Audit and Governance Committee

Dorset County Council

Date of Meeting	20 September 2016
Officer	Chief Financial Officer
Subject of Report	**Treasury Management and Prudential Code Review 2015/16**
Executive Summary	At the meeting of the Cabinet on 11 February 2015 members approved the Treasury Management Strategy Statement and Prudential Indicators for 2015-16. At this meeting, Cabinet approved the adoption of the CIPFA Prudential Code and in turn the adoption of the Treasury Management Code of Practice. In adopting the code, recommended best practice is for Members to receive an annual report on the Treasury Management Strategy and Prudential Indicators, a mid year update on progress against the strategy and a year end review of actual performance against the strategy. This report provides Members with an update on the economic background, its impact on interest rates, performance against the annual investment strategy, an update of any new borrowing, any debt rescheduling, compliance with the prudential Code.
Impact Assessment: *Please refer to the protocol for writing reports.*	Equalities Impact Assessment: N/A
	Use of Evidence:

	CIPFA 2015/16 benchmarking Capita Asset Services Benchmarking 2015/16
	Budget: All treasury management budget implications are reported as part of the Corporate Budget outturn report, alongside the Asset Management reports that include the progress of the capital programme.
	Risk Assessment: This report is for information. However, treasury management is an inherently risky area of activity and a number of controls are embedded in its operation. The key Treasury risks are highlighted as part of the Annual Treasury Management Strategy approved by Cabinet as part of the Budget setting process. This report highlights any variances from this strategy and draws out any specific risks which have arisen. Current Risk: HIGH Residual Risk MEDIUM
	Other Implications:
Recommendation	That the Committee: 1. Note and comment upon the report.
Reason for Recommendation	To better inform members of the Treasury Management process and strategy, in accordance with the corporate priority to ensure money and resources are used wisely.
Appendices	Appendix 1 – Prudential Indicators Appendix 2 – Borrowing as at 31 March 2016 Appendix 3 – Investment Balances as at 31 March 2016
Background Papers	Treasury Management Annual Strategy 2015/16 Capita Treasury Solutions – Independent Economic Analysis Capital Programme Budget and Monitoring report 2015/16
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1. Background

1.1. This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2015/16. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

1.2. During 2015/16 the minimum reporting requirements were that the full Council should receive the following reports:

a) An annual treasury strategy in advance of the year (Cabinet 11 February 2015)
b) A mid-year (minimum) treasury update report (Audit and Scrutiny 24 November 2015)
c) An annual review following the end of the year describing the activity compared to the strategy (this report).

1.3. The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is therefore important in that respect, as it provides details of the outturn position for 2015/16 for treasury activities, and highlights compliance with the Council's policies previously agreed by members.

1.4. The report provides commentary of the overall performance of the treasury activities of the Council, and all of the prudential indicators are summarised in Appendix 1.

2. The Economy and Interest Rates

2.1. When the Treasury Management Strategy for 2015/16 was agreed in February 2015, market expectations were for the first increase in UK Bank Rate to occur in the second half of 2015. However the rate remained unchanged for the whole financial year as UK growth slowed due to a number of factors including the appreciation of sterling against the Euro, weak growth in the European Union (EU), China and emerging markets, plus the dampening effect of the Government's continuing austerity programme and uncertainty created by the UK referendum on membership of the EU.

2.2. In the US the Federal Reserve agreed its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the referendum vote has caused a re-emergence of caution over the timing and pace of further increases. Markets anticipate that there will now be only one more increase in 2016.

2.3 In the Eurozone, the European Central Bank (ECB) commenced in March 2015 its €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected Eurozone countries. This was intended to run initially to September 2016 but in response to a continuation of weak growth, has been extended to March 2017. At its December 2015 and March 2016 meetings the ECB progressively cut its deposit facility rate to reach 0.4% and its main refinancing rate from 0.05% to zero. It also increased its monthly asset purchases from €60bn to €80bn. This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and a start to some improvement in economic growth. The ECB is also struggling to get inflation up from near zero towards its target of 2%.

2.4. Shortly after the result of the referendum, the Council's treasury advisor, Capita Asset Services, has provided the following updated interest rate forecast:

	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.50%	0.50%	0.50%
5yr PWLB rate	1.00%	1.10%	1.10%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.30%	1.30%
10yr PWLB rate	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%	1.80%	1.80%	1.80%	1.90%
25yr PWLB rate	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%
50yr PWLB rate	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%

2.5 In August the Monetary Policy Committee (MPC) agreed to cut the Bank Rate to 0.25% and to renew its programme of quantitative easing. Capita believe that the Bank Rate could even be cut further to 0.1%, or even 0.0%. Thereafter Capita do not expect the MPC to take any further action on the Bank Rate until 2018 as they expect the pace of economic recovery to be weak during a period of great uncertainty as to the final agreement between the UK and the EU on arrangements after the referendum.

3. Capital Expenditure and Financing

3.1. The Council's capital programme can be funded in two main ways:

a) Financed immediately through the application of capital or revenue resources, which includes applying capital receipts from asset sales, capital grants received from central government or direct from revenue budgets, and has no impact on the Council's borrowing need; or
b) If insufficient financing is available, or a decision is made not to apply resources, the capital expenditure will give rise to a borrowing need.

3.2. The Council is only permitted to borrow to finance capital expenditure and cannot borrow to fund on going revenue expenditure.

3.3. Capital expenditure forms one of the Council's prudential indicators and is reported in more detail as part of the quarterly asset management updates to Cabinet. The actual capital spend for 2014/15, the budget for 2015/16 and 2016/17 and outturn for 2015/16 are illustrated in Table 1.

Table 1 Capital Expenditure 2014/15 – 2016/17

Prudential Indictor 1	2014/15 actual £'000	2015/16 budget £'000	2015/16 actual £000	2016/17 budget £000
Capital Expenditure	80,774	91,227	87,958	81,756

4. The Council's Overall Borrowing Need

4.1. The unfinanced capital spend element of the capital programme is called the Capital Financing Requirement (CFR) and is made up of the Council's underlying need to borrow in addition to any PFI and finance lease liabilities it may have. The CFR figure is a therefore a gauge of the Council's debt position and results from the Council's capital activity and the resources that have been used to pay for it.

4.2. The Council was debt free until 2002, when the Government changed the way in which it helped councils to fund their capital spend by replacing capital grants with revenue grants to cover the costs of principal repayment and the interest costs of borrowing. This funding was included as part of the revenue support grant (RSG) funding formula, and gave councils little option other than to borrow to fund capital expenditure. As part of the 2010 grant changes this part of the funding formula has been removed.

4.3. Part of the Council's treasury activity is to address the funding requirements for this borrowing need. The treasury team organises the Council's cash position to ensure that there is sufficient cash available to meet the capital plans and the resulting cash flow requirements. Borrowing may be sourced through external bodies, such as the Government through the Public Works Loans Board (PWLB) or the money markets, or by utilising temporary cash resources from within the Council.

4.4. The Council's borrowing need, and therefore the CFR, cannot increase indefinitely, and statutory controls require the Council to make an annual charge to the Income and Expenditure account over the life of the assets that are being financed by the borrowing requirement. This charge is known as the minimum revenue provision (MRP) and is effectively a repayment of the borrowing need.

4.5. It is important to note that the borrowing need or requirement is not the same as the actual amount of borrowing or debt held by the Council. The decisions on the level of debt are taken as part of the treasury management operations of the Council, subject to overriding limits set by Members through agreement of the Annual Treasury Management Strategy.

4.6. The CFR can also be reduced by:
a) The application of additional capital financing resources (such as unapplied capital receipts or government grants); or
b) Charging more than the statutory revenue charge (MRP) each year through a voluntary revenue provision.

4.7. The Council's CFR for the year is shown in Table 2 and is one of the key prudential indicators. It includes the PFI and leasing liabilities, as well as the Council's underlying need to borrow. Table 2 shows the actual CFR for 2014/15 and 2015/16. The CFR ended 2015/16 at £326.2m, £8.7m less than the 2014/15 level of £334.9m

Table 2 CFR Actual 2014/15 and 2015/16

Capital Financing Requirement Prudential Indicator 2	2014/15 Actual £'000	2015/16 Actual £'000
Underlying Borrowing Requirement b/f	**279,121**	**292,845**
Capital Expenditure	80,774	87,958
Revenue Contributions	-2,311	-4,942
Capital Receipts applied	-4,899	-6,083
Grants	-44,419	-72,050
Reserves Applied	0	-1,611
Minimum Revenue Provision	-17,464	-12,023
Other Adjustments	2,043	3,219
Underlying Need to Borrow	**292,845**	**287,313**
Other Long Term Liabilities	42,042	38,933
Capital Financing Requirement	**334,887**	**326,246**

5. Borrowing Outturn for 2015/16

5.1. Actual borrowing activity is constrained by the prudential indicators for net borrowing and the CFR. In order to ensure that borrowing levels are prudent over the medium term, the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council cannot borrow to support its day to day revenue expenditure. Net borrowing should therefore have not exceeded the CFR for 2015/16 plus the expected changes in the CFR for 2016/17 and 2017/18 from financing the capital programme. This indicator therefore allows the Council some flexibility over the timing of the borrowing so, if interest rates are favourable, for example, it can borrow in advance of its immediate cash need.

5.2. Table 3 highlights the Council's gross borrowing, its investment balances and the net borrowing against the CFR and authorised borrowing limit.

Table 3 –Gross and Net Debt – excluding PFI

Gross and Net Debt Prudential Indictor 3	Actual 31/03/2014 £000	Actual 31/03/2015 £000	Actual 31/03/2016 £000
Gross Debt	213,871	215,124	184,341
Investments	87,573	56,620	12,738
Net Debt	126,298	158,504	171,603

Underlying need to Borrow	279,121	292,845	287,313
Under borrowing	65,250	77,721	102,972

Authorised Limit	353,000	353,000	355,000
Operational Boundary	333,000	333,000	335,000
Maximum Gross Debt	213,871	215,124	215,124

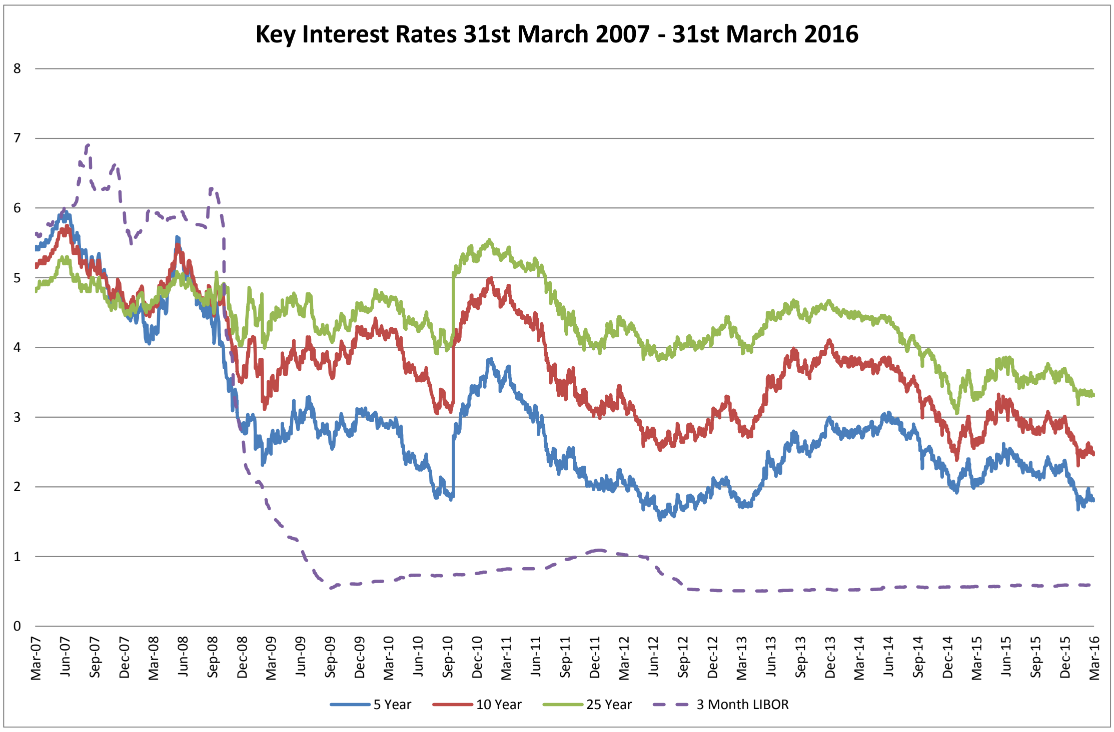
5.3. The gross and net debt positions should be considered in light of the prevailing economic conditions summarised in section 2. The treasury management strategy over the past few years has been to reduce investment balances and delay borrowing. This strategy has been adopted for two main reasons:

a) To reduce counterparty risk on the Council's investments – the lower the level of investment balances the lower the size of any losses if counterparties fail, which has been a major risk during the financial crisis;

b) To reduce the cost of carrying cash balances – shorter term investment interest rates are at historically low levels and the gap between the cost of borrowing and investment returns is at its widest for 20 years.

5.4. Chart 1 illustrates the divergence of long term borrowing rates and short term investment returns, as indicated by the 3 month LIBOR rate, over the past 9 years.

Chart 1



5.5. Prior to September 2008 the 3 month LIBOR rate moved broadly in line with the longer period borrowing rates, and reflected the flat yield curve at that time. This meant that it was possible to take borrowing in advance of need and invest it, temporarily until required, at a similar rate to that it was borrowed at. However, since the financial crisis short term investment rates have reduced significantly, and although the longer term borrowing rates have also reduced, the gap between borrowing costs and investment returns has increased markedly. Borrowing costs over 25 years are currently in the region of 2.2% compared to the 3 month LIBOR rate of about 0.40%. On a typical borrowing tranche of £10m, this difference would amount to a carrying cost of £180k per annum, until it is spent.

5.6. For this reason the Council has adopted a strategy of delaying long term borrowing until cash is actually needed. However, the Council continues to be mindful as to the projections for long term borrowing costs, as projected increases in these costs will result in higher future long term borrowing costs if borrowing is delayed.

5.7. The Council has a target of maintaining an under borrowed position of around £100m, this however has to be matched with assessing the long term costs of borrowing. The under borrowing position as at 31 March 2016 was £103m

5.8. In 2015/16 long term borrowing decreased by £30.8m, with no short term borrowing. There were three loan maturities totalling £30m plus the annual repayments associated with the two PWLB annuity loans held. No new long term borrowing was taken out in 2015/16.

Table 4 - Changes in Borrowing 2015/16

	Loan Type	**Rate**	**£**
Borrowing as at 31/3/15		**3.52%**	**215,123,769**
<u>Repayments</u>			
Loan 25	PWLB Maturity	0.66%	-10,000,000
Loan 39	West Midlands Police	0.485%	-10,000,000
Loan 33	Hampshire CC	0.70%	-10,000,000
Loan 2	PWLB annuity	4.70%	-768,745
Loan 3	PWLB annuity	4.65%	-13,874
Borrowing as at 31/3/16		**3.98%**	**184,341,150**

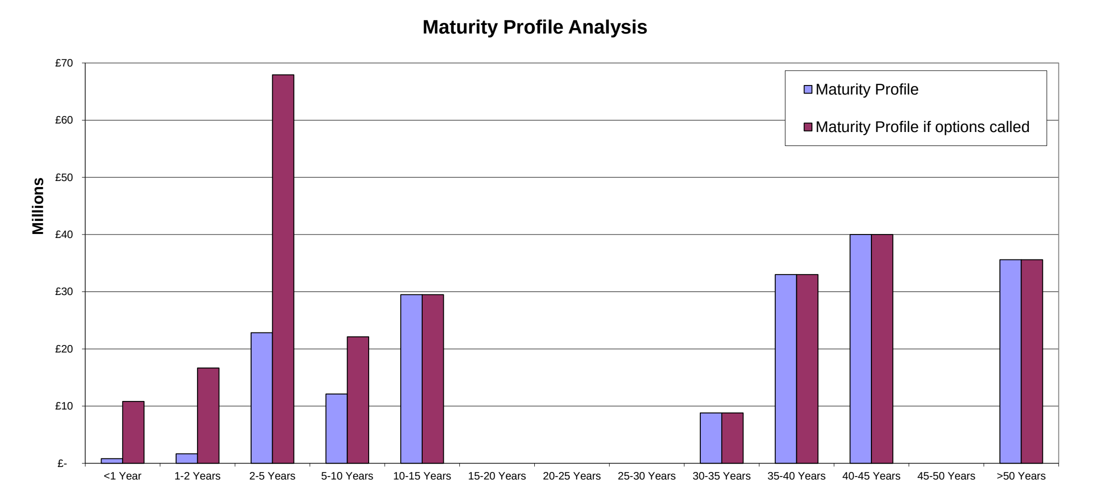
5.9. A schedule of all borrowing at 31 March 2016 is shown in Appendix 2. The Council's borrowing includes £95.1M of 'Lender Option Borrower Option' (LOBO) loans. Generally the interest rate on a LOBO is fixed for an initial period of a number of years, after which the lender has the option to change the rate at contractually defined periods such as six monthly, annually, two yearly etc. If the borrower does not agree to the change in interest rate, then they may repay the loan without penalty.

5.10. The Council has only taken out such loans when the rates offered were significantly lower than the prevailing rate for a loan for the same duration from the PWLB or other market sources. In addition, some of the loans have been taken out on a forward basis ahead of need to mitigate the risk of changes in interest rates without incurring a 'cost of carry' i.e. where borrowed funds are invested ahead of need for very low return. This ability to agree borrowing in advance is not a facility available from the PWLB.

5.11. The main risk of a LOBO loan is that the lender will only exercise their option to increase rates when rates generally available are higher, although the borrower will have benefited from lower rates for a number of years. In order to mitigate the risk of rising interest rates, the Council continually monitors market expectations of interest rate rises and its overall borrowing requirements. In addition the debt portfolio is structured so that not too much debt matures (or hits a lender option date) at the same time.

5.12. The maturity structure of the Council's borrowing remained within the prudential limits for 2015/16. The maturity limits are in place to ensure that the Council is managing its refinancing, liquidity and interest rate risks. If a high proportion of borrowing matures in any one year it may place pressure on the cash flow position of the Council and force it to refinance these loans at unfavourable rates. By spreading the maturity profile of loans the Council can provide for their repayment in an orderly way

Chart 2



6. Investment Outturn for 2015/16

6.1. The Council invests in accordance with the Annual Investment Strategy, which is approved by the Council alongside the Treasury Management Strategy in February each year.

6.2. The cash resources of the Council are made up of revenue and capital resources, as well as cash flow monies. The Council's core cash resources represented in its balance sheet are comprised as follows:

Table 5 – Analysis of Core Cash Resources

	1 April 2015 £000	**31 March 2016 £000**
Balances	31,901	30,248
Earmarked Reserves	62,581	56,085
Provisions	4,528	3,275
Usable Capital Receipts/Grants	27,483	17,380
Amount Available for Investment	**126,493**	**126,493**
Actual Cash Balances	**56,620**	**12,738**
Difference between amount available and cash	-69,873	-94,250
Made up of:		
Internal (Under) Borrowing	-77,721	-102,972
Working Capital	-7,848	8,722

6.3. The Council's cash resources are more than the amount of cash that is currently being invested largely because of the strategy to borrow from internal resources to fund the capital programme. Investment balances do fluctuate throughout the year as part of the day to day operations of the Council. Table 6 shows the investment balances at the start of the year, the maximum, minimum and average balances held during the year and the investment balances at the end of the year for 2014/15 and for 2015/16.

6.4. Interest earned during the year was £0.538m, a reduction of £0.416m on the previous financial year. This was due to a combination of the decrease in balances held and lower rates of interest available in the market, which saw the return fall from 0.91% in 2014/15 to 0.75% in 2015/16. For comparative purposes the 7 day LIBID rate, a widely used benchmark for returns on liquid cash, averaged 0.36% over 2015/16.

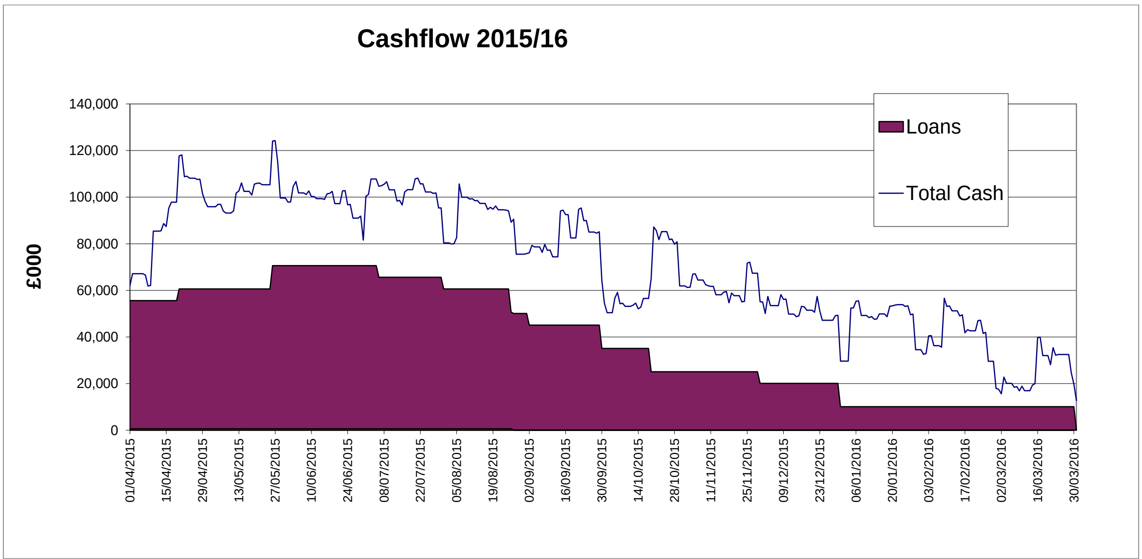
Table 6 – Analysis of Investments

	Actual 2014/15	Actual 2015/16	Difference
	£000	£000	£000
Investments as at 1 April	**87,573**	**56,620**	**30,953**
Maximum cash balance	166,785	124,244	42,541
Minimum cash balance	56,620	12,738	43,882
Average cash balances	104,716	71,492	33,224
Investments as at 31 March	**56,620**	**12,738**	**43,882**
Investment Income	954	538	416
Average Return*	**0.91%**	**0.75%**	**0.26%**

6.5. Cash balances tend to be higher at the start of the financial year as government grants and council tax precepts are received, and reduce as the year goes on. In addition, cash balances have been reducing year on year as a result of changes to funding from central government funding and the Council's strategy to avoid borrowing in advance of need.

6.6. Chart 3 below shows the actual cash and investment balances for the financial year. The coloured blocks show fixed term investments ("loans") and the gap between these blocks and the total cash line show the amount of liquid cash available, which is held in either call accounts or overnight money market funds. Call accounts and money market funds tend to offer lower rates of return than fixed term investments, so the strategy has been to maximise the amount invested in fixed term loans whilst maintaining an adequate level of liquidity to meet the Council's cash-flow needs.

Chart 3



7. Update on Loans to Icelandic Banks

7.1. On 21 May 2015 the administrator of Heritable bank paid the fifteenth interim payment to all unsecured creditors in August 2015. The total amount returned to Dorset County Council to date is £13,011,391 or 98% of the claim for £13,276,929 registered with the administrators. It is anticipated that one further small repayment may be received which would complete 100% of the claim.

8. Treasury Management Performance

8.1. Treasury Management in a large organisation is an inherently risky area, with annual cash turnover generated from its day to day operations at Dorset County Council in the region of £1,500m gross. The treasury management function is therefore highly regulated and subject to scrutiny.

8.2. A measure taken to assess the performance of the treasury management function is to take part in benchmarking with other local authorities. The Council takes part in the annual CIPFA benchmarking exercise, the last one of which involved 42, mainly large local authorities and provides an insight into the relative performance of Dorset County Council's treasury function. This benchmarking exercise covers all aspects of the prudential code as well as information on the rates of return on investments and interest costs on borrowings.

8.3. The headline results of the 2015/16 CIPFA benchmarking exercise were as follows:

a) DCC had above average net budget requirement at £330m (av. £242m);
b) The capital programme was below average at £91m (£103m);
c) The CFR was above average at £326m (£323m);
d) Total borrowing was below average at £184m (£259m)
e) Use of internal financing was above average at £103m (£53m);
f) Investment balances were less than average at £16m (£113m);
g) The interest earned was 0.75% against an average return of 0.87%;
h) Interest paid on borrowing was 3.98% against the average of 4.35%.

9. Risk Management

9.1. Return on investments must be assessed against the level of risk taken by the Council. Since the Icelandic banking crisis, most authorities, including Dorset County Council, have tightened their treasury management policy, and re-emphasised the investment priorities of security of deposits first, liquidity of investments second, and return third.

9.2. The Treasury Management Policy restricts the number of counterparties to those with credit ratings of A- or higher. The only institutions where investments can be made for more than one year are other Local Authorities, the Government and the big four high street banking groups (Barclays Bank Plc, HSBC Bank Plc, Lloyds Banking Group Plc and Royal Bank of Scotland Plc).

9.3. The list of investments held as at 31 March 2016 are highlighted in Appendix 2, alongside the analysis of the investments in terms of counterparty, credit ratings, sovereigns and maturity profiles.

Richard Bates
Chief Financial Officer
September 2016