REPORT to :	Policy Council
LEAD OFFICER:	Director of Finance and IT
DATE:	1st December 2016

WARD/S AFFECTED: All

Treasury management mid-year review for 2016-17 and annual report 2015-16

1. PURPOSE

1.1 To update Members with regard to the Treasury Management position to date and proposed Strategy for the remainder of 2016-17, and to formally report the Treasury outturn for 2015-16, as previously reflected in reporting to Audit and Governance Committee, and in the 2015-16 Outturn Corporate Monitoring Report (14th July Executive Board).

2. RECOMMENDATIONS

2.1 The Council is recommended to

(a) agree the continuation of the existing Treasury Management Strategy, and Treasury and Prudential Indicators for 2016-17, as set at Finance Council in March 2016, and
(b) note the Outturn position for 2015-16.

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 2016 the Council agreed a Treasury Management Strategy and MRP Policy for 2016-17.

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. 2015-16 OUTTURN

5.1 Original Strategy for 2015-16

5.1.1 The Strategy for 2015-16 was approved by Council on 2nd March 2015. 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 2015-16

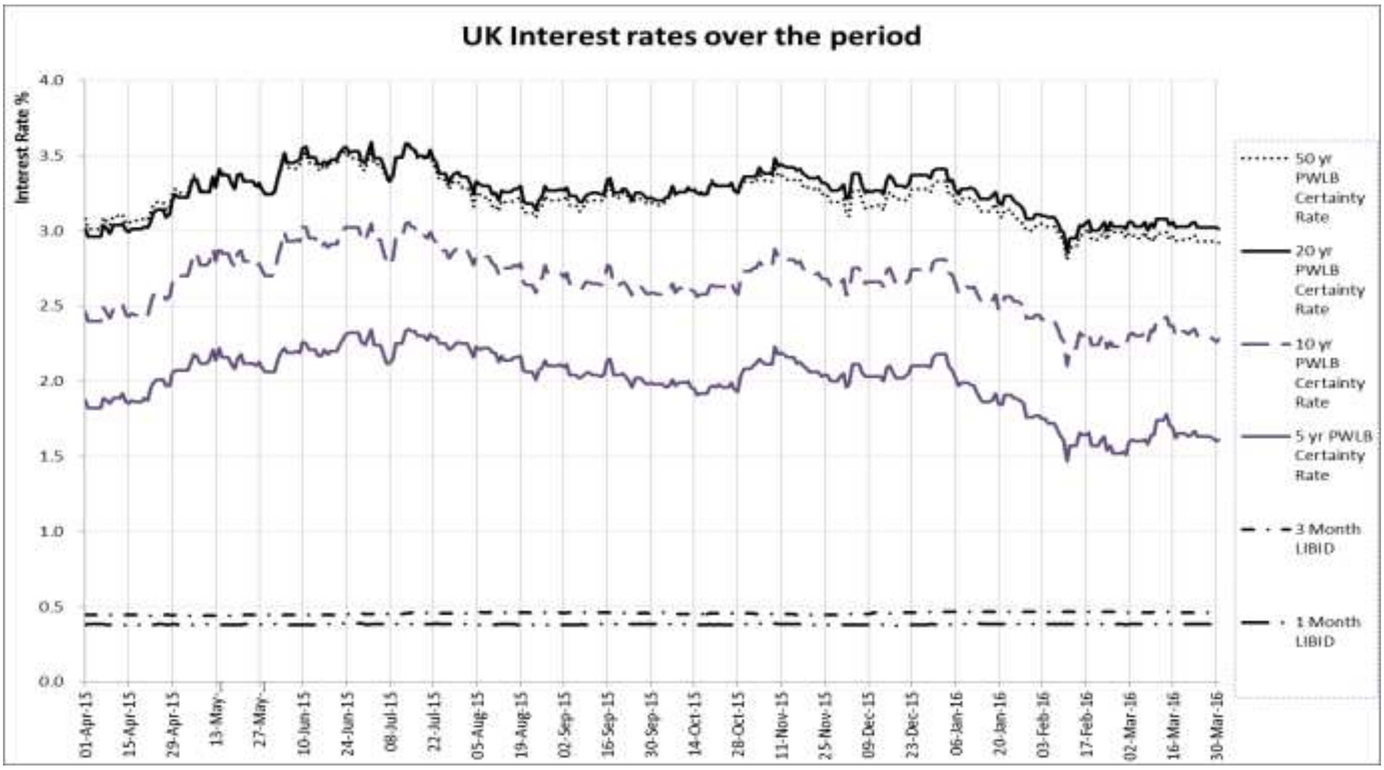
5.2.1 The UK economy slowed in 2015, with Gross Domestic Product growth falling away somewhat. CPI inflation hovered around zero through 2015 and was even negative in April, September and October 2015. Remaining well below the Bank of England's 2% Target, low inflation reflected both falling oil prices and the appreciation of sterling. The labour market continued to improve through 2015 with both record employment rates and unemployment at a 12 year low (nearing 5%). Wage growth was modest, but, after a long period of falling, real earnings (i.e. after inflation), grew at their fastest rate in 8 years, boosting consumer spending. In February to March 2016, the impending referendum on whether the UK was to remain in the EU was linked to a 3% depreciation in sterling.

5.2.2 A slowdown in the Chinese economy grabbed the headlines, with high market volatility, and pointed to limited prospects for global growth as a whole. Uncertainty dominated markets, even as the US economy continued to grow. In the USA, the Federal Reserve was able to raise rates in December 2015 (to a still low 0.25%-0.50%). This rise, the first in 9 years, was initially expected to be followed by a series of further increases, but markets have more recently pared back expectations of further rate rises.

Central banks in the Eurozone, Switzerland, Sweden and Japan were forced to take policy rates into negative territory. The European Central Bank also announced a range of measures to inject sustained economic recovery and boost domestic inflation.

5.2.3 Across the year, the Bank of England's MPC (Monetary Policy Committee) made no change to policy, leaving Bank Rate at 0.5% (unchanged since March 2009). In its meetings and announcements, the Bank was at pains to emphasise that when interest rates did begin to rise they were expected to do so more gradually and to a lower level than in recent cycles.

Gilt yields – which determine the cost of UK Government borrowing – rose to a high in June, before falling back towards the end of the year. The pattern of interest rates over the year was as follows:



The Public Works Loans Board (PWLB) rates in the above chart directly mirror gilt yields (UK Government borrowing costs). Nominal investment rates, measured through the London Inter-Bank Bid Rate (LIBID), also shown above, remained largely flat across the year, so short run investment returns and the cost of short term borrowing remained stable and low.

5.3 Treasury Management Performance 2015-16

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

	31 Mar 2015 Principal (£ M)	Rate / Return	Avg Life (Yrs)	31 Mar 2016 Principal (£ M)	Rate / Return	Avg Life (Yrs)
Fixed rate funding:						
PWLB	116.7	4.51%	22.8	112.9	4.44%	22.7
Market Debt (Long Term)	10.3	4.47%	39.7	10.3	4.47%	38.7
Market Debt (Short Term)	5.0	0.35%		18.5	0.47%	
	132.0			**141.7**		
Variable rate funding:						
PWLB	0.0			0.0		
Market	13.5	6.28%	16.2	11.5	5.38%	18.0
	13.5			**11.5**		
Loans taken by BwDBC	**145.5**	**4.69%**	**23.4**	**153.2**	**4.52%**	**23.5**

(table continued)

	31 Mar 2015 Principal (£ M)	Rate / Return	Avg Life (Yrs)	31 Mar 2016 Principal (£ M)	Rate / Return	Avg Life (Yrs)
Debt from PFI arrangements	71.5			70.1		
Other long term liabilities – debt managed by Lancashire County Council	17.4	2.1%		16.6	2.0%	
Total debt	**239.4**			**239.9**		
Total investments	**7.5**	**0.40%**		**10.5**	**0.44%**	

5.3.2 No new long term borrowing was taken in 2015-16. The key changes to the Council's overall debt position across the year were:

a) Principal repayments of PWLB debt:
£1.6M on EIP (Equal Instalment of Principal) loans & £2.2M Maturity loan repaid,

b) Repayment of £2M of market debt,

c) An increase in the level of short term borrowing, from £5M to £18.5M,

d) 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.

The recognition of PFI assets and liabilities on the balance sheet is designed to show our effective long term control over the assets concerned, and the parallel "indebtedness" arising from financing the cost of them, but do not add to the "bottom line" met by the Council Tax payer.

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

5.3.4 The Council's CFR (Capital Financing Requirement) - i.e. its outstanding indebtedness arising from the Capital Programme - grew across the year, while its long term borrowing fell:

Movements in CFR and Long Term Borrowing	2014/15	2015/16
(excluding PFI/LCC debt)	£M	£M
BwD Capital Financing Requirement Brought Fwd	182.3	198.9
New Spend Financed From Borrowing in Year	24.0	18.5
BwD Debt MRP made in Year	-7.3	-6.6
BwD Capital Financing Requirement Carried Fwd	198.9	210.8
Long Term Borrowing Brought Fwd	143.3	140.5
Net Long Term Borrowing in Year	-2.8	-5.8
Long Term Borrowing Carried Fwd	140.5	134.7
CFR under-funded by long term borrowing	58.4	76.1

The gap between the Council's CFR and its long term borrowing – which is effectively covered by short term borrowing and the use of the Council's balances – widened further, to £76M.

Though some short term borrowing was taken, investment balances therefore continued to be significantly lower than they could otherwise have been. Together with the still low interest rates available and taking a cautious and short-term approach to investment, this reduced the amount of interest earned on balances, but delivered large savings on the cost of long term borrowing.

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

Outturn 2014-15 £'000		**Original Budget 2015-16** £'000	**Outturn 2015-16** £'000
7,372	Interest paid on borrowing	7,743	6,895
6,484	PFI interest paid	6,358	6,358
(297)	Interest receipts	(176)	(367)
8,064	Provision for debt repayment – non-PFI	9,154	7,285
1,495	Provision for debt repayment – PFI	1,441	1,441

5.3.6 Interest paid on borrowing in 2015-16 was around £0.8M 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 £16,000 to around £56,000.

As with the required balance sheet adjustments, PFI interest charges did not add to the "bottom line" faced by the Council Taxpayer, as grants covered their cost.

5.3.7 The daily average investment balance over the year was down, at £27M (£37M in 2014-15). Balances were at low points at the start (£7M) and end (£10M) of the year, along with a brief dip at the middle of the year (see **Appendix 1**).

Overall interest earned was up slightly, to £0.37M in 2015-16 (£0.29M in 2014-15), mainly because of interest received on the Cathedral quarter project. Interest earned on treasury cash investments fell, though the average rate of return was slightly up, at 0.44% (against 0.40% in 2014-15).

5.3.8 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 2015-16. 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.

5.3.9 The position with regard to performance against Treasury and Prudential Indicators in 2015-16 is summarised in **Appendix 2**. There were no breaches of the Borrowing Limits. Outturn capital spend was £66M, up on the £52M forecast. However, the level of capital spend financed from borrowing was lower than forecast, and the outturn total Capital Financing Requirement (including LCC and PFI debt) was £297.5M, which was lower than the original forecast at the start of the year (of £312.8M).

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 Municipal Bonds Agency

The Council, towards the end of 2014/15, invested in the Local Capital Finance Company (LCFC), to support the creation of an agency which could act as an alternative source of borrowing for local authorities, to ultimately look to reduce borrowing costs for local authorities. The new agency has since changed its name to "the Municipal Bond Agency" (MBA). 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.

5.6 Counterparty Update

5.6.1 UK legislation – in common with that across much of Europe - placed the burden of rescuing failing banks heavily onto unsecured institutional investors, including local authorities and pension funds. During the year, all three credit ratings agencies reviewed their ratings to reflect the loss of government support for most financial institutions and the potential for loss driven default as a result of new "bail-in" regimes in many countries. Despite reductions in government support many institutions saw upgrades due to an improvement in their underlying strength and an assessment that that the level of loss given default is low.

5.6.2 In December the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies which showed that the Royal Bank of Scotland and Standard Chartered Bank were the weakest performers. However, the regulator did not require either bank to submit revised capital plans, since both firms had already improved their ratios over the year.

5.6.3 Arlingclose monitored the changing circumstances across the year, issuing frequent guidance on investment risks. In general terms, the limited range of investments used, day to day, by the Council, meant that there were no significant implications for us.

6. STRATEGY REVIEW 2016-17

6.1 Original Strategy for 2016-17

6.1.1 The Treasury Management Strategy for 2016-17 was approved by Council on 29th February 2016. 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 2016-17 continued the approach set for 2015-16, 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 meant 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 2016-17 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 2016-17.

6.2 Economic Review 2016-17

6.2.1 At the start of the year, there was a significant uncertainty about the outlook for global growth. The slowdown in the Chinese economy and the knock-on effects for trading levels and commodity prices, the uncertainty over the outcome of the US presidential election and the impending referendum on the UK's future relationship with the EU, all resulted in nervousness and a shaky start for markets.

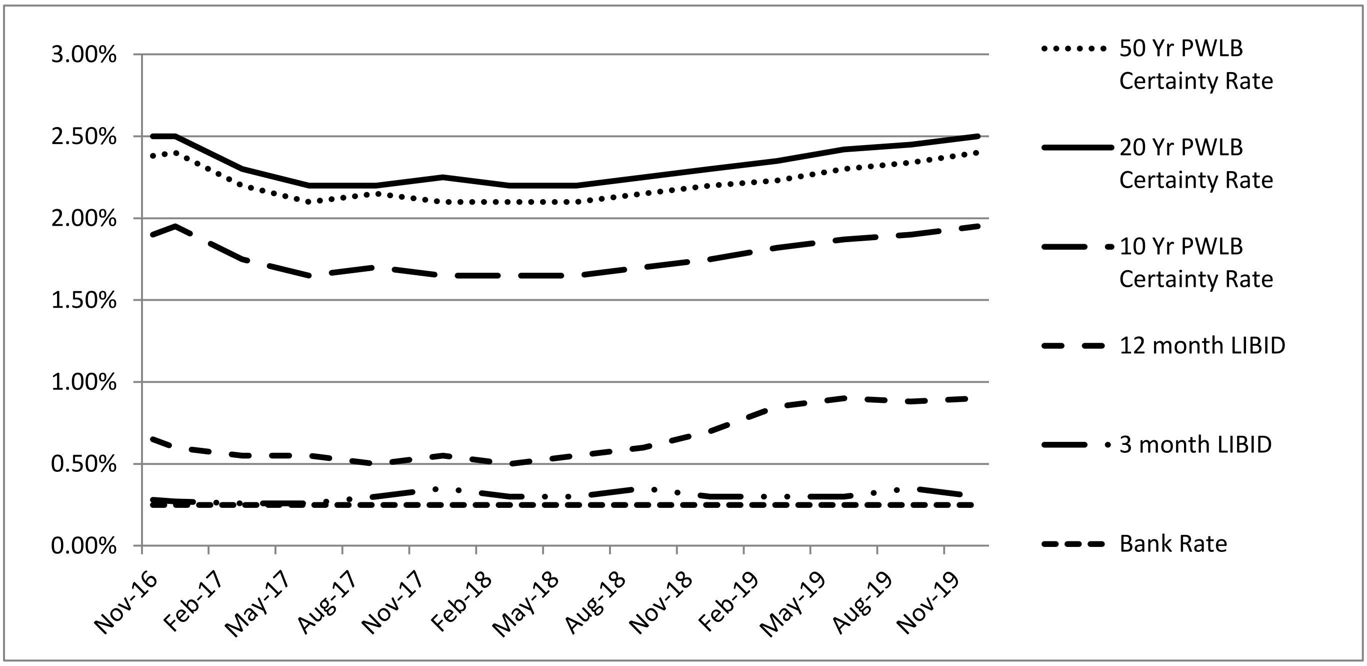
UK growth continued, though at a subdued level, and inflation remained low. Internationally, a modest pace of growth in the UK's main trading partners remained the most likely prospect. There was market volatility reflecting fluctuations in opinion polls on the EU referendum – in the run up to the poll, market sentiment shifted in favour of Remain, only to react markedly when the Exit vote was announced.

6.2.2 The vote to leave the EU sent shockwaves through the domestic, European and global political spectrum. From 23rd June to 1st July the sterling exchange rate index fell by 9% and short-term volatility of sterling against the dollar increased significantly. Worldwide, markets reacted very negatively with a big initial fall in equity prices, subsequently largely reversed.

UK Government bond yields also fell sharply - i.e. the price of gilts rose as investors sought safe haven from riskier assets. The cost of UK government borrowing has fallen sharply.

The Bank of England sought to reassure markets and investors, and in August its Monetary Policy Committee cut Bank Rate from 0.50% to 0.25%. It has been stressed that the Bank is ready to support money market liquidity and a further reduction in Bank Rate is possible.

6.2.3 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 below:



6.3 Treasury Performance to Date

6.3.1 Thus far, cash balances have typically averaged between £10M and £25M. These levels have been supported by short term borrowing (at low rates, averaging around 0.4%). No long term borrowing has yet been taken, and indeed £6.8M of PWLB debt was repaid at the end of September.

Analysis of debt outstanding

	1st April 2016		31st October 2016	
	£M	£M	£M	£M
TEMPORARY DEBT				
Less than 3 months	5.0		0.0	
Greater than 3 months (full duration)	13.5		37.0	
		18.5		37.0
LONGER TERM DEBT				
PWLB	112.9		106.1	
Bonds	21.5		21.5	
Other Market Debt	0.3		0.3	
		134.7		127.9
Lancs County Council transferred debt		16.6		16.3
Recognition of Debt re PFI Arrangements		70.1		69.2
TOTAL DEBT		239.9		250.4
Less: Temporary Lending		-10.5		-19.0
		229.4		231.4

6.3.2 Investments have continued to be made with a limited range of banks, building societies and Money Market Funds, along with the Government's Debt Management Office, earning interest at low levels (averaging around 0.30% in the first half of the year). It is likely that investment returns will dip even further in the second half of the year.

6.3.4 Savings of almost £0.4M on the Original Estimate for external interest payments have already been reported through Corporate Monitoring, reflecting lower borrowing last year, and this year to date. Investment returns remain low, and will fall well below the Original Estimate (which was only £0.1M). Further interest savings are possible, depending upon the resilience of 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 It is proposed that the originally approved **Investment Strategy and Criteria** - and the **Treasury and Prudential Limits and Indicators** - remain unchanged.

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 Debt Management Office (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 widening 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 around 0.25% to 0.50%.

It is not currently anticipated that the Council will seek to take funds via the Municipal Bonds Agency this year (see paragraph 5.5).

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 majority of its loans (£106.1M) have been borrowed from the Public Works Loan Board at long-term fixed rates of interest.

6.5.3 The other significant element of the Council's long term debt is £21.5M of bonds. 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 bond is a loan 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 The 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. Both longer-term investments and any variable rate instruments would hedge against that risk, though the Council currently holds neither of these. However this risk is viewed as of lower priority compared to the requirements of optimising the security and liquidity of investments.

6.6 Minimum Revenue Provision (MRP) Policy

6.6.1 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”.

6.6.2 In setting the MRP for 2016-17, the Council amended its policy regarding historical government supported borrowing. The MRP Policy Statement at the start of 2016-17 proposed

(a) for existing capital expenditure financed from debt up to 2007/08 and all new Government-supported borrowing arising in 2007/08 AND thereafter, to spread the cost outstanding at the end of 2014/15 evenly over 50 years (from 2015/16 through to 2064/65)
(b) for capital expenditure financed from debt arising in 2007-08 and thereafter that is self-financed (i.e. not supported by the Government), to use the Asset Life Method to determine MRP,

This means in practice
(a) for the older and Government-supported debt, that a flat 2% of the outstanding balance as at the end of 2014/15 is charged over the following 50 years.
(b) for more recent, self-financed debt, that the MRP is charged evenly over the asset lives of the acquisitions acquired under Prudential Borrowing.

6.6.3 The Council will continue to consider its MRP Policy, and if further changes are possible that would remain prudent and may generate savings, it will report further in due course.

7. FINANCIAL IMPLICATIONS

The financial implications arising from the 2015-16 Treasury Outturn and latest position for 2016-17 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 has issued Guidance on Local Government Investments, under the Local Government Act 2003, effective from 1st April 2010. Under this, authorities should manage their investments within an approved strategy, setting out what categories of investment they will use and how they assess and manage the risk of loss of investments.

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:	0.01

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DATE:	17 November 2016
BACKGROUND PAPER:	Treasury Management strategies for 2015-16 and 2016-17 approved at Council 2nd March 2015 and 29th February 2016 respectively.