

Treasury Management – 2016-17 Out-turn Report

1. Contacts

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2. Recommendations

- 2.1. That the Cabinet (a) considers this review of Treasury Management activity and performance for 2016-2017 and (b) notes the final Prudential Indicators for 2016-2017 to 2021-2022 as detailed in appendix 2 to the agenda report.**

3. Outcomes to be achieved

- 3.1. The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires at least bi-annual reporting of Treasury Management performance. The first report for 2016-2017 was considered by the Cabinet on 6 September 2016.
- 3.2. This report also summarises:
- Capital activity and how it was financed
 - The Council's prudential indicators as at 31 March 2017.
- 3.3. This report was considered by the Corporate Governance and Audit Committee on 29 June 2017 and an oral update will be provided of any key comments made.

4. Treasury Management

- 4.1. The Council continues to manage in excess of £50m of cash within its Treasury Management Strategy. For 2016-2017 an overall return of 1.25% was achieved, as shown below.

Investments	Average £k	Total income return	%
Internal	46,864	358	0.76

External	7,500	319	4.25
Total	54,364	677	1.25

4.2. Significant developments during the year included:

- The purchase of short-term corporate bonds where returns have exceeded available money market rates and where they met our counterparty lending criteria
- a second investment of £5m was made in the local authority property fund
- Treasury benchmarking indicators were agreed and performance against these is reported via the Council's Covalent reporting system. A copy of the indicators for 2016-17 is included at appendix 1

5. Borrowing

5.1 The Authority did not undertake and borrowing in 2016-2017.

6. Exceptions

6.1. During 2016-2017 one investment during the period was made for a period that exceeded the maximum allowable period by one day. This was approved by the Head of Finance and Governance as no other suitable investment opportunities existed and the Council's money market funds was at the maximum available balance.

6.2. The Council's change of banker on 1 April 2016 created some issues which Treasury staff have now resolved. The reportable events occurred during the year were:

- 11 April to 17 May 2016 the Council's Nat-West current account was overdrawn on six occasions between £150k and £612k. These instances arose as the Council's new arrangements to automatically move money between its current and investment accounts at the Nat-West did not operate as initially expected.
- A number of investments were repaid to the Council's old HSBC account during the year, despite all counterparties being advised of the change to the Council's banker prior to 1 April 2016. This resulted in the following short term overdrafts whilst the funds were redirected to the Council's new bank account:

Date	Overnight balance
23 May 2016	(£1.7m)
08 Dec 2016	(£0.9m)
19 Dec 2016	(£2.5m)
27 Mar 2017	(£2.8m)

For each instance, officers took action to recover any direct costs (interest or charges) that resulted from these counterparty's errors.

- 2 September 2016: Balance 'sweeping' arrangements between the Council's accounts did not operate, leading to the Council's creditors account being overdrawn by £6.3m overnight. National Westminster acknowledged this was due to a failure of their systems and refunded any costs incurred.

6.3. All these events were reported to the Corporate Governance and Audit Committee during 2016-2017.

7. Investment Briefings

7.1. Briefings to help Members exercise proper oversight of treasury management activities are offered each year to all members. The last event took place on 13 January 2017.

8. Estates portfolio

8.1. The Estates Team continues to manage a substantial portfolio of properties producing rental and licence fee income. This includes industrial premises, industrial ground leases, retail and commercial premises, offices, sports and community facilities and various licence agreements.

8.2. In 2014-2015 and 2015-2016 the Council acquired three properties principally as investment purchases and has just completed the purchase of another property, comprising prime retail premises in the centre of Chichester. The investment purchases are all within the Chichester District and the acquisitions have an associated community/economic development benefit by supporting the provision of business accommodation. Overall these properties produce an income in excess of £2.5 million per annum.

9. Capital Expenditure and Financing 2016-2017

9.1. Under the Prudential Code, the Council is required to take into account the following:

- Affordability;
- Prudence and sustainability;
- Professional good practice;
- Transparency; and
- The Council's treasury management framework.

9.2. Capital expenditure in 2016-2017 and financing is shown in appendix 2. Total expenditure, including the asset replacement programme, was £6.3m, some £1.6M less than the revised estimate of £7.9m due largely to the following variations and capital budget underspends which will slip into FY2017-2018.

Variation £m	Project
0.297	Vehicle replacements
0.125	New telephone system
0.400	Refurbishment of ADC car park

0.135	Beach management works
0.135	Affordable Housing Grant

- 9.3. £1.06m of total project spend was considered to be revenue in nature and was therefore funded from a combination of revenue reserves and revenue grants and contributions.
- 9.4. The balance of £5.24m was funded by capital receipts, the capital projects fund and capital grants and contributions thereby negating the need to borrow funds from external bodies.
- 9.5. The credit agreement in respect of the Council's multi-function devices leased in 2014-15 continues to require a small Minimum Revenue Provision (MRP) charge (£31,000) to be made against the Council's General Fund.

10. Resource and Legal Implications

- 10.1. Any investment interest received in the year is currently not used to help balance the revenue budget, but used to fund one off costs or towards funding capital projects. Any underperformance may therefore have an impact on the Council's overall funding position, but this is kept under review and reported to members as part of the budget process. Currently the approved capital programme remains fully funded.
- 10.2. The Council has complied with all the relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management, means that, its capital expenditure is prudent, affordable and sustainable, and demonstrates a low risk approach.

11. Other Implications

Crime and Disorder	None
Climate Change	None
Human Rights and Equality Impact	None
Safeguarding and Early Help	None

12. Appendices

- 12.1. Appendix 1 - Investment indicators
- 12.2. Appendix 2 - Prudential indicators
- 12.3. Appendix 2 - Economic and credit commentary prepared by Arlingclose
- 12.4. Appendix 3 - Benchmarking definitions

Appendix 1: Treasury Management Indicators – 2016-17 benchmarks

Internal indicators

1. Security

Measure	CDC Actuals				Non-met District Q4 average	Rating
	Qtr 1	Qtr 2	Qtr 3	Qtr 4		
	16-17	16-17	16-17	16-17		
Average Credit Score (time-weighted)	2.85	3.56	3.44	3.40	4.01	GREEN
Average Credit Rating (time weighted)	AA	AA-	AA	AA	AA-	GREEN
Proportion Exposed to Bail-in (%)	19	41	40	48	58	GREEN

2. Liquidity

Measure	CDC Actuals				Non-met districts Q4 average	Rating
	Qtr 1	Qtr 2	Qtr 3	Qtr 4		
	16-17	16-17	16-17			
Proportion available within 7 days (%)	7	18	21	24	31	GREEN
Proportion available within 100 days (%)	49	44	52	47	57	GREEN
Average days to maturity	246	213	176	174	137	AMBER

3. Return

Measure	CDC Actuals				Non-met districts Q4 average	Rating
	Qtr 1	Qtr2	Qtr 3	Qtr4		
	16-17	16-17	16-17	16-17		
Internal investment return %	0.82	0.82	0.73	0.68	0.62	GREEN
External funds – income return %	4.55	4.42	4.31	4.50	3.66	GREEN
External funds – capital gains/losses %	(10.13)	(9.16)	(8.00)	(3.77)	0.29	AMBER

Total treasury Investments – income return %	1.16	1.38	1.29	1.37	1.31	GREEN
Property – income return (investment Purchases only) % ¹	8.28 (full year)					GREEN

Other Treasury indicators required by CIPFA's Code or adopted voluntarily

4. **Interest Rate Exposure:** 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 amount and proportion of net principal invested during the year were:

	2016/17	2017/18	2018/19
Upper limit on fixed interest rate exposure	£28m/40%	£24m/40%	£22m/40%
Actual (30 September 2016)	£10m/17%		
Upper limit on variable interest rate exposure	£70m/100%	£60m/100%	£55m/100%
Actual	£57.42m/82%		

- 5 **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. The actual principal sum invested to final maturities beyond 31 march 2017 was:

	2016/17	2017/18	2018/19
Limit on principal invested beyond year end	£35m	£30m	£25m
Actual @ 31 March 2017	£15m	£15m	£13m

5. **Liquidity:** The authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	Target	Actual
Total cash available within three months (30 September 2016)	£10m	Met – minimum maintained throughout year

Appendix 2: CAPITAL EXPENDITURE OUT TURN AND PRUDENTIAL INDICATORS 2016-17

Actual Spend compared to Original and Revised Estimate

2016-17				
Original Estimate £000's	Revised Estimate £000's	Out-turn £000's	Out-turn Variance to Original £000's	Out-turn Variance to Revised £000's
9,239	7,885	6,320	(2,919)	(1,565)

The overall spend on projects was £6.32m, of which £5.26m met the definition of capital expenditure as determined by the Local Government Act 2003. The balance of £1.06m of project spend was deemed to be more of a revenue nature, and charged to the income and expenditure account and funded from the revenue reserves or income. Due to the tighter definition of capital expenditure the current "capital" programme contains a number of schemes that are strictly revenue.

The sources of funding for the capital expenditure incurred in 2016-17 were:

	£m
Capital Receipts	1.30
Capital Projects Fund	1.30
Asset Replacement Fund	1.59
Capital Grants and Contributions	0.63
General Fund	0.45
Minimum revenue provision	0.03
TOTAL FUNDING	5.30

Prudential Indicators 2016-17

The Local Government Act 2003 requires the Authority to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice.

To demonstrate that the authority has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year. The future period estimates reported here are the most recent estimates produced and approved as part of the 2017-18 budget process.

Adoption of the CIPFA Treasury Management Code: The Authority adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition in February 2012.

Estimates of Capital Financing Requirement:

The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31.03.17 Actual £m	31.03.18 Estimate £m	31.03.19 Estimate £m	31.03.20 Estimate £m	31.03.21 Estimate £m	31.03.22 Estimate £m
CFR	(1.37)	(1.41)	(1.44)	(1.47)	(1.48)	(1.48)

The CFR is forecast to remain negative over the next three years as the Council expects to remain debt-free over this period.

In principle the CFR should equal zero, as the Council has fully funded its capital investment programme since becoming debt free following its Large Scale Voluntary Transfer (LSVT) of its housing stock in 2001, however a negative balance post LSVT is relatively common. To bring the CFR back to a more meaningful figure i.e. zero, there is the option to leave part of capital expenditure unfunded or effectively financed from internal borrowing which will increase the CFR to zero.

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the authority should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	31.03.17 Actual £m	31.03.18 Estimate £m	31.03.19 Estimate £m	31.03.20 Estimate £m	31.03.21 Estimate £m	31.03.22 Estimate £m
Borrowing (Operational Boundary only)	0	0	0	0	0	0
Finance leases	0.1	0.1	0.1	0.05	0	0
Total Debt	0.1	0.1	0.1	0.05	0	0

The actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt, below.

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.

Operational Boundary	2016/17 Approved £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
Borrowing	5	5	5	5	5	5
Other long-term liabilities	0	0	0	0	0	0
Total Debt - authorised	5	5	5	5	5	5
Actual Debt	0	0	0	0	0	0

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 authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	2016/17 Approved £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
Borrowing	10	10	10	10	10	10
Other long-term liabilities	0	0	0	0	0	0
Total Debt	10	10	10	10	10	10
Actual Debt	0	0	0	0	0	0

No borrowing was undertaken other than the short-term use of the Council's overdraft facility for short term liquidity and an ongoing credit arrangement of £123k for multi-function devices acquired in 2014-15. The authorised limit or operational boundaries were not exceeded at any point during 2016-17.

Ratio of Financing Costs to Net Revenue Stream: This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2016/17 Actual %	2017/18 Estimate %	2018/19 Estimate %	2019/20 Estimate %	2020/21 Estimate %	2021/22 Estimate %
General Fund	(6.57)	(5.75)	(1.00)	(1.60)	(1.65)	(1.59)

The estimates of financing costs reflect the Budget Spending Plans for 2017-18 to be reported to Cabinet on 7 February 2017 and considered by Council on 7 March 2017. These indicators have been updated to reflect the current phasing of the capital programme and the effect on the cash flow forecasts for investments, but do not reflect the potential for additional income from the investment made in May 2017 in pooled investment funds. The estimates for 2018-19 onwards will be updated as part of the 2018-19 budget process.

The fact that the percentages remain negative shows that the investment interest remains an income source to the Council. To date investment interest has been used to fund one off projects/capital spending rather than balance the revenue budget. With effect from 2017-18 the investment return earned on the council's property investments (projected at circa £400,000 per annum) will be applied as part of the deficit reduction plan considered by Cabinet in December 2016 and recommended for approval by full Council.

Incremental Impact of Capital Investment Decisions:

This is an indicator of affordability that shows the theoretical impact of capital investment decisions on Council Tax levels.

Incremental Impact of Capital Investment Decisions	2016/17 Actual £	2017/18 Estimate £	2018/19 Estimate £	2019/20 Estimate £	2020/21 Estimate £	2021/22 Estimate £
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General Fund - increase in annual band D Council Tax	3.44	(2.88)	5.85	1.86	(3.63)	N/A
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The 2016-17 figure is the net effect on revenue resources of the actual difference between budget and out-turn for 2016-17. The figures for 2017-18 onwards are calculated as the net effect on expected future revenue budgets of the decisions taken in 2016-17 in respect of capital financing and investment.

The main variable affecting future year forecasts is the extent to which the capital programme will be financed from capital receipts and grant contributions rather than from general fund resources.

Interest Rate Exposures - see main report section 10.7

Total Principal Sums Invested for Periods Longer than 364 days – see main report section 10.9

Appendix 3: Economic and credit commentary prepared by Arlingclose

Date of analysis: 21 April 2017

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.

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. Standard Chartered was reintroduced to the counterparty list in March 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 Authority's list due to a 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.

Appendix 4 – Benchmarking definitions

The benchmarking compares various measures of risk and return, which are calculated as follows:

Investment Value

For internal investments, the value is the sum initially invested. For external funds, the value is the fund's bid price on the quarter end date multiplied by the number of units held.

Rate of Return

For internal investments, the return is the effective interest rate, which is also the yield to maturity for bonds. For external funds (LAPF) this is measured on an offer-bid basis less transaction fees. For external funds the income only return excludes capital gains and losses.

Average returns are calculated by weighting the return of each investment by its value. All interest rates are quoted per annum.

Duration

This measure applies to internal investments only. This is the number of days to final maturity. For instant access money market funds, the number of days to final maturity is one.

Average duration is calculated by weighting the duration of each investment by its value. Higher numbers indicate higher risk.

Credit Risk

Each investment is assigned a credit score, based where possible on its average long-term credit rating from Fitch, Moody's and Standard & Poor's. This is converted to a number, so that AAA=1, AA+=2, etc. Higher numbers therefore indicate higher risk. Unrated local authorities are assigned a score equal to the average score of all rated local authorities.

Average credit risk is measured in two ways. The value-weighted average is calculated by weighting the credit score of each investment by its value. The time-weighted average is calculated by weighting the credit score of each investment by both its value and its time to final maturity. Higher numbers indicate higher risk.