Audit and Governance Committee

Dorset County Council

Date of Meeting	19 January 2018
Officer	Chief Financial Officer
Subject of Report	**Treasury Management Mid Year update 2017/18**
Executive Summary	At the meeting of the Cabinet on 1 February 2017 members approved the Treasury Management Strategy Statement and Prudential Indicators for 2017-18. 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 is the mid-year 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.
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 monitoring and 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 – Schedule of Borrowing
Background Papers	Treasury Management Strategy Statement 2017/18 Capital Programme Budget and Monitoring reports 2017/18
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1. Summary / Key Issues

1.1. Key issues to highlight are:

1.2 The Bank Rate was increased from 0.25% to 0.50% in November 2017, but ‘forward guidance’ from the Bank of England suggested that future increases will be small and gradual.

1.3 Following the increase in Bank Rate there have been some small increases to returns from short term investments and the cost of shorter term borrowing, but with negligible differences to long term borrowing rates.

1.4 Whilst the timing of future interest rate movements is uncertain, the wide gap between long term borrowing costs and short term investment returns looks set to continue for the foreseeable future. This supports the Council's continued strategy of delaying external borrowing by using internal balances ("internal borrowing") to avoid a high cost of carry from borrowing in advance of need.

1.5 The projected Underlying Borrowing Requirement at the financial year end is £307.7m, £3.3m below the expected level of £311.0m when the annual strategy was agreed.

1.6 External borrowing at 31 December 2017 was £212.9m and is expected to increase to £222.4m by the end of the financial year, £11.1m below the expected level of £233.5m when the annual strategy was agreed.

1.7 Therefore the Council is expected to be £85.2m under-borrowed at the end of the financial year, £7.7m higher than the expected level of £77.5m when the annual strategy was agreed, but below the target level of £100m.

1.8 The Council has entered into a two year forward deal to borrow £20m at a rate of 2.52% for a minimum period of 23 years, maximum 48 years.

1.9 The terms of six existing loans have been renegotiated leading to annual savings in interest costs of approximately £100k.

1.10 Returns from investments remain very low as a result of the strategy of using internal balances to avoid/delay borrowing and the low rates of return available on short term investments.

1.11 All County Councillors have been invited to a treasury management training event provided by Chris Scott from Link Asset Services (formerly Capita Asset Services), the Council's treasury management advisers, at County Hall on Friday 19 January 2018.

2. Background

2.1 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.

2.2 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.

2.3 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."

2.4 The Council is required by regulations issued under the Local Government Act 2003 to produce for each financial year as minimum:

- An annual treasury strategy in advance of the year;
- A mid-year treasury update report (this report), and
- An annual review following the end of the year describing the activity compared to the strategy.

This report also meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA prudential Code for Capital Finance.

2.5 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 2017/18 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.

3. Treasury Management Advisers

3.1 The Council uses Link Asset Services as its treasury management advisers, with the Link Group acquiring the business from the Capita Group in November 2017. No changes to service are expected from this change of ownership.

3.2 Link 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.

3.3 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.

4. The Economy and Interest Rates

4.1 Part of Link's service is to assist the Council to formulate a view on interest rates. The following table shows Link'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-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.25
3 month LIBID	0.40	0.40	0.40	0.40	0.40	0.60	0.60	0.60	0.70	0.90	0.90	1.00	1.20	1.20	1.20
6 month LIBID	0.45	0.50	0.50	0.50	0.60	0.80	0.80	0.80	0.90	1.00	1.00	1.10	1.30	1.30	1.40
12 month LIBID	0.65	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.10	1.30	1.30	1.40	1.50	1.50	1.60
5 Yr PWLB	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.10	2.10	2.20	2.30	2.30
10 Yr PWLB	2.10	2.10	2.20	2.30	2.40	2.40	2.50	2.60	2.60	2.70	2.70	2.80	2.90	2.90	3.00
25 Yr PWLB	2.70	2.80	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.40	3.50	3.50	3.60	3.60
50 Yr PWLB	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40	3.40

4.2 When the Treasury Management Strategy for 2017/18 was agreed in February 2017, Link's expectation, in line with many commentators, was that the Bank Rate would remain unchanged at 0.25% for the whole financial year. It was thought that during the period when the UK is negotiating the terms for withdrawal from the EU, the Monetary Policy Committee (MPC) would wish to avoid taking actions that could dampen growth prospects. Accordingly, a first increase to 0.50% was not tentatively pencilled in by Link until after those negotiations have concluded.

4.3 Link did however highlight that if strong inflationary pressures were to emerge, then the pace and timing of increases in Bank Rate could be brought forward, and accordingly the MPC agreed a 0.25% increase in Bank Rate at its meeting on 2 November 2017. This removed the emergency cut in August 2016 after the EU referendum. The MPC also gave forward guidance that they expected to increase Bank Rate only twice more by 0.25% to end at 1.00% by 2020.

4.4 The November increase in Bank Rate has led to some small increases in returns available on short term investments such as Money Market Funds and to the cost of shorter term borrowing. However, longer term borrowing rates have been largely unaffected, primarily as result of the forward guidance that future increases are expected to be slow and gradual. Nevertheless, while there is still much uncertainty around the outcome of Brexit negotiations in particular, it is difficult to be confident about rate movements over the next few years.

5. Capital Expenditure and Financing

5.1 The Council's capital programme can 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 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.

5.3 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 2015/16 and 2016/17, the budget for 2016/17 and the latest projected outturn for 2017/18 are summarised in Table

1 below. Projected capital spend for 2017/18 is approximately £3.7m lower than budget due to slippage.

Table 1 Capital Expenditure 2015/16 - 2017/18

Prudential Indicator 1	2015/16 actual £'000	2016/17 actual £'000	2017/18 budget £'000	2017/18 projected £'000
Capital Expenditure	**87,958**	**69,022**	**66,781**	**63,061**
Financed in Year	87,958	69,022	49,482	54,176
Unfinanced capital spend	0	0	17,299	8,885

6 The Council's Overall Borrowing Need

6.1 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.

6.2 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.

6.3 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 ("internal borrowing").

6.4 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.

6.5 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.

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 by 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. The actual CFR for 2016/17 is shown as well as the budgeted and latest estimate for the 2017/18 financial year. It is difficult to predict the exact CFR at year-end 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	**2016/17 Actual £'000**	**2017/18 Budget £'000**	**2017/18 Projected £'000**
Underlying Borrowing Requirement b/f	**287,313**	**293,675**	**298,769**
Capital Expenditure	69,022	66,781	63,061
Grants and Contributions	-38,028	-29,953	-33,011
Capital Receipts Applied	-3,764	-3,200	-5,750
Revenue Contributions (RCCO)	-2,429	-6,076	-5,126
Reserves Applied	0	0	0
Minimum Revenue Provision	-16,674	-10,253	-10,289
Other Adjustments	3,329	0	0
Underlying Need to Borrow	**298,769**	**310,974**	**307,654**
Other Long Term Liabilities	37,574	31,176	34,100
Capital Financing Requirement	**336,343**	**342,150**	**341,754**

7 Borrowing as at 31 December 2017

7.1 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.

7.2 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)

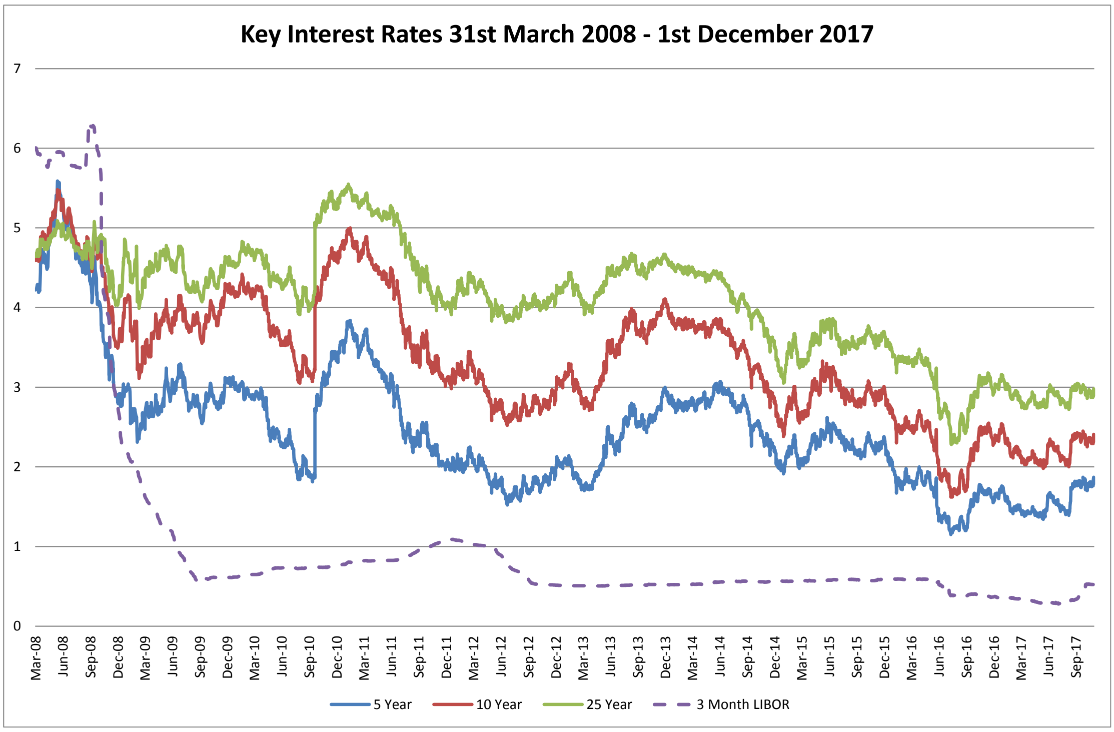
Gross and Net Debt Prudential Indicators 5-7	**Actual 31/03/2017 £'000**	**Budget 31/03/2018 £'000**	**Projected 31/03/2018 £'000**
Gross Debt	213,281	233,521	222,423
Investments	15,664	10,300	19,800
Net Debt	197,617	223,221	202,623
Underlying Need to Borrow	298,769	310,974	307,654
Under Borrowing	85,488	77,453	85,231
Operational Boundary	335,000	335,000	335,000
Authorised Limit	355,000	355,000	355,000
Maximum Gross Debt	218,936	233,521	222,423

7.3 The Council's debt position should be considered in light of the prevailing economic conditions summarised in section 4. 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 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.

7.4 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



7.5 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 2.7% compared to the 3 month LIBOR rate of approximately 0.3%. On a typical borrowing tranche of £10m, this difference would amount to a carrying cost of approximately £240k per annum, until it has been spent.

7.6 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.

7.7 As schedule of actual borrowing as at 31 December 2017 is shown in Appendix 2. Projected borrowing at 31 March 2018 is expected to increase by £9.1m from the position at 1 April 2017, but this is subject to continual review throughout the year. Projected changes in borrowing for the financial year are set out in table 4 below:

Table 4 - Borrowing

		Rate	Outstanding
Borrowing as at 31/03/17		**3.51%**	**£213,281,322**
Less Repayments:			
Loan 2	PWLB annuity	4.70%	-£843,595
Loan 3	PWLB annuity	4.65%	-£14,527
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	West Midlands PCC	0.50%	-£5,000,000
Loan 45	Oxfordshire County Council	0.50%	-£5,000,000
Plus New Borrowing:			
Loan 46	Leicester City Council	0.60%	£10,000,000
Loan 49	London Borough of Camden	0.60%	£10,000,000
	ANO Council	0.70%	£10,000,000
	ANO Council	0.70%	£10,000,000
Projected Borrowing as at 31/03/18		**3.30%**	**£222,423,200**
Net Increase / (Decrease)			**£9,141,878**

7.8 The table shows that a further £20m of borrowing is anticipated over the remainder of the financial year. It is assumed that this will be drawdown in two equal tranches from other local authorities for durations of 12 months at an interest rate of 0.70% but the exact amounts, durations and rates may vary depending upon availability.

7.9 The Council has also entered into a forward commitment to borrow £20m in two years' time at a rate of 2.52% for a minimum period of 23 years, and a maximum of 48 years. This has reduced the Council's exposure to the risk of interest rate rises in the next two years at a rate lower than the comparable PWLB rate available without incurring the cost of borrowing for that period.

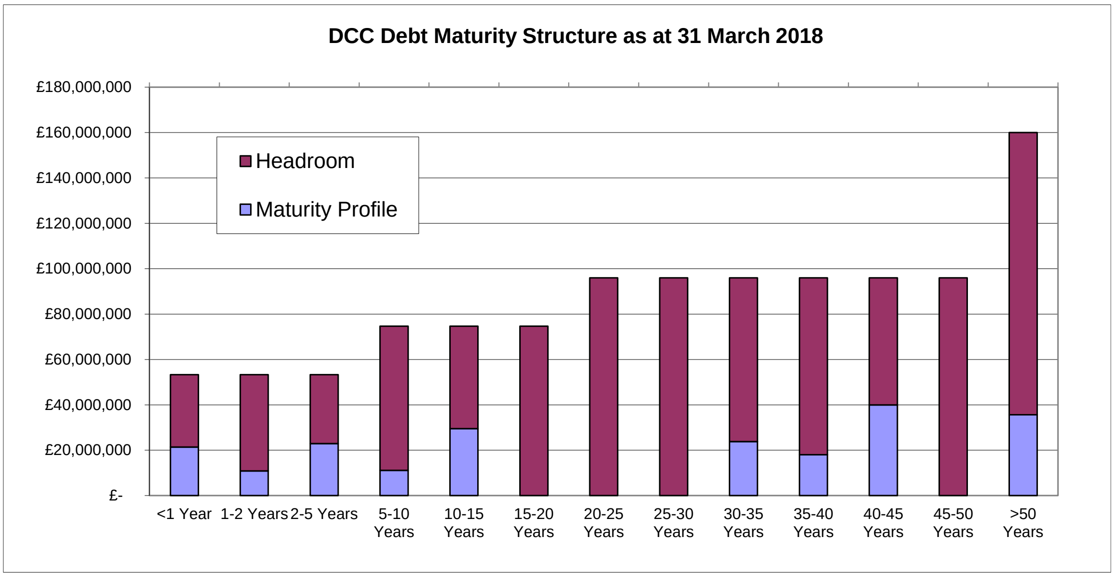
7.10 In addition, the terms of six existing loans have been renegotiated leading to combined annual savings of approximately £100k:

- Loan 13: interest rate reduced from 4.8% to 4.625% and the removal of lender and borrower options.
- Loan 31: interest rate reduced from 3.19% to 2.60%, with a five year extension to the term of the loan.
- Loans 35-38: amalgamation of four existing loans at interest rates of 4.0% and 4.03% into one instrument at an interest rate of 3.9%.

7.11 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.

7.12 The maturity structure of the Council's borrowing remains within the prudential limits for 2017/18, as set out in the chart below:

Chart 2 Debt Maturity Structure



7.13 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.

8 Investments as at 30 November 2017

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 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 2016/17 and as projected for 2017/18.

8.3 Net investment income projected for the year is approximately £80k, compared to the budget of £100k, and a similar level to the previous financial year. The low interest return is due to low average balances held as a result of the strategy to delay borrowing, and therefore the cost of borrowing, by reducing investment balances, and low rates of interest available in the market.

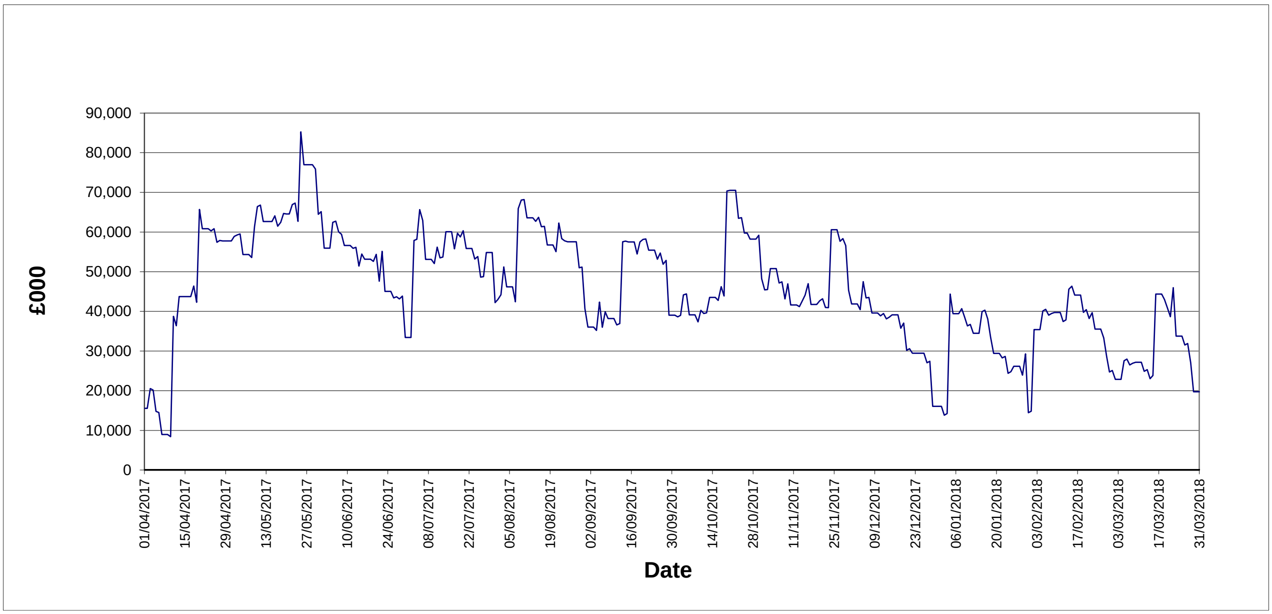
Table 5 - Analysis of Investments

	Actual 2016/17 £'000	Budget 2017/18 £'000	Projected 2017/18 £'000
Investments as at 1 April	**12,738**	**17,500**	**15,664**
Maximum cash balance	55,683	48,900	85,300
Minimum cash balance	874	9,900	8,500
Average cash balances	31,735	24,200	45,500
Investments as at 31 March	**15,664**	**10,300**	**19,800**
Gross Investment Income	**123**	**100**	**118**
Average Return	0.39%	0.41%	0.26%
Less DLEP Income*	45	-	39
Net Investment Income	**78**	**100**	**79**

**Dorset LEP balances are co-mingled with DCC balances for cash management purposes, with an annual transfer to the LEP of interest earned, calculated on daily LEP balances using 7 day LBID.*

8.4 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 2017/18



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, 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.

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, HSBC Bank, Lloyds Banking Group and Royal Bank of Scotland).

10 Training for Elected Members

10.1 All Dorset County Councillors have been invited to a treasury management training event at County Hall on Friday 19 January 2018. The training will be provided by Chris Scott from Link Asset Services, the Council’s treasury management advisers, and will cover the basics of treasury management in local government, including the responsibilities of elected members.

10.2 Further training will be made available as and when required, but as a minimum training will be offered to new and existing elected members in the year following local elections.

Richard Bates
Chief Financial Officer
January 2018