Annual Treasury Management Review 2016/17

Purpose

This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2016/17. 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).

During 2016/17 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 23/02/2016)
- a mid-year (minimum) treasury update report
- an annual review following the end of the year describing the activity compared to the strategy (this report)

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 treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit Committee before they were reported to the full Council.

Executive Summary

During 2016/17, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	2015/16 Actual £'000	2016/17 Budget / Estimate	2016/17 Actual £'000
Capital expenditure	4,030	4,926	2,803
Capital Financing Requirement	0	0	0
Gross borrowing	0	0	3,000
External debt	0	0	0

Prudential and treasury indicators	2015/16 Actual £'000	2016/17 Estimate £'000	2016/17 Actual £'000
Investments			
• Longer than 1 year	0	0	2,000
• Under 1 year	22,342	23,000	28,129
Total	**22,342**	**23,000**	**30,129**

Other prudential and treasury indicators are to be found in Appendix 1 of this report. The financial year 2016/17 proved to be challenging with continued low investment returns.

1. Introduction and background

This report summarises the following:

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed investment activity.

2. The Council's capital expenditure and financing 2016/17

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- Financed through borrowing

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

£m	2015/16 Actual £'000	2016/17 Budget £'000	2016/17 Actual £'000
Capital expenditure			
Expenditure in the year	4,030	4,926	2,803
Financed by:			
Capital Receipts	2,674	3,580	1,421
Capital grants and other contributions	894	676	966
Revenue	250	370	250
Earmarked Reserves	212	300	166
Total Financing	4,030	4,926	2,803
Unfinanced capital expenditure	**0**	**0**	**0**

3. The Council's overall borrowing need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2016/17 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements.

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

The council took no long term borrowing out during 2016/17. The Council borrowed £3 million at the end of the financial year for cash-flow purposes.

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2015/16) plus the estimates of any additional capital financing requirement for the current (2016/17) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to either borrow in advance of its immediate capital needs in 2016/17 or reduce its investments. The table below highlights the Council's gross borrowing position against the CFR.

	31 March 2016 Actual	31 March 2017 Budget	31 March 2017 Actual
Gross borrowing position	0	0	3,000,000
CFR	0	0	0

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2016/17 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Ratio of financing costs as a proportion of net revenue - 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 borrowing costs. As the Council is in a net investment position (investment income is greater than interest payable) the calculation results in a negative figure.

	2016/17
Authorised limit	£6.5m
Operational boundary	£4.5m
Borrowing – 1st April 2016	£0
Borrowing – 31st March 2017	£3m
Financing costs as a proportion of net revenue stream	-2.33%

4. Treasury Position as at 31 March 2017

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established through member reporting detailed in the summary. At the beginning and the end of 2016/17 the Council's treasury position was as follows:

	31 March 2016 Principal	Rate/Return	31 March 2017 Principal	Rate/Return
Total debt	£0	-	£3m	0.30%
CFR	£0		£0	
Over / (under) borrowing	£0		£0	
In house investments:	£22.334m	0.76%	£30.129m	0.60%

5. The Strategy for 2016/17

The expectation for interest rates within the treasury management strategy for 2016/17 anticipated low but rising Bank Rate, (starting in quarter 1 of 2017), and gradual rises in medium and longer term fixed borrowing rates during 2016/17. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

6. The Economy and Interest Rates

The two major landmark events that had a significant influence on financial markets in the 2016-17 financial year was the UK EU referendum on 23 June and the election of President Trump in the USA on 9 November. The first event had an immediate impact in terms of market expectations of when the first increase in Bank Rate would happen, pushing it back from quarter 3 2018 to quarter 4 2019. At its 4 August meeting, the Monetary Policy Committee (MPC) cut Bank Rate from 0.5% to 0.25% and the Bank of England's Inflation Report produced forecasts warning of a major shock to economic activity in the UK, which would cause economic growth to fall almost to zero in the second half of 2016. The MPC also warned that it would be considering cutting Bank Rate again towards the end of 2016 in order to support growth. In addition, it restarted quantitative easing with purchases of £60bn of gilts and £10bn of corporate bonds, and also introduced the Term Funding Scheme whereby potentially £100bn of cheap financing was made available to banks.

In the second half of 2016, the UK economy confounded the Bank's pessimistic forecasts of August. After a disappointing quarter 1 of only +0.2% GDP growth, the three subsequent quarters of 2016 came in at +0.6%, +0.5% and +0.7% to produce an annual growth for 2016 overall, compared to 2015, of no less than 1.8%, which was very nearly the fastest rate of growth of any of the G7 countries. Needless to say, this meant that the MPC did not cut Bank Rate again after August but, since then, inflation has risen rapidly due to the effects of the sharp devaluation of sterling after the referendum. By the end of March 2017, sterling was 17% down against the dollar but had not fallen as far against the euro. In February 2017, the latest CPI inflation figure had risen to 2.3%, above the MPC's inflation target of 2%. However, the MPC's view was that it would look through near term supply side driven inflation, (i.e. not raise Bank Rate), caused by sterling's devaluation, despite forecasting that inflation would reach nearly 3% during 2017 and 2018. This outlook, however, is dependent on domestically generated inflation, (i.e. wage inflation), continuing to remain subdued despite the fact that unemployment is at historically very low levels and is on a downward trend. Market expectations for the first increase in Bank Rate moved forward to quarter 3 2018 by the end of March 2017 in response to increasing concerns around inflation.

USA.

Quarterly growth in the US has been very volatile during 2016 but a strong performance since mid-2016, and strongly rising inflation, prompted the Fed into raising rates in December 2016 and March 2017. The US is the first major western country to start on a progressive upswing in rates. Overall growth in 2016 was 1.6%.

EU.

The EU is furthest away from an upswing in rates; the European Central Bank (ECB) has cut rates into negative territory, provided huge tranches of cheap financing and been doing major quantitative easing purchases of debt during 2016-17 in order to boost growth from consistently weak levels, and to get inflation up from near zero towards its target of 2%. These purchases have resulted in depressed bond yields in the EU, but, towards the end of 2016, yields rose, probably due at least in part to rising political concerns around the positive prospects for populist parties and impending general elections in 2017 in the Netherlands, France and Germany. The action taken by the ECB has resulted in economic growth improving significantly in the eurozone to an overall figure of 1.7% for 2016, with Germany achieving a rate of 1.9% as the fastest growing G7 country.

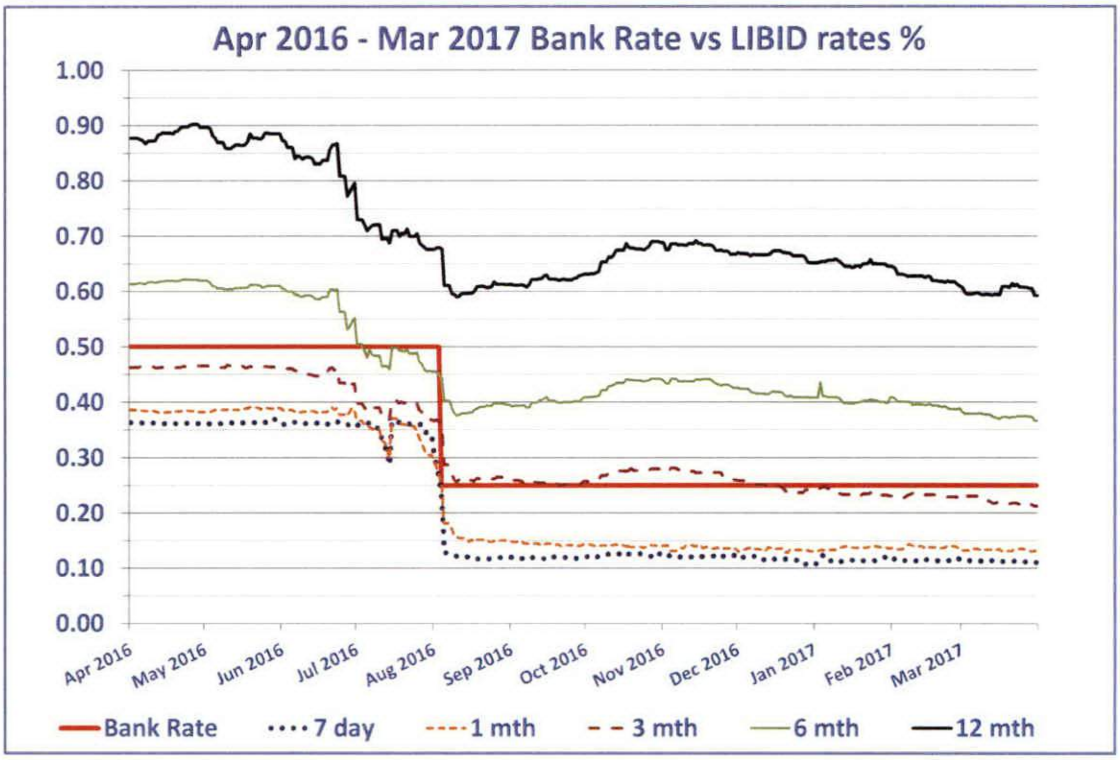
On the other hand, President Trump's election and promise of fiscal stimulus, which are likely to increase growth and inflationary pressures in the US, have resulted in Treasury yields rising sharply since his election. Gilt yields in the UK have been caught between these two influences and the result is that the gap in yield between US treasuries and UK gilts has widened sharply during 2016/17 due to market perceptions that the UK is still likely to be two years behind the US in starting on an upswing in rates despite a track record of four years of strong growth.

Japan struggled to stimulate consistent significant growth with GDP averaging only 1.0% in 2016 with current indications pointing to a similar figure for 2017. It is also struggling to get inflation up to its target of 2%, only achieving an average of -0.1% in 2016, despite huge monetary and fiscal stimulus, though this is currently expected to increase to around 1% in 2017. It is also making little progress on fundamental reform of the economy.

China and emerging market counties. At the start of 2016, there were considerable fears that China's economic growth could be heading towards a hard landing, which could then destabilise some emerging market countries particularly exposed to a Chinese economic slowdown and / or to the effects of a major reduction in revenue from low oil prices. These fears have largely subsided and oil prices have partially recovered so, overall, world growth prospects have improved during the year.

Equity markets. The result of the referendum, and the consequent devaluation of sterling, boosted the shares of many FTSE 100 companies which had major earnings which were not denominated in sterling. The overall trend since then has been steeply upwards and received further momentum after Donald Trump was elected President as he had promised a major fiscal stimulus to boost the US economy and growth rate.

7. Investment rates in 2016/17



After the EU referendum, Bank Rate was cut from 0.5% to 0.25% on 4 August and remained at that level for the rest of the year. Market expectations as to the timing of the start of monetary tightening started the year at quarter 3 2018, but then moved back to around the end of 2019 in early August before finishing the year back at quarter 3 2018. Deposit rates continued into the start of 2016/17 at previous depressed levels but then fell during the first two quarters and fell even further after the 4 August MPC meeting resulted in a large tranche of cheap financing being made available to the banking sector by the Bank of England. Rates made a weak recovery towards the end of 2016 but then fell to fresh lows in March 2017.

8. Investment Outturn for 2016/17

Investment Policy – the Council's investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council on 23rd February 2016. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, borrowing £3m toward the end of the financial year for cash flow purposes.

The Council maintained an average balance of £29.3m of internally managed funds during the financial year. The internally managed funds earned an average rate of return of 0.60%. The comparable performance indicator is the average 3 month LIBID rate, which was 0.32%. This compares with a budget assumption of £29m investment balances earning an average rate of 0.70%.

The Council's budget assumed £209,700 investment interest for the year. Actual returns totalled £205,393.

Type of Investments	Balance on 01/04/2016 £	Average Weighed Balance Held in 2016/17 £	Interest Earned in 2016/17 £	% Rate Achieved in 2016/17 %	Balance on 31/03/2017 £
Fixed Term Deposits	17,985,000	22,254,233	141,698	0.69	25,743,000
Call Accounts & MMF's	3,860,525	6,557,262	41,353	0.38	3,890,000
CCLA	488,446	500,000	22,342	4.47	496,205
Total Investments	**22,333,971**	**29,311,495**	**205,393**	**0.60**	**30,129,205**

Appendix 1 – Treasury and Prudential Indicators

Prudential Indicator	2015/16 Actual £'000	2016/17 Budget £'000	2016/17 Actual £'000
Capital Expenditure	4,030	4,926	2,803
Ratio of financing costs to net revenue stream	-3.11%	-2.55%	-2.33%
Capital financing requirement	0	0	0
Incremental impact of capital investment decisions – increase in Council Tax (band D) per annum [based upon investment interest foregone]	£0.34	£0.66	£0.18

<table>
<tr><th>Treasury Management Indicators</th><th>2015/16</th><th>2016/17</th><th>2016/17 Actual debt*</th></tr>
<tr><td>Authorised limit for external debt</td><td>6,500k</td><td>6,500k</td><td rowspan="2">3,000k</td></tr>
<tr><td>Operational boundary for external debt</td><td>4,500k</td><td>4,500k</td></tr>
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* = short-term borrowing as at 31st March 2017