Audit and Governance Committee

Dorset County Council

Date of Meeting	25 October 2018
Officer	Chief Financial Officer
Subject of Report	**Treasury Management and Prudential Code Review 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. 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.
Impact Assessment: *Please refer to the protocol for writing reports.*	Equalities Impact Assessment: N/A Use of Evidence: CIPFA 2017/18 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 2018 Appendix 3 – Investment Balances as at 31 March 2018
Background Papers	Treasury Management Annual Strategy 2017/18 Link: Independent Economic Analysis Capital Programme Budget and Monitoring report 2017/18
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1. Summary of Key Points

1.1. Key points to highlight are:

1.2. The Bank Rate was increased from 0.25% to 0.50% in November 2017, and again by a further 0.25% to 0.75% in August 2018. ‘Forward guidance’ from the Bank of England continues to suggest that future increases will be small and gradual, with the pace of change dependent on wider economic developments.

1.3. Following the increases in Bank Rate there have been some small increases to returns from short term investments and the cost of shorter term borrowing, but more limited impact on 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 Underlying Borrowing Requirement at 31 March 2018 was £306m, £5m below the expected level of £311m when the annual strategy was agreed by Council in February 2017, but £7m higher than the position as at 31 March 2017.

1.6. External borrowing at 31 March 2018 was £227m, £7m lower than the expected level of £234m when the annual strategy was agreed, but £14m higher than the position as at 31 March 2017.

1.7. Therefore, the Council was £79m ‘under-borrowed’ (or ‘internally borrowed’) at the end of the financial year. This is £2m lower than the expected level of £77m when the annual strategy was agreed, £6m higher than the position at 31 March 2017 and below the target level of £100m.

1.8. The net cost to the Council of interest on debt less returns on investments was £7.3m in 2017/18, compared to £7.4m in 2016/17.

1.9. As at 31 March 2018, the Council held £45m of debt maturing before March 2019. It is anticipated that most of this debt will need to be refinanced in 2018/19, but this will be dependent on cashflows through the year. Borrowing decisions in 2018/19 will also need to be mindful of the likely combined balance sheet for the new Dorset Council.

1.10. In November 2017, the Council entered into a two year forward agreement to borrow £20m in November 2019 at a rate of 2.52% for a minimum period of 23 years, and maximum period of 48 years. This agreement gave the Council some protection against the risk that interest rates rise faster than expected over the next two years, but without the cost of paying interest for that period.

1.11. During the year, the terms of six existing loans have been renegotiated leading to annual savings in interest costs of approximately £100k.

1.12. 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 in the market on short term investments.

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 a minimum:

- An annual treasury strategy in advance of the year (Cabinet 1 February 2017)
- A mid-year treasury update report (Audit and Scrutiny 19 January 2018)
- An annual review following the end of the year describing the activity compared to the strategy (this report).

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).

2.5. 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 2017/18 for treasury activities, and highlights compliance with the Council's policies previously agreed by members.

2.6. 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.

3. Treasury Management Advisers

3.1. The Council uses Link Asset Services (formerly Capita Asset Services) as its treasury management advisers. 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; 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 Link's service is to assist the Council to formulate a view on interest rates. When the Treasury Management Strategy for 2017/18 was agreed in February 2017, Link's expectation, in line with most commentators, was for the Bank Rate to increase from 0.25% to 0.50% by the middle of 2019, followed by one further increase to 0.75% by the end of financial year 2019/20. However, during 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend.

4.2 After the UK economy surprised with strong growth in the second half of 2016, growth disappointed in in the first half of 2017. The main reason for this was the sharp increase in inflation caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer spending power as inflation exceeded average wage increases, with consumers responding by cutting back on expenditure.

4.4 Growth did pick up modestly in the second half of 2017, and consequently, market expectations rose significantly during the autumn that the Monetary Policy Committee (MPC) would be raising Bank Rate imminently. At its November 2017 meeting, the MPC duly delivered by raised Bank Rate from 0.25% to 0.50%.

4.5 In the early part of 2018, there was evidence that wage increases had started to rise, and subsequently the minutes from the February 2018 MPC meeting revealed a more imminent and faster pace of increases in Bank Rate than had previously been expected.

4.6 Market expectations for increases in Bank Rate, therefore, shifted considerably during the second half of 2017-18 and resulted in investment rates from 3–12 months increasing sharply during the quarter to 31 March

2018. Borrowing rates increased with shorter term rates increasing more sharply than longer term rates.

4.7 Since the end of the financial year, at its meeting on 1 August 2018, the MPC voted unanimously to increase Bank Rate by 0.25% to 0.75%.

4.8 The following table gives Link's most recent forecast for UK Bank Rate, short term investment returns (LIBID) and borrowing rates from the Public Works Loans Board (PWLB)**:**

	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
BANK RATE	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 month LIBID	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 month LIBID	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 month LIBID	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5 Yr PWLB	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10 Yr PWLB	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25 Yr PWLB	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50 Yr PWLB	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

5. Capital Expenditure

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 and 2016/17, the budget for 2017/18 and outturn for 2017/18 are summarised in Table 1 below. Actual capital spend for 2017/18 was approximately £10M lower than budget due to higher than expected slippage in the capital programme.

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 actual £'000**
Capital Expenditure	**87,958**	**69,022**	**66,781**	**56,833**

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 CFR ended 2017/18 at £340.6m, £4.3m more than the 2016/17 level of £336.3m.

Table 2 Capital Financing Requirement (CFR)

Capital Financing Requirement Prudential Indicator 2	2016/17 Actual £'000	2017/18 Actual £'000
Underlying Borrowing Requirement b/f	**287,313**	**298,769**
Capital Expenditure	69,022	56,833
Grants and Contributions	-38,028	-38,942
Capital Receipts Applied	-3,764	-3,522
Revenue Contributions (RCCO)	-2,429	-728
Reserves Applied	0	0
Minimum Revenue Provision	-16,674	-9,920
Other Adjustments	3,329	3,273
Underlying Need to Borrow	**298,769**	**305,763**
Other Long Term Liabilities	37,574	34,861
Capital Financing Requirement	**336,343**	**340,624**

7. Borrowing

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 2017/18 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.

Table 3 Gross and Net Debt (excluding PFI)

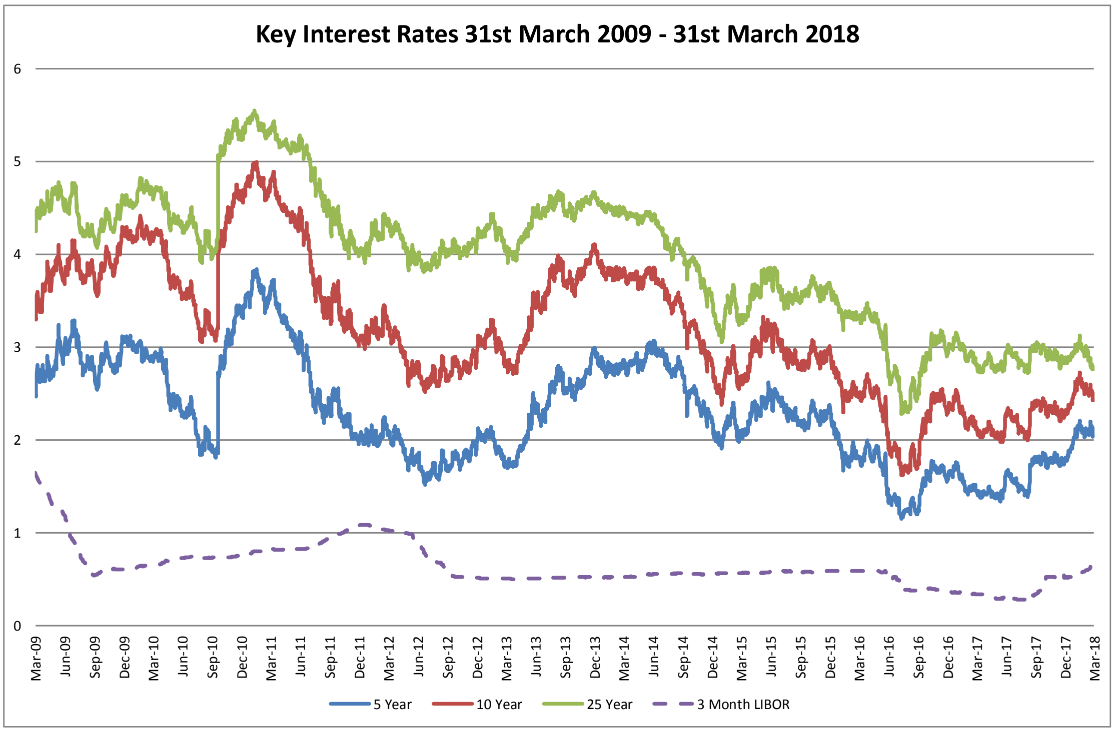
Gross and Net Debt Prudential Indicators 5-7	**Actual 31/03/2017 £'000**	**Budget 31/03/2018 £'000**	**Actual 31/03/2018 £'000**
Gross Debt	213,281	233,521	226,863
Investments	15,664	10,300	47,029
Net Debt	197,617	223,221	179,834
Underlying Need to Borrow	298,769	310,974	305,763
Under Borrowing	85,488	77,453	78,900
Operational Boundary	335,000	335,000	335,000
Authorised Limit	355,000	355,000	355,000
Maximum Gross Debt	218,936	233,521	242,423

7.4. 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 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.

7.7. 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 2.8% compared to the 3 month LIBOR rate of about 0.8%. On a typical borrowing tranche of £10m, this difference would amount to a carrying cost of £200k per annum, until it is spent.

7.8. 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 of 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.

7.9. As schedule of actual borrowing as at 31 March 2018 is shown in Appendix 2. In 2017/18 long term borrowing increased by £13.6m, as set out in the table below.

Table 4 - Changes in Borrowing 2017/18

		Rate	Outstanding
Borrowing as at 31/03/17		**3.51%**	**£213,281,322**
Less Repayments:			
Loan 2	PWLB annuity	4.70%	-£844,278
Loan 3	PWLB annuity	4.65%	-£14,527
	Dorset LEP	0.00%	-£560,000
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	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
Loan 50	West Sussex County Council	0.70%	£10,000,000
Loan 51	London Borough of Havering	0.70%	£5,000,000
Loan 52	PCC for West Midlands	0.70%	£5,000,000
Loan 53	London Borough of Wandsworth	0.75%	£5,000,000
Borrowing as at 31/03/18		**3.27%**	**£226,862,517**
Net Increase / (Decrease)			**£13,581,195**

7.10. In November 2017, the Council also entered into a forward commitment to borrow £20m in two years' time (November 2019) at a rate of 2.52% for a minimum period of 23 years, and a maximum of 48 years. This reduced the Council's exposure to the risk of interest rate rises in this two year period at a rate lower than the comparable PWLB rate available without incurring the cost of borrowing for that period.

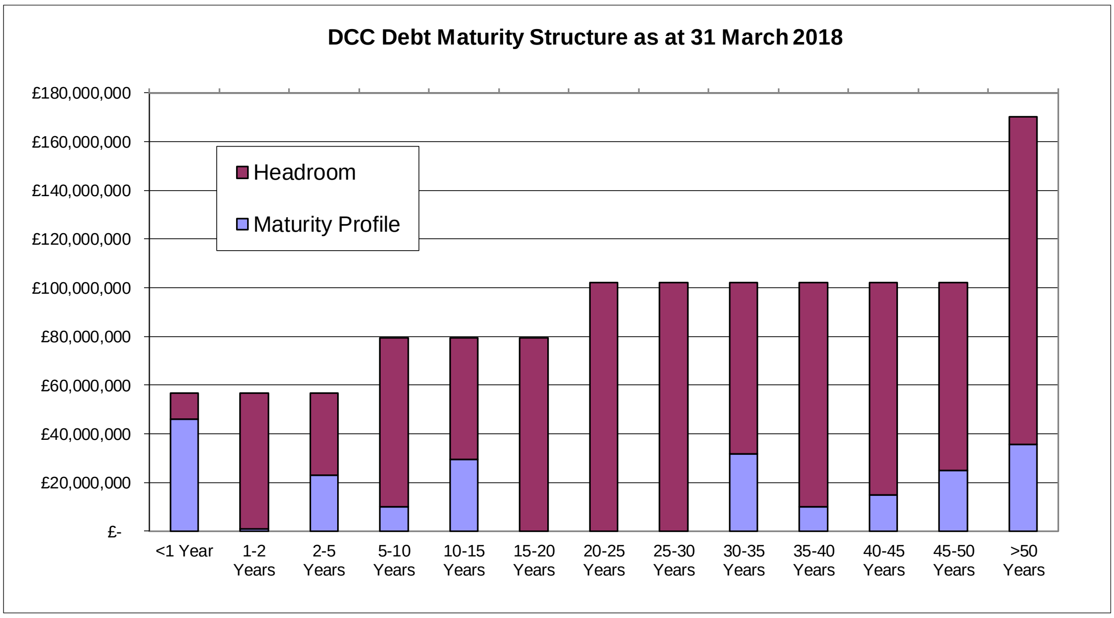
7.11. In addition, the terms of six existing loans were renegotiated in the year leading to combined annual savings of approximately £100k:

- 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.
- Loan 48: amalgamation of four existing loans at interest rates of 4.0% and 4.03% into one instrument at an interest rate of 3.90%.

7.12. The Council has a target of maintaining an under borrowed position of around £100m, and at 31 March 2018 the Council was under borrowed by £79m. 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 remained within the prudential limits for 2017/18, as set out in the chart below.

Chart 2



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.

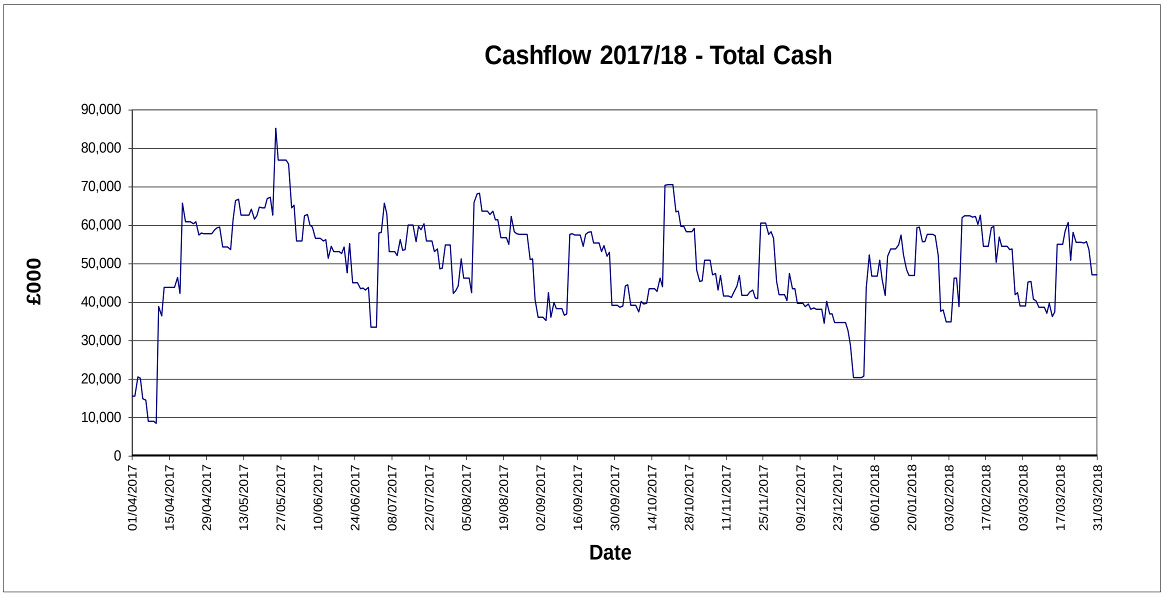
8. Investments

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. Balances available for investment do fluctuate throughout the year as part of the day to day operations of the Council, and cashflows are monitored and projections updated on a daily basis. Liquidity was maintained at adequate levels during the year with no concerns over the ability to discharge creditors and other payments as they fell due.

8.3. 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 was 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



8.4. Table 5 shows the cash and investment balances for 2016/17 and for 2017/18 at the start and end of each year, and the maximum, minimum and average balances held during each year, and the returns on those balances.

Table 5 - Analysis of Investments

	Actual 2016/17 £'000	**Budget 2017/18 £'000**	**Actual 2017/18 £'000**
Investments as at 1 April	**12,738**	**17,500**	**15,664**
Maximum cash balance	55,683	48,900	85,339
Minimum cash balance	874	9,900	8,496
Average cash balances	31,735	24,200	44,891
Investments as at 31 March	**15,664**	**10,300**	**47,029**
Gross Investment Income	**123**	**100**	**151**
Average Return	0.39%	0.41%	0.34%
Less DLEP Income*	45	30	39
Net Investment Income	**78**	**70**	**112**

**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.*

8.5. Net investment income for the year was approximately £110k, compared to the budget of £70k, and approximately £80k for the previous financial year. The low return on investments is a result of the combination of the strategy to delay borrowing (and therefore the cost of borrowing) by 'internally borrowing', and the low rates of interest available in the market. For comparative purposes the 7day LIBID rate, a widely used benchmark for returns on liquid cash, averaged 0.22% over 2017/18.

8.6. 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.

8.7 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).

8.8. The investments held as at 31 March 2018 are listed in Appendix 3, alongside the analysis of the investments in terms of counterparty, credit ratings, sovereigns and maturity profiles.

9. Treasury Management Performance

9.1. 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.

9.2. 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 27, mainly large local authorities and provides an insight into the relative performance of Dorset County Council's treasury function.

9.3. The headline results of the 2017/18 CIPFA benchmarking exercise were as follows:

- DCC had above average net budget requirement at £330m (av. £297m);
- The capital programme was below average at £67m (£98m);
- The CFR was below average at £340m (£426m);
- Total borrowing was below average at £227m (£393m)
- Use of internal financing was above average at £79m (£74m);
- Investment balances were less than average at £38m (£140m);
- Investment income was 0.34% against an average return of 0.30%;
- Interest paid on borrowing was 3.37% against the average of 3.80%.

10. Member and Officer Training

10.1. The high level of risk inherent in treasury management means officers need to be adequately experienced and qualified. Officers attend national treasury management events and training courses and have twice yearly strategy and review meetings with Link, as well as regular contact over the telephone.

10.2. A training session for all elected Members was held in January 2018 and run by Link to explain the basics and outline the responsibilities that Members have in relation to treasury management. It is Dorset County Council policy to offer training to Members where it is felt to be appropriate and relevant.

11. Local Government Reorganisation in Dorset

11.1. Dorset’s existing nine councils will be replaced with two new unitary councils from April 2019, with Bournemouth Borough Council, the Borough of Poole and Christchurch Borough Council forming one unitary council, and the six other councils forming the other.

11.2. It will therefore be necessary to ‘disaggregate’ existing investments and borrowings attributable to Christchurch Borough Council from the County Council’s assets and liabilities. The process for doing is being developed and agreed during 2018/19, in common with other services and activities of the County Council provided to Christchurch Borough Council.

Richard Bates
Chief Financial Officer
October 2018