

Title of Report: Treasury Annual Report 2016/17

Report of: Darren Collins – Strategic Director, Corporate Resources

Purpose of the Report

1. Cabinet is asked to recommend to Council the attached Treasury Annual Report for 2016/17.

Background

2. In line with what the Government defines as best practice and the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management, the Council must consider a Treasury Annual Report each year.
3. The attached Treasury Annual Report has been prepared taking into account the Local Government Act 2003, Communities and Local Government's (CLG) Guidance on Local Government Investments, CIPFA's Prudential Code for Capital and CIPFA's Code of Practice on Treasury Management. The document is also consistent with the Council's approved Treasury Management Policy and Strategy, which require an annual report to be presented to Council prior to the end of September each year.

Proposals

4. Cabinet is asked to recommend to Council the Treasury Annual Report attached at Appendices 2 and 3 in order to ensure that the Council fully complies with the requirements of good practice.

Recommendation

5. Cabinet is asked to recommend to Council the Treasury Annual Report for 2016/17.

For the following reason:

To ensure that the Council fully complies with the requirements of Financial Regulations and good practice as recommended by the Chartered Institute of Public Finance and Accountancy (CIPFA) in its Code of Practice on Treasury Management.

Policy Context

1. The proposals in this report are consistent with the vision and key priorities as set out in the Council Plan to deliver Vision 2030 and in particular contribute to maintaining a sustainable financial position.

Background

2. The Council fully complies with the requirements of good practice as recommended by the Chartered Institute of Public Finance and Accountancy (CIPFA) in its Code of Practice on Treasury Management and its Prudential Code for Capital and the Department for Communities and Local Government (CLG) Guidance on Local Authority Investments, which include the:
 - Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities;
 - Creation and maintenance of Treasury Management Practice Statements which set out the manner in which the Council will seek to achieve those policies and objectives;
 - Receipt by the Council of an annual strategy report for the year ahead and an annual review report of the previous year;
 - Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions; and
 - Delegation by the Council of the role of scrutiny of treasury management strategy and policies and receipt of a mid-year review report to a specific named body which in this Council is the Audit and Standards Committee.
3. Comprehensive details of procedures in place to ensure compliance with the Code are included within the Council's Treasury Management Practices and these procedures are followed without exception.
4. Treasury Management in this context is defined as:

“The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. ”
5. Taking into account the annual reporting requirements stipulated in the Code of Practice, this Annual Treasury Report covers:
 - The strategy for 2016/17 (including investment and borrowing strategies);
 - Treasury Management approach to risk;
 - Outturn 2016/17 performance measurement (including market interest rates, investment and borrowing performance and compliance with treasury limits set prior to the start of the financial year as Prudential Indicators);
 - Debt restructuring and repayment; and
 - Summary of Treasury Management performance for the year 2016/17.

Consultation

6. Consultation on the production of the Treasury Annual Report has taken place with the Council's treasury advisors Capita Asset Services. The outcome of the consultation process, along with guidance issued by CIPFA, has informed the format and content of the annual report.

Alternative Options

7. There are no alternative options, as the Treasury Annual Report is required in order to comply with CIPFA's Code of Practice on Treasury Management.

Implications of Recommended Option

8. Resources:

- a) **Financial Implications** - The Strategic Director, Corporate Resources confirms that there are no direct financial implications associated with this report. The Annual Report sets out a financial summary of Treasury Management activity for the 2016/17 financial year end and compares this to budget.
- b) **Human Resources Implications** - There are no human resources implications arising from this report.
- c) **Property Implications** - There are no property implications arising from this report.

9. Risk Management Implications

The Treasury Annual Report has been prepared to report on performance against the annual Treasury Policy and Strategy. These are prepared with the primary objective of safeguarding the Council's assets and a secondary objective of maximising returns on investments and minimising the costs of borrowing.

10. Equality and Diversity Implications

There are no equality and diversity implications arising from this report.

11. Crime and Disorder Implications

There are no crime and disorder implications arising from this report.

12. Sustainability Implications

There are no sustainability implications arising from this report.

13. Human Rights Implications

There are no human rights implications arising from this report.

14. Area and Ward Implications

There are no direct area and ward implications arising from this report.

15. Background Information:

The following documents have been relied on in the preparation of the report:

- Local Government Act 2003
- CLG Guidance on Local Government Investments
- CIPFA's Prudential Code for Capital
- CIPFA's Code of Practice on Treasury Management
- Council's approved Treasury Policy & Strategy Statements 2016/17 to 2018/19
- Council's approved Treasury Management Practice Statements

Treasury Management Annual Report 2016/17

The Strategy for 2016/17

1. The 2016/17 Treasury Management Strategy was approved by Council on 17 March 2016.
2. The formulation of the 2016/17 Treasury Management Strategy involved determining the appropriate borrowing and investment decisions with the primary objective of safeguarding the Council's assets and a secondary objective of maximising returns on investments and minimising the costs of borrowing.
3. The Treasury Management Strategy fully complies with the requirements of CIPFA's Treasury Management Code of Practice and covered the following:
 - prospects for interest rates;
 - treasury limits in force including prudential indicators;
 - the borrowing strategy;
 - the extent of debt rescheduling opportunities; and
 - the investment strategy.

Investment Strategy

4. Part 1 of the Local Government Act 2003 relaxed the constraints under which local authorities can invest. These investment regulations came into force on 1 April 2004 and in conjunction with supplementary guidance are considered best practice.
5. Investments are managed in-house using counterparties listed in an approved lending list. Investments are placed over a range of periods and are dependent on the assessed security of the counterparty, the liquidity requirements of the cash flow, interest rate expectations and the interest rates actually on offer.
6. The expectation for interest rates within the Treasury Management Strategy for 2016/17 anticipated a low but rising Bank Rate, (starting in quarter 1 of 2017), and gradual rises in medium and longer term fixed borrowing rates during 2016/17. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.
7. In this scenario, the Treasury Strategy was to delay borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

Borrowing Strategy

8. Based on the advice of Capita Asset Services and other information the borrowing strategy for 2016/17 was as follows:
 - When 25 year Public Works Loan Board (PWLB) rates fall back to or below 3.20% borrowing should be considered, with preference given to terms of less than 35 years to enhance the diversity of the borrowing portfolio.

- Consideration will be given to borrowing market loans which are at least 20 basis points below the PWLB target rate.
9. Any potential opportunities for repaying debt before the maturity date to reduce borrowing costs was monitored and assessed throughout the year. However, the cost of premiums on any early repayment of debt was considered prohibitive for any debt restructuring.

Treasury Management Approach to Risk

10. The primary objective is to protect funds and minimise risk. Procedures have been put in place to ensure this takes place and these are fully documented in the Council's Treasury Management Practice Statements (TMPS), which are constantly kept under review. These procedures are followed without exception. The most recent Internal Audit report concluded that Treasury Management control systems and procedures are operating well. All funds were safeguarded in 2016/17.

Outturn 2016/17 – Performance Measurement

11. It should be noted that procedures in relation to the Prudential Code were effective from 1 April 2004 and continue to apply to this report on 2016/17 performance. The performance, against limits in respect of borrowing set prior to the start of the financial year as Prudential Indicators, will be reported to Cabinet on 20 June 2017 as part of the Capital Monitoring process. None of the approved Prudential Indicators set for 2016/17 were breached in the year. For completeness the Prudential Indicators are shown at Appendix 4.

Market Interest Rates

12. Performance must be considered in conjunction with actual rate movements over the financial year which were as follows:
- **Shorter-term interest rates** – Following the EU referendum in August 2016 the Monetary Policy Committee (MPC) reduced the Base Rate to 0.25% and it remained at that level for the rest of the year.
 - **Longer-term interest rates** – Market expectations as to the timing of the start of monetary tightening started the year at quarter 3 2018, but then moved back to around the end of 2019 in early August before finishing the year back at quarter 3 2018. Deposit rates continued into the start of 2016/17 at previous depressed levels but then fell during the first two quarters and fell even further after the 4 August (MPC) meeting resulted in a large tranche of cheap financing being made available to the banking sector by the Bank of England. Rates made a weak recovery towards the end of 2016 but then fell to fresh lows in March 2017.

Investment Performance

13. The major issue for treasury management in 2016/17 has been ensuring the security of investments whilst generating a reasonable rate of return. Due to the difference between the cost of borrowing and investment interest and the reduction in suitable counterparties the Council has continued to use investment balances to temporarily fund the capital programme. This has resulted in a saving on borrowing costs.

14. The Council's investment policy is governed by CLG guidance, which has been implemented in the annual investment strategy approved by the Council on 14th March 2017. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.) The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.
15. There has been a continued use of a range of investment instruments in order to increase flexibility, spread risk, maximise liquidity and obtain attractive rates. There has been an increased use of Notice Reserve accounts, and money market funds with high rated banks to maintain the security of the funds and enhance the rate of return on investments.
16. A summary of the year's activity is shown at Appendix 3. The investment interest earned in the year was £0.413m (2015/16 £0.582m) with an average interest rate of 0.55% (2015/16 0.54%). Interest earned on loans to third parties, agreed as part of the capital programme, increased total interest to £1.667m which was £0.042m less than the original budget of £1.709m. This includes £0.887m interest relating to Newcastle International Airport.
17. The overall return for the year of 0.55% exceeds the accepted benchmark for 2016/17, which was 0.20%. This benchmark is the 7-day London Interbank Bid Rate (LIBID), which is traditionally linked to the base rate.
18. Furthermore, the Council is a member of Capita Asset Services Investment Benchmarking Group which assesses both the rate of return and the risk of the counterparty to calculate a weighted average rate of return, which is used for comparison across other local authorities. The Council achieved an average return of 0.42% on its investments for Quarter 4 2016/17 which is in line with the risk adjusted expectations defined in the Benchmarking Report. The Council is between the lower (0.34%) and upper (0.46%) performance boundaries which compares to other Local Authorities in the group against an expected rate of return based on the amount of risk applied.

Heritable Bank

19. The Council had a deposit of £2.792m at risk in Heritable Bank, a wholly owned subsidiary of an Icelandic bank, Landsbanki, when it entered administration in October 2008. The full deposit in Heritable was due to mature by the end of 2008/09 with interest.
20. To date dividends totalling £2.736m (98.00p in the £) have been received. This is an overachievement against the estimated return of 90p in the £. As the original investment was impaired in 2010/11 to reflect the expected return, all additional income above 90p in the £ is revenue income. The additional 8.00p in the £ recovered to date equates to £283,049 revenue income.
21. The most recent update from the administrators, Ernst and Young, in March 2017, provided detail of all dividends received to date and advised that no further dividend is expected until the conclusion of the matter. Ernst and Young intend to issue a further report early within the next accounting period.

Borrowing Performance

22. The total external borrowing at 31 March 2017 was £610.189m, which was within the operational borrowing limit of £725m. This is a net reduction of £7.131m from the opening figure of £617.320m. The reduction is represented by £31m of new borrowing offset by £38.131m repayment of borrowing.
23. Investment returns/interest rates were low during 2016/17 and were well below long term borrowing rates. Therefore value for money considerations indicated that best value could be obtained by delaying new external borrowing by using internal cash balances to finance new capital expenditure in the short term (this is referred to as internal borrowing). In 2016/17 there was £37.108m of internal borrowing. Any short term savings gained from adopting this approach was weighed against the potential for incurring additional long term costs by delaying unavoidable new external borrowing until later years when PWLB long term rates are forecast to be higher.

| | 31 March 2016 Actual | 31 March 2017 Actual |
|-----------------------|-------------------------|-------------------------|
| CFR General Fund (£m) | 286.125 | 301.792 |
| CFR HRA (£m) | 345.505 | 345.505 |
| Total CFR (£m) | 631.630 | 647.297 |

24. The details of the borrowing taken during 2016/17 are as follows:

| Date | Term (years) | Amount £m | Interest Rate (%) | Source |
|------------|-----------------|---------------|-------------------------|--------|
| 14/06/2016 | 45 | 5.000 | 2.62 | PWLB |
| 21/02/2017 | 48 | 6.000 | 2.33 | PWLB |
| 28/02/2017 | 11 | 10.000 | 2.08 | PWLB |
| 28/02/2017 | 36.5 | 10.000 | 2.56 | PWLB |
| | | 31.000 | | |

25. At 31 March 2017 £490.189m of the total borrowing was from the PWLB and £120m was in the form of market loans. The average interest rate on borrowing has reduced from 4.49% in 2015/16 to 4.37% during 2016/17 which will reduce borrowing costs.
26. There was no short-term borrowing taken during 2016/17. The majority of the loans taken in 2016/17 were over 35 years which lengthens the life of the debt portfolio and provides long term security in terms of borrowing costs by securing loans at historically low rates.
27. The overall revenue cost of borrowing in 2016/17 was £26.284m. As a consequence of the level of capital expenditure and the application of the Treasury management Strategy this was £1.441m less than the budget.

Debt Restructuring & Repayment

28. Due to the reintroduction of redemption rates on the early repayment of PWLB debt it was anticipated that there would be little scope to restructure PWLB debt.
29. The rates payable on the early redemption of debt was monitored throughout the year. The cost of early repayment outweighed any savings and therefore there was no early redemption of debt.

Summary of Treasury Management Performance for the Year 2016/17

30. Total interest income was £0.042m less than the budget, which was mainly due to using internal cash balances to finance new capital expenditure in the short term, resulting in lower balances available to invest.
31. Borrowing costs were £1.441m less than budget due to borrowing being taken at lower interest rates than estimated and the decision to temporarily fund the capital programme from cash balances.
32. There were no opportunities for restructuring debt during 2016/17.
33. Overall Treasury Management performance against budget for 2016/17 generated net savings of £1.399m, this is summarised in the following table:

| | Budget | 2016/17 Actual | Saving |
|---------------------|---------------|---------------------------|----------------|
| | £m | £m | £m |
| Cost of Borrowing | 27.725 | 26.284 | (1.441) |
| Interest Income | (1.709) | (1.667) | 0.042 |
| Net Position | 26.016 | 24.617 | (1.399) |

34. Treasury Management remained challenging throughout 2016/17 with the continuation of the lowest bank interest rate in history and continuing pressure on available counterparties.

Appendix 3

Investment Activity

| | 2015/16 | 2016/17 |
|---|----------|---------|
| Number of investments made in 2014/15 maturing in 2015/16 | 8 | n/a |
| Number of investments made in 2015/16 maturing in 2015/16 | 44 | n/a |
| Number of investments made in 2015/16 maturing in 2016/17 | n/a | 14 |
| Number of investments made in 2016/17 maturing in 2016/17 | n/a | 41 |
| Total number of investments maturing in year | 52 | 55 |
| Number of investments made in 2016/17 maturing in 2017/18 | n/a | 14 |
| Average duration of investments (including overnight) | 5 days | 4 days |
| Average duration of investments (excluding overnight) | 102 days | 84 days |
| Non-specified investments: | | |
| Rated non-high | | |
| Approved limit | 55% | 55% |
| Maximum level invested | 34% | 41% |
| Not Rated | | |
| Approved limit | 0% | 0% |
| Maximum level invested* | 0.14% | 0.06% |
| Investments greater than 364 days | | |
| Approved limit | £15m | £15m |
| Maximum level Invested | £0m | £0m |

*Relates to local authority investments greater than 364 days and the impaired investment with Heritable Bank.

Prudential Indicators 2016/17

The 2016/17 Prudential Indicators were agreed by Council on 23 February 2016. This is now compared with the 2016/17 actual position as at 31 March 2017.

Certain Treasury Management indicators must be monitored throughout the year on a regular basis in order to avoid breaching agreed limits. The capital expenditure and capital financing requirement indicators have been revised in line with the revised budget and none of the other approved Prudential Indicators set for 2016/17 have been breached.

| <i>Capital Expenditure</i> | | |
|--|---------------------------------------|---------------------------|
| | 2016/17 £000 Reported Indicator | 2016/17 £000 Actual |
| Non-HRA | 48,799 | 45,914 |
| HRA | 22,270 | 19,147 |
| Total | 71,069 | 65,061 |
| To reflect the reported capital monitoring agreed by Council during the year | | |

| <i>Ratio of Financing Costs to Net Revenue Stream</i> | | |
|--|-------------------------------|-------------------|
| | 2016/17 Reported Indicator | 2016/17 Actual |
| Non-HRA | 13.77% | 12.82% |
| HRA | 46.36% | 43.44% |

| <i>Capital Financing Requirement</i> | | |
|---|---------------------------------------|---------------------------|
| | 2016/17 £000 Reported Indicator | 2016/17 £000 Actual |
| Non-HRA | 317,655 | 301,792 |
| HRA | 345,505 | 345,505 |

There were no breaches to the Prudential Indicators set for 2016/17.

| Authorised Limit for External Debt | |
|---|--|
| | 2016/17 £000 Reported Indicator |
| Borrowing | 750,000 |
| Other Long Term Liabilities | 0 |
| Total | 750,000 |
| Maximum YTD £617,319 | |

| Operational Boundary for External Debt | |
|---|--|
| | 2016/17 £000 Reported Indicator |
| Borrowing | £725,000 |
| Other Long Term Liabilities | 0 |
| Total | £725,000 |
| Maximum YTD £617,319 | |

The Council's actual external debt at 31 March 2017 was £610,189. It should be noted that actual external debt is not directly comparable to the Authorised Limit and Operational Boundary, since the actual external debt reflects the position at one point in time.

Estimated Incremental Impact on Council Tax and Housing Rents

This indicator is set at the time the Council's budget is set. Therefore, there is no requirement for this Indicator to be monitored on a quarterly or annual basis.

Adherence to CIPFA code on Treasury Management

The Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Services.

| Upper Limit on Fixed and Variable Interest Rates Exposures | | |
|---|--|---|
| Range | 2016/17 £000 Reported Indicator | 2016/17 £000 Actual Position |
| Fixed Rate | Max 624,164 Min 357,170 | 500,817 <i>Max</i> 512,154 <i>Min</i> 468,307 |
| Variable | Max 152,227 Min -30,000 | 40,500 <i>Max</i> 41,000 <i>Min</i> 18,000 |
| All within agreed limits. (Max and Min YTD) | | |

| Upper / Lower Limits for Maturity Structure of Fixed Rate Borrowing | | | | |
|--|---------------------------------------|------------------------|------------------------------------|------------------------|
| | 2016/17 Reported Indicator | | 2016/17 Actual Position | |
| | Upper Limit | Lower Limit | Actual Percentage | Maximum YTD |
| Under 12 months | 20% | 0% | 3.25% | 6.91% |
| 12 months to 24 months | 20% | 0% | 4.01% | 10.50% |
| 24 months to 5 years | 50% | 0% | 19.47% | 20.51% |
| 5 years to 10 years | 50% | 0% | 6.98% | 8.06% |
| 10 year to 20 years | 50% | 0% | 14.71% | 15.39% |
| 20 years to 30 years | 50% | 0% | 0.00% | 0.00% |
| 30 years to 40 years | 50% | 0% | 12.92% | 12.92% |
| 40 years to 50 years | 60% | 0% | 28.17% | 29.13% |
| 50 years and above | 30% | 0% | 1.97% | 2.05% |
| All within agreed limits. | | | | |

On 8 March 2007, Council agreed to the placing of investments for periods of longer than 364 days in order to maximise investment income before forecasted cuts in interest rates. An upper limit was set and agreed as a new Prudential Indicator.

| Upper Limit on amounts invested beyond 364 days | | | |
|--|--|---|---|
| | 2016/17 £000 Reported Indicator | 2016/17 £000 Actual Position | 2016/17 £000 Maximum YTD |
| Investments | 15,000 | 0 | 0 |