READING BOROUGH COUNCIL

REPORT BY DIRECTOR OF FINANCE

TO:	**AUDIT & GOVERNANCE COMMITTEE**		
DATE:	**18 JULY 2017**	**AGENDA ITEM:**	**9**
TITLE:	**TREASURY OUTTURN REPORT FOR 2016/17 & RELATED UPDATE**		
LEAD COUNCILLOR:	**COUNCILLOR LOVELOCK**	**PORTFOLIO:**	**LEADERSHIP/FINANCE**
SERVICE:	**ALL**	**WARDS:**	**BOROUGHWIDE**
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1. PURPOSE OF REPORT AND EXECUTIVE SUMMARY

1.1 CIPFA recommends that after the financial year end councils produce an annual report of their treasury activities. This report presents the outturn report for 2016/17. A short presentation will be made at the Committee to highlight key treasury management issues.

1.2 The opportunity is also taken to briefly cover in this report some current treasury and related issues likely to impact the Council during 2017/18; in the context of the Council's present financial plan and revised budget considered by Policy Committee.

2. RECOMMENDED ACTION

2.1 That the committee considers the annual Treasury Outturn Report for 2016/17.

3. POLICY CONTEXT

3.1 The Council is required to have a Treasury Management Strategy & Investment Statement in place in order to comply with legislative requirements and recommended professional practice. We are also required at least twice annually to report on the activity (which we normally achieve through this annual report and a mid-year report in September).

4. THE PROPOSAL

The Treasury Outturn Report is attached in the Appendix.

5. CONTRIBUTION TO STRATEGIC AIMS

Proper management of the Council's Treasury position helps support the overall achievement of the Council's financial and service objectives, particularly the Corporate Strategic Objective of remaining financially sustainable.

6. COMMUNITY ENGAGEMENT AND INFORMATION

The Council does not directly consult with the community on this particular issue, though occasionally receives queries about its treasury activity to which an appropriate response is made.

7. EQUALITY IMPACT ASSESSMENT

An EIA is not relevant at this time.

8. LEGAL IMPLICATIONS

None, at this stage.

9. FINANCIAL IMPLICATIONS

As set out in the Treasury Outturn Report

10. BACKGROUND PAPERS

The statement has been prepared using a template provided by Arlingclose, adapted for Reading's needs.
CIPFA Treasury Management & Prudential Codes and guidance notes.
Papers received in connection with the establishment of Municipal Bonds Agency, save confidential and legally privileged items.

Treasury Management Outturn Report 2016/17

Introduction

The Council has adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) which requires the Council to approve a treasury management annual report after the end of each financial year. This report fulfils the Council's legal obligation to have regard to the CIPFA Code.

The Council's treasury management strategy for 2016/17 was approved in February 2016. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

External Context

Economic background: Politically, 2016/17 was an extraordinary twelve month period which defied expectations when the UK voted to leave the European Union and Donald Trump was elected the 45th President of the USA. Uncertainty over the outcome of the US presidential election, the UK's future relationship with the EU and the slowdown witnessed in the Chinese economy in early 2016 all resulted in significant market volatility during the year. Article 50 of the Lisbon Treaty, which sets in motion the 2-year exit period from the EU, was triggered on 29th March 2017.

UK inflation had been subdued in the first half of 2016 as a consequence of weak global price pressures, past movements in sterling and restrained domestic price growth. However the sharp fall in the Sterling exchange rate following the referendum had an impact on import prices which, together with rising energy prices, resulted in CPI inflation rising from 0.3% year on year in April 2016 to 2.3% year on year in March 2017.

In addition to the political fallout, the referendum's outcome also prompted a decline in household, business and investor sentiment. The repercussions on economic growth were judged by the Bank of England to be sufficiently severe to prompt its Monetary Policy Committee (MPC) to cut the Bank Rate to 0.25% in August and embark on further gilt and corporate bond purchases as well as provide cheap funding for banks via the Term Funding Scheme to maintain the supply of credit to the economy.

Despite growth forecasts being downgraded, economic activity was fairly buoyant and GDP grew 0.6%, 0.5% and 0.7% in the second, third and fourth calendar quarters of 2016. The labour market also proved resilient, with the unemployment rate dropping to 4.7% in February, its lowest level in 11 years.

Following a strengthening US labour market, the Federal Reserve increased US interest rates at its meetings in December 2016 and March 2017, taking the target range for official interest rates to between 0.75% and 1.00%.

Financial markets: Following the referendum result, gilt yields (the interest rate on government borrowing) fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. After September there was some reversal in longer-dated gilt yields which moved higher, largely due to the MPC revising its earlier forecast that Bank Rate would be dropping to near 0% by the end of 2016 (and there was market speculation about the possibility of negative interest rates). The yield on the 10-

year gilt rose from 0.75% at the end of September to 1.24% at the end of December, almost back at pre-referendum levels of 1.37% on 23rd June. 20- and 50-year gilt yields also rose in Q3 2017 to 1.76% and 1.70% respectively, however in Q4 yields 20-50 year yields remained flat at around 1.6%.

After recovering from an initial sharp drop after the referendum, stock markets rallied, (though displayed some volatility at the beginning of November following the US presidential election result). The FTSE-100 and FTSE All Share indices closed at 7342 and 3996 respectively on 31st March, both up 18% over the year. Commercial property values fell around 5% after the referendum (after which the Council also invested in 2 commercial properties in Reading) but had mostly recovered by the end of March.

Money market rates for overnight and one week periods have remained low since Bank Rate was cut in August. 1- and 3-month LIBID rates averaged 0.36% and 0.47% respectively during 2016-17. Rates for 6- and 12-months increased between August and November, only to gradually fall back to August levels in March, they averaged 0.6% and 0.79% respectively during 2016-17.

Credit background: Various indicators of credit risk reacted negatively to the result of the referendum on the UK's membership of the European Union. UK bank credit default swaps saw a modest rise but bank share prices fell sharply, on average by 20%, with UK-focused banks experiencing the largest falls. Non-UK bank share prices were not immune, although the fall in their share prices was less pronounced.

Fitch and Standard & Poor's downgraded the UK's sovereign rating to AA. Fitch, S&P and Moody's have a negative outlook on the UK. Moody's has a negative outlook on those banks and building societies that it perceives to be exposed to a more challenging operating environment arising from the 'leave' outcome.

None of the banks on the Council's lending list failed the stress tests conducted by the European Banking Council in July and by the Bank of England in November, the latter being designed with more challenging stress scenarios, although Royal Bank of Scotland was one of the weaker banks in both tests. The tests were based on banks' financials as at 31st December 2015, 11 months out of date for most. As part of its creditworthiness research and advice, the Council's treasury advisor Arlingclose regularly undertakes analysis of relevant ratios - "total loss absorbing capacity" (TLAC) or "minimum requirement for eligible liabilities" (MREL) - to determine whether there would be a bail-in of senior investors, such as local Council unsecured investments, in a stressed scenario.

<u>Local Context</u>

On 31 March 2017, the Council had £353.4m of Borrowing, (an increase of £35m over 31/3/2016) and £27.2m of Investments (£15m of which are longer term), (an increase of £15.2m over 31/3/2016). The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), which increased from £466.4m to £493.0m over the year while usable reserves and working capital are the underlying resources available for investment (which from the balance sheet fell by £8.5m).

As is evident from these figures, the Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and minimise net interest costs.

These factors and the year-on-year change are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.16 Actual £m	2016/17 Movement £m	31.3.17 Actual £m
General Fund CFR	273.0	30.0	303.0
HRA CFR	193.4	- 3.4	190.0
Total CFR	**466.4**	26.6	**493.0**
Less: Other debt liabilities *	- 31.8	0.8	- 31.0
Borrowing CFR	**433.7**	28.3	**462.0**
Less: External Borrowing	318.4	36.1	354.5
Less: Investments	**12.0**	15.2	27.2
Other Balances (Working capital & Earmarked Reserves)	103.3	- 23.0	80.3

* finance leases & PFI liabilities that form part of the Council's total debt

External borrowing has increased due to a rise in the CFR as new capital expenditure was higher than the debt repaid, mainly through the minimum revenue provision. Although investments also rose (arising from a strategic decision to increase the CCLA property fund investment and the year end short term cash flow situation, there was a decrease in both reserves and working capital (the latter due to the timing of receipts and payments).

The treasury management position as at 31 March 2017 and the year-on-year change in show in table 2 below.

Table 2: Treasury Management Summary

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %
PWLB	273.9	- 6.5	267.4	3.59
LOBO & Other Long-term borrowing	30.0	-	30.0	4.18
Short-term borrowing	21.0	35.0	56.0	0.37
Total borrowing	**324.9**	**28.5**	**353.4**	**3.12**
Long-term investments	12.0	3.0	15.0	
Short-term investments	-	12.2	12.2	0.29
Cash and cash equivalents	8.3	1.4	9.7	
Total investments	**20.3**	**4.4**	**24.7**	**0.29**
Net borrowing	**304.6**	**24.1**	**328.7**	

Note: the figures in the table are mainly from the balance sheet in the Council's draft statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments

The increase in Borrowing CFR in table 1 has translated into a rise in short term borrowing, which has also risen (as for cashflow reasons there has been an increase in investment balances).

Borrowing Activity

At 31st March 2017, the Council held £353.4m of loans, an increase of £35m on the previous year, as part of its strategy for funding previous years' capital programmes. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %	31.3.17 WAM* years
Public Works Loan Board	273.9	(6.5)	267.4	3.58	28.5
Banks (LOBO & Other Long Term)	30	(5)	25	4.18	20.7
Local authorities (short-term)	14.5	41.5	56	0.37	0.3
Total borrowing	**318.4**	**35**	**353.4**		

*Weighted average maturity

The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

To meet these objectives, no new long term borrowing was undertaken in 2016/17, while existing loans were allowed to mature without replacement. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

The "cost of carry" analysis performed by the Council's treasury management advisor Arlingclose did not significant enough value in borrowing in advance for future years' planned expenditure and therefore none was taken.

The Council continues to holds £25m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during 2016/17. However, Barclays Bank informed the Council that it had revoked its right to exercise their options in future, and £5m has therefore been reclassified as a long term fixed rate bank loans.

Investment Activity

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2016/17, the Council's investment balance ranged between £12 and £70.4 million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change in show in table 4 below.

Table 4: Investment Position

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %	31.3.17 WAM* days
Money Market Funds	-	10.3	12.2	0.26	1
Bank Deposits	-	1.9	1.9	0.15	1
Other Pooled Funds (CCLA Property Fund)	12.0	3.0	15.0	4.83	30
Total investments	**12.0**	**15.2**	**29.1**		

*Weighted average maturity – *all the short term lending in year was overnight; a strategic decision was taken early in the year to increase the CCLA Property Fund Investment*

Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

To meet these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Council to kept to a minimum bank and building society deposits and held its short term cash in money market funds.

As a result, investment credit risk was improved. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 5 below. To reduce bail in exposure we would need to move to covered bonds, but at the current time don't normally hold enough cash for that to be a viable choice.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)
31.03.2016	5.67	A	100%	1
30.06.2016	4.68	A+	100%	1
30.09.2016	4.67	A+	100%	1
31.12.2016	4.77	A+	100%	1
31.03.2017	4.91	A+	100%	1
Similar LAs	**4.77**	**A+**	**65%**	**119**
All LAs	**4.30**	**AA-**	**60%**	**47**

*Weighted average maturity

The Council's best performing investments in 2016/17 were its £15m (by 31 March) of externally managed pooled property funds with CCLA. These generated an average total return of £0.65m (4.34%). This income return helped support the budget for services during the year. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives is regularly reviewed. In light of their strong performance and the Council's latest cash flow forecasts, investment in this fund has been for the 2017/18 financial year.

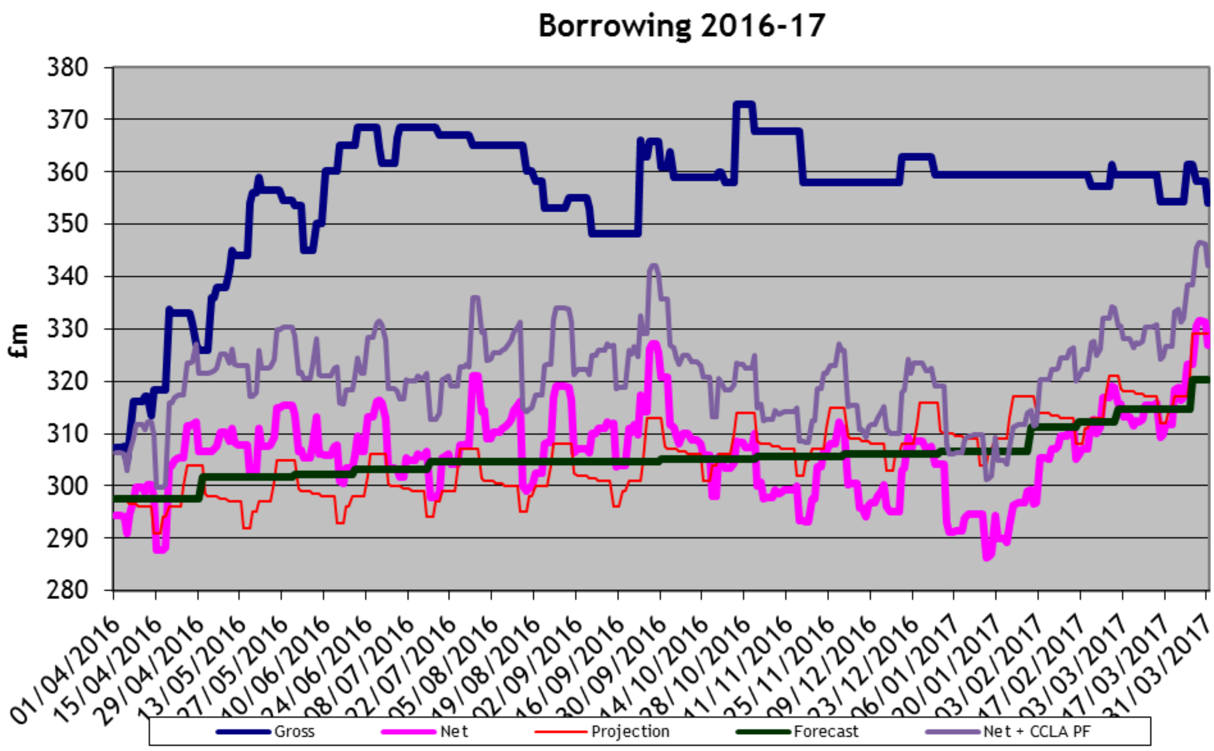
Other Investment Activity (Commercial Property)

Although not classed as a treasury management activity and therefore not covered by the CIPFA Code, the Council also purchased £24m of investments in directly owned property during the year. As a consequence (after revaluation and other adjustments), the Investment Property on the Council's Balance Sheet increased from £29m to £51.3m during the year.

Except for the CCLA Property Fund investment, our direct property investment generated a higher return than that earned on treasury investments, but returns reflect the additional risks to the Council of holding such investments.

Performance Report

The Council primarily measures the financial performance of its treasury management activities in terms of its impact on the revenue budget. The net General Fund Revenue Budget was £9.3m an at the year end this was underspent by £0.5m, primarily arising from the better returns on the CCLA Property Fund, lower that forecast borrowing financed capital in 2015/16, and the low interest rates on short term borrowing in the year.



Another way of looking at performance is to consider the treasury activity during the year. Generally this shows that in the early part of the financial year, when initially there was a high cash demand (no doubt in the main to settle some 31/3/16 creditors), the Council took rather too much temporary borrowing, as from late May onwards until the last weeks of the year we generally had well over £20m cash in hand (measured by the gap between the top blue line measuring gross borrowing and second purple "Net + CCLA" line. In 2017/18, we have sought to manage the cash position more tightly, avoiding having excess cash in a very low interest rate environment.

Compliance Report

All treasury management activities undertaken during 2016/17 complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 6 below.

Table 6: Investment Limits

	2016/17 Maximum	31.3.17 Actual	2016/17 Limit	Complied
Any single organisation, except UK Government	£15m	£1.9m	£15m	✓
Money Market Funds (Including Pooled Funds)	**£50.2m Aggregate £20m in one fund**	**£10.2m**	**£20m each fund**	✓

Other investments permitted by the approved 2016/17 TMSS were not used

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 7: Debt Limits

	2016/17 Maximum	31.3.17 Actual	2016/17 Operational Boundary	2016/17 Authorised Limit	Complied
Borrowing	372.3	353.4	400	410	✓
PFI & finance leases	**31.8**	**31.0**	**40**	**40**	✓
Total debt	**404.1**	**384.4**	**440**	**450**	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure. Total debt was never above the operational boundary during 2016/17.

Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators.

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.3.17 Actual	2016/17 Target	Complied
Portfolio average credit score	4.91	6.0	✓

Liquidity: The Council has within its treasury strategy indicated we will normally hold at least £10m short term cash at any time. This was met after the first few days of the financial year.

Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed was:

	31.3.17 Actual	**2016/17 Limit**	**Complied**
Upper limit on fixed interest rate exposure	89.7%	120%	✓
Upper limit on variable interest rate exposure	10.3%	50%	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate. The in year maxima were 104.2% fixed and 11.5% variable, both within the limits set.

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

	31.3.17 Actual	**Upper Limit**	**Lower Limit**	**Complied**
Under 12 months	17.6%	25%	0%	✓
12 months and within 24 months	1.4%	25%	0%	✓
24 months and within 5 years	4.0%	25%	0%	✓
5 years and within 10 years	6.3%	25%	0%	✓
10 years and above	70.7%	100%	40%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment. The percentages above assume LOBOs run to maturity; allowing for the possibility of LOBOs with an option date within 1 year being called, increases the under 12 month percentage to 23.3%.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2016/17	**2017/18**	**2018/19**
Actual principal invested beyond year end	£0m	£0m	£0m
Limit on principal invested beyond year end	£20m	£15m	£15m
Complied	✓	✓	✓