Suffolk County Council

Agenda Item 8

Audit Committee

Report Title:	Treasury Management Mid-Year Report
Meeting Date:	29 November 2016
Lead Councillor(s):	Councillor Michael Bond
Local Councillor(s):	All Councillors
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Brief summary of report

1. The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that Local Authorities report on the mid-year performance of the treasury management function. The Council's Treasury Management Strategy and Prudential Indicators for 2016/17 were approved by the County Council on 11 February 2016 as part of the Revenue Budget 2016/17 and Capital Programme 2016/19. This report sets out details of the treasury management activities to 30 September 2016 in relation to the Council's strategies for borrowing and investments and compliance with Prudential Indicators.

Action recommended

2. The Committee is asked to review and confirm the arrangements in place for treasury management are effective

Reason for recommendation

3. The Audit Committee, within its Terms of Reference, has responsibility for ensuring that effective treasury management control procedures are operating within the Council.

Alternative options

4. The Committee may request further information before agreeing the action recommended.

Who will be affected by this decision?

5. All stakeholders.

Main body of report

Background

6. The Council operates a balanced budget from which the treasury team ensures day to day cash flow events are adequately planned. Surplus monies are invested in low risk counterparties, ensuring adequate liquidity initially before maximising investment return.

7. The treasury management operations team also manages the medium and long term cash flow forecasts which may involve arranging short or long term loans, or investing longer term cash flow surpluses. Current debt is also reviewed and may be restructured to meet Council risk or cost objectives.

8. In line with the requirements of the CIPFA TM Code, the Council has adopted a set of Treasury Management Practices (TMPs), which set out the detailed controls and limits for its treasury management operations. These are maintained and reviewed by the Director of Resource Management and any significant changes are reported to Cabinet.

External Context - Economic Commentary and Outlook

9. The initial estimate of Q2 2016 GDP showed reasonably strong growth as the economy grew 0.7% quarter-on-quarter, as compared to 0.4% in Q1 and year on year growth running at a healthy pace of 2.2%. The UK economic outlook changed significantly on 23 June 2016 when the result of the referendum on EU membership prompted forecasters to change previous projections, with worst-case scenarios seeming more probable. However, Q3 2016 growth is above these predictions at 0.5% with year on year growth remaining at 2.2%

10. The Monetary Policy Committee initiated substantial monetary policy easing at its August meeting to mitigate the worst of the downside risks. This included a cut in Bank Rate to 0.25%, further gilt and corporate bond purchases (Quantitative Easing) and cheap funding for banks (Term Funding Scheme) to maintain the supply of credit to the economy. The minutes of the August meeting also suggested that many members of the Committee supported a further cut in Bank Rate to near-zero levels. The Bank, however, does not appear keen to lead the UK into negative interest rate territory, although it cannot be ruled out.

11. The new members of the UK government, particularly the Prime Minister and Chancellor, are likely to follow the example set by the Bank of England. After six years of fiscal consolidation, the Autumn Statement on 23 November is likely to witness fiscal initiatives to support economic activity and confidence, most likely infrastructure investment. Tax cuts or similar cannot be ruled out.

12. Whilst the economic consequences of BREXIT remain speculative, there is expectation that uncertainty over the UK's future trade relations with the EU and the rest of the world will reduce investment intentions and tighten credit

availability, prompting lower activity levels and potentially a rise in unemployment.

13. Meanwhile, higher import prices, following the 20% depreciation of sterling over the past year, mean that Consumer Price Inflation (CPI) is judged likely to be at 1.3% by the end of the year and to rise above the 2% target by mid-2017, before peaking at 2.75% a year later and then beginning to fall back to around 2.5% by Q4 of 2019. The rise in inflation is unlikely to prompt monetary tightening by the Bank of England, with policymakers looking through import-led CPI spikes, concentrating instead on the negative effects of BREXIT on economic activity and, ultimately, inflation.

14. **Market reaction:** Following the referendum result gilt yields fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. The yield on the 10-year gilt fell from 1.37% on 23 June to a low of 0.52% in August, a quarter of what it was at the start of 2016. The 10-year gilt yield has since risen to 1.25% at the end of October. The yield on 2 and 3 year gilts briefly dipped into negative territory intra-day on 10 August to -0.1% as prices were driven higher by the Bank of England's bond repurchase programme. However, both yields recovered to 0.07% and 0.08% respectively by the end of September. The fall in gilt yields was also reflected in the fall in Public Works Loan Board (PWLB) borrowing rates with lows of 1.62% for borrowing of 10 years. The most noticeable fall in money market rates was for very short-dated periods (overnight to 1 month) where rates fell to between 0.1% and 0.2%

Local Context

15. At 31 March 2016 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £650.1m, while usable reserves and working capital which are the underlying resources available for investment were £291.8m. The Council had £322m of borrowing and £65.4m of investments.

16. Forecast changes in these balances are shown in the balance sheet analysis in **Table 1** below:

Table 1: Balance Sheet Analysis	**31.3.15 Actual £m**	**31.3.16 Actual £m**	**31.3.17 Budget £m**	**31.3.17 Q2 Estimate £m**	**31.3.18 Q2 Estimate £m**	**31.3.19 Q2 Estimate £m**	**31.3.20 Q2 Estimate £m**	**31.3.21 Q2 Estimate £m**
Capital Financing Requirement	647.3	650.1	748.5	715.7	758.9	780.6	786.7	792.4
Less: PFI debt liabilities	104.3	101.6	98.7	63.2	60.4	57.6	54.6	51.6
Borrowing CFR	**543.0**	**548.5**	**649.8**	**652.4**	**698.7**	**723.1**	**732.1**	**740.8**
Less : External borrowing long term	323.1	322.0	296.0	296.0	265.1	264.1	263.1	262.1
Internal borrowing	**219.9**	**226.5**	**353.8**	**356.4**	**433.6**	**459.0**	**469.0**	**478.7**
Less: Usable reserves	-214.1	-223.3	-151.5	-199.5	-176.7	-153.9	-131.1	-108.3
Less : Working capital	-60.8	-68.5	-68.3	-73.7	-77.4	-80.1	-83.1	-11.1
Investments/New borrowing (-)	**55.0**	**65.4**	**-134.0**	**-83.2**	**-179.5**	**-225.0**	**-254.9**	**-359.4**

17. The Council has an increasing CFR over the next 4 years due to the capital programme, and will require to borrow up to £359.4m over the forecast period.

18. The MiniPrivate Finance Initiative debt liability reduces sharply in 2016/17 due to the payment of a capital contribution in relation to the Energy from Waste Facility in October 2016, external borrowing has funded this capital contribution.

19. The anticipated cost of the capital programme, which is charged to revenue, based on the above predictions is shown in **Table 2** below:

Table 2: Capital Financing Projections	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m
External Interest Received	- 0.91	- 0.71	- 0.44	- 0.44	- 0.31	- 0.30
Internal Interest Received	- 1.65	- 1.65	- 1.65	- 1.64	- 1.64	- 1.64
Interest Paid	20.31	20.36	17.11	19.05	20.80	21.25
Less PFI Interest Paid	- 7.32	- 6.10	- 4.32	- 4.14	- 3.96	- 3.77
MRP Repayments	4.49	2.67	4.23	5.21	5.72	6.13
Net Interest and MRP	**14.94**	**14.57**	**14.94**	**18.04**	**20.60**	**21.67**

20. Net Interest and Minimum Revenue Provision (MRP) is anticipated to reduce in 2016/17 due to short term borrowing being used which is at a lower interest rate than long term borrowing, along with a change to the MRP profile which will be approved as part of the 2017/18 budget process. Net Interest and MRP will then increase year on year due to additional borrowing required to finance the capital programme.

Borrowing Activity for 2016/17

21. External borrowing is driven by approved borrowing for the capital programme and re-borrowing required to refinance existing debt due for repayment, or any changes in the Council's internal reserves.

22. The Council's chief objective when borrowing continues to be striking 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.

23. The approved Borrowing strategy for 2016/17 is to undertake any new borrowing required short term (less than one year to maturity), subject to the prudential constraints related to the maturity structure of the Council's external debt. As at 30 September 2016, the Council had £45m short term borrowing at an average rate of 0.25%. This short term borrowing ranges from 31 days to 344 days and has been borrowed from other Local Authorities and Police and Crime Commissioners It is estimated that total borrowing at 31 March 2017 will be £379.2m (£296m long term borrowing plus £83.2m short term).

24. Affordability and the "cost of carry" remain important influences for the Council's borrowing strategy. Presently, any long term borrowing undertaken ahead of need would result in the proceeds being invested in money markets at rates of interest significantly lower than the cost of borrowing. Therefore, this strategy is not currently being pursued. As short-term interest rates have remained, and are likely to remain, lower than long-term rates for a significant period, the Council determined it was more cost effective in the short-term to make use of internal resources and short term borrowing.

25. Borrowing activity undertaken in 2016/17 to 30 September 2016 is shown in **Table 3**.

Table 3: Borrowing Activity 2016/17	Balance at 01/04/2016	Maturing Debt	Re-classification	New Borrowing	Balance at 30/09/16	Average Rate
	£m	£m	£m	£m	£m	%
CFR	**650.1**					
Short Term Borrowing	-	-	-	45.0	45.0	0.258%
Long Term Borrowing : PWLB	147.1	- 25.5	-	-	121.5	3.705%
Long Term Borrowing : Bank loans	-	-	45		45.0	3.864%
Long Term Borrowing : LOBO	175.0		- 45	-	130.0	4.020%
Total Borrowing	**322.1**	**- 25.5**	**-**	**45.0**	**341.5**	**3.391%**
Other Long Term Liabilities:						
PFI Liability - Waste	88.2	-	-	-	88.2	
PFI Liability - Fire	13.4	-	-	-	13.4	
Total External Debt	**423.7**	**- 25.5**	**-**	**45.0**	**443.2**	
Increase /Decrease (-) in Borrowing £m					**19.5**	

PWLB : Public Works Loan Board loans

LOBO : Lender Option, Borrower Option loans

26. As at 31 March 2016 the Council held £175m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. The loan call periods range from every six months to every five years, and the Council acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

27. In June 2016, Barclays Bank Plc informed the Council of its decision to cancel all the embedded options within standard LOBO loans. This effectively converted £45m of the Council's Barclays LOBO loans to fixed rate loans removing the uncertainty on both interest cost and maturity date. This waiver was done by 'deed poll'; it is irreversible and transferable by Barclays to any new lender.

Debt Rescheduling

28. The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Councils portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

Investment Activity for 2016/17

29. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. The Council's cash balance also includes money held on behalf of schools and other third parties including the New Anglia Local Enterprise Partnership, Suffolk Strategic Partnership and money held on behalf of vulnerable adults.

30. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles. Security of capital has remained the Council's main investment objective and has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2016/17.

31. The transposition of European Union directives into UK legislation places the burden of rescuing failing EU banks disproportionately onto unsecured local

authority investors through potential bail-in of unsecured bank investments including certificates of deposit.

32. The Council's surplus cash is currently invested in unsecured bank deposits, and money market funds, which although they are unsecured have a high bank or country rating. Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the Council's aim to diversify into more secure asset classes. Treasury Bills and Repurchase Agreements (REPO's) (where a holder of government securities sells the securities to a lender and agrees to repurchase them at an agreed future date at an agreed price), are currently being investigated. It is hoped that the Council will make use of these secure investments in the later part of 2016/17 once the legalities of these transactions have been confirmed.

33. The investment activity undertaken in 2016/17 to 30 September 2016 is shown in the **Table 4** below:

Table 4 : Investment Activity 2016/17	Maximum Investment per criteria	Balance at 01/04/2016	Investments Made	Investments Recalled/ Matured	Balance on 30/09/2016	Avg Rate
	£m	£m	£m	£m	£m	%
Money Market Funds:						
Aberdeen Global Liquidity Fund Plc	25.0	6.6	48.6	-46.1	9.1	0.49%
BlackRock Institutional Cash Series Plc	25.0	2.5	57.4	-55.6	4.3	0.44%
Deutsche Global Liquidity Series Plc	25.0	6.7	51.8	-58.5	0.01	0.47%
Federated Investors (UK) LLP	25.0	7.1	51.0	-49.9	8.2	0.48%
Goldman Sachs Asset Management International	25.0	0.04	0.00	0.00	0.04	0.42%
Insight Investment Funds Management Ltd	25.0	7.1	45.0	-44.8	7.3	0.47%
JP Morgan Liquidity Funds	25.0	5.4	53.9	-58.1	1.2	0.45%
Morgan Stanley Liquidity Funds (Luxembourg)	23.2	3.8	46.5	-49.1	1.1	0.43%
Cash Plus Money Market Funds:						
Santander 95 day call account	10.0	0.0	10.0	0.0	10.0	0.65%
Deposit Accounts:						
Lloyds Deposit Account	25.0	5.2	7.9	-7.5	5.6	0.50%
Fixed Term Deposits:						
Fixed Term Deposits : Local Authorities	£20m per Authority	6.0	15.0	-21.0	0.0	0.55%
Fixed Term Deposits : Other Banking institutions UK (A Bank rating or above)	Secured £40m, Unsecured £10	15.0	30.0	-25.0	20.0	0.67%
Fixed Term Deposits : Other Banking institutions Non UK (AAA Country rating)	Secured £50m, Unsecured £15m	0.0	33.0	-3.0	30.0	0.56%
Total		**65.4**	**450.1**	**-418.6**	**96.9**	

34. Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- across rating agencies Fitch, Standard and Poor's (S&P) and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Counterparty Update

35. There were various credit risk changes following the result of the referendum on the UK's membership of the European Union. Fitch downgraded the UK's sovereign rating by one notch to AA from AA+, and S&P downgraded its corresponding rating by two notches to AA from AAA. Rating agencies have also indicated further potential downgrade of the UK's credit rating. S&P also downgraded the long-term ratings of the local authorities to which it assigns ratings as well as the long-term rating of the EU from AA+ to AA.

36. There was no immediate change to Arlingclose's credit advice on UK banks and building societies as a result of the referendum result. However, over the six-month period Standard Chartered has been suspended from the Council's investment list due to the risk exposure they have to the far East, specifically the global slow-down of the China economy. The Council has also reduced its investments held in Deutsche money market funds due to the perceived reputational risk of Deutsche Bank. Our advisors also believe there is a risk that the uncertainty over the UK's future trading prospects will bring forward the timing of the next UK recession.

Prudential Indicators

37. The Council can confirm that it has complied with its Prudential Indicators for the period 1 April to 30 September 2016. Further details of the Prudential Indicators are shown in **Appendix One**.

38. The treasury management function operated within the limits details in the Treasury Management Practices.

39. The latest internal audit on treasury management activities (November 2015) gave an overall rating of "High Standard".

Other Activity Update

40. The contract with the Council's bank, Lloyds Bank, has been extended for a further 2 years until January 2020. Before this extended contract expires a full re-tender for banking services for the Council will take place. The contract with the Council's Financial Advisers, Arlingclose, expires in February 2018 and work will commence to re-tender this contract in early 2017.

Outlook for the remainder of 2016/17

41. The economic outlook for the UK has immeasurably altered following the popular vote to leave the EU. The long-term position of the UK economy will be largely dependent on the agreements the government is able to secure with the EU, particularly with regard to Single Market access.

42. The short to medium-term outlook has been more downbeat due to the uncertainty generated by the result and the forthcoming negotiations. Economic and political uncertainty will likely dampen or delay investment intentions, prompting lower activity levels and potentially a rise in unemployment. The downward trend in growth apparent on the run up to the referendum may continue through the second half of 2016, although some economic data has held up better than was initially expected, perhaps suggesting a less severe slowdown than feared.

43. Arlingclose has changed its central case for the path of Bank Rates over the next three years and believe that any currency-driven inflationary pressure will be looked through by Bank of England policymakers. Their central case is for Bank

Rates to remain at 0.25%, but there is a 40% possibility of a drop to close to zero, with a small chance of a reduction below zero. Table 5 below shows the likely bank base rate (central case), and the possible rate changes to this (upside risk and downside risk). If bank rates do reduce below zero, this may mean the Council is charged for having cash balances. This has recently been the case in Europe and Japan. Gilt yields are forecast to be broadly flat from current levels, albeit experiencing short-term volatility.

Table 5 : Arlingclose Interest Rate Forecast

	Dec-16	Jun-17	Dec-17	Jun-18	Dec-18	Jun-19	Dec-19
Official Bank Rate							
Upside Risk	0.000	0.000	0.000	0.000	0.250	0.250	0.250
Arlingclose Central Case	**0.250**	**0.250**	**0.250**	**0.250**	**0.250**	**0.250**	**0.250**
Downside Risk	-0.250	-0.250	-0.250	-0.500	-0.500	-0.500	-0.500

44. In addition, Arlingclose believes that the Government and the Bank of England have both the tools and the willingness to use them to prevent market-wide problems leading to bank insolvencies. The cautious approach to credit advice means that the banks currently on the Council's counterparty list have sufficient equity buffers to deal with any localised problems in the short term.

Conclusion

45. In compliance with the requirements of the CIPFA Code of Practice, this report provides the Council with a summary report of the treasury management activity during the first six months of 2016/17. As indicated in this report, there has been no breach in Prudential Indicators and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

Sources of Further Information

a) Chartered Institute of Public Finance and Accountancy's Treasury Management Code or Practice (2011)

b) Suffolk County Council Treasury Management Practices 2016/17

c) Local Government Act 2003

d) The Prudential Code for Capital Finance in Local Authorities (2013 Edition)

Appendix One – Prudential Indicators

1. **Estimates of Capital Expenditure:** Table 1 below shows the amount of capital expenditure expected by the Council as at Quarter 2. This includes planned expenditure from previous years which is still to be spent.

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Table 1: Capital Programme	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Capital Expenditure	137.4	136.37	101.70
Financed by:			
Capital Grants	51.6	44.96	36.08
Capital Contributions	1.7	32.985	22.95
Capital Receipts	5.4	1.84	1
Revenue	9.8	6.3	12
Net Financing Requirement	68.9	50.28	29.67

2. **Capital Financing Requirement and Gross Debt**: The Capital Financing Requirement measures the Council's underlying need to borrow for a capital purpose. Gross external debt is expected to remain below the CFR during the forecast period.

Table 2: CFR and Gross Debt	2015/16 Actual £m	2016/17 Budget £m	2016/17 Q2 Estimate £m
Capital Financing Requirement for Borrowing	548.48	649.79	652.40
Capital Financing Requirement for PFI	101.62	98.71	63.18
Gross External Borrowing	322.05	429.99	379.21
PFI Debt Liability	101.62	98.71	63.18

3. **Operational Boundary and Authorised limit for External Debt**: The operational boundary is based on the Council's estimate of most likely (i.e. prudent, but not worst case scenario) for external debt. The authorised limit has been based on the Council's estimated CFR and represents the maximum the Council is permitted to borrow in compliance with the Local Government Act 2003.

Table 3: Operational Boundary and Authorised Limit	2015/16 Actual £m	2016/17 Budget £m	2016/17 Q2 Estimate £m
Operational Boundary for external borrowing	322	501	379
Operational Boundary for long term liabilities	102	99	63
Total Operational Boundary	**424**	**600**	**442**
Authorised limit for external borrowing	548	650	379
Authorised limit for long term liabilities	102	99	63
Total Authorised limit	**650**	**749**	**442**

The Operational Boundary and Authorised limits shown in the 2016/17 Budget column are those approved by the Council on 11 February 2016. The other columns show the actual debt for 2015/16 and revised forecast debt as at Quarter 2 for 2016/17.

4. **Ratio of Financing Costs to Net Revenue Stream**: This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Table 4: Ratio of financing costs to net Revenue Stream	2016-17 Budget	2016-17 Revised Estimate
	6.48%	5.04%

5. **Incremental Impact of Capital Investment Decisions**: This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from this.

Table 5: Incremental Impact of Capital Investment Decisions	2016-17 Budget	2016-17 Q2 Estimate
	£	£
Increase in annual Band D Council Tax	0.69	1.76

6. **Interest Rate Exposures**: The upper limits on fixed interest rate exposure represent the Operational Borrowing limit in each year and the upper limits on variable interest rate exposures is the difference between the CFR and the operational boundary. Fixed rate investments and borrowings are those where the rate of interest in fixed for the whole financial year. Instruments that mature during the year are classed as variable rate as the rate is likely to change when they are re-financed or invested. The actual/ forecast balance is the net of total borrowing and total investments for the year.

Table 6: Interest Rate Exposure	2015/16 Actual £m	2016/17 Q2 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Upper Limit on fixed interest rate exposure	450	600	600	600
Actual or Forecast	301	275		
Upper Limit on variable interest rate exposure	167	148	167	167
Actual or Forecast	-45	73		

7. **Maturity Structure of Borrowing**: The upper and lower limits on the maturity structure of fixed rate borrowing are forecast below for 2016/17:

Table 7: Maturity Structure	Lower	Upper	Call dates	Maturity dates
Under 12 months	0%	40%	43%	30%
Over 12 months and within 24 months	0%	40%	6%	0%
Over 24 months and within 5 years	0%	50%	19%	3%
Over 5 years and within 10 years	25%	70%	14%	14%
10 years and above		100%	18%	53%

For monitoring purposes, the Treasury team and its advisors have assessed the risk of early repayment of LOBO loans as minimal and treated these as long term borrowing: Over 10 years £200m (53%), giving fixed rate borrowing of £114.96m (30%) due in Under 12 months.