BLACKBURN with DARWEN BOROUGH COUNCIL

REPORT to :	Council Forum
LEAD OFFICER:	Director of Finance and IT
DATE:	5th October 2017

WARD/S AFFECTED: All

Treasury Management Mid-Year Strategy Review for 2017/18 and Annual Report 2016/17

1. PURPOSE

1.1 To update Members with regard to the Treasury Management position to date and proposed Strategy for the remainder of 2017/18, and to formally report the Treasury outturn for 2016/17, as previously reflected in reporting to Audit and Governance Committee, and in the 2016/17 Outturn Corporate Monitoring Report (13th July Executive Board).

2. RECOMMENDATIONS

2.1 The Council is recommended to

(a) note the Outturn position for 2016-17

(b) agree to the proposed changes to the Treasury Indicators for the Maturity Structure of Borrowing, and for the Upper Limit on Variable Interest Rate Exposure,

(c) agree to the continuation of the existing Treasury Management Strategy, and the remaining Treasury and Prudential Indicators for 2017/18, as set at Finance Council in February 2017.

3. BACKGROUND

3.1 In March 2012 the Council adopted CIPFA's 2011 Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes, and an updated Treasury Management Policy Statement.

3.2 In February 2017 the Council agreed a Treasury Management Strategy and Minimum Revenue Provision (MRP) Policy for 2017/18.

3.3 The CIPFA Treasury Management Code requires the Council to approve a Treasury Management Strategy (including various Treasury Management indicators) before the start of each financial year, and to consider both the outturn after each year end, and the mid-year position in each current year. The Council has determined to combine the formal outturn report and mid-year review into a single report.

4. KEY ISSUES AND RISKS

4.1 Treasury Priorities

The Council has operated within CIPFA and statutory guidance and requirements in respect of Treasury Management practice. The approved Treasury Management Policy Statement, together with the more detailed Treasury Management Practices and each year's Annual Strategy have all emphasised the importance of security and liquidity over yield.

5. 2016/17 OUTTURN

5.1 Original Strategy for 2016/17

5.1.1 The Strategy for 2016/17 was approved by Council on 29th February 2016. The main aspects of the strategy are outlined below :

- With short-term interest rates expected to continue to be lower than long-term rates it was acknowledged, for another year, that it may continue to be more cost effective not to borrow and instead reduce the level of investments.

- Long-term borrowing would be taken if it became apparent that there was a risk of significantly increased interest rates.

- Any balances over and above those required to maintain basic liquidity could be invested either in the medium term (out to a year) or the longer term (over a year), though it was recognised that long term investment was unlikely. Priority was given to security of funds and liquidity (accessibility) over yield (or return).

- The limits to investment by reference to amount, duration and credit rating were largely unchanged from those applying in previous years

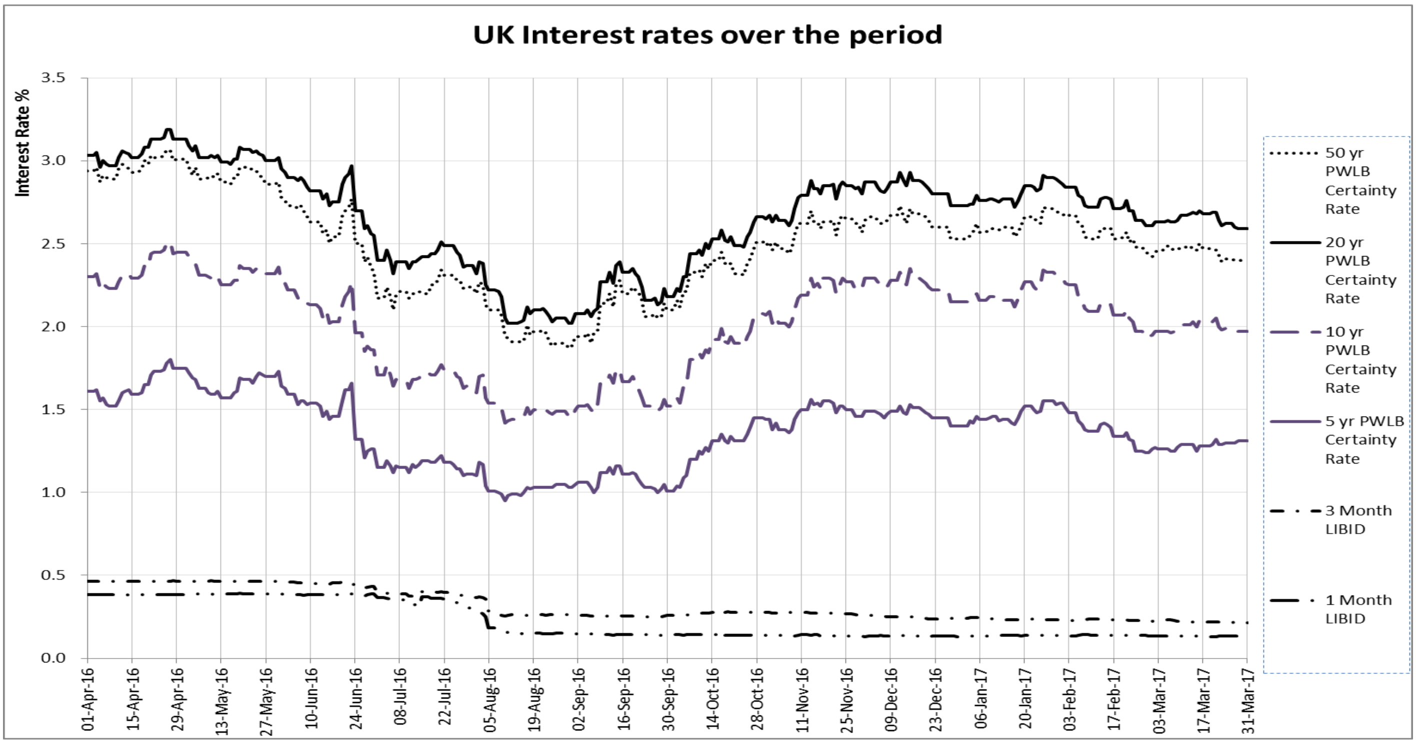
5.2 Economic Review 2016/17

5.2.1 There was significant market volatility across the year, driven by both (a) a slowdown in the Chinese economy in early 2016, and (b) uncertainty over and reactions to political events, including the UK referendum on European Union membership, and United States and European elections. UK inflation had been subdued in the first half of 2016, but falling Sterling exchange rates and rising energy prices resulted in higher inflation, with CPI rising from 0.3% (April 2016) to 2.3 % (April 2016). There was also a decline in household, business and investor confidence. This prompted the Bank of England's Monetary Policy Committee (MPC) to cut the Bank Rate to 0.25% in August and embark on further gilt and corporate bond purchases.

5.2.2 Though growth forecasts were downgraded, UK economic activity was fairly buoyant and unemployment rates fell further, to their lowest for more than a decade. The United States economy strengthened enough to prompt the Federal Reserve to increase rates in December 2016 and March 2017, but the European economy remained stagnant.

5.2.3 After the Referendum result, UK gilt yields – which determine the cost of government borrowing - fell sharply across the maturity spectrum, on the view that Bank Rate would remain extremely low for the foreseeable future. They then went back up in the Autumn, before falling again, in the longer maturities, towards the year end.

The pattern of interest rates over the year is summarised in the chart below. Local government long term borrowing costs are set by the Public Works Loans Board (PWLB) - these directly mirror gilt yields. Nominal investment rates, measured through the London Inter-Bank Bid Rate (LIBID), are also shown - these declined slowly across the year, so short run investment returns and the cost of short term borrowing remained stable and low.



5.3 Treasury Management Performance 2016/17

5.3.1 By 31st March 2017, the Council had net borrowing of over £162M, arising from its revenue and capital income and expenditure, up £19M from the previous year.

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in the table below.

Balance Sheet Summary	31 March 2016 £M	2016/17 Movement £M	31 March 2017 £M
General Fund CFR	297.5	4.2	301.7
Less CFR re Debt Managed by LCC	-16.6	0.3	-16.3
Less CFR re PFI Debt	-70.1	0.1	-70.0
Loans/Borrowing CFR	**210.8**	**4.6**	**215.4**
Less Usable Reserves	-52.5	3.1	-49.4
Less Working Capital	-15.3	11.6	-3.7
Net Borrowing	**143.0**	**19.3**	**162.3**

The overall increase in **net borrowing** was due to new capital expenditure financed from borrowing being greater than the financing applied (including MRP), and because of a decline in both usable reserves and in working capital.

The Council's new MRP Policy – under which, from 2016/17, for a number of years,
- (a) the MRP charge to the accounts in respect of both PFI debt and debt managed by Lancashire County Council (LCC) will be less than the actual debt repaid, and
- (b) the MRP charge to the accounts in respect of the Council's own capital spend financed from

borrowing will be reduced,

has resulted in the Council's CFR being higher than it otherwise would have been, and will increase borrowing interest costs in the short run.

5.3.2 The following table summarises debt and investments at the start and end of the year:

	31 Mar 2016 Principal (£ M)	Rate / Return	Avg Life (Yrs)	31 Mar 2017 Principal (£ M)	Rate / Return	Avg Life (Yrs)
Fixed rate funding:						
PWLB	112.9	4.44%	22.7	105.3	4.18%	23.5
Market Debt (Long Term)	10.3	4.47%	38.7	10.3	4.47%	37.7
Market Debt (Short Term)	18.5	0.47%		57.0	0.40%	
	132.0			**172.6**		
Variable rate funding:						
PWLB	0.0			0.0		
Market	11.5	5.38%	18.0	11.5	5.38%	17.0
	13.5			**11.5**		
Loans taken by BwDBC	**153.2**	**4.52%**	**23.5**	**184.1**	**4.32%**	**24.0**

Debt from PFI arrangements	70.1			68.6		
Debt managed by Lancashire County Council	16.6	2.0%		16.0	2.1%	
Total debt	**239.9**			**268.7**		

Total investments	**10.5**	**0.44%**		**22.2**	**0.31%**	

No new long term borrowing was taken in 2016/17. The key changes to the Council's overall debt position across the year were:

a) Principal repayments on PWLB debt:
£1.6M on EIP (Equal Instalment of Principal) loans & a £6M Maturity loan repaid,

b) An increase in the level of short term borrowing, from £18.5M to £57M,

c) Repayments of part of the outstanding debt recognised on the balance sheet for Building Schools for the Future the debt, and for debt managed by LCC.

No debt rescheduling was undertaken, because the premiums payable on early repayment of PWLB debt made it uneconomic to do so.

Short term loans were taken for a range of durations at various points across the year. Investments continued to be maintained to ensure sufficient resources to cover day to day cash flow needs, and would be higher when the timing of short term loans taken was not aligned to the immediate cash flow requirements of the Council.

Overall investment balances were significantly lower than they would have been if long term borrowing had been taken to cover the Council's CFR position, and the degree to which long term debt was less than CFR widened, from around £76M to around £88M.

The deliberate strategy of taking short term loans continued to reduce the interest earned on balances, but delivered large savings on borrowing costs.

5.3.3 In summary, the outturn position in respect of interest costs and income, and MRP charges, was as follows:

Outturn 2015/16 £'000		Original Budget 2016/17 £'000	Outturn 2016/17 £'000
6,668	Interest paid on borrowing	6,250	5,917
227	Interest paid on debt managed by LCC	349	289
6,358	PFI interest paid	6,456	6,460
(367)	Interest receipts	(176)	(214)
6,591	MRP on Council borrowing	7,744	4,985
1,441	MRP – PFI debt	1,543	130
694	MRP – debt managed by LCC	666	340

5.3.4 Interest paid on borrowing in 2016/17 was around £0.3M less than the Original Estimate, which had allowed for higher levels of borrowing. As already noted, there was no new long term borrowing taken in the year. Included in the interest paid was that on short term borrowing – the element relating to short term debt went up from around £56,000 to around £124,000.

PFI interest charges did not add to the "bottom line" faced by the Council Taxpayer, as grants covered their cost.

5.3.5 The average investment balance over the year was down, at £20M (£27M in 2015/16). Balances were lowest at the start of the year, along with a brief dips in the early summer (see **Appendix 1**). In turn, overall interest earned was down to £0.21M in 2016/17 (£0.37M in 2015/16). The most significant component was the dividend and interest income from the Council's BSF PFI holding, at £0.14M (against £0.13M in 2015/16). Interest earned on treasury cash investments fell, and the average rate of return was also down, at 0.3% (against 0.44% in 2015/16).

Interest rates have been low for several years, and the rates available from the limited range of institutions used by the Council remained low across 2016/17. Funds have continued to be invested for short periods, and sometimes with the government's Debt Management Office, to manage risk – this also contributed to the low returns.

5.3.6 The impact of the new MRP Policy can be seen in the significant MRP savings in 2016/17.

5.3.7 The position with regard to performance against Treasury/Prudential Indicators in 2016/17 is summarised in **Appendix 2**. There were no breaches of the Borrowing Limits. Outturn capital spend was £23M, down on the £29M forecast. The level of capital spend financed from borrowing was also lower than forecast, and the outturn **total** Capital Financing Requirement of £302M (including LCC and PFI debt) was lower was lower than the original forecast.

The high level of short term borrowing by the end of 2016/17 caused two of the Council's Treasury Indicators to be "breached" in the last two weeks of the year -

(a) Proportion of Fixed Term Debt Maturing in Less Than a Year was over the 30% Limit
(b) Variable Interest Rate Exposure was over the £43M Limit

These breaches were warning flags, showing that the Council took more short term borrowing than it had anticipated. These Limits are designed to help the Council recognise and manage its risk appetite, not to act as a block on treasury practices, and their breach is not a significant issue.

5.4 Treasury Management Consultancy

5.4.1 The Council is contracted up to 31st March 2020 to receive treasury management support from Arlingclose Limited. They provide advice and information on the Council's investment and borrowing activities, although responsibility for final decision making remains with the Council and its officers.

5.4.2 Over the period, in providing support to the Council, Arlingclose have reviewed the Council's Treasury management procedures and activities. They have provided member training; ongoing officer training; support for and review of treasury decisions, reports and strategies; feedback on accounting for treasury activities; benchmarking with other authorities; guidance on borrowing and investment opportunities; forecasts of interest rates; and regular updates on credit ratings and other information on credit quality. The quality of the support provided has been of a high standard.

5.5 Counterparty Update

5.6.1 Various indicators of credit risk reacted negatively to the result of the EU Referendum. 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.

5.6.3 The Authority's treasury advisor, Arlingclose, monitored the changing circumstances across the year, issuing frequent guidance on investment risks. As part of its creditworthiness research and advice, it undertook regular analysis of relevant ratios to determine whether there would be a bail-in of senior investors, such as local authority unsecured investments, in a stressed scenario.

In general terms, the limited range of investments used, day to day, by the Council, meant that there were no significant implications for us. (One building society was removed from the Council's investment list in July due to deterioration in credit indicators.)

6. STRATEGY REVIEW 2017/18

6.1 Original Strategy for 2017/18

6.1.1 The Treasury Management Strategy for 2017/18 was approved by Council on 27th February 2017. The Council adopted the latest (2011) edition of the CIPFA Code of Practice on Treasury Management in March 2012.

6.1.2 The broad strategy set at the start of 2017/18 continued the approach set for 2016/17, recognising a widening, significant long-term under-borrowing against the Council's accumulated Capital Financing Requirement. There was uncertainty over the timing of still anticipated future increases in borrowing costs - interest rate increases, if not in 2016/17, were then still expected in the next few years. The availability of cheaper short-term cash still meant, however, that it was still likely that the Council would be able to limit long-term borrowing and generate net interest savings, as it had been doing for a number of years.

6.1.3 **The Original 2017/18 Investment Limits** – were set by reference to amount, duration and credit rating - distinguished between Unsecured Deposits, which would be subject to greater risk of credit loss, and Secured Deposits, where there was less risk. The limits set were largely comparable to those applying in previous years. The medium term intention was that, should investment balances grow, a greater diversity of investments would be used, again with a view to managing risk. **Appendix 3** summarises the investment criteria set for 2017/18.

6.2 Economic Review 2017/18

6.2.1 The UK Consumer Price Inflation (CPI) index grew appreciably early in the year, hitting a maximum in May of 2.9% - it is currently 2.6%. Though fuel prices dipped in the early part of the year, this was more than offset by the continuing impact of the fall in the value of sterling. Employment data remained buoyant, but though GDP continued to grow, the rate of increase appears to have fallen away.

An easing off of the rate of growth in the United States early in 2017 is still expected to be followed by further recovery in their growth rates, and there are recent signs of recovery in a number of European economies.

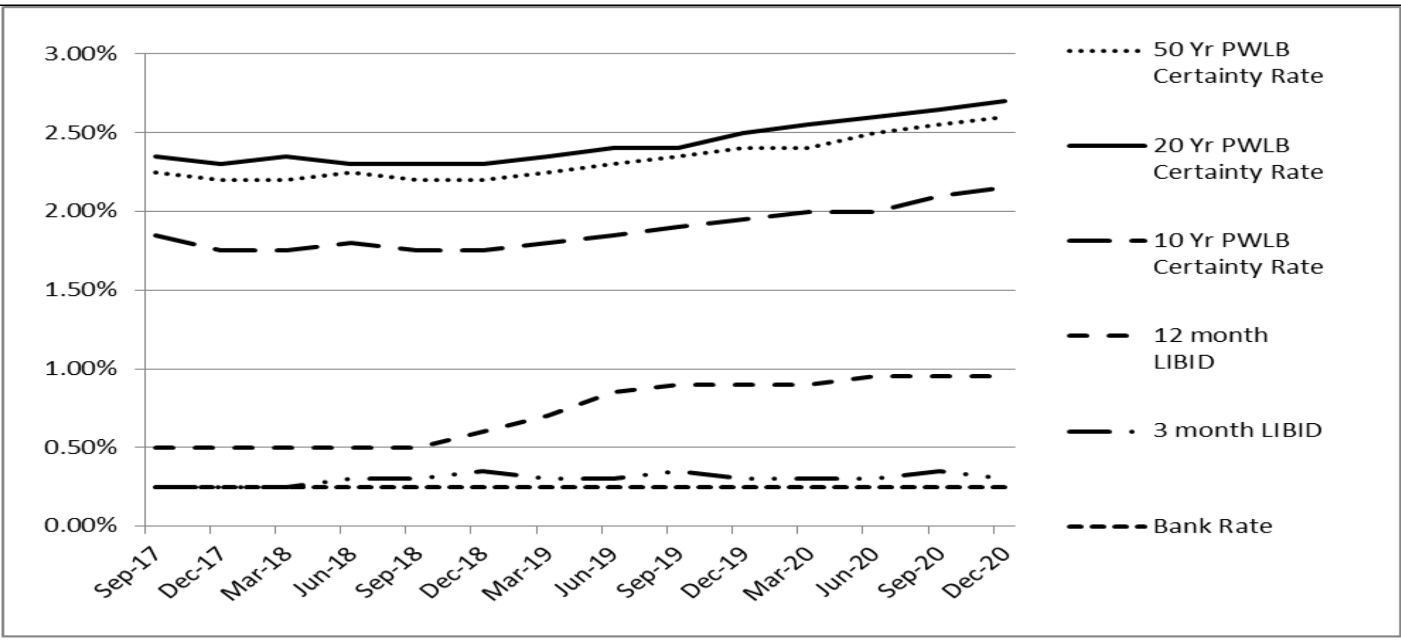
6.2.2 The UK political and economic uncertainty associated with "Brexit" was exacerbated by the outcome of the June general election. The reaction from the markets was muted, but business confidence now hinges on the progress made (or not) over Brexit negotiations, whether new trade treaties and arrangements are successfully concluded and whether or not the UK continues to remain part of the EU customs union post the country's exit from the EU.

There has been no significant change in the Bank of England's monetary policy over the period. Notwithstanding the uncertainty, Arlingclose project that the Bank of England will "look through" what it expects to be a limited period of higher inflation and maintain its low-for-longer stance on policy interest rates for an extended period.

6.2.3 With regard to UK banks, credit default swap rates – an indicator of confidence in the banking sector - have continued a downward trend, reaching three year lows by the end of June. Bank share prices have not moved in any particular pattern.

Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. Arlingclose advised a reduction in the maximum duration of deposits at Bank of Scotland, HSBC Bank and Lloyds Bank, as there is some uncertainty surrounding which banking entities councils will be dealing with once ring-fencing is implemented, or what the balance sheet structures of those banks will be. However, this Council's already limited range of investments was unaffected, as funds were already placed with banks and building societies on a limited time basis, or on an instant access basis.

6.2.4 Market expectations are now for a significant period of low interest rates. The **Council's current projections for interest rates**, based on the latest central forecast from our advisors Arlingclose is summarised in the chart below.



6.3 Treasury Performance to Date

6.3.1 Thus far, cash balances have typically averaged between £20M and £35M. These levels have been supported by short term borrowing (at low rates, averaging below 0.4%). No long term borrowing has yet been taken, while short term borrowing has fluctuated, but currently stands at around the same level as the start of the year.

Analysis of debt outstanding

	31st March 2017		31st August 2017	
	£M	£M	£M	£M
TEMPORARY DEBT				
Less than 3 months	8.0		0.0	
Greater than 3 months (full duration)	49.0		59.3	
		57.0		59.3
LONGER TERM DEBT				
PWLB	105.3		105.3	
Bonds	21.5		21.5	
Other Market Debt	0.3		0.3	
		127.1		127.1
Lancs County Council transferred debt		16.0		15.8
Recognition of Debt re PFI Arrangements		68.6		67.9
TOTAL DEBT		268.7		270.1
Less: Temporary Lending		-10.5		-22.1
		246.5		248.0

6.3.2 Investments have continued to be made with a limited range of banks, building societies and Money Market Funds, along with other local authorities, and the Government's Debt Management Office (DMO), earning interest at low levels (averaging below 0.25% in the first half of the year). It is likely that investment returns will remain low in the second half of the year.

6.3.4 Net savings of around £0.24M on the Original Estimate for interest and MRP costs have already been reported through corporate monitoring, reflecting lower borrowing last year, and this year to date. Investment returns remain low, and will fall below the Original Estimate. Further net interest savings are possible, depending upon the Council's cash flow.

It is likely that the Council will be able to continue to borrow short term monies at low rates for the rest of this year, and into future years.

6.4 Investment and Borrowing Strategy for the rest of the year

6.4.1 Though the Council's Investment Criteria allow investment in other organisations and structures, the priority given to maintaining liquidity, and limited opportunities for straightforward trading in Secured Deposits, have meant that simple, tried and tested, and short dated options have been used. Therefore, actual investments have continued to be made in - fixed term deposits and instant access accounts with banks and building societies; instant access Money Market Funds; and fixed term deposits with local authorities and the UK Government's DMO.

It is likely, particularly if material levels of borrowing are taken in future, that at least some investments will be made in a wider range of high grade instruments, such as Treasury bills. The Council's professional treasury advisers, Arlingclose, consider that such widening of the range of the Council's investment instruments is both appropriate and prudent.

6.4.2 It is proposed that the Borrowing Strategy also remain unchanged, with the Council looking to take new borrowing as determined by cash flow requirements and by reference to movements in long term interest rates. However, while it seemed possible that at least some of the Council's ongoing borrowing needs would be covered from longer term and/or PWLB borrowing, it now seems likely that the best value will lie in continuing to take a mix of short term borrowing, at rates of between 0.25% and 0.50%.

It is not currently anticipated that the Council will seek to take funds via the Municipal Bonds Agency (MBA) this year, and any decision to do so would be subject to a separate report to Executive Board. The Council, in 2014/15, supported the creation of the Local Capital Finance Company – which became the MBA - to become an agency which could act as an alternative source of borrowing for local authorities, to ultimately bring down borrowing costs. The MBA has yet to issue its first tranche of borrowing, but hopes to do so soon. It is also looking to position itself to support other forms of borrowing for local authorities.

6.5 Risk Management

6.5.1 The Council's primary objectives for the management of its investments 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, highly rated banks and pooled funds. In addition, the Council holds some investments that entail a slightly higher level of risk, including unrated building society deposits (where risks have been mitigated by limiting the amount and duration of exposure).

6.5.2 The Council's primary objective for the management of its debt is to ensure its long-term affordability. The largest part of its loans is from the Public Works Loan Board at long-term fixed rates of interest.

6.5.3 Another significant element of the Council's long term debt is £21.5M of loans from banks and other institutions. Of these, £16.5M worth are "lender's option, borrower's option" (LOBO) loans with initially fixed (and initially low) rates of interest. Under these instruments the Lender can, at certain times, exercise an option to increase the rate payable on the debt, and the Borrower has the choice then either to accept the proposed increase or repay the whole loan (which would mean, effectively, having to live with whatever the market conditions for interest rates were at that point).

This exposes the Council to some risk of rising long-term interest rates, but that is mitigated by the fact that £5M of this debt (forming a large part of the lowest interest rate elements) can only be "called" once in every five years. Recent estimates based on the current projected future interest rates, suggest LOBOs are unlikely to be called in the next 5 years (assuming no extraneous influences).

The other £5M loan is from Barclays Bank, which has chosen to cancel the embedded options in what was a LOBO loan, effectively converting it into a plain fixed rate loan. This has removed the uncertainty on both interest cost and maturity date. This waiver was done by 'deed poll'; it is irreversible and transferable by Barclays to any new lender.

6.5.4 A combination of short duration investments and long duration debt exposes the Council to the risk of falling investment income during periods of low interest rates. However, the risk of low investment returns is viewed as of lower priority compared to the benefits of optimising the security and liquidity of investments, and the savings made on borrowing costs. Also, though the Council has no long term investments, it is hedged against the investment return risk by its short term debt.

6.5.5 The rapidly expanding part of the debt portfolio - of around £60M in short term loans from other local authorities - does raise new issues. If the medium to long term cost of debt were to move upwards, it may be necessary to restructure the Council's debt quickly, and cope with an increased cost of borrowing. This issue is kept under review, with regular updates from Arlingclose.

6.6 Treasury and Prudential Indicators

6.6.1 The originally approved Treasury and Prudential Limits and Indicators were set at cautious levels and can largely remain unchanged. However it is proposed to vary two indicators to allow for the ongoing increase in the level of short-term borrowing being undertaken, as follows :

(a) Upper Limit on Variable Interest Rate Exposures	2017/18 £M	2018/19 £M	2019/20 £M
This was originally set as	*54.2*	*58.3*	*57.3*
and it is **now proposed** to be set as	**90.0**	**90.0**	**90.0**

(b) Maturity Structure of Borrowing – upper/lower limits on fixed rate borrowing were set at :

	Upper	Lower
Under 12 months	35%	0%
12 months and within 24 months	20%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	30%	0%
10 years and above	95%	25%

It is **now proposed** to increase the **Upper Limit Under 12 months** from 35% to 45%.

The proportion of fixed rate borrowing with a maturity of Under 12 months has already exceeded the 35% limit set at the start of the year on a number of occasions in this year. This is not a serious matter, as it is merely highlighting the high levels of short term borrowing being taken. Nonetheless it is recommended that the Limit be increased, as set out above.

The proposed increase in the Limits is effectively acknowledging that the Council is prepared to live with the risks of an increase in borrowing costs while looking to keep those costs at a minimum.

6.7 Minimum Revenue Provision (MRP) Policy

6.7.1 The Council's MRP (Minimum Revenue Provision) is the minimum amount which must be charged to revenue each year as a provision for the repayment of debt. The Council, within regulatory guidance, sets its own policy to ensure that the MRP it makes each year is prudent. The charge includes elements relating to "historic debt", acquired before the Prudential Borrowing regime, together with elements relating to more recent "Prudential Borrowing debt".

6.7.2 In setting the 2017/18 MRP Policy, the Council reflected policy changes made in 2016/17, which generated significant savings. No further changes to MRP Policy are now recommended.

7. FINANCIAL IMPLICATIONS

The financial implications arising from the 2016/17 Treasury Outturn and latest position for 2017/18 have been incorporated into Corporate Budget Monitoring Reports.

8. LEGAL IMPLICATIONS

8.1 Under the Local Government Act 2003, local authorities determine locally their levels of capital investment and associated borrowing. The Prudential Code has been developed to support local authorities in taking these decisions, and the Council is required by Regulation to have regard to the Code when carrying out its duties under Part 1 of the Local Government Act 2003.

8.2 The Department for Communities and Local Government issued Guidance on Local Government Investments, under the Local Government Act 2003, effective from 1st April 2010. Authorities must manage their investments within an approved strategy, setting out what categories of investment they will use and how they will assess and manage the risk of loss of investments.

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9. POLICY IMPLICATIONS, RESOURCE IMPLICATIONS, CONSULTATIONS

None

10. STATEMENT OF COMPLIANCE

The recommendations are made further to advice from the Monitoring Officer and the Section 151 Officer has confirmed that they do not incur unlawful expenditure. They are also compliant with equality legislation and an equality analysis and impact assessment has been considered. The recommendations reflect the core principles of good governance set out in the Council's Code of Corporate Governance.

VERSION:	**0.05**

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DATE:	26th September 2017
BACKGROUND PAPER:	Treasury Management strategies for 2016/17 and 2017/18 approved at Council 29th February 2016 and 27th February 2017 respectively.