Agenda Item 9

Policy and Scrutiny

Open Report on behalf of Executive Director of Finance & Public Protection

Report to:	**Overview and Scrutiny Management Board**
Date:	**29 June 2017**
Subject:	**Treasury Management Annual Report 2016/17**

Summary:

This report has been prepared in accordance with the reporting recommendations of the CIPFA Code of Practice 2011 and details the results of the Council's treasury management activities for the financial year 2016/17. The report compares this activity to the Treasury Management Strategy for 2016/17, approved by the Executive Councillor responsible for Finance on 21 March 2016. It will also detail any issues arising in treasury management during this period. The Treasury Management Annual Report 2016/17 will be considered by the Executive Councillor for Resources and Communications in due course.

Actions Required:

The Overview and Scrutiny Management Board is invited to support the content of the Treasury Management Annual Report 2016/17 and agree any comments to be passed onto the Executive Councillor for Resources and Communications.

1. Background

1. Introduction and Background

1.1. Treasury Management relates to the policies, strategies and processes associated with managing the cash and debt of the Council through appropriate borrowing and lending activity. It includes the effective control of the risks associated with the lending and borrowing activity and the pursuit of optimum performance consistent with the risks.

1.2. This Annual Treasury Report will cover the following positions for the year 2016/17:

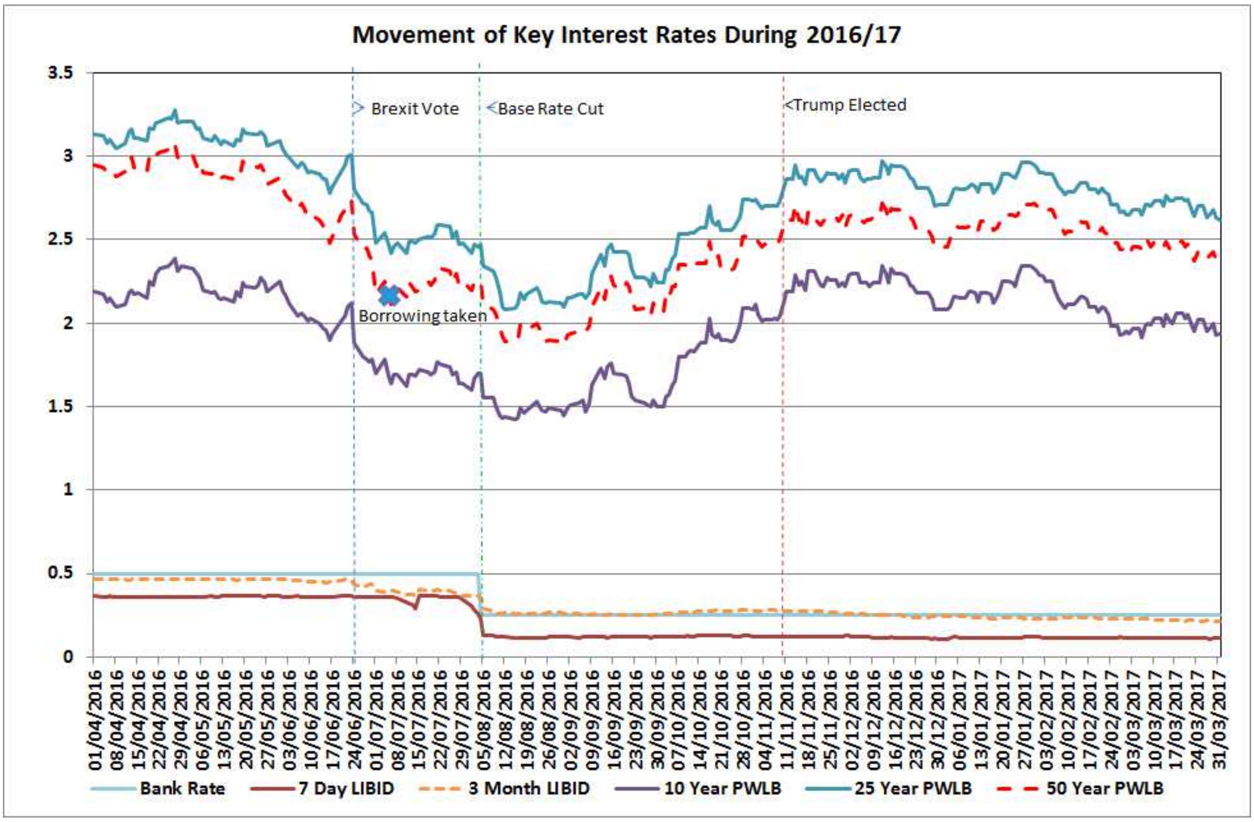
- An economic overview and interest rate review.
- Investment outturn and comparison with strategy.
- Annual investment strategy / authorised lending list changes during the year.
- Borrowing outturn and debt rescheduling activity and comparison with strategy.
- Other treasury issues during 2016/17.

2. <u>Economic Overview and Interest Rate Forecast 2016/17</u>

2.1. At the time of setting the Strategy in February 2016, the markets were forecasting short-term Bank Rate to increase to 0.75% from 0.50% by December 2016 for the first time since 2008, in response to the low inflation strong growth environment in the UK. This first increase was pushed further into the future following the Bank of England Inflation Report in May 2016, which pegged back its growth forecast and factored in concerns over a Brexit vote to leave.

2.2. Long term rates were forecast to rise moderately over 2016/17 by around 0.30%, but remain extremely volatile and difficult to predict due to upside and downside external market influences.

2.3. The graph below shows the actual movement of both UK long term and short term interest rates over 2016/17.



2.4. The graph shows that two major landmark events had significant influence on financial markets during the year. This was the UK EU referendum on 23 June 2016 and the election of President Trump in the USA on 9 November 2016.

2.5. The UK voted to leave the European Union in the 23 June 2016 referendum. Shocks to the markets subsequent to this result and fears for Economic Growth led the Bank of England (BOE) to cut Base Rate on 4 August 2016 to 0.25% from 0.50%, for the first time since 2009, and increase Quantitative Easing (QE) by £60bn to £435bn. The graph shows the impact on interest rates due to these events. Short term rates dropped to 0.25% levels following the Base Cut and have remained flat since. Long term rates fell significantly after the Brexit vote but have rallied since September 2016 as growth and consumer confidence confounded the pessimistic forecasts of the BOE.

2.6. Annual growth for 2016 was 1.8%, better than most G7 countries. Retail sales was 2.3% in April 2017, 4% higher than a year ago. Inflation rose sharply due to the effects of the sharp devaluation of sterling after the referendum. CPI was 2.7% in March and sterling was 17% down against the dollar. As a result of these figures the BOE did not alter rates during the rest of the financial year, seeing no reason for a further cut or increase. Inflation is not being seen as a problem to address as unemployment fell to its lowest in 42 years (4.6%), subduing any wage inflation inherent in the economy.

2.7. Market expectations for the first increase in Bank Rate moved forward to December 2018 by the end of March, in response to the increases in inflation, with the next increase in Base Rate not expected until June 2019.

2.8. The US voted for President Trump in their election on 9 November 2016. He has promised expansion of infrastructure expenditure in the US at the same time as promising to cut taxes. Stock markets in the US reached record highs since the election. The Fed raised interest rates by 0.25% in December 2016 to 0.75% in response to rising growth and inflation. Annual growth for the US was 1.6% in 2016.

2.9. The European Central Bank (ECB) announced its commitment to extend QE by another 9 months to December 2017 and cut rates to negative territory in an attempt to boost the European economy and get inflation up from near zero levels. This resulted in an overall growth figure of 1.7% in 2016 for the EU, with Germany achieving a rate of 1.9%, the fastest growing G7 country.

3. Investment Outturn 2016/17 and Comparison with Strategy

3.1. The Council's investment activity, position and return as at 31 March 2017 are detailed in the table below:

Investment Activity 2016/17	**£m**		
Opening Balance at 01.4.2016	224.66		
Investments Made In 2016/17	1,064.26		
Investments Repaid In 2016/17	1,033.22		
Closing Balance at 31.3.2017	**255.69**		
Investment Return 2016/17	**Return Annualised**	**Weighted Benchmark Annualised**	**Outperformance**
Year to 31.03.2017	0.65%	0.31%	0.34%

3.2. The investment balance at 31 March 2017 comprised general and earmarked reserves, Pension Fund Cash (£9.9m), income received but not yet used/spent and general movement of working capital. The average value of investments during 2016/17 was £280.1m. The investment balance has risen from the previous year primarily due to both Revenue and Capital underspends in 2016/17.

3.3. In line with the strategy, investments were made in periods of 2 days to 2 years to lock into rates above base rate level, and extensive use of bank call accounts and money market funds were made that offered returns ranging from 0.40% to 0.70%. Several 364 day investments have been made during the year, and one two year investment, to take advantage of the enhanced yields available, including investments in Bonds and Certificates of Deposit. As a result, the weighted average maturity of the investment portfolio lengthened slightly over the year, starting at 125 days and ending at 153 days on 31 March 2017.

3.4. The benchmark target return for investments used is a weighted benchmark that uses both the 7 day London Interbank Bid Rate (LIBID) and 3 month LIBID market rates, weighted to better reflect the maturity of the investments made and therefore the risk parameters of the investment portfolio. Being a market rate, this benchmark moves relative to market movement; market rates have fallen over the year. The cumulative benchmark rate for 2016/17 was 0.31% compared to 0.45% in 2015/16. The Council outperformed this benchmark by 0.34% in 2016/17 with a return of 0.65%, compared to 0.73% in 2015/16, and produced an investment return of £1.390m, (£1.533m in 2015/16), compared to a forecast of £1.2m. This outperformance was achieved by investing in longer term investments at average rates of 0.60% for most of the year.

3.5. The investment return was also benchmarked against the Capita Benchmarking analysis, comprising a mixture of 9 other authorities in the East Midlands area and 13 English Counties. The results are detailed below as at 31 March 2017.

Capita Benchmarking – Position at 31/3/2017			
	LCC	**Benchmark Group(8)**	**English Counties (13)**
March Return %	0.55%	0.48%	0.52%
Risk Banding	0.53% -0.65%	0.42% - 0.54%	0.43% -0.56%
WAM (days)	153	80	86

3.6. The benchmarking results show that the Council is above par with the investment returns achieved by its Capita comparators in 2016/17. This is due to a longer Weighted Average Maturity (WAM) position taken by the Council. This is a good result given the conservative nature of the Counterparties allowed on the Authorities Lending List (restricted to a Long Term minimum rating of A+) for which these comparators were not restricted to. Capita calculates a risk banding return that should be achievable for the level of risk being taken on investments and the Council is in line with this banding.

3.7. Temporary borrowing totalling £22m was taken throughout the year to cover a shortfall in liquidity predicted at certain times. The average cost of this temporary borrowing was 0.25%, which was cost positive as surplus borrowing was invested in money market funds at an average of 0.32%. This was in line with strategy and as an alternative to drawing on higher yielding Notice Accounts when necessary. No temporary borrowing remained outstanding at 31 March 2017.

4. <u>Annual Investment Strategy/ Authorised Lending List Changes During 2016/17</u>

4.1. The Council's Annual Investment Strategy for 2016/17 was approved, along with the Treasury Strategy, by the Executive Councillor responsible for Finance on 21 March 2016, after being scrutinised by the Value for Money Scrutiny Committee on 22 February 2016. The Strategy outlines the Council's investment priorities as **the security of capital and the liquidity of investments**, with the aim to achieve the optimum return on investments commensurate with proper levels of security and liquidity.

4.2. As such investments are only placed with highly credit rated financial institutions, using Capita's suggested creditworthiness approach, including Short and Long Term Ratings, Sovereign Credit Ratings and Credit Default Swap overlay information provided by Capita.

4.3. In addition to Capita's credit methodology, the Council also maintains a minimum limit of **A+ Long Term Rating (two out of three agencies)** for all its Counterparties, excluding part-nationalised UK banks and a **minimum limit AA- Sovereign Rating, (two out of three agencies)** for any Country in which a Counterparty is based. Appendix A shows the Council's Authorised Lending List at 31 March 2017, based on this creditworthiness approach, together with a key explaining the credit rating scores.

4.4. The table below shows the changes to the Authorised Lending List over 2016/17, which were additions at the start of the year as a result of the relaxation of Long Term Rating Limit of A+ to two out of three credit rating agencies only.

Counterparty	**Action**	**Reason**
Lloyds Group (UK) (Lloyds and BOS)	Addition: Limit £15m / 6 Months.	Revised Credit Methodology.
UBS Ltd (UK)	Addition: Limit £15m / 6 Months.	Revised Credit Methodology.
BNP Paribas (France)	Addition: Limit £15m / 6 Months.	Revised Credit Methodology.
BNP Paribas Fortis (Belgium)	Addition: Limit £15m / 6 Months.	Revised Credit Methodology.

National Bank of Canada(Canada)	Addition: Limit £15m / 6 Months.	Revised Credit Methodology.
Landesbank Hessen-Thueringen Girozentrale (Heleba) (Germany)	Addition: Limit £20m / 364 Day.	Revised Credit Methodology.
ING Bank (Netherlands)	Addition: Limit £15m / 6 Months.	Revised Credit Methodology.
Bank of America (USA)	Addition: Limit £15m / 6 Months.	Revised Credit Methodology.

4.5. At the 31 March 2017 no investments to Counterparties on the list were in breach of limit due to limit changes.

4.6. A full list of the investments held at 31 March 2017, compared to Capita's creditworthiness list, and changes to credit rating of counterparties during March 2017 are shown in Appendix B.

5. Borrowing Outturn & Debt Rescheduling Activity 2016/17 and Comparison with Strategy

5.1. The Capital Programme expenditure plans were revised during 2016/17 from that agreed by Full Council at its meeting on 19 February 2016 and actual spending was under budget. The result on the corresponding Borrowing Requirement for the year is shown in the table below:

	Original Budget at 1/4/2016 £m	**Final Budget at 31/3/2017 £m**	**Actual at 31/3/2017 £m**	**Underspend £m**
Net Capital Expenditure Programme 2016/17	86.408	76.307	38.322	37.985
Borrowing Requirement 2016/17	78.794	50.353	15.774	34.579

5.2. The Strategy for 2016/17 stated that new borrowing would be undertaken in all periods with the aim of achieving an even spread of maturity profile and keeping an increase in the average cost of the Council's debt to a minimum. Borrowing would be undertaken at a time appropriate to coincide with an identified dip in borrowing rates available.

5.3. The Council's actual borrowing and debt rescheduling position as at 31 March 2017 and activity during 2016/17, is detailed in the table below:

Borrowing Activity 2016/17	Maturing Debt £m	Debt To Fund Capital Expenditure £m	Total £m	% Cost
Opening Balance at 1.4.2016	0.0	480.099	480.099	4.077%
New Borrowing in 2016/17	0.0	12.000	12.000	2.393%
Borrowing Matured/Repaid in 2016/17	(14.000)	(1.354)	(15.354)	
Debt Rescheduling:-				
Borrowing Repaid in 2016/17	0.0	0.0	0.0	
Borrowing Replaced in 2016/17	0.0	0.0	0.0	
Closing Balance at 31.3.2017	**(14.000)**	**490.745**	**476.745**	**4.068%**
Authorised Limit For External Debt 2016/17			584.851	

5.4. The table above shows that a total of £12.0m of external borrowing was taken during the year. This borrowing was taken in line with the Strategy taken from the Public Works Loan Board (PWLB) in late June 2016 and early July 2016, when rates fell to record lows after the Brexit Vote. The borrowing was taken over 45 to 48 years to meet a gap in the maturity profile, at an average rate of 2.39%, hence lowering the existing level of Council debt to 4.068% from 4.077%. The graph at 2.3 shows that the low point of the year for this period of borrowing was late August 2016 when rates dropped to 1.87% after the Base Rate Cut, but started to rise slowly from this point forward to the end of the year.

5.5. Total Lenders Option Borrowers Option (LOBO) debt the Council has stands at £30m, well within the limit set in the strategy of 10% of total external debt (equating to £47.6m). A limit is set on this type of borrowing to limit the amount of variability within the debt portfolio for debt repayment.

5.6. Appendix C shows the maturity profile of the Council’s long term debt as at 31 March 2017, including the variability effect of the £30m LOBO debt held. (LOBO debt allows the Lender the opportunity to change the rate on the Loan at specified intervals and the Borrower the option to accept this change or repay the loan.) The graph shows a fairly even maturity profile with no debt maturing in any one year exceeding 10.05% of the total debt portfolio.

5.7. Internal Borrowing is using internal balances to finance capital spend, instead of external borrowing. This strategy reduces interest rate risk (the risk of unexpected adverse changes in interest rate) and credit risk (the risk of default by counterparties to whom investments are held as investment exposure falls) and also provides a net saving in interest costs in the short term. The balance of internal borrowing at 31 March 2017 stood at £69.343m from £66.213m the previous year and is broken down as follows:

2011/12	£15.459m
2012/13	£56.486m
2013/14	£26.028m
2014/15	-£13.417m
2015/16	-£18.343m
2016/17	£3.130m
Total	£69.343m

A further £34.579m of internal borrowing will be carried forward to 2017/18 along with the Capital Programme and Borrowing Requirement underspends, which will bring total internal borrowing to £103.922m (17.8% of the 2017/18 borrowing requirement). Scope for further internal borrowing after this will be limited as cash balances are run down going forward.

5.8. It is worth pointing out that the internal borrowing balance detailed above can be taken externally at any time if investment interest rate yield curves reverse and move higher than long term borrowing rates in the future.

5.9. The table below shows how the final borrowing requirement for 2016/17 was utilised.

	£m
Final Borrowing Requirement 2016/17	15.774
Made Up Of:	
Voluntary Repayment Debt 2016/17	0.644
Actual Borrowing Undertaken in 2016/17	12.000
Internal Borrowing CF from 2015/16	50.092
Internal Borrowing 2016/17	-12.383
Internal Borrowing Underspend CF to 2017/18	-34.579
Total	**15.774**

5.10. No debt rescheduling activity took place during the year due to all existing borrowing loans being in premium position (meaning that the coupon rate of existing debt is higher than the current market rate for equivalent outstanding periods and so a premium would be incurred to repay this debt back early).

5.11. Due to the significant underspend of the capital programme borrowing requirement in 2016/17 as detailed in 5.1 above, which has been carried forward to 2017/18, interest paid on long term borrowing in 2016/17 was some £1.9m under budget at £19.533m.

5.12. Full Council, at its meeting on 19 February 2016, approved the Council's Prudential Indicators for 2016/17, set as a requirement of the Prudential Code to ensure the Council's capital financing, in particular its long term borrowing, is prudent, affordable and sustainable. It can be confirmed that no Prudential Indicator limits were breached during 2016/17. Appendix D compares actual key treasury Prudential Indicators with those estimated for 2016/17.

6. Other Treasury Management Issues

6.1. Revision to Minimum Revenue Provision Policy

Minimum Revenue Provision (MRP) is a charge to the Council's revenue account to make provision for the repayment of the Council's outstanding capital debt liabilities. The Council is required by law to set aside an amount for this provision which it considers to be prudent. Statutory Guidance which accompanies Regulations provides options for the calculation of MRP and gives Council's significant discretion in determining the level of MRP.

Some work was done during the year to look at the method at which the Council calculates its MRP provision in order to revise this to bring it up to date with current funding circumstances. Two main changes included:

- moving to a full repayment method for pre 2008 debt and base this on a standard asset life of 50 years, equating to a flat rate of 2% per year over 50 years. Prior to this repayment of this debt was based on a 4% reducing balance method. The effect of this change is to re-profile MRP to later years (15 years on), making savings in earlier years. This new approach better reflects the current Revenue Grant funding approach received from Government.

- introducing an annuity method calculation for those assets/projects financed by borrowing where the benefits of those assets are expected to increase in later years, such as Infrastructure Spending (Lincoln Eastern Bypass, East-West Link, Relief Road Projects etc). This again makes savings to MRP in earlier years by re-profiling the charge to later years.

These changes to MRP have resulted in a reduction of MRP in 2016/17 of £4.395m.

2. Conclusion

Interest Rates dipped in the middle of the year, reacting to the shocks from the vote to leave the EU in June. Base Rate was cut to 0.25% in early August for the first time since 2009 and has remained at this level since. Long Term rates fell to historic lows in August then rallied back to the end of the year as growth and consumer confidence have remained strong. Long term levels ended the year at around 0.50% lower than they started. In light of this backdrop the Council outperformed its investment benchmark during the year by 0.34%, achieving an annualised return of 0.65%. It also beat benchmarking comparators from Capita. It achieved this by lengthening the Weighted Average Maturity of its investments which stood at 153 days at 31 March 2017.

The cost of the Council's borrowing dropped to 4.07% after a sum of £12m PWLB borrowing was taken in June/July at an average rate of 2.39% in line with strategy. The Council's internal borrowing level stood at £69.343m at 31 March 2017. A total of £34.579m of internal borrowing will be carried forward in 2017/18 along with capital expenditure and borrowing requirement underspends. Temporary borrowing of £22m was undertaken in 2016/17 to cover predicted liquidity issues. This sum was repaid before 31 March 2017.

Changes to the MRP calculation were made to bring it up to date with current circumstances regarding capital financing and make it better reflect the level of assets financed by borrowing. The result has been to re-profile the level of MRP over the next 50 years, leading to significantly lower repayment in the next few years, but higher repayment after 15 years out.

3. Consultation

a) Have Risks and Impact Analysis been carried out?

Yes

b) Risks and Impact Analysis

Risk & Impact Analysis for Treasury Management forms TMP1 of the Treasury Management Practices, as required by the CIPFA Code of Practice 2011. A Risk Register which details the main risks for Treasury Management has been completed and is reviewed annually. Both the TMPs and the Risk Register are held in the Treasury Files held on IMP at County Offices.

4. Appendices

These are listed below and attached at the back of the report	
Appendix A	Authorised Lending List at 31 March 2017 and Credit Rating Key
Appendix B	Investment Analysis Review at 31 March 2017 -Capita Asset Services Ltd
Appendix C	LCC Long Term Maturity Profile as at 31 March 2017
Appendix D	Prudential Indicators -Actuals Compared to Estimates 2016/17

5. Background Papers

Document title	Where the document can be viewed
Treasury Management Strategy Statement and Annual Investment Strategy 2016/17 -21/3/2016	Lincolnshire County Council, Finance and Public Protection
Council Budget 2016/17 - 19/2/2016	Lincolnshire County Council, Finance and Public Protection

This report was written by Karen Tonge, who can be contacted on 01522 553639 or karen.tonge@lincolnshire.gov.uk.