown below, and represents a key prudential indicator because it is a measure of the Council's underlying indebtedness. The movement in the CFR is close to the estimate.

Capital Financing Requirement	Actual £000	Estimate £000	Variance £000
Opening balance 1 April 2016	13,255	13,256	-1
plus unfinanced capital expenditure	3,574	3,536	38
less Minimum Revenue Provision	(837)	(835)	(2)
Closing balance 31 March 2017	**15,992**	**15,957**	35

4 Treasury Position at 31 March 2017

4.1 Whilst the Council's gauge of its underlying need to borrow is the CFR, the Director of Corporate Resources can manage the Council's actual borrowing position by either borrowing to the level of the CFR or choosing to utilise other available funds instead, sometimes termed under-borrowing. The Council is under-borrowed as its external debt amounts to only £4m.

4.2 Although the Council is under-borrowed relative to its CFR, it also holds investments and the summary treasury position on the 31 March 2017 compared with the previous year is shown below. This is a snapshot of investments on the date and will not necessarily be equal to the whole year average figures reported below.

Treasury position	31 March 2017		31 March 2016	
	Principal £m	Average Rate	Principal £m	Average Rate
Fixed Interest Rate Debt	4.0	3.4%	4.0	3.4%
Investments	(50.1)	1.5%	(31.8)	0.9%
Net borrowing position	**(46.1)**		**(27.8)**	

4.3 Returns continued at historically low levels during 2016/17 reflecting the continuing low interest rates being offered by counterparties who are a good credit risk. The current outlook points to a continuation of low rates with no significant increases expected in the medium term. The use of pooled funds including a diversified selection of equity, bonds and property has lifted income to some extent but their use is limited by the desired overall risk profile of the Council's investments.

5 Prudential Indicators

5.1 **Gross Debt and the CFR** - In order to ensure that borrowing levels are prudent over the medium term the Council's external debt must only be for a capital purpose. Gross debt should not therefore, except in the short term, exceed the CFR for 2016/17 plus the expected CFR movement over 2017/18 and 2018/19. As external debt was £4m and the CFR is £16m and is not planned to decrease over the relevant future period the Council has complied with this prudential indicator.

5.2 The **Authorised Limit** is the "Affordable Borrowing Limit" required by section 3 of the Local Government Act 2003. The Council set the Authorised Limit at £15m for 2016/17. The table below demonstrates that during 2016/17 the Council has maintained gross borrowing within its Authorised Limit.

5.3 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 are acceptable subject to the Authorised Limit not being breached. This indicator was set at £4m and gross borrowing was at £4m for the whole year.

5.4 **Actual financing costs as a proportion of net revenue stream** - This indicator shows the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. This is a gauge of the affordability of capital spend. As shown in the table below, the actual indicator was within the estimate. Financing costs were reduced on estimate due to healthier than estimated investment income.

	2016/17
Authorised Limit	£15.0m
Operational Boundary	£4.0m
Maximum gross borrowing position in the year	£4.0m
Minimum gross borrowing position in the year	£4.0m
Financing costs as a proportion of net revenue stream	Actual 2% Estimate 4%

5.5 **Upper limits on variable and fixed rate exposure** – These indicators identify maximum limits for variable and fixed interest rate exposures. The table below shows the actual maximums in 2016/17. 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. The variable exposure is exclusively investments and thus appears as a negative figure as the indicator shows the net debt position.

	Limit	**Actual**	**Met?**
Upper limit on fixed rate exposure	£15m	£4m	✓
Upper limit on variable rate exposure	£0m	-£28m	✓

5.6 **Maturity structures of borrowing -** These gross limits are set to reduce the Council's exposure to large fixed rate loans falling due for refinancing. As the Council only has one debt and has set the percentage range to allow it freedom to refinance the debt there is no danger of not meeting this indicator. The table below shows the 2016/17 estimates and end of year position.

Maximum percentage of borrowing in each age category	Original Indicator	Actual Position
Maturity Structure of fixed borrowing		
Under 12 months	100%	0%
12 months to 2 years	100%	0%
2 years to 5 years	100%	100%
5 years to 10 years	100%	0%
10 years and above	100%	0%

5.7 **Total Principal Funds Invested over 364 days** – This limit ensures liquid funds are maintained. The actual position was within the indicator.

2016/17	Indicator	Actual Position
Maximum principal sums invested > 364 days	£12m	£4m

Economic and treasury management context for 2016/17

5.8 The Council's Treasury Management activities are critically affected by what is happening in the general economy which is subject to continuing uncertainty. The Council has engaged Arlingclose Ltd to advise on various aspects of Treasury Management and a part of that advice, a commentary on the economic background and the finance sector during 2016/17, is included as the appendix to this report.

Debt management activity during 2016/17

5.9 No new borrowing was undertaken so the Council's only debt was £4.0m from Public Works Loan Board borrowed on 23 April 2009 for 10 years at 3.38%.

5.10 As the CFR shown above is close to £16m the Council is using its internal resources in lieu of borrowing. This lowers overall treasury risk by reducing both external debt and temporary investments and was judged to be the best way of funding capital expenditure. Current borrowing costs are historically low (e.g. PWLB 50 year loan under 2.5%) and our advisers prediction is that they will not be increasing significantly in the next three years.

6 Investment activity in 2016/17

6.1 The Council's objectives are to give priority to the security and liquidity of its funds before seeking the best rate of return. The majority of its surplus cash is therefore held as short-term investments with the UK Government, local authorities, and highly credit-rated banks, building societies and pooled funds. The Council's Treasury Management activity fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Treasury Management Code of Practice and the DCLG Investment guidance. These require the Council to approve an investment strategy before the start of each financial year and all investment activity during the year conformed to this strategy apart from breach of single institution limit detailed below.

6.2 Both the CIPFA Code and government guidance require the Council 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 Council'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.

6.3 In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Council diversified into more secure and higher yielding asset classes during 2016/17. £11.8m that was available for longer-term investment was moved from bank and building society deposits into covered bonds and pooled property, bond and equity funds.

6.4 The Council's longer term cash balances comprise revenue and capital reserves and its core cash resources are shown in the table below. The Council is borrowing internally to cover its CFR which reduces the funds to be invested by £11.5m (2015/16 £10m).

Balance Sheet Resources	31 March 2017 £m	31 March 2016 £m	31 March 2015 £m
Revenue reserves	20.0	17.3	16.1
Other reserves and provisions	14.4	3.5	2.4
Usable capital receipts	5.3	5.8	0
Unapplied capital contributions	13.2	8.6	9.4
Working capital	8.6	5.7	4.8
Total	**61.5**	**40.9**	**32.7**

6.5 **Yield** - The investment income budget for the year 2016/17 was £0.275m (2015/16 £0.249m). The actual interest received was £0.605m (2015/16 £0.288m). Cash balances were well above budget due to slipping of capital spend, revenue underspending and higher receipts of developer contributions. Pooled funds boosted income while otherwise the returns available from 'good' quality counterparties remained at historic lows. An overall return of 1.2% (0.8% in 2015/16) was achieved; the benchmark, which is the average LIBID 7 day rate, was 0.20% (0.45% in 2015/16).

6.6 **Security** – A benchmark is used as a way of expressing the credit risk of the whole portfolio of counterparties that the Council invests with. The Council has adopted a benchmark of an equivalent credit rating of A- against which the portfolio was assessed at the end of each month. The portfolio average credit rating was A+ for the complete year which is two notches above the benchmark.

6.7 **Liquidity benchmark** – The Council needs to ensure it has a sufficient level of liquidity so it has funds available when necessary. To ensure liquidity the Council set a benchmark of the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing. For 2016/17 the benchmark amount was £3m. The actual funds available were far in excess of the benchmark for the whole year; the lowest amount available overnight was £6.2m with another £9.4m available within a week.

6.8 **Compliance with strategy** – There was an instance when the limit on single institution investments was breached. The circumstances are detailed below.

6.9 On 29 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 funds were kept with the bank than usual in readiness. The payment was not made on that date, but the balance was not reduced in time before the end of business for the day. This was rectified the next morning. The breach of the limit has already been reported to this Committee on 4 January 2017 in the Treasury Management mid-year report but it is included here for completeness.

6.10 **Unrated Pooled funds** - 2016/17 was the first year that unrated pooled funds comprising equity, bonds and property were used. During the year £10m was invested in these funds yielding £0.290m with an average return of 4.5%. The rest of the investments yielded an average of 0.7% so there is a significant increase in yield for this class of investment. It follows that increased return brings an increase in risk and in this case the risk is to the capital value of the investments and at the end of the year the capital value of investments was £6,000 below the initial investment. However, it should be remembered that these investments are longer term so the current small capital loss should not be overemphasised.

6.11 These funds have no defined maturity date, but are available for withdrawal after a notice period. Their performance and continued suitability in meeting the Council's investment objectives are regularly reviewed. In light of their stronger income performance and the Council's latest cash flow forecasts, investment in these funds has been maintained for the 2017/18 financial year.

7 Outcome of consultations

7.1 The views of the Council's treasury management consultants, Arlingclose Ltd, have been incorporated in all aspects of the above report.

8 Resource consequences

8.1 This report provides information only; no staffing or financial resources are required as a result of it.

9 Other considerations

9.1 There are no consequences in respect of legal, Crime & Disorder; Human Rights; Equality & Diversity and Sustainability.

Appendix

Economic Background in 2016/17: 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. The UK Government triggered Article 50 of the Lisbon Treaty on 29 March 2017, setting in motion the 2-year exit period from the EU.

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 23 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 31 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 Council'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 31 December 2015, 11 months out of date for most. As part of its creditworthiness research and advice, the Council'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.

On the advice of Arlingclose, new investments with Deutsche Bank and Standard Chartered Bank were suspended in March 2016 due to the banks' relatively higher credit default swap (CDS) levels and disappointing 2015 financial results. The Council held a Standard Chartered Bank CD (Certificate of Deposit) bought in February 2016 until maturity in early August 2016. The sale of the CD was considered but on balance it was felt that the risk of default was low enough to keep hold of the investment until its maturity. Standard Chartered Bank was reintroduced to the counterparty list in April 2017 following its strengthening financial position, but Deutsche Bank was removed altogether from the list.

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