Medway Council
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CABINET

11 JULY 2017

TREASURY MANAGEMENT OUTTURN ANNUAL REPORT

Portfolio Holder: Councillor Alan Jarrett, Leader

Report from: Phil Watts, Chief Finance Officer

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Summary

This report gives an overview of treasury management activity during 2016/17.

1 Budget and Policy Framework

1.1 The Council's treasury management strategy and policy are approved by Full Council following consideration by Cabinet and Audit Committee. The Audit Committee is responsible for approving the annual treasury outturn. In line with the Constitution an annual report must be taken to Cabinet detailing the Council's treasury management outturn within six months of the close of each financial year.

2 Background

2.1 This Council is required by regulations issued under the Local Government Act 2003 to produce an annual review of 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).

2.2 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 25 February 2016)
- A mid-year treasury update report (Council 13 October 2016)

2.3 The regulatory environment places responsibility 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.

2.4 This Council also promotes prior scrutiny of the Treasury Strategy and mid-year review by submission to Audit Committee before reporting to Cabinet and Full Council.

2.5 This annual treasury outturn report covers:

- The Council's treasury position as at 31 March 2017;
- Borrowing activity 2016/17
- Performance measurement
- The strategy for 2016/17
- The economy and interest rates in 2016/17
- Borrowing rates in 2016/17
- The borrowing outturn for 2016/17
- Debt rescheduling;
- Compliance with treasury limits and Prudential Indicators
- Investment rates in 2016/17
- Investment outturn for 2016/17

3 The Economy and Interest Rates

3.1 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.

3.2 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.

3.3 **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%.

3.4 **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.

3.5 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.

3.6 **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.

3.7 **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.

3.8 **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.

4 Overall Treasury Position as at 31 March 2017

4.1 The Council's debt and investment position at the beginning and end of the year was as follows.

Table 1 – borrowing and investment levels

	31/03/16 £m	Rate	31/03/17 £m	Rate
Long Term Borrowing – PWLB/LOBO	164.0	4.22%	164.0	4.22%
Long Term Borrowing – Growing Places/Salix	7.5		7.4	
Short Term Borrowing	9.3	0.75%	36.2	0.36%
Plus Other Long Term Liabilities*	0.5		0.3	
Total Debt	181.3		207.9	
Capital Financing Requirement (CFR)	252.0		256.0	
(Under)/Over Borrowing	(70.7)		(48.1)	
Less investments (exc CCLA)	19.5	1.13%	21.8	1.30%
Less CCLA investment **	2.8	-4.14%	2.8	3.17%
Net borrowing	159		183.3	

* Embedded Leases (on balance sheet)

** The return on the CCLA investment includes the change in capital value. The overall negative return for the year ended 31 March 2016 was largely due to downward capital devaluation reflecting the bid-offer pricing spread. Capital value was also lower at 31 March 2017 (£2.78m) compared with 31 March 2016 (£2.82m) but both values were based on bid price. The overall return in 2016/17 comprising both capital deterioration and dividend income was positive.

5 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 2016), 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.

5.2 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.

5.3 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.

6 The Borrowing Requirement and Debt

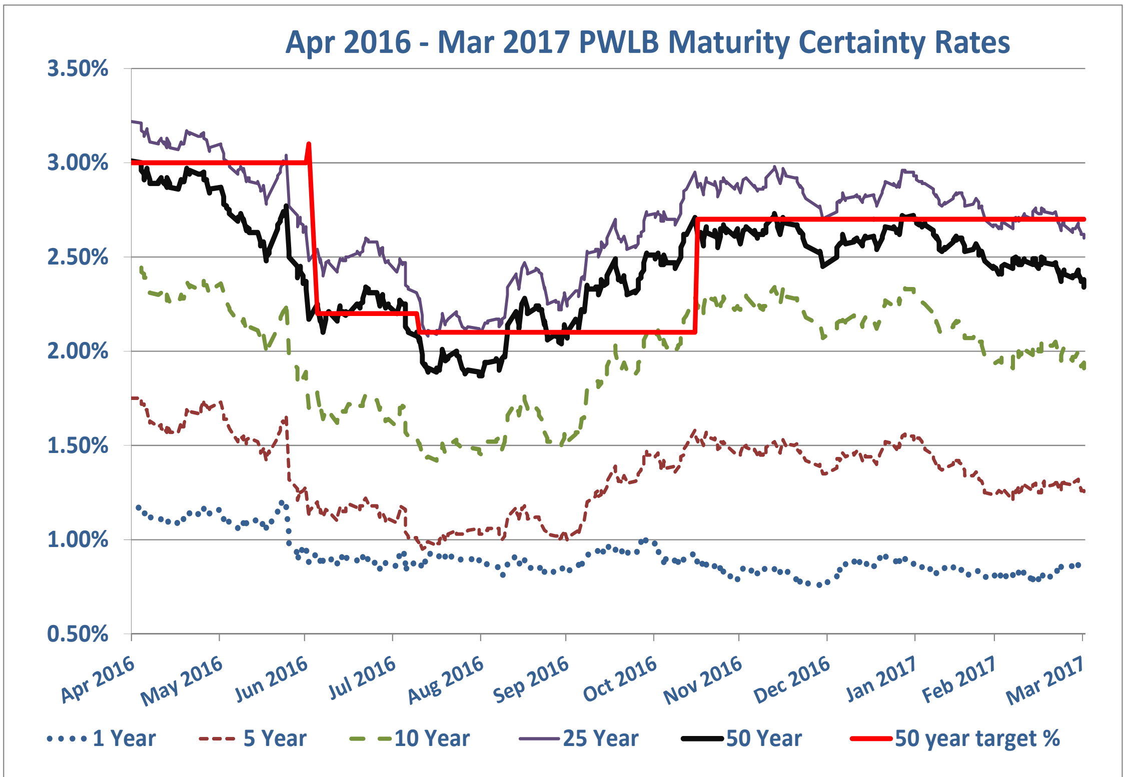
6.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2016/17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

Table 2 Capital Financing Requirement

	31 March 2016 Actual £000	31 March 2017 Budget £000	31 March 2017 Actual £000
CFR General Fund (£m)	212,110	189,583	214,093
CFR HRA (£m)	40,566	44,673	41,941
Total CFR	252,034	234,256	256,034

7 Borrowing rates in 2016/17

7.1 During 2016-17, PWLB rates fell from April to June and then gained fresh downward impetus after the referendum and Bank Rate cut, before staging a partial recovery through to December and then falling slightly through to the end of March. The graph for PWLB rates below, show for a selection of maturity periods, the average borrowing rates, the high and low points in rates. Spreads and individual rates at the start and end of the financial year.



8 Borrowing Outturn for 2016/17

8.1 The borrowing strategy for the council confirmed the holding of £101.8 million in Lenders Options, Borrowers Options (LOBO) debt. These are debts that are subject to immediate repayment or variation of interest chargeable and the option to repay, on request from the lender on the review dates. However, the lender can only apply this clause once within the lifetime of the LOBO. Previously these loans have been classified as fixed rate but following the 2015/16 audit they have been reclassified as variable.

8.2 No new long term loans were taken out and no repayments of long term loans made except for annuity repayments.

8.3 The approach during the year was to use cash balances to finance new capital expenditure so as to run down cash balances and minimise counterparty risk incurred on investments. This also maximised treasury management budget savings, as investment rates were much lower than most new borrowing rates.

8.4 Expenditure levels at the end of March 2107 necessitated the undertaking of temporary borrowing from other councils. Details of the borrowing is shown in the table below

Lender	Amount Borrowed	Date Borrowed	Date Repaid	Annual Interest Rate
Middlesborough Borough Council	£10m	27/2/17	28/4/17	0.28%
Royal Borough of Kensington & Chelsea	£5m	24/10/16	17/10/17	0.36%
City of London Corporation	£10m	7/3/17	28/4/17	0.43%
Gateshead Council	£5m	7/3/17	18/4/17	0.40%
Police & Crime Commissioner for West Midlands	£5m	7/3/17	3/4/17	0.30%

8.5 Liquidity is being managed through continued use of temporary borrowing rather than taking out longer term borrowing higher rates. The new loans borrowed to date in 2017/18 are as follows

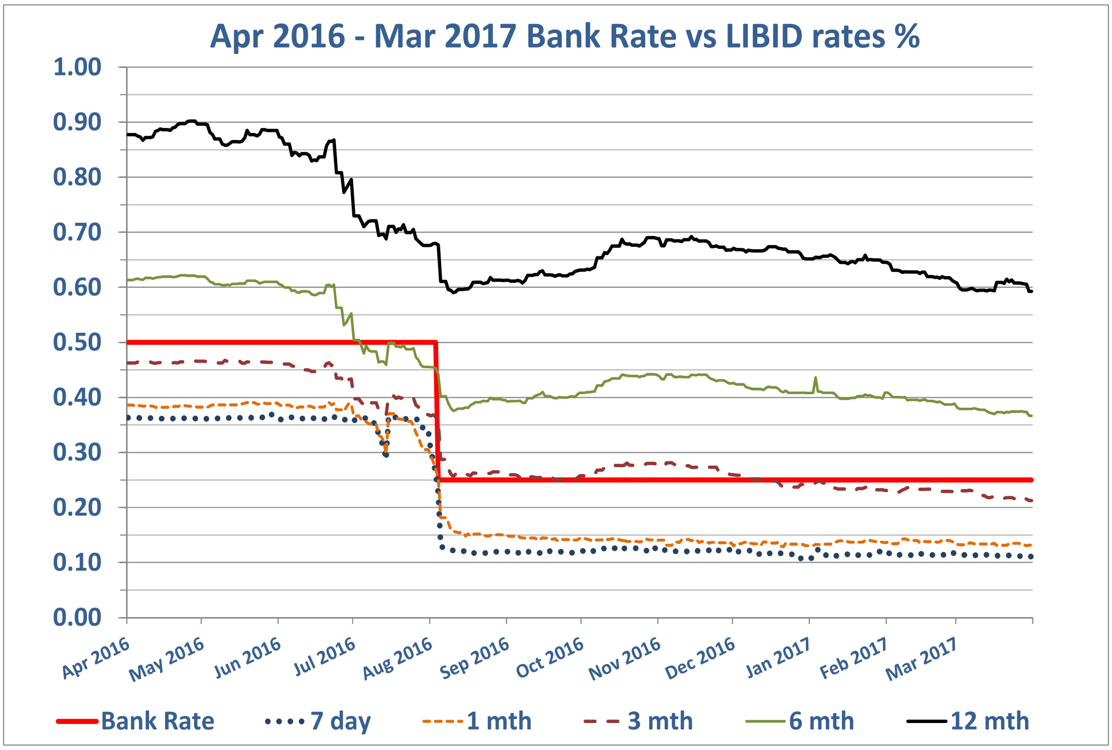
Lender	Amount Borrowed	Date Borrowed	Repayment Date	Annual Interest Rate
Westminster City Council	£10m	19/4/17	20/2/18	0.53%
Essex County Council	£10m	28/4/17	31/10/17	0.50%
Leicester City Council	£5m	28/4/17	30/10/17	0.50%
Derbyshire CC Pension Fund	£10m	28/4/17	29/9/17	0.45%

9 Debt Rescheduling

9.1 No debt restructuring was undertaken during 2016/17 as the average differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable. It is not envisaged that that there will be any opportunities where the debt restructuring would be economically viable in 2017/18.

10 Investment Rates in 2016/17

10.1 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.



11 Investment Outturn for 2016/2017

11.1 **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 25 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.).

11.2 **Internally Managed Investments** – The Council manages its investments in-house using the institutions listed in the Council's approved lending list. These funds are identified as 'core funds' where the investment can be for an extended time period and usually fixed prepayment date, or 'cash flow' where the investment is required to be available for immediate liquidity. The council can invest for a range of periods from overnight to 5 years dependent on forecast of the Council's cash flows, the duration and counterparty limits set out in the approved investment strategy, its interest rate view and the interest rates on offer. During the year all investments were made in full compliance with the Council's treasury management policies and practices. The Annual Investment Strategy, outlines the Council's investment priorities as:

(1) Security of capital and liquidity; and
(2) The achievement of optimum return (yield) on investments.

11.3 **Externally Managed Investments** – The Council invested £3m in the Churches Charities & Local Authorities (CCLA) Property Fund.

11.4 **Investment performance for 2016/17 –** Detailed below is the result of the investment strategy undertaken by the Council.

Table 3 Internally Managed Investment Performance 2016/17

	Average Investment	Rate of Return (gross of fees)
Internally Managed – Core Funds	£19,475,000	2.06%
Internally Managed – Cash Flow Funds	£14,916,740	0.32%
Overall Internally Managed Funds (excluding CCLA)	£34,391,740	1.30%

11.5 Core funds were invested with other local authorities as follows

Authority	£m	Maturity Date	Rate%
City of Newcastle Upon Tyne	5.000	31/7/19	2.35
Lancashire County	5.000	1/8/18	2.00
Doncaster Metropolitan Borough	5.000	8/8/19	2.35
Newport City	4.475	10/7/17	1.50
	19.475		

11.6 The Council invested £3m in the CCLA Property Fund on 31 October 2015. The capital value that the holding could have been sold for on 31 March 2016 was £2.823m. Over the year 2016/17 the value of the holding fell by a further £0.044m to £2.779m but yielded divided income of £0.134m net of management charges.

11.7 No institutions in which investments were made during 2016/2017 had any difficulty in repaying investments and interest in full during the year.

11.8 The graph below is produced by Capita Asset Services (our external adviser) in its own benchmarking exercises which are built to compare return vs. risk.

11.9 The "x" axis of the graph shows the "Model Weighted Average Rate of Return" (WARoR), this is the level of return we should expect for the level of risk that we are taking with our investment portfolio. This is then plotted against the "Actual Weighted Average Rate of Return" on the "y" scale. Running diagonally upwards across the graph are two parallel lines, if a Council performance falls between these lines then they are deemed to be receiving a return as would be expected for their level of risk, below these two lines and performance is considered below that expected and above indicates that the return being received is above expectation. As can be seen Medway's return is "above" that expected for our level of risk.

11.10 The Capita benchmarking is run as a snap shot as at 31 March 2017 and not the performance for the whole of 2016-17 financial year.

Actual Returns against Model Returns

	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Medway Council	186%	161%	0 25%	155%	167%	Above

12 Compliance with Treasury Limits

12.1 The 2016/17 strategy placed a limit of 40% of the borrowing portfolio which could be subject to variable interest rates. LOBOs were classified as fixed rate borrowing in the strategy. Subsequently the Council has been advised that LOBOs should be treated as variable rate borrowing. Under this definition the proportion of variable rate borrowing at 31 March 2017 was 69.3% including LOBO's which stood at 51.6%. However the 2017/18 strategy includes a specific limit for LOBO loans of 65% of the loan book. There would be no breach in 2016/17 if either the LOBO's were classified as fixed rate or alternatively had the 2017/18 limits been in place. The outturn for the Prudential Indicators is shown in Appendix 1.

13 Audit Committee – 29 June 2017

13.1 Members considered a report which gave an overview of treasury management activity during 2016/17. It was noted that this report would also be referred to Cabinet on 11 July 2017.

13.2 The Principal Accountant gave a detailed presentation of the main highlights of the report and also made a couple of corrections as follows:

Table 1 (page 38 of the (Audit Committee) Agenda) – add "4.22%" to the Rate column for Long Term Borrowing – PWLB/LOBO for the year ended 31/03/17.

Paragraph 8.5 (page 40 of the (Audit Committee) Agenda) – reference to 2016/17 should read 2017/18.

13.3 A Member referred to the tables set out in pages 40 and 42 of the (Audit Committee) Agenda (loans made to or from other Local Authorities) and requested that in future this information should include the total sums repaid.

13.4 A Member requested information on the financial relationship (excluding pensions) between Medway Council and Kent County Council and the Chief Finance Officer undertook to provide a Briefing Note on this matter.

13.5 The Committee approved the treasury management outturn annual report and referred it to Cabinet. The Committee also requested a briefing note setting out on the financial relationship (excluding pensions) between Medway Council and Kent County Council.

14 Risk Management

14.1 Risk and the management thereof is a key feature throughout the strategy and in detail within the treasury management practices (TMP1) within the Treasury Strategy.

15 Financial Implications

15.1 Overall the Interest and Financing budget made a surplus over its targeted budget of £181k. Bank rate continued at the historically low rate of 0.5% throughout 2015/16, however, the overall rate achieved on cash based investments averaged 1.3%.

15.2 A breakdown of the Interest and Financing budget is shown below

Table 4 Interest and Finance Budget against spend

	Budget 2016/17 £000's	Actual 2016/17 £'000s	(Under)/ Overspend £'000s
Treasury Expenses	170	218	48
Interest Earned	(3,284)	(3,101)	183
Interest Paid	8,730	8,734	4
KCC Principal	1,538	1,538	0
MRP	3,004	3019	15
Invest to Save recharges	(541)	(972)	(431)
Total	**9,617**	**9,436**	**(181)**

15.3 The shortfall in interest earned is due to the low interest rates available and the squeeze on cash resources from spending of past receipts and reserves for capital expenditure.

15.4 The budget for invest to save was set before the outturn for 15/16 was known. The actual invest to save income for 15/16 was £836k which is closer to the 16/17 outturn than the budget set for that year. The increase from £836k to £972k is due to financing of capital expenditure incurred in 2015/16.

15.5 The body of the report and the appendix outline the significant financial implications. Any transactions undertaken on either investments or borrowings are governed by the London Code of Conduct, the council's treasury policy statement, and the CIPFA Code of Practice on Treasury Management in Local Authorities.

16 Legal implications

16.1 For the financial year 2016/17 our investments were managed in compliance with the Codes of Practices, guidance and regulations made under the Local Government Act 2003.

17 Recommendation

17.1 The Cabinet is asked to note the comments of the Audit Committee and note the Treasury Management Outturn Annual Report.

18. Suggested reasons for decision

18.1 Section 7.1 (e) of the Council's Financial Rules state that the Chief Finance Officer shall report to Cabinet and the Audit Committee not later than September on treasury management activities in the previous year.

Appendices
Appendix 1 Prudential and Treasury Indicators

Background papers
None

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Appendix 1

PRUDENTIAL AND TREASURY INDICATORS

	2015/16	2016/17	2016/17
	£'000	£'000	£'000
	Actual	Estimate	Actual
Capital Expenditure			
Non - HRA	35,312	23,716	40,073
HRA	6,784	7,439	7,656
TOTAL	42,096	31,155	47,729
Ratio of financing costs to net revenue stream			
Non - HRA	4.08%	2.35%	4.16%
HRA	23.18%	17.24%	22.73%
Gross borrowing requirement			
brought forward 1 April	166,006	164,766	180,797
carried forward 31 March	180,797	168,687	207,684
in year borrowing requirement	14,791	(87)	26,888
Capital Financing Requirement as at 31 March			
Non – HRA	211,399	189,583	214,093
HRA	40,566	44,673	41,941
TOTAL	251,965	234,256	256,034
HRA Limit on Indebtedness	45,846	45,846	45,846
Annual change in Cap. Financing Requirement			
Non – HRA	4,103	(9,901)	1,983
HRA	24	2,143	1,375
TOTAL	4,127	(7758)	3,358

	2015/16 Limit £'000	2016/17 Limit £'000	2016/17 Breach?
Authorised Limit for external debt -			
borrowing	420,285	408,296	No Breach
other long term liabilities	4,400	1,100	No Breach
TOTAL	424,685	409,396	No Breach
Operational Boundary for external debt -			
borrowing	382,077	371,178	No Breach
other long term liabilities	4,000	1,000	No Breach
TOTAL	386,077	372,178	No Breach
HRA Limit on Debt	45,846	45,846	No Breach
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	100%	100%	No Breach
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments	40%	40%	See report paragraph 12.1
Upper limit for total principal sums invested for over 364 days (per maturity date)	£150,000	£150,000	No Breach

Maturity structure of fixed rate borrowing during 2015/16	upper limit	lower limit	Breach?
under 12 months	50%	0%	No Breach
12 months and within 24 months	50%	0%	No Breach
24 months and within 5 years	50%	0%	No Breach
5 years and within 10 years	50%	0%	No Breach
10 years and above	100%	0%	No Breach