MEETING:	**AUDIT AND GOVERNANCE COMMITTEE**
DATE:	**13 JULY 2017**
TITLE:	**TREASURY MANAGEMENT 2016/17**
PURPOSE:	**CIPFA's Code of Practice requires that a report on the results of the Council's actual treasury management is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
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Executive Summary

During 2016/17 the Council's borrowing remained well within the limits originally set, total interest received on deposits was £313,000 which was below the budgeted level of £358,470. There were no new defaults by banks in which the Council deposited money.

1. Introduction and Background

CIPFA's revised Code of Practice on Treasury Management was adopted by the Council on 1st March 2011 and the Council fully complies with its requirements. The Code requires that I report on the results of the Council's actual treasury management in the previous financial year against that which was expected. It is considered that the Audit Committee is the appropriate body to consider this report.

This report compares our actual performance for 2016/17 against the strategy which was set out in February 2016 for the financial year and was approved by the full Council at its meeting on 3 March 2016 and can be accessed at
https://democracy.cyngor.gwynedd.gov.uk/ielistdocuments.aspx?cid=136&mid=1700&ver=4

The report looks at:

- the economic background;
- the borrowing requirement and debt management;
- investment activity;
- compliance with Prudential Indicators.

This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the Welsh Government's Investment Guidance.

The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

2. External Context

Economic background: Politically, 2016/17 was an extraordinary twelve month period which defied expectations when the UK voted to leave the European Union and Donald Trump was elected the 45th President of the USA. Uncertainty over the outcome of the US presidential election, the UK's future relationship with the EU and the slowdown witnessed in the Chinese economy in early 2016 all resulted in significant market volatility during the year. Article 50 of the Lisbon Treaty, which sets in motion the 2-year exit period from the EU, was triggered on 29th March 2017.

UK inflation had been subdued in the first half of 2016 as a consequence of weak global price pressures, past movements in sterling and restrained domestic price growth. However the sharp fall in the Sterling exchange rate following the referendum had an impact on import prices which, together with rising energy prices, resulted in CPI rising from 0.3% year/year in April 2016 to 2.3% year/year in March 2017.

In addition to the political fallout, the referendum's outcome also prompted a decline in household, business and investor sentiment. The repercussions on economic growth were judged by the Bank of England to be sufficiently severe to prompt its Monetary Policy Committee (MPC) to cut the Bank Rate to 0.25% in August and embark on further gilt and corporate bond purchases as well as provide cheap funding for banks via the Term Funding Scheme to maintain the supply of credit to the economy.

Despite growth forecasts being downgraded, economic activity was fairly buoyant and GDP grew 0.6%, 0.5% and 0.7% in the second, third and fourth calendar quarters of 2016. The labour market also proved resilient, with the ILO unemployment rate dropping to 4.7% in February, its lowest level in 11 years.

Following a strengthening labour market, in moves that were largely anticipated, the US Federal Reserve increased rates at its meetings in December 2016 and March 2017, taking the target range for official interest rates to between 0.75% and 1.00%.

Financial markets: Following the referendum result, gilt yields fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. After September there was a reversal in longer-dated gilt yields which moved higher, largely due to the MPC revising its earlier forecast that Bank Rate would be dropping to near 0% by the end of 2016. The yield on the 10-year gilt rose from 0.75% at the end of September to 1.24% at the end of December, almost back at pre-referendum levels of 1.37% on 23rd June. 20- and 50-year gilt yields also rose in Q3 2017 to 1.76% and 1.70% respectively, however in Q4 yields remained flat at around 1.62% and 1.58% respectively.

After recovering from an initial sharp drop in Q2, equity markets rallied, although displaying some volatility at the beginning of November following the US presidential election result. The FTSE-100 and FTSE All Share indices closed at 7342 and 3996 respectively on 31st March, both up 18% over the year. Commercial property values fell around 5% after the referendum, but had mostly recovered by the end of March.

Money market rates for overnight and one week periods remained low since Bank Rate was cut in August. 1- and 3-month LIBID rates averaged 0.36% and 0.47% respectively during 2016-17. Rates for 6- and 12-months increased between August and November, only to gradually fall back to August levels in March, they averaged 0.6% and 0.79% respectively during 2016-17.

Credit background: Various indicators of credit risk reacted negatively to the result of the referendum on the UK's membership of the European Union. UK bank credit default swaps saw a modest rise but bank share prices fell sharply, on average by 20%, with UK-focused banks experiencing the largest falls. Non-UK bank share prices were not immune, although the fall in their share prices was less pronounced.

Fitch and Standard & Poor's downgraded the UK's sovereign rating to AA. Fitch, S&P and Moody's have a negative outlook on the UK. Moody's has a negative outlook on those banks and building societies that it perceives to be exposed to a more challenging operating environment arising from the 'leave' outcome.

None of the banks on the Council's lending list failed the stress tests conducted by the European Banking Council in July and by the Bank of England in November, the latter being designed with more challenging stress scenarios, although Royal Bank of Scotland was one of the weaker banks in both tests. The tests were based on banks' financials as at 31st December 2015, 11 months out of date for most. As part of its creditworthiness research and advice, the Council's treasury advisor Arlingclose regularly undertakes analysis of relevant ratios - "total loss absorbing capacity" (TLAC) or "minimum requirement for eligible liabilities" (MREL) - to determine whether there would be a bail-in of senior investors, such as local Council unsecured investments, in a stressed scenario.

In July, following a review of unrated building societies' annual financial statements, Cumberland, Harpenden and Vernon building societies were removed from the Council's list due to a deterioration in credit indicators. The maximum advised maturity was also lowered for eleven other societies from 6 months to 100 days due to the uncertainty facing the UK housing market following the EU referendum.

Local Context

At 31 March 2017 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £177.1m, while usable reserves and working capital which are the underlying resources available for investment were £86m.

At 31 March 2017, the Council had £112.8m of loans and leases, and £29.4m of investments. The Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

The Council has a decreasing CFR over the next 2 years and a reducing level of investments and therefore may need to borrow over the forecast period.

	31.3.16 Actual £m	2016/17 Movement £m	31.3.17 Actual £m
CFR	173	4	177
Less: Other debt liabilities	-2	0	-2
Borrowing CFR	**171**	**4**	**175**
Less: Usable reserves	-58	1	-57
Less: Working capital	-67	31	-36
Net investments	**46**	**36**	**82**

Borrowing Strategy

At 31 March 2017 the Council held £112.7m of loans, (a decrease of £2.1m from 31 March 2016) as part of its strategy for funding previous years' capital programmes.

The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained, and are likely to remain at least over the forthcoming two years, lower than long-term rates, the Council determined it was more cost effective in the short-term to use internal resources instead.

The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with this 'cost of carry' and breakeven analysis.

Treasury management summary

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %
Long-term borrowing Short-term borrowing	(110,676) (2,067)	2,533 (578)	(108,143) (2,645)	5.71 10.63
Total borrowing	**(112,743)**	**1,955**	**(110,788)**	**5.98**
Long-term investments Short-term investments Cash and cash equivalents	2,341 49,821 14,191	(170) (24,011) (12,807)	2,171 25,810 1,384	1.59 0.51 0.15
Total investments	**66,353**	**(36,988)**	**29,365**	**0.53**
Net borrowing	**46,390**	**(35,033)**	**81,423**	**5.95**

3. Borrowing Activity in 2016/17

At 31st March 2017, the Council held £108.7m of loans, a decrease of £1.8m on the previous year, as part of its strategy for funding previous years' capital programmes. The year-end borrowing position and the year-on-year change are in the table below.

Borrowing Position

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %	31.3.17 WAM* years
Public Works Loan Board Banks (fixed-term)	94.3 16.2	(1.8) 0	92.5 16.2	6.05 4.22	25 61
Total borrowing	**110.5**	**(1.8)**	**108.7**	**5.72**	**30**

*Weighted average maturity

The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

In furtherance of these objectives, no new borrowing was undertaken in 2016/17, while existing loans were allowed to mature without replacement. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

The "cost of carry" analysis performed by the Council's treasury management advisor Arlingclose did not indicate any value in borrowing in advance for future years' planned expenditure and therefore none was taken.

At the beginning of the year the Council continued to hold £16.2m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during 2016/17. However, Barclays Bank informed the Council that it had revoked its right to exercise their options in future, and £16.2m has therefore been reclassified as fixed rate bank loans.

4. Investment Activity

The Council has held significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2016/17 the Council's investment balances have ranged between £87.9million and £29.5 million.

The Welsh Government's Investment Guidance gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

Investment Position

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %	31.3.17 WAM* days
Banks & building societies (unsecured)	51.1	(29.8)	21.3	0.5	442
Covered bonds (secured)	2.3	(0.2)	2.1	0.7	1262
Government (incl. local authorities)	13.0	(7.0)	6.0	0.4	189
Total investments	**66.4**	**(37.0)**	**29.4**	**0.6**	**603**

*Weighted average maturity

Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Budgeted Income and Outturn

The average cash balances were £58.7m during the year. The UK Bank Rate has been maintained at 0.5% since March 2009. Short-term money market rates have remained at relatively low levels. New deposits were made at an average rate of 0.53%. Investments in Money Market Funds generated an average rate of 0.45%.

The Council's budgeted investment income for the year was £0.34m. The Council's investment income outturn for the year was £0.31m.

Compliance Report

The Head of Finance is pleased to report that all treasury management activities undertaken during 2016/17 complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in the table below.

Investment Limits

	2016/17 Maximum	31.3.17 Actual	2016/17 Limit	Complied
Any single organisation, except UK Government	£5m	£4m and below	£8m each	✓
Any group of funds under the same management	£0	£4m and below	£8m per group	✓
Foreign countries	£5m	£4m and below	£8m per country	✓
Unsecured investments with Building Societies	£6m in total	£6m in total	£8m in total	✓
Money Market Funds	£40m in total	£0	£40m in total	✓
Non-specified investments	£40m in total	£0	£80m in total	✓

Compliance with the authorised limit and operational boundary for external debt is demonstrated in the table below.

Debt Limits

	2016/17 Maximum	31.3.17 Actual	2016/17 Operational Boundary	2016/17 Authorised Limit	Complied
Borrowing	£113m	£111m	£180m	£190m	✓

Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators.

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the time-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment and taking the arithmetic average, weighted by the length of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.3.17 Actual	**2016/17 Target**	**Complied**
Portfolio average credit score	3.27	a score of 7 or lower	✓

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing / it can borrow each quarter without giving prior notice.

	31.3.17 Actual	**2016/17 Target**	**Complied**
Total cash available within 3 months	18.325m	£10m	✓

Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed was:

	31.3.17 Actual	**2016/17 Limit**	**Complied**
Upper limit on fixed interest rate exposure	100%	100%	✓
Upper limit on variable interest rate exposure	0	50%	✓

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

	31.3.17 Actual	**Upper Limit**	**Lower Limit**	**Complied**
Under 12 months	2.2%	25%	0%	✓
12 months and within 24 months	0	25%	0%	✓
24 months and within 5 years	4.2%	50%	0%	✓
5 years and within 10 years	15.6%	75%	0%	✓
10 years and within 20 years	25.4%	100%	0%	✓
20 years and within 30 years	12.6%	100%	0%	✓
30 years and within 40 years	16.5%	100%	0%	✓
40 years and within 50 years	8.6%	100%	0%	✓
50 years and above	14.9%	100%	0%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2016/17	**2017/18**	**2018/19**
Actual principal invested beyond year end	£2.1m	£2.1m	£0
Limit on principal invested beyond year end	£40m	£20m	£10m
Complied	✓	✓	✓

Appendix 1

Prudential Indicators 2016/17

The Local Government Act 2003 requires the Council to have regard to CIPFA's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

This report compares the approved indicators with the outturn position for 2016/17. Actual figures have been taken from or prepared on a basis consistent with, the Council's statement of accounts.

Estimates of Capital Expenditure: The Council's capital expenditure and financing may be summarised as follows.

Capital Expenditure and Financing	2016/17 Estimate £m	2016/17 Actual £m	Difference £m
General Fund Expenditure	**27.7**	**29.3**	**1.6**
Capital receipts	0.7	0.8	0.1
Government Grants	10.7	11.5	0.8
Revenue contributions	5.5	5.9	0.4
Supported borrowing	4.1	4.1	0.0
Prudential borrowing	6.7	7.0	0.3
Total Financing	**27.7**	**29.3**	**1.6**

Capital Financing Requirement

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

Capital Financing Requirement	31/03/17 Estimate £m	31/03/17 Actual £m	Difference £m
General Fund	182.1	177.0	5.1

The CFR rose by £1.6m as capital expenditure financed by debt outweighed the resources put aside for debt repayment.

Actual Debt: The Council's actual debt at 31 March 2017 was as follows:

Debt	**31/03/17 Estimate £m**	**31/03/17 Actual £m**	**Difference £m**
Borrowing	113.4	113.4	0
Finance leases	0.0	2.3	2.3
Total Debt	**113.4**	**115.7**	**2.3**

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

Debt and CFR	**31/03/17 Estimate £m**	**31/03/17 Actual £m**	**Difference £m**
Total debt	113.4	113.4	0
CFR	175	177	2
Headroom	**61.6**	**63.6**	**2**

Total debt remained below the CFR during the year.

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

Operational Boundary and Total Debt	**31/03/17 Boundary £m**	**31/03/17 Actual Debt £m**	**Difference £m**
Borrowing	**175**	**113.4**	**61.6**
Other long-term liabilities	**0**	**2.3**	**(2.3)**
Total Debt	**175**	**115.7**	**59.3**

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Boundary and Total Debt	**31/03/17 Boundary £m**	**31/03/17 Actual Debt £m**	**Difference £m**
Borrowing	**195**	**113.4**	**81.6**
Other long-term liabilities	**0**	**2.3**	**(2.3)**
Total Debt	**195**	**115.7**	**79.3**

Ratio of Financing Costs to Net Revenue Stream

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

Ratio of Financing Costs to Net Revenue Stream	**31/03/17 Estimate %**	**31/03/17 Actual %**	**Difference %**
Total	**5.91**	**5.20**	**0.71**

APPENDIX 2

Credit Score Analysis

Scoring:

Long-Term Credit Rating	**Score**
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
BBB+	8
BBB	9
BBB-	10

The value weighted average reflects the credit quality of investments according to the size of the deposit. The time weighted average reflects the credit quality of investments according to the maturity of the deposit

The Council aimed to achieve a score of 7 or lower, to reflect the Council's overriding priority of security of monies invested and the minimum credit rating threshold of A- for investment counterparties.