Audit and Governance Committee

Dorset County Council

Date of Meeting	20 January 2017
Officer	Chief Financial Officer
Subject of Report	**Treasury Management Mid Year update 2016/17**
Executive Summary	At the meeting of the Cabinet on 11 February 2016 members approved the Treasury Management Strategy Statement and Prudential Indicators for 2016-17. Cabinet had previously 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 and an update on the deposits held with Icelandic Banks.
Impact Assessment:	Equalities Impact Assessment: N/A

<table>
<tr><td rowspan="4">Please refer to the <u>protocol</u> for writing reports.</td><td>Use of Evidence:

CIPFA 2015/16 benchmarking
Capita Asset Services Benchmarking 2015/16</td></tr>
<tr><td>Budget:

All treasury management budget implications are reported as part of the Corporate Budget monitoring and outturn report, alongside the Asset Management reports that include the progress of the capital programme.</td></tr>
<tr><td>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</td></tr>
<tr><td>Other Implications:</td></tr>
<tr><td>Recommendation</td><td>That the Committee:

1. Note and comment upon the report.</td></tr>
<tr><td>Reason for Recommendation</td><td>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.</td></tr>
<tr><td>Appendices</td><td>Appendix 1 – Prudential Indicators</td></tr>
<tr><td>Background Papers</td><td>Treasury Management Annual Strategy 2016/17
Capital Programme Budget and Monitoring reports 2016/17</td></tr>
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</table>

1. Background

1.1. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. The role of treasury management is to ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

1.2. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending requirements. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.3. Accordingly, treasury management is defined as:
"The management of the local authority'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."

1.4. The Council is required by regulations issued under the Local Government Act 2003 to produce an annual review of treasury management activities and the actual prudential and treasury indicators. The Act also requires the production of a mid year update on treasury management and prudential activities. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA prudential Code for Capital Finance.

1.5. During each financial year a minimum of three reports will be produced; a report in February, which will sit alongside the Council's revenue and capital budget reports, outlining the treasury management strategy for the forthcoming financial year; a report in September reporting on the previous year's treasury management activity and prudential indicators; and a report in January providing members with an update of the year to date position. In doing so, the Council will be fully compliant with the Act.

1.6. The regulatory environment places responsibility on members for the review and scrutiny of treasury management policies and activities. This report is therefore important in that respect as it provides details of the mid year position for 2016/17 for treasury activities, and in doing so highlights compliance with the Council's policies previously agreed by members. 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. Treasury Management Advisers

2.1. The Council uses Capita Asset Services as its treasury management advisers. Capita provides a range of services which include:

- Technical support on treasury matters, capital finance issues and the drafting of reports;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- Debt rescheduling advice surrounding the existing portfolio;

- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings-market information service comprising the three main credit rating agencies.

2.2. Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice, the final decision on treasury matters remains with the Council. This service is subject to regular review.

3. Economic Background and Interest Rate Forecast

3.1. Part of Capita's service is to assist the Council to formulate a view on interest rates. The following table gives Capita's most recent forecast for UK Bank Rate, short term investment returns (LIBID) and borrowing rates from the Public Works Loans Board (PWLB)**:**

	NOW	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
BANK RATE	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.75	0.75
3 month LIBID	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.40	0.50	0.60	0.70	0.80	0.90
6 month LIBID	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.50	0.60	0.70	0.80	0.90	1.00
12 month LIBID	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.80	0.80	0.90	1.00	1.10	1.20	1.30	1.40
5 yr PWLB	1.50	1.60	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.80	1.80	1.90	1.90	2.00	2.00
10 yr PWLB	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.60	2.60	2.70
25 yr PWLB	3.00	2.90	2.90	2.90	2.90	3.00	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.30	3.40
50 yr PWLB	2.70	2.70	2.70	2.70	2.70	2.80	2.80	2.80	2.90	2.90	3.00	3.00	3.10	3.10	3.20

3.2. When the Treasury Management Strategy for 2016/17 was agreed in February 2016, Capita's expectation, in line with most commentators, was for the Bank Rate to increase from 0.50% to 0.75% late 2016, followed by gradual increases thereafter to 1.75% by the end of financial year 2018/19. However, in order to counteract what it forecast was going to be a sharp slowdown in growth resulting from the UK's decision to leave the EU, the Monetary Policy Committee (MPC) at its meeting 4 August 2016 cut the Bank Rate from 0.50% to 0.25%.

3.3. The MPC also gave a strong steer that it was likely to cut the Bank Rate again by the end of 2016. However, economic data since August has indicated much stronger growth in the second half of 2016 than previously forecast; and inflation forecasts have also risen substantially, primarily as a result of the sharp fall in the value of sterling. Consequently, the Bank Rate was not cut again in November and, on current trends, it now appears unlikely that there will be another cut, although that cannot be completely ruled out if there was a significant dip downwards in economic growth.

3.4. During the two-year period 2017 to 2019, when the UK is negotiating the terms for withdrawal from the EU, it is expected that the MPC will wish to avoid taking actions that could dampen growth prospects, for example by raising the Bank Rate, which will already be adversely impacted by the uncertainties of the form Brexit will eventually take. Accordingly, a first increase to 0.50% is not tentatively pencilled in until after those negotiations have been concluded. However, if strong domestically generated inflation, for

example from wage increases within the UK, were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.

3.5. With so many external influences weighing on the UK, economic and interest rate forecasting remains challenging. Forecasts (and future MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, for example in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments. However, the overall longer run expectation is still for gilt yields and PWLB rates to rise, albeit gently.

3.6. Capita believes that the overall balance of risks to economic recovery in the UK remains to the downside. Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Monetary policy action reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some major developed economies, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
- Weak capitalisation of some European banks.
- A resurgence of the Eurozone sovereign debt crisis.
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or US Federal Reserve's rate increases, causing a further flight to safe havens (bonds).
- UK economic growth and increases in inflation are weaker than currently anticipated.
- Weak growth or recession in the UK's main trading partners - the European Union and the United States.

3.7. The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates, include:

- The pace and timing of increases in the Federal Reserve's funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider European Union and the United States, causing an increase in the inflation premium inherent to gilt yields.

4. Capital Expenditure and Financing

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

- 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
- If insufficient financing is available, or a decision is made not to apply resources, the capital expenditure will give rise to a borrowing need.

4.2. The Council is only permitted to borrow to finance capital expenditure or for short term cash flow needs, and cannot borrow to fund on going revenue expenditure.

4.3. 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 and 2015/16, the budget for 2016/17 and the latest projected outturn for 2016/17 are summarised in Table 1 below. Projected capital spend for 2016/17 is approximately £18M lower than budget due to slippage.

Table 1 Capital Expenditure 2014/15 – 2016/17

Prudential Indicator 1	**2014/15 actual £'000**	**2015/16 actual £'000**	**2016/17 budget £'000**	**2016/17 projected £'000**
Capital Expenditure	**80,774**	**87,958**	**81,756**	**63,500**
Financed in Year	60,538	87,958	62,025	62,037
Unfinanced capital spend	20,236	0	19,731	1,463

5. The Council's Overall Borrowing Need

5.1. 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 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.

5.2. The Council was debt free until 2002, when the Government changed the way in which it helped councils to fund their capital spend. Rather than paying councils capital grants the Government gave 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.

5.3. Part of the Council's treasury activity is to address the funding requirements for this borrowing need. The treasury team manages the Council's cash position to ensure that there is sufficient cash available to meet the capital plans and the resulting cash flow requirements. The 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.

5.4. 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.

5.5. It is important to stress 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 as part of the Annual Treasury Management Strategy.

5.6. The CFR can also be reduced by:

- The application of additional capital financing resources (such as unapplied capital receipts or government grants); or
- Charging more than the statutory revenue charge (MRP) each year through a voluntary revenue provision.

5.7. 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. The actual CFR for 2015/16 is shown as well as the budgeted and latest estimate for the 2016/17 financial year. It is difficult to predict the exact make-up of the CFR as it is largely affected by the spending profile of the capital programme and year end accounting decisions.

Table 2 Capital Financing Requirement (CFR)

Capital Financing Requirement Prudential Indicator 2	**2015/16 Actual £'000**	**2016/17 Budget £'000**	**2016/17 Projected £'000**
Underlying Borrowing Requirement b/f	**292,845**	**298,174**	**287,313**
Capital Expenditure	87,958	81,756	63,500
Revenue Contributions	-4,942	-6,076	-6,076
Capital Receipts applied	-6,083	-200	-200
Grants	-72,050	-45,758	-45,758
Reserves Applied	-1,611	0	0
Minimum Revenue Provision	-12,023	-10,003	-10,003
Other Adjustments	3,219	0	0
Underlying Need to Borrow	**287,313**	**317,893**	**288,776**
Other Long Term Liabilities	38,933	34,798	34,798
Capital Financing Requirement	**326,246**	**352,691**	**323,574**

6. Borrowing Position as at 31 December 2016

6.1. 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. This indicator therefore allows the Council some flexibility over the timing of the borrowing so, for example, if interest rates are favourable it can borrow in advance of its immediate cash need.

6.2. 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 Debt (excluding PFI)

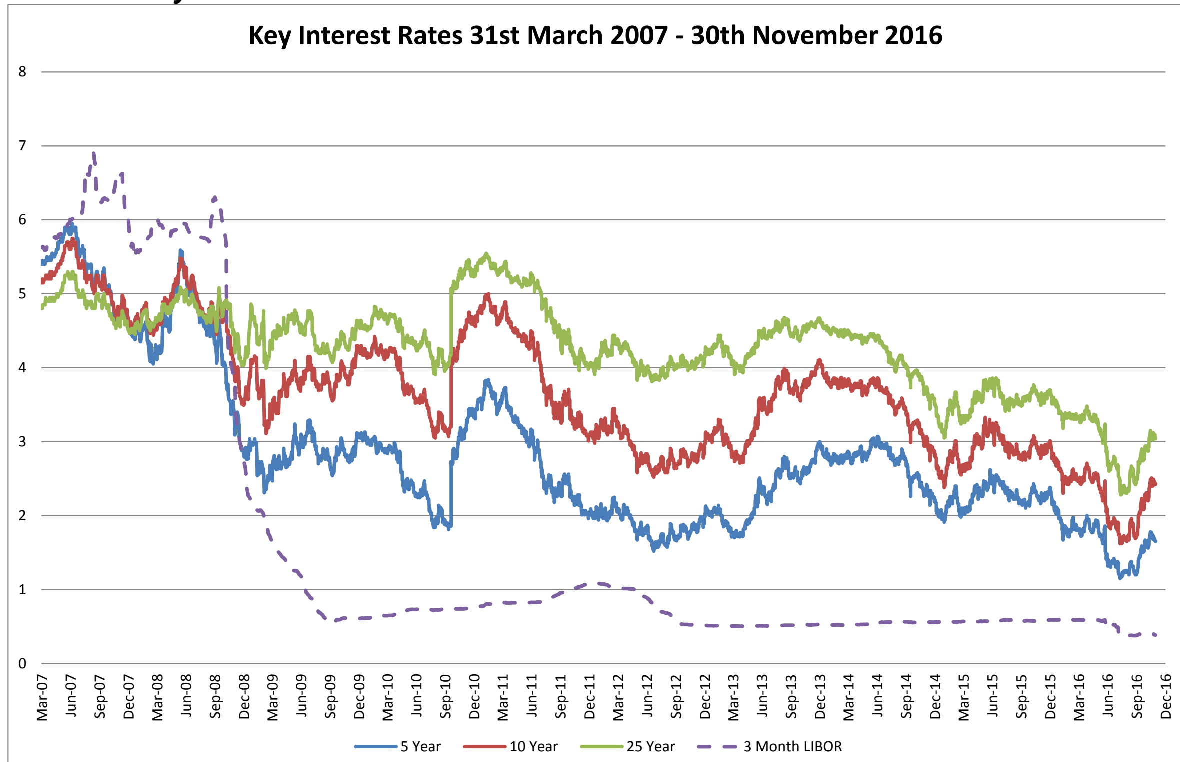
Gross and Net Debt Prudential Indicators 5-7	Actual 31/03/2016 £'000	Budget 31/03/2017 £'000	Projected 31/03/2017 £'000
Gross Debt	184,341	204,341	198,521
Investments	12,738	13,106	7,008
Net Debt	171,603	191,235	205,529
Underlying need to Borrow	287,313	317,893	288,776
Under borrowing	102,972	113,552	90,255
Authorised Limit	355,000	355,000	355,000
Operational Boundary	335,000	335,000	335,000
Maximum Gross Debt	215,124	204,341	198,521

6.3. The debt and net positions should be considered in light of the prevailing economic conditions summarised in section 3. 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:

- 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;
- 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.

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

Chart 1 - Key Interest Rates



6.5. 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 it was required, at a similar rate to what 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 slightly, the gap between borrowing costs and investment returns has increased markedly. Borrowing costs over 25 years are currently in the region of 3.0% compared to the 3 month LIBOR rate of approximately 0.5%. On a typical borrowing tranche of £10m, this difference would amount to a carrying cost of approximately £250k per annum, until it has been spent.

6.6. For this reason the Council has adopted a strategy of delaying long term borrowing until the cash is actually required. 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.

6.7. Projected borrowing at 31 March 2017, as of now, is expected to increase by £14.2m from the position at 1 April 2016, but this is subject to continual review throughout the year. Projected changes in borrowing for the financial year are summarised in table 4 below:

Table 4 - Borrowing

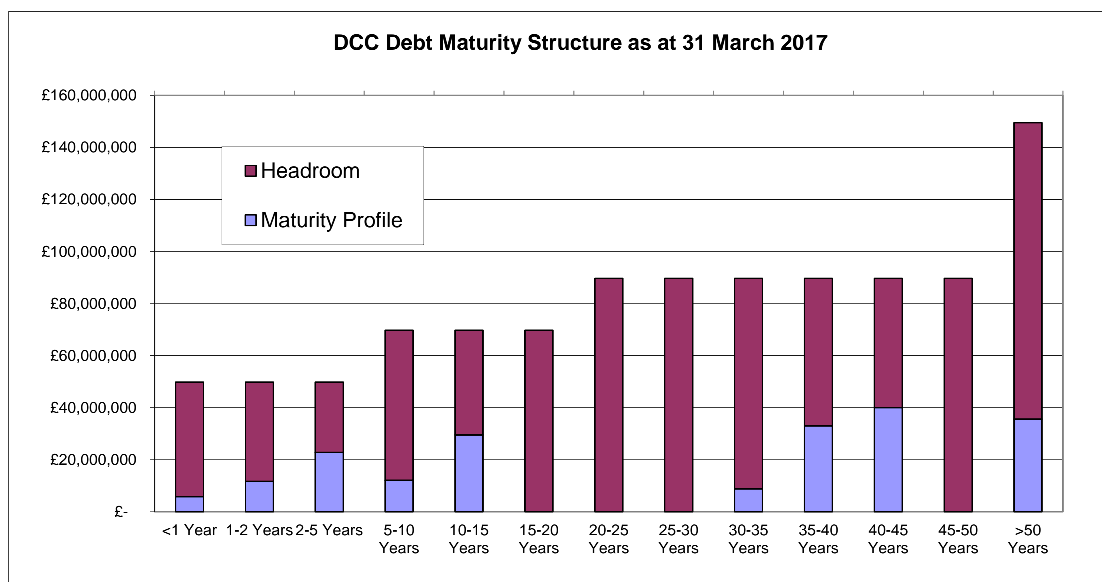
	Description	**Rate**	**Outstanding**
Borrowing as at 31/03/16		**3.98%**	**£184,341,150**
New Borrowing			
Loan 40	London Borough of Islington	0.65%	£5,000,000
Loan 41	Leicester City Council	0.70%	£10,000,000
Repayments			
Loan 2	PWLB annuity	4.70%	-£805,301
Loan 3	PWLB annuity	4.65%	-£14,527
Projected Borrowing as at 31/03/17		**3.73%**	**£198,521,322**
Net Increase / (Decrease)			**£14,180,172**

6.8. Loan 40 will mature at the end of this financial year on 31 March 2017 but it has been assumed, for cashflow reasons, that this loan will be renewed or replaced with new debt.

6.9. The Council has a target of maintaining an under borrowed position of around £100m. This however has to be balanced with assessing the long term costs of borrowing and also has to be viewed in terms of the maturity structure of the existing portfolio of long term borrowing.

6.10. The maturity structure of the Council's borrowing remains within the prudential limits for 2016/17, as set out in the chart below:

Chart 2 Debt Maturity Structure



6.11. The maturity limits are 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.

7. Investment Position as at 31 December 2016

7.1. 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.

7.2. The cash resources of the Council are made up of revenue and capital resources, as well as cash flow monies. Investment balances do fluctuate throughout the year as part of the day to day operations of the Council. Table 5 shows the investment balances at the start of the year, the maximum, minimum and average balances held, and the balances at the end of the year for 2015/16 and as projected for 2016/17.

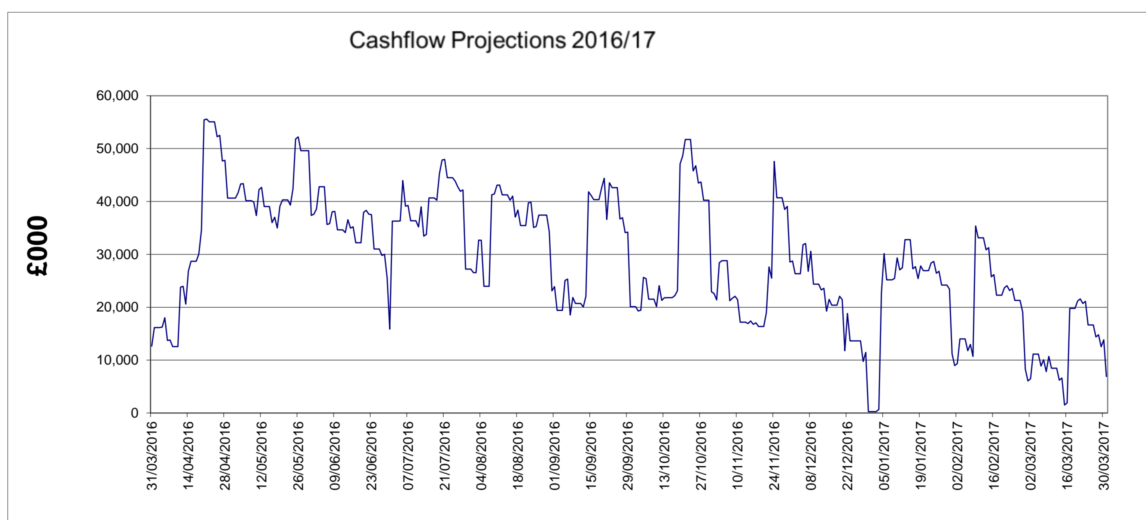
7.3. Investment income projected for the year is £0.1m, a reduction of £0.4m on the previous financial year. The reason for the anticipated reduction is the decrease in average balances held a result of the strategy to delay borrowing, and therefore the cost of borrowing, by reducing investment balances, and lower rates of interest available in the market, with average returns expected to fall from 0.75% in 2015/16 to 0.41% in 2016/17.

Table 5 - Analysis of Investments

	Actual 2015/16	Budget 2016/17	Projected 2016/17
	£'000	£'000	£'000
Investments as at 1 April	**56,620**	**20,400**	**12,738**
Maximum cash balance	124,244	60,100	55,700
Minimum cash balance	12,738	2,300	400
Average cash balances	71,492	33,700	29,100
Investments as at 31 March	**12,738**	**13,100**	**7,000**
Investment Income	**538**	**250**	**120**
Average Return	**0.75%**	**0.65%**	**0.41%**

7.4. Historically balances available for investment tended to be higher at the start of the financial year as government grants are received, and reduce as expenditure is incurred more evenly through the year. Over recent years this pattern has become less pronounced as the level of government funding has reduced. Chart 4 below shows the projected daily investment balances for this financial year.

Chart 4 Cashflow Projections



8. Risk Management

8.1. Return on investments must be assessed against the level of risk taken by the Council. Since the Icelandic banking crisis, many 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.

8.2. 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, HSBC Bank, Lloyds Banking Group and RBS).

Richard Bates
Chief Financial Officer
January 2017