Audit and Governance Committee

Dorset County Council

Date of Meeting	21 January 2019
Officer	Chief Financial Officer
Subject of Report	**Treasury Management Mid Year update 2018/19**
Executive Summary	At the meeting of the Cabinet on 31 January 2018 members approved the Treasury Management Strategy Statement and Prudential Indicators for 2018-19. 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 2017/18 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 – Interest Rate Forecast Appendix 3 – Schedule of Borrowing at 31-Dec-2018 Appendix 4 – Schedule of Investments at 31-Dec-2018
Background Papers	Treasury Management Strategy Statement 2018/19 Capital Programme Budget and Monitoring reports 2018/19
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1. Summary of Key Points

1.1. Key points to highlight are:

1.2 The Bank Rate was increased from 0.50% 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 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 31 March 2019 is £302.0m, £16.7m below the expected level of £318.7m when the annual strategy was agreed by Council in February 2018, and £3.8m lower than the position as at 31 March 2018, primarily due to capital programme slippage.

1.6 External borrowing at 31 December 2018 was £206.4m and is expected to increase to £211.0m by the end of the financial year, £15.8m below the position at the start of the financial year and £21.4m below the expected level when the annual strategy was agreed.

1.7 Therefore the Council is expected to be £91.0m under-borrowed at the end of the financial year, £4.7m higher than the expected level of £86.3m when the annual strategy was agreed, but below the target level of £100m.

1.8 The forecast net cost to the Council of interest on debt less returns on investments is £7.2m for 2018/19, compared to £7.3m for 2017/18.

1.9 As at 31 December 2018, the Council held £25m of debt maturing before 31 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 throughout 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 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 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 2018/19 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 (formerly Capita Asset Services) as its treasury management advisers.

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 UK economic growth in the first half of 2018/19 was seen as modest, but sufficiently robust for the Monetary Policy Committee (MPC) to unanimously vote to increase Bank Rate on 2nd August from 0.5% to 0.75%. Some MPC members have expressed concerns about a build-up of inflationary pressures and the MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are widely expecting the next increase in Bank Rate for the second half of 2019. However, the MPC are expected to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

4.2 Part of Link's service is to assist the Council to formulate a view on interest rates, and their most recent forecast for UK Bank Rate, short term investment returns (LIBID) and borrowing rates from the Public Works Loans Board (PWLB) is shown in Appendix 2. Link believe that future increases will be small and gradual, with Bank Rate reaching 2.0% by early 2022, but that the pace of change will be dependent on wider economic developments.

5. Capital Expenditure and Financing

5.1 The Council's capital programme 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 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 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 2016/17 and 2017/18, the budget for 2017/18 and the latest projected outturn for 2018/19 are summarised in Table 1 below. Projected capital spend for 2018/19 is approximately £6.5m lower than budget due to slippage.

Table 1 Capital Expenditure 2016/17 - 2018/19

Prudential Indicator 1	2016/17 actual £'000	2017/18 actual £'000	2018/19 budget £'000	2018/19 projected £'000
Capital Expenditure	**69,022**	**56,833**	**64,341**	**57,864**

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 2017/18 is shown as well as the budgeted and latest estimate for the 2018/19 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	2017/18 Actual £'000	2018/19 Budget £'000	2018/19 Projected £'000
Underlying Borrowing Requirement b/f	**298,769**	**305,763**	**305,763**
Capital Expenditure	56,833	64,341	57,864
Grants and Contributions	-38,942	-30,011	-41,855
Capital Receipts Applied	-3,522	-7,573	-4,935
Revenue Contributions (RCCO)	-728	-5,169	-5,229
Reserves Applied	0	0	0
Minimum Revenue Provision	-9,920	-10,539	-9,646
Other Adjustments	3,273	1,891	0
Underlying Need to Borrow	**305,763**	**318,703**	**301,962**
Other Long Term Liabilities	34,861	32,600	32,600
Capital Financing Requirement	**340,624**	**351,303**	**334,562**

7 Borrowing as at 31 December 2018

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 2018/19 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 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 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)

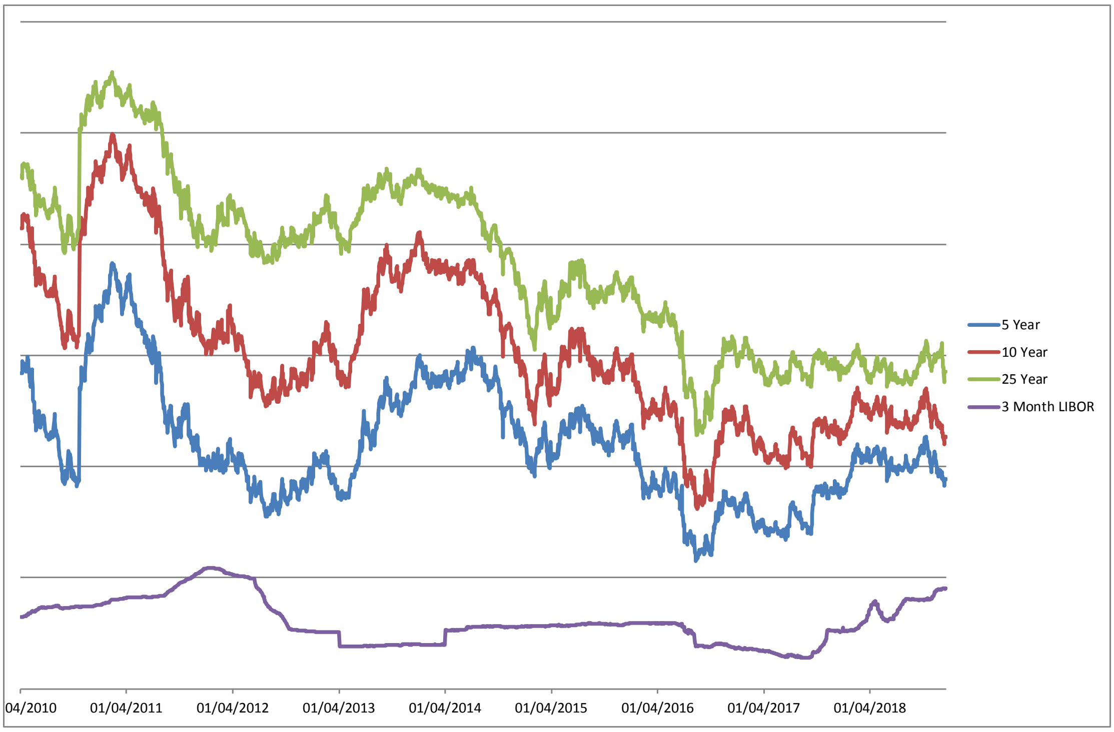
Gross and Net Debt Prudential Indicators 5-7	**Actual 31/03/2018 £'000**	**Budget 31/03/2019 £'000**	**Projected 31/03/2019 £'000**
Gross Debt	226,863	232,423	210,963
Investments	47,029	22,000	21,268
Net Debt	179,834	210,423	189,695
Underlying Need to Borrow	305,763	318,703	301,962
Under Borrowing	78,900	86,280	90,999
Operational Boundary	335,000	340,000	340,000
Authorised Limit	355,000	360,000	360,000
Maximum Gross Debt	242,423	232,423	226,863

7.5 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.

7.6 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 31 March 2010 – 30 November 2018



7.7 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 that at which it was borrowed.

7.8 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 2.9% compared to the 3 month LIBOR rate of approximately 0.9%. On a typical borrowing tranche of £10m, this difference would amount to a carrying cost of approximately £200k per annum, until it has been spent.

7.9 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.

7.10 A schedule of actual borrowing as at 31 December 2018 is shown in Appendix 3. Projected borrowing at 31 March 2019 is expected to decrease by £15.9m from the position at 1 April 2018, 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 - Movements in Borrowing

		Rate	Outstanding
Borrowing as at 31/03/18		**3.27%**	**£226,862,516**
Less Repayments:			
Loan 2	PWLB annuity	4.70%	-£883,710
Loan 3	PWLB annuity	4.65%	-£15,926
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
Plus New Borrowing:			
	ANO Council	1.15%	£10,000,000
	ANO Council	1.15%	£10,000,000
	ANO Council	1.15%	£10,000,000
Projected Borrowing as at 31/03/19		**3.52%**	**£210,962,880**
Net Increase / (Decrease)			**-£15,899,636**

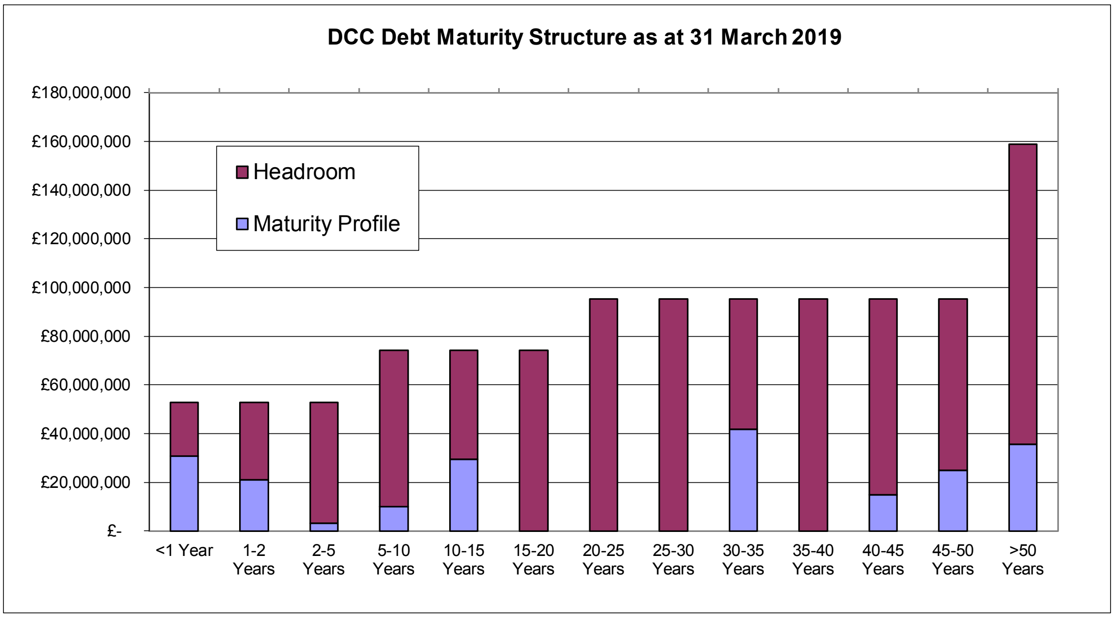
7.11 The table shows that a further £30m of borrowing is anticipated over the remainder of the financial year. It is assumed that this will be drawn down in three equal tranches from other local authorities for durations of up to 12 months at an interest rate of 1.15%. The exact amounts, durations and rates may vary depending upon need and availability, and any borrowing decisions will also need to be mindful of the likely combined balance sheet for the new Dorset Council.

7.12 The Council has also entered into a forward commitment to borrow £20m in 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.

7.13 The Council has a target of maintaining an under borrowed position of around £100m (approximately one third of the borrowing requirement). 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.

7.14 The maturity structure of the Council's borrowing remains within the prudential limits for 2018/19, as set out in the chart below:

Chart 2 Debt Maturity Structure



7.15 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.

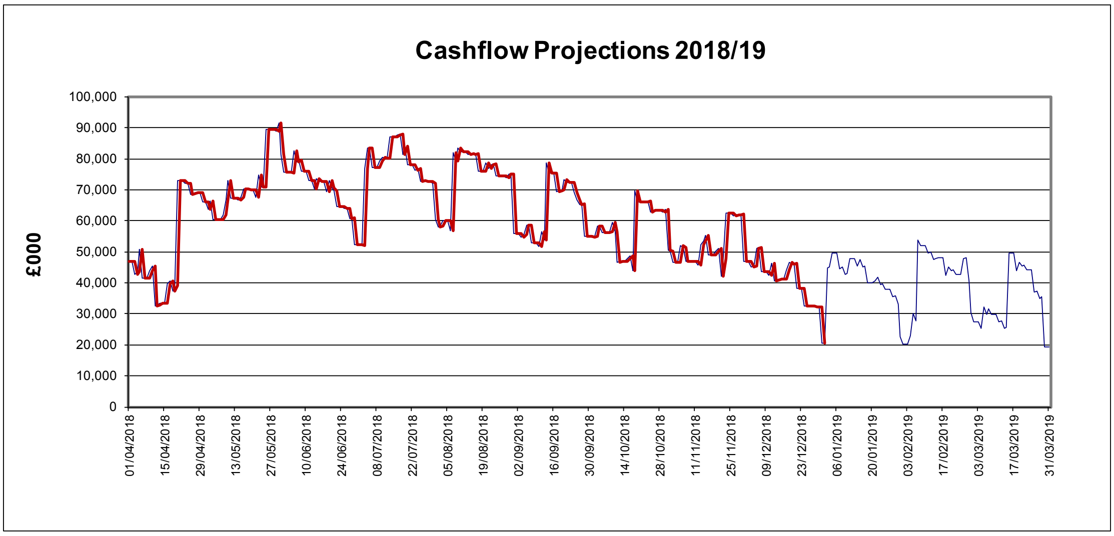
8 Investments as at 31 December 2018

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 has been maintained at adequate levels during the year with no concerns over the ability to discharge creditors and other payments as they fall 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 to date, and the forecast balances for the remainder of the year.

Chart 3 Cashflow Projections 2018-19



8.4 A schedule of actual cash and investments as at 31 December 2018 is shown in Appendix 4. 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 2017/18 and as projected for 2018/19.

Table 5 - Analysis of Investments

	Actual 2017/18 £'000	**Budget 2018/19 £'000**	**Projected 2018/19 £'000**
Investments as at 1 April	**15,664**	**21,500**	**47,029**
Maximum cash balance	44,891	59,100	91,499
Minimum cash balance	8,496	9,800	19,424
Average cash balances	44,891	34,300	56,324
Investments as at 31 March	**47,029**	**22,000**	**19,424**
Gross Investment Income	**151**	**191**	**351**
Average Return	0.34%	0.56%	0.62%
Less DLEP Income*	39	45	164
Net Investment Income	**112**	**146**	**186**

**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 projected for the year is approximately £190k, compared to the budget of £150k and £110k 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 7 day LIBID rate, a widely used benchmark for returns on liquid cash, averaged 0.48% over the year to date.

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 December 2018 are listed in Appendix 3, alongside the analysis of the investments in terms of counterparty, credit ratings, sovereigns and maturity profiles.

9 Member and Officer Training

9.1 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.

9.2 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.

10 Local Government Reorganisation in Dorset

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. It will therefore be necessary to ‘disaggregate’ existing investments and borrowings attributable to Christchurch Borough Council from the County Council’s assets and liabilities.

Richard Bates
Chief Financial Officer
January 2019