BODY:	**CABINET**
DATE:	**12th July 2017**
SUBJECT:	**Treasury Management Annual Report 2016-17**
REPORT OF:	**Deputy Chief Executive**

Ward(s):	All
Purpose:	To report on the activities and performance of the Treasury Management service during 2016/2017
Decision Type	
Contact:	Alan Osborne, Deputy Chief Executive, Financial Services Telephone Number 01323 415149.
Recommendations:	Cabinet is recommended to: 1. Agree the annual Treasury Management report for 2016/17. 2. Approve the 2016/17 prudential and treasury indicators included. 3. Approve the re-profiling of the Authorised Limit and Operational Boundary. 4. Note the review of Minimum Revenue Provision.

1.0 Introduction

1.1 This Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management 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 22 February 2017)
- a mid year (minimum) treasury update report (Council 16 November 2016)
- an annual report following the year describing the activity compared to the strategy (this report)

In addition Treasury Management updates are included in the quarterly performance management reports, considered by both the Cabinet and Scrutiny Committee.

Recent changes in the regulatory environment place a much greater onus on Members for the review and scrutiny of treasury management policy and activities. This report is 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 also 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 Audit & Governance Committee before they were reported to the full Council. Member training on treasury management issues was undertaken on 23 November 2015 in order to support Members' scrutiny role.

1.2 This report summarizes:

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement (CFR));
- Reporting of the required prudential and treasury indicators and changes to be approved;
- Review of Minimum Revenue Provision (MRP);
- 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;
- Debt activity and investment activity.

2.0 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

- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

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

	2015/16 Actual £m	2016/17 Estimate £m	2016/17 Actual £m
Non-HRA capital expenditure	12.24	38.24	21.19
HRA capital expenditure	5.03	6.39	5.76
Total capital expenditure	**17.93**	**44.63**	**26.95**

Resourced by:			
• Capital receipts	1.78	5.24	3.00
• Capital grants & external funding	2.69	3.59	5.93
• Capital Reserves	5.36	5.35	3.84
• Revenue	0.01	0.06	-
Use of internal balances/ borrowing	**8.08**	**30.39**	**14.18**

3.0 The Council's overall borrowing need

3.1 The Capital Financing Requirement (CFR) represents the Council's total underlying need to borrow to finance capital expenditure, i.e. capital expenditure that has not been resourced from capital receipts, capital grants and contributions or the use of reserves. Some of this borrowing is from the internal use of cash balances.

3.2 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 sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

3.3 **Reducing the CFR** – the Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP), to reduce the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need (there is no statutory requirement to reduce the HRA CFR). This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

3.4 The Council's 2016/17 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2016/17 on 3 February 2016.

The Council's CFR for the year is shown below, and represents a key prudential indicator. The figures include a credit sales agreement on the balance sheet, which increases the Council's borrowing need, the CFR.

CFR	31 March 2016 Actual £m	31 March 2017 Original Indicator £m	31 March 2017 Actual £m
Opening balance	68.23	76.1	75.09
Add unfinanced capital expenditure (per table 2.0)	8.09	3.1	14.18
Less MRP	(1.23)	(1.2)	(0.39)
Closing balance	75.09	78.0	88.88

3.5 The borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the Authorised Limit.

Net borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2016/17 plus the expected changes to the CFR over 2017/18 and 2018/19. This indicator allows the Council some flexibility to borrow in advance of its immediate capital need in 2016/17. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2016 Actual £m	31 March 2017 Original £m	31 March 2017 Actual £m
Net borrowing position	53.15	59.0	55.10
CFR	75.09	78.0	88.88

The Authorised limit - the Authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. 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	£93.0m
Maximum gross borrowing position	£55.1m
Operational boundary	£78.0m
Average gross borrowing position	£61.4m
Financing costs as a proportion of net revenue stream: Non HRA HRA	 4.4% 11.8%

The Non HRA financing costs as a proportion appears low due to the review of MRP in 2016-17 which considered the financing over past years and produced a one off reduction in the MRP for 2016-17. The figure would have been 10.9% if the review had not taken place.

3.6 The Authorised Limit and Operational Boundary for 2017-18 were approved Cabinet in February 2017. Cabinet are asked to approve a re-profiling of the CFR as investment opportunities arose in earlier years than originally estimated. The old and new limits are detailed below showing there in no overall increase in the CFR by 2019/20.

Operational boundary - £m	**2017/18 Estimate**	**2018/19 Estimate**	**2019/20 Estimate**
Original approved 2 February 2017	116.0	141.6	162.0
Amended for approval	131.9	149.7	162.0

Authorised limit £m	**2017/18 Estimate**	**2018/19 Estimate**	**2019/20 Estimate**
Original approved 2 February 2017	131.0	156.6	177.0
Amended for approval	146.9	164.7	177.0

3.7 During 2016-17 the Council undertook a review of the Minimum Revenue Provision (MRP) which resulted in a reduced MRP during 2016-17. The Council considers that its approach to MRP is prudent and affordable and is in accordance with the approved strategy.

4.0 Treasury Position as at 31 March 2017

4.1 The Council's debt and investment position is organised by staff within Financial Services 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 both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. 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	£38.55m		£46.55m	
-Market	£13.50m		£18.50m	
- Serco Paisa	£1.09m		£0.76m	
Total debt	**£53.10m**	**4.14%**	**£65.81m**	**3.66%**
CFR	£75.1m		£88.9m	
Over/ (under) borrowing	(£21.95m)		(£23.09m)	
Total investments	**£0m**		**£0m**	

The Council held cash balances of £1.7m in a current account on which interest of 0.15 was being earned.

4.2 The maturity structure of the debt portfolio excluding Serco Paisa was as follows:

	31 March 2016 Actual £m	2016/17 Original limits £m	31 March 2017 Actual £m
Under 12 months	6.00	3.00	10.00
12 months and within 24 months	7.00	4.00	4.00
24 months and within 5 years	9.02	8.3	9.02
5 years and within 10 years	4.14	4.9	4.14
10 years and above	25.89	38.8	37.89

The exposure to fixed and variable rates (including Serco Paisa) was as follows:

	31 March 2016 Actual £m	2016/17 Original Limits £m	31 March 2017 Actual £m
Principal - Debt Fixed rate	53.10	59.0	65.81

Principal – Investments Variable rate	0	N/a	0

5.0 The Strategy for 2016/17

5.1 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.

In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

During 2016/17 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.

During 2016/17 the Council used internal balances and temporary borrowing to ensure new borrowing was taken at the most advantageous rates. The Council took various long term borrowing during 2016/17 to lock into historically low rates and thereby reduce the risk of interest rate increases expected in the future. These are detailed below at 6.1.

6.0 Borrowing Outturn for 2016/17

6.1 **Treasury Borrowing**.

Borrowing – new loans totaling £12m were drawn down from PWLB in 2016-17 to fund the net unfinanced capital expenditure and to replace maturing loans and temporary loans of £7m were taken to cover cash flow requirements. The loans drawn were all fixed rate as follows:

Lender	Principal	Interest Rate	Start date	Maturity
PWLB	£2m	2.87%	7/4/16	24/3/66
PWLB	£2m	2.86%	16/5/16	24/3/63
PWLB	£2m	2.78%	3/6/16	24/9/60
PWLB	£2m	2.68%	10/6/16	24/3/64
PWLB	£2m	2.49%	20/6/16	24/3/59
PWLB	£2m	1.92%	15/8/16	24/9/59
Runnymede BC	£2m	0.30%	10/2/17	10/5/17
Middlesbrough BC	£5m	0.36%	22/3/17	15/5/17

This compares with a budget assumption of borrowing at an interest rate of 3.50%.

Rescheduling – no debt rescheduling was carried out during the year as there was no financial benefit to the Council.

Repayment – £4m of long term PWLB debt was repaid at maturity on 24 March 2017. A temporary loan of £2m from Lewes DC was repaid on 1 June 2016.

Summary of debt transactions – the overall position of the debt activity resulted in a fall in the average interest rate by 0.48%, representing a saving to the General Fund.

7.0 Interest Rates in 2016/17

7.1 The tight monetary conditions following the 2008 financial crisis continued through 2016/17 with little material movement in the shorter term deposit rates.

7.2 Bank Rate fell to an historical low of 0.25% during the year. Investment rates remained very low. With many financial institutions failing to meet the Council's investment criteria, the opportunities for investment returns were limited. The investment rates at the beginning, average and end of the year are provided below.

Investment Term	Interest Rate March 2016	Average Rate	Interest rate April 2017
Overnight	0.40%	0.20%	0.11%
1 Month	0.40%	0.22%	0.13%
3 Months	0.55%	0.31%	0.21%
6 Months	0.70%	0.46%	0.37%
12 Months	0.95%	0.95%	0.59%

The PWLB rates (including the 0.2% reduction for Certainty Rate) at the beginning, average and end of the year are provided below.

Loan Term	Interest Rate March 2016	Average Rate	Interest rate April 2017
1 Year	1.13%	0.93%	0.83%
5 Years	1.62%	1.36%	1.24%
10 Years	2.31%	2.01%	1.91%
20 Years	3.14%	2.72%	2.60%
50 Years	2.95%	2.49%	2.35%

8.0 Investment Outturn for 2016/17

8.1 **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 3 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.).

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

8.3 **Resources** – the Council's longer term cash balances comprise, primarily, revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and met the expectations of the budget:

Balance Sheet Resources	31 March 2016 £m	31 March 2017 £m
Balances	3.28	2.66
Earmarked reserves	8.30	8.98
HRA	3.68	4.37
Major Repairs Reserve	0	0.51
Capital Grants & Contributions	4.28	5.61
Usable capital receipts	6.05	5.16
Total	**25.59**	**27.29**

8.4 **Investments held by the Council** - the Council maintained an average balance of £13.1m of internally managed funds. The internally managed funds earned an average rate of return of 0.44%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.32%. This excludes the Council's investment with Lloyds Bank of £1m for 5 years at 3.03% which supports the Local Authority Mortgages Scheme (LAMS).

9.0 The Economy and Interest Rates Forecast

9.1 The two major landmark events that had a significant influence on financial markets in the 2016-17 financial year were 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.

9.2 The Council's treasury advisor, Capita, provides the following forecast as at 17th May 2017:

	NOW	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
BANK RATE	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.75
3 month LIBID	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.40	0.50	0.60	0.70	0.80
6 month LIBID	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.50	0.60	0.70	0.80	0.90
12 month LIBID	0.60	0.60	0.60	0.70	0.70	0.80	0.80	0.90	1.00	1.10	1.20	1.30
5 yr PWLB	1.20	1.40	1.40	1.50	1.60	1.70	1.70	1.80	1.80	1.90	1.90	2.00
10 yr PWLB	1.90	2.00	2.10	2.20	2.30	2.30	2.40	2.40	2.50	2.50	2.60	2.60
25 yr PWLB	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30
50 yr PWLB	2.40	2.50	2.60	2.70	2.70	2.80	2.80	2.90	2.90	3.00	3.00	3.10

The Capita central forecast is for the Bank Rate to increase to 0.50% in quarter 2 of 2019.

10.0 **Executive Summary and Conclusion**

10.1 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:

Actual prudential and treasury indicators	2015/16 Actual £m	2016/17 Original £m	2016/17 Actual £m
Actual capital expenditure	17.93	45.1	26.95
Total Capital Financing Requirement:			
• Non-HRA	34.01	62.7	47.18
• HRA	41.08	41.4	41.70
• Total	75.09	104.1	88.88
Net borrowing	52.05		65.1
External debt	52.05		65.1
Investments (all under 1 year)	0		0

Other prudential and treasury indicators are to be found in the main body of this report. The Deputy Chief Executive also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the Authorised limit), was not breached.

The financial year 2016/17 continued the challenging environment of previous years; low investment returns and continuing counterparty risk continued.

11.0 Consultation

Not applicable

Background Papers:

The Background Papers used in compiling this report were as follows:

CIPFA Treasury Management in the Public Services code of Practice (the Code)
Cross-sectorial Guidance Notes
CIPFA Prudential Code
Treasury Management Strategy and Treasury Management Practices adopted by the Council on 18 May 2010.

To inspect or obtain copies of background papers please refer to the contact officer listed above.