Audit and Governance Committee

Dorset County Council

Date of Meeting	20 September 2017
Officer	Chief Financial Officer
Subject of Report	**Treasury Management and Prudential Code Review 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. 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 is the year-end review of actual performance against the strategy, and 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, and compliance with the Prudential Code. This report also includes responses to any Key Lines of Enquiry (KLOEs) raised by Members.
Impact Assessment: *Please refer to the protocol for writing reports.*	Equalities Impact Assessment: N/A
	Use of Evidence: CIPFA 2016/17 benchmarking

	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: N/A
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 2017 Appendix 3 – Investment Balances as at 31 March 2017
Background Papers	Treasury Management Annual Strategy 2016/17 Capita: Independent Economic Analysis Capital Programme Budget and Monitoring report 2016/17
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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 treasury management review of activities and the actual prudential and treasury indicators for 2016/17. 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).

1.5. During 2016/17 the minimum reporting requirements were that the full Council should receive the following reports:

- An annual treasury strategy in advance of the year (Cabinet 11 February 2016)
- A mid-year (minimum) treasury update report (Audit and Scrutiny 20 January 2017)
- An annual review following the end of the year describing the activity compared to the strategy (this report).

1.6. 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 2016/17 for treasury activities, and highlights compliance with the Council's policies previously agreed by members.

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

2. Key Lines of Enquiry (KLOE)

2.1. At the last meeting of the Audit and Governance Committee, Members were invited to raise any Key Lines of Enquiry (KLOE) they would wish to inform future reports. The KLOEs subsequently received are set out below together with summary responses:

2.2. Even though short term borrowing was not at a high rate of interest how does it not add to our revenue costs as there is still some interest to be paid?

All external borrowing has a cost to the Council, however since the financial crisis of 2008 there has been a significant divergence between the cost of borrowing for the shorter term and for the longer term as set out in paragraph 7.5, chart 1. Paragraph 7.9 gives an indication of the current difference in costs between borrowing for one year and for 25 years. Although interest on borrowing does have a revenue budget impact, we also have a budget for that interest based on our predictions of borrowing in each year.

2.3. Can we have a summary of the overall borrowing position again with some detail in how we intend to pay off the debts as well as the interest?

A schedule of all borrowing as at 31 March 2017 is included in Appendix 2. Paragraphs 6.4 to 6.6 describe how the Council's underlying borrowing requirement may be reduced, and paragraph 7.13 describes how the maturity structure of the Council's borrowing is managed to allow for the orderly repayment of debt.

2.4. It might also be helpful to see the arguments for and against using capital receipts from sales to reduce our debt or further invest in new capital projects.

The decision to include any new project in the capital programme is subject to approval of the business case for that investment, with all such business cases reviewed by the Managing Our Assets Group (MOAG), chaired by the Chief Financial Officer. This provides robust governance around the options to apply capital receipts to reduce the Council's underlying borrowing requirement or to reinvest in capital assets. Please note also that Cabinet has agreed up to £5m to support the revenue costs of transformation between 2016/17 and 2018/19 from the flexible use of capital receipts.

3. Treasury Management Advisers

3.1 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; and
- Credit ratings-market information service comprising the three main credit rating agencies.

3.2 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.

4. The Economy and Interest Rates

4.1. Part of Capita's service is to assist the Council to formulate a view on interest rates. 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.

4.2. However, at its meeting 4 August 2016 the Monetary Policy Committee (MPC) cut the Bank Rate from 0.50% to 0.25% in order to counteract what it forecast to be a sharp slowdown in growth resulting from the UK's decision to leave the EU. The MPC also warned that it would be considering cutting Bank Rate again towards the end of 2016 in order to support growth. In addition, it restarted quantitative easing with purchases of £60bn of gilts and £10bn of corporate bonds, and also introduced the Term Funding Scheme whereby potentially £100bn of cheap financing was made available to banks.

4.3. In the second half of 2016, the UK economy out-performed the Bank's pessimistic forecasts of August. After a disappointing quarter 1 of only +0.2% GDP growth, the three subsequent quarters of 2016 came in at +0.6%, +0.5% and +0.7% to produce an annual growth for 2016 overall, compared to 2015, of 1.8%, very nearly the fastest rate of growth of any of the G7 countries. Also inflation has risen rapidly primarily due to the effects of the sharp devaluation of sterling after the referendum.

4.4. In February 2017, the latest CPI inflation figure had risen to 2.3%, above the MPC's inflation target of 2%. However, the MPC's view was that it would 'look through' near term supply side driven inflation caused by sterling's devaluation and not raise Bank Rate, despite forecasting that inflation would reach nearly 3% during 2017 and 2018. This outlook is dependent on domestically generated inflation (i.e. wage inflation) continuing to remain subdued despite the fact that unemployment is at historically very low levels and remains on a downward trend. Market expectations for the first increase in Bank Rate moved forward to quarter 3 2018 by the end of March 2017 in response to increasing concerns around inflation.

4.5 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	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	0.50	0.50	0.75	0.75
3 month LIBID	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	0.50	0.60	0.70	0.80	0.90	1.00
12 month LIBID	0.60	0.60	0.70	0.70	0.80	0.80	0.90	1.00	1.10	1.20	1.30	1.40
5 Yr PWLB	1.30	1.40	1.50	1.60	1.70	1.70	1.80	1.80	1.90	1.90	2.00	2.00
10 Yr PWLB	1.90	2.10	2.20	2.30	2.30	2.40	2.40	2.50	2.50	2.60	2.60	2.70
25 Yr PWLB	2.60	2.80	2.90	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.30
50 Yr PWLB	2.40	2.60	2.70	2.70	2.80	2.80	2.90	2.90	3.00	3.00	3.10	3.10

5. Capital Expenditure and Financing

5.1. The Council's capital expenditure on long-term assets may either be:

- 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.

5.2. Capital expenditure is 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 2015/16, the budget for 2016/17 and outturn for 2016/17 are summarised in Table 1 below. Actual capital spend for 2016/17 was approximately £12M lower than budget due to slippage in the capital programme.

Table 1 Capital Expenditure 2015/16 – 2016/17

Prudential Indicator 1	**2015/16 actual £'000**	**2016/17 budget £'000**	**2016/17 actual £000**
Capital Expenditure	87,958	81,756	69,022

6. The Council's Overall Borrowing Need

6.1. 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.

6.2. 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, and is therefore a gauge of the Council's indebtedness. The CFR results from the Council's capital activity and the resources that have been used to pay for it. It represents the 2016/17 unfinanced capital expenditure and prior year's net unfinanced capital which has not yet been paid for by revenue or other resources.

6.3. Part of the Council's treasury management activity is to address the funding requirements for this borrowing need. The treasury management 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. This may be sourced through borrowing from 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.

6.4. The Council's underlying borrowing need, and therefore the CFR, cannot increase indefinitely. Statutory controls are in place to ensure that the cost of capital assets are broadly charged to revenue over the life of those assets. The Council is required to make an annual charge to revenue called the Minimum Revenue Provision (MRP) which is effectively a reduction of the borrowing need.

6.5. 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 Statement.

6.6. 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.

6.7. 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 2015/16 and 2016/17. The CFR ended 2016/17 at £336.3m, £10.1m more than the 2015/16 level of £326.2m.

Table 2 CFR Actual 2015/16 and 2016/17

Capital Financing Requirement Prudential Indicator 2	**2015/16 Actual £'000**	**2016/17 Actual £'000**
Underlying Borrowing Requirement b/f	**292,845**	**287,313**
Capital Expenditure	87,958	69,022
Revenue Contributions	-4,942	-2,429
Capital Receipts applied	-6,083	-3,764
Grants	-72,050	-38,028
Reserves Applied	-1,611	0
Minimum Revenue Provision	-12,023	-16,674
Other Adjustments	3,219	3,329
Underlying Need to Borrow	**287,313**	**298,769**
Other Long Term Liabilities	38,933	37,574
Capital Financing Requirement	**326,246**	**336,343**

7. Borrowing Outturn for 2016/17

7.1. Actual borrowing activity is constrained by the prudential indicators for the CFR, the operational boundary and the authorised limit.

7.2. In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council's external borrowing should not, except in the short term, exceed the CFR for 2016/17 plus the expected changes in the CFR for the current and next two financial years from financing the capital programme. This essentially means that the Council is not borrowing to support its revenue expenditure. This indicator 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. The Council has complied with this prudential indicator.

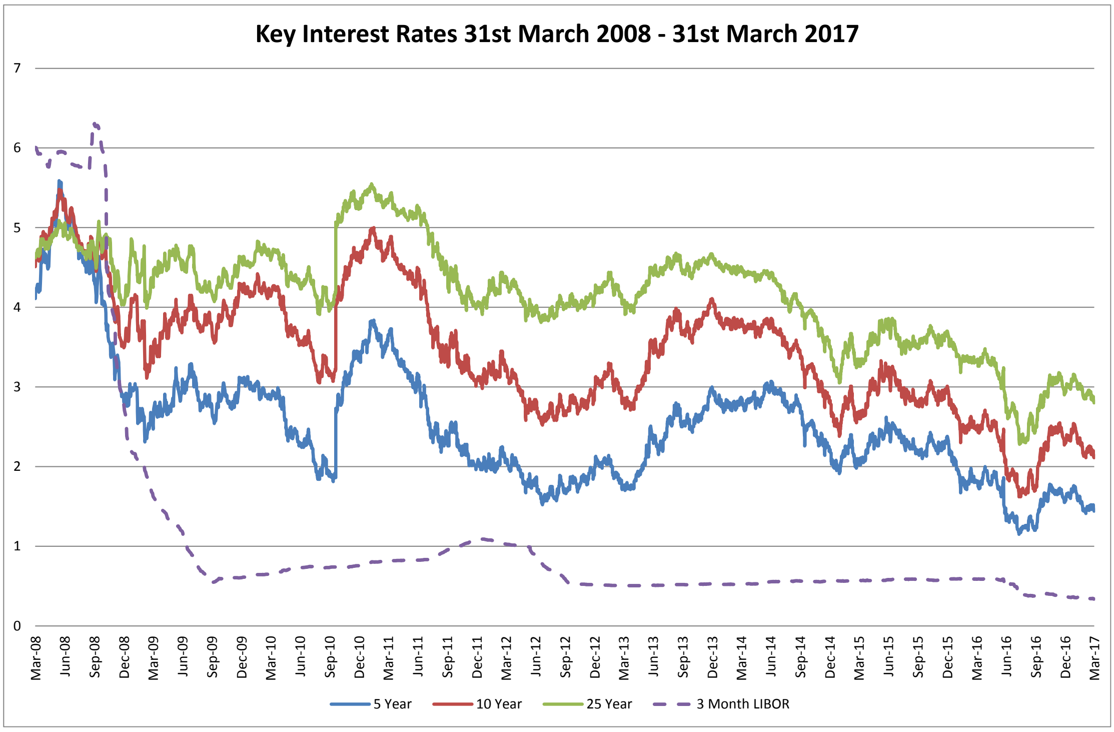
7.3. The operational boundary is the limit beyond which external debt is not normally expected to exceed, based on the CFR plus an allowance for short term borrowing that might be required for cash flow purposes or unexpected calls on capital resources. The authorised limit is based on the operational boundary but includes a margin to allow for unusual or unpredicted demands on cash. The Council has complied with these prudential indicators.

7.4. The treasury management strategy over the past few years has been to postpone borrowing and reduce investment balances. 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 was 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.

7.5. 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



7.6. 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 2.6% compared to the 3 month LIBOR rate of about 0.30%. On a typical borrowing tranche of £10m, this difference would amount to a carrying cost of £230k per annum, until it is spent.

7.7. 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.

7.8. 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 2017 was £85m.

7.9. In 2016/17 long term borrowing increased by £28.9m, as set out in the table below. The additional borrowing was all from other local authorities for approximately 12 months, at rates ranging from 0.48% to 0.70%. As an indication of the impact on revenue costs, the annual interest on one year borrowing of £10m at 0.50% from another local authority is £50k, compared to £260k on a 25 year loan from the PWLB at 2.60%.

Table 3 - Changes in Borrowing 2016/17

	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
Loan 42	Leicester City Council	0.52%	£5,000,000
Loan 43	Guildford Borough Council	0.48%	£5,000,000
Loan 44	PCC for West Midlands	0.50%	£5,000,000
Loan 45	Oxfordshire County Council	0.50%	£5,000,000
Repayments			
Loan 2	PWLB annuity	4.70%	-£805,301
Loan 3	PWLB annuity	4.65%	-£14,527
Loan 34	LEP	0.00%	-£240,000
Loan 40	London Borough of Islington	0.65%	-£5,000,000
Borrowing as at 31/03/17		**3.51%**	**£213,281,322**
Net Increase / (Decrease)			**£28,940,172**

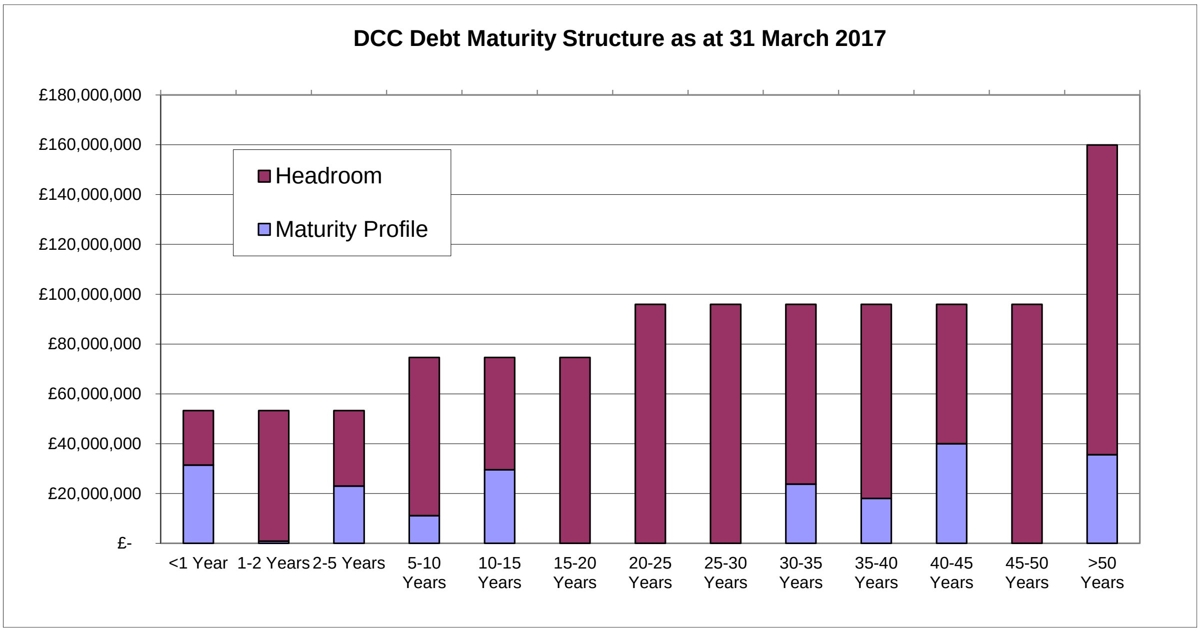
7.10. A schedule of all borrowing at 31 March 2017 is shown in Appendix 2. The Council's borrowing includes £95.1M of 'Lender Option Borrower Option' (LOBO) loans. Generally the interest rate on a LOBO is fixed for an initial period of a number of years, after which the lender has the option to change 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.

7.11. 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.

7.12. 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.

7.13. The maturity structure of the Council's borrowing remained within the prudential limits for 2016/17. 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



8. Investment Outturn for 2016/17

8.1. 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.

8.2. 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 4 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 2015/16 and for 2016/17.

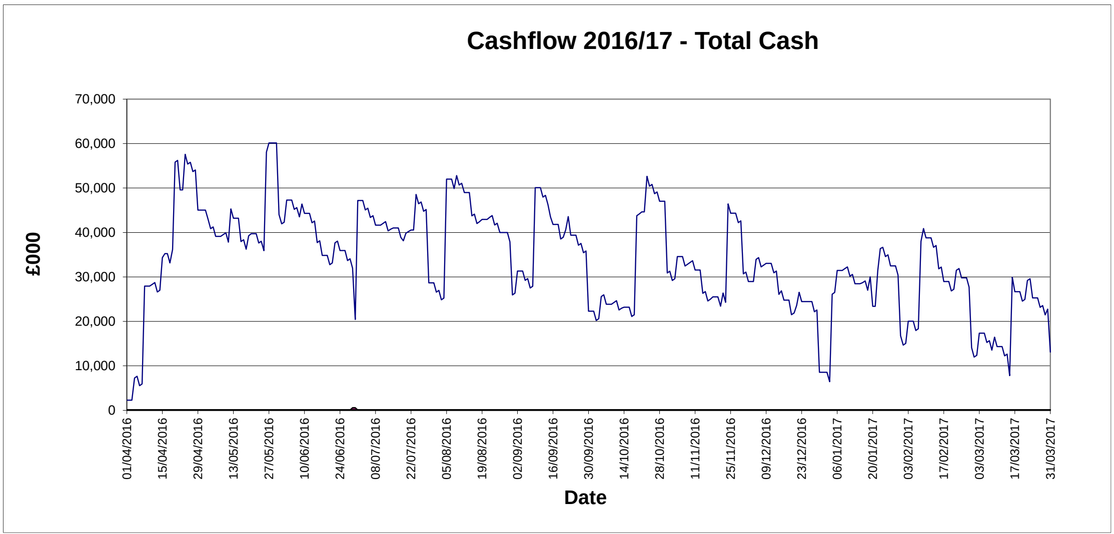
8.3. Interest earned during the year was £78k a reduction of £320k on the previous financial year. This was due to a combination of the decrease in balances held and lower rates of interest available in the market, which saw the return fall from 0.75% in 2015/16 to 0.42% in 2016/17. For comparative purposes the 7 day LIBID rate, a widely used benchmark for returns on liquid cash, averaged 0.21% over 2016/17.

Table 4 – Analysis of Investments

	Actual 2015/16	Actual 2016/17
	£000	£000
Investments as at 1 April	**56,620**	**12,738**
Maximum cash balance	124,244	55,683
Minimum cash balance	12,738	874
Average cash balances	52,992	18,735
Investments as at 31 March	**12,738**	**15,664**
Investment Income	398	78
Average Return	**0.75%**	**0.42%**

8.4 Historically balances available for investment tended to be higher at the start of the financial year as government grants were received, and reduced 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 3 below shows the actual cash and investment balances for the financial year.

Chart 3



9. Update on Loans to Icelandic Banks

9.1. 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.

10. Treasury Management Performance

10.1. 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.

10.2. 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 35, mainly large local authorities and provides an insight into the relative performance of Dorset County Council's treasury function.

10.3. The headline results of the 2016/17 CIPFA benchmarking exercise were as follows:

- DCC had above average net budget requirement at £300m (av. £251m);
- The capital programme was below average at £69m (£104m);
- The CFR was below average at £336m (£375m);
- Total borrowing was below average at £213m (£354m)
- Use of internal financing was above average at £85m (£73m);
- Investment balances were less than average at £16m (£138m);
- The interest earned was 0.42% against an average return of 0.85%;
- Interest paid on borrowing was 3.76% against the average of 4.06%.

11. Risk Management

11.1. 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.

11.2. 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).

11.3. The investments held as at 31 March 2017 are listed in Appendix 3, alongside the analysis of the investments in terms of counterparty, credit ratings, sovereigns and maturity profiles.

Richard Bates
Chief Financial Officer
September 2017