North Somerset Council

REPORT TO AUDIT COMMITTEE

DATE OF MEETING: 7 SEPTEMBER 2016

SUBJECT OF REPORT: TREASURY MANAGEMENT OUT-TURN 2015/16

TOWN OR PARISH: ALL

OFFICER/MEMBER PRESENTING: MALCOLM COE, HEAD OF FINANCE & PROPERTY

KEY DECISION: NO

RECOMMENDATIONS

The Audit Committee is asked to;

- note the council's performance in carrying out its treasury management activities in 2015/16 and to refer this report to the Executive for further consideration

1. SUMMARY OF REPORT

This report informs the Audit Committee of the council's;

- treasury management activities during 2015/16, and confirms that the transactions during the year complied with the approved Treasury Management Policy, *in accordance with the requirement of the council's Accountability and Responsibility Framework* .
- prudential indicators for 2015/16, *as required by CIPFA's Prudential Code for Capital Finance in Local Authorities*.

2. POLICY

Treasury activities during 2015/16 were carried out in accordance with the Treasury Management Policy approved by Council in February 2015.

3. DETAILS

External Investments - Background

Members will be aware that the council has an in-house treasury team who manage the overall cash-flow activities for both investments and borrowing transactions on a daily basis, and in addition also utilise the services of an external fund manager, Tradition UK, who manage a small proportion of the council's investment balances on our behalf.

Both of these teams operate within the boundaries of the council's approved Investment Strategy which aims to be flexible and offer the ability to operate a mixed portfolio, with funds divided between in-house and external fund manager and a range of investment products. This flexibility allows the council to take advantage of a range of investment opportunities and market conditions that may occur throughout the year, as well as enabling the council to diversify both credit and counter-party risk by allowing the council to invest in higher-rated institutions via our fund manager.

Clearly the primary objective of the council's Investment Strategy is to maintain the security of all cash balances by ensuring that all investments placed are within secure products and only offered to counter-parties who meet strict risk criteria.

At an operational level, the in-house treasury team manage the majority of the overall cash-flows, which at times can be volatile and fluctuate significantly during the months and year. These fluctuations bring constraints when reviewing potential investment opportunities, which therefore impact upon the potential level of investment returns achievable. The external fund managers have no cash-flow or timing constraints, they have the primary objective of maximising the return on the investments managed within the various risk parameters of the council's Investment Strategy and returns would be expected to be higher.

During 2015/16 the majority of the council's investments were made utilising fixed-term cash deposits with a range of banks and building societies in both the UK and overseas as well as to other local authorities. These types of deposit do offer the protection of the principal sums invested which means that by using these investments the council is significantly reducing the risk of capital losses, however they can sometimes limit the level of interest return available.

Subtle amendments have been made to the operational activities within the last quarter of 2015/16 following the Section 151 Officers request to adopt the recommendations of Arlingclose, the council's treasury advisors. The most significant of which relates to the counter-parties the council will choose to place its fixed term cash deposits with. The purpose of this change is to reduce counterparty exposure to those institutions who may be susceptible to the financial risks surrounding the recently introduced EU Bail In regulations. In practice this means that less money will be invested within UK and European banks and building societies, and more will be invested in overseas banks and other local authorities.

Other changes relate to the amount of time that investments will now be placed with specific counter-parties as Arlingclose recommend much shorter durations with certain institutions.

The changes were in response to benchmarking exercise carried out which showed that in comparison to other Arlingclose clients, the council held more exposure to risk in some of these areas than other clients. The Section 151 officer has reviewed the guidance of Arlingclose and would like the council to be more in line with the other local authority profiles.

Members should be assured that these changes in operational practice have not meant any deviation from the council's approved Investment Strategy, all transactions still conform to the approvals granted within the Strategy. Whilst marginally improving the overall risk levels faced by the council, it should be noted that these changes will impact on the returns the council is able to generate on its cash deposit investments in the medium and longer-term. Reductions in both counter-parties and duration will reduce both the returns and the flexibilities available to the council – it is widely known that UK and European banks and building societies and longer-term investments all bring higher yields than the options now selected.

It should be noted that these changes will not apply to the investment placed with the unrated CCLA property fund, as Arlingclose support this product. Further information is provided on this below.

External Investment Balances

At the year-end the council's external investments totalled £88.5m, which is a minor increase on the £82m recorded at the end of the previous year. This sum includes monies managed by the council's in-house team during the year as well those sums managed by the council's external fund manager. A review has indicated that the increase is largely due to additional business rates and council tax receipts in 2015/16.

Analysis of Investments (principal sums placed)			
	NSC Cash Deposits £m	Tradition UK Ltd £m	**TOTAL £m**
Investments maturing in less than 1 year	53.5	28.00	**81.50**
Investments maturing after 1 year	5.0	2.00	**7.00**
Investment Balance – 31 March 2016	**58.50**	**30.00**	**88.50**
Investments maturing in less than 1 year	35.00	21.00	**56.00**
Investments maturing after 1 year	17.00	9.00	**26.00**
Investment Balance - 31 March 2015	**52.00**	**30.00**	**82.00**

The table below shows further analysis of the investments held at 31 March 2016, compared to the same period last year.

	31/3/2016 £m	31/3/2015 £m	Movement £m
UK Banks	**23.00**	24.00	-1.00
Overseas Banks	**6.00**	0.00	+6.00
UK Building Societies	**43.00**	48.00	-5.00
Local Authorities	**8.00**	5.00	+3.00
Debt Management Office	**3.50**	5.00	-1.50
CCLA (*)	**5.00**	0.00	+5.00
TOTAL INVESTMENTS 31 March	**88.50**	**82.00**	**+6.50**

(*) It should be noted that although an initial investment of £5m was placed in the CCLA property fund, this investment product does not offer the same protection of principal sums as fixed term cash deposits as it relates to the purchase of share capital, meaning that its value will increase or decrease depending upon its quoted share price.

A valuation was carried out at the end of the financial year based upon the traded share prices at that time and this showed that the council's investment balance had reduced to £4.749m, which is a reduction of 0.251m compared to its purchase price.

If the investment had been sold at this date, then a loss of £0.251m would have been realised which would have been charged to the council's revenue budget and funded by tax-payers. However accounting regulations mean that this this loss will held within an earmarked reserve until such time as the investment is sold. The council's treasury advisors support this investment and recommend that Members view it as a long-term investment which will appreciate in value over time, subject of course, to appropriate market and trading conditions.

Members should note that this investment does offer higher returns compared to fixed term cash deposits, although this does reflect the higher nature of the risk undertaken.

Investment Performance in 2015/16

The table below shows the average rates of return achieved during 2015/16 on investments placed by both of the treasury teams.

	In-house				Tradition			
	Ave Return (%)	Return (£m)	Ave Duration (days)	Ave Loans (No.)	Ave Return (%)	Return (£)	Ave Duration (days)	Ave Loans (No.)
Qtr 1 – b/fwd & to Jun 15	0.94%	593	193	44	1.02%	0.33	368	16
Qtr 2 – to Sept 15	0.59%	64	84	17	0.83%	0.05	253	6
Qtr 3 – to Dec 15	0.69%	61	130	19	0.00%	0.00	0	0
Qtr 4 – to Mar 16	0.42%	14	28	14	1.05%	0.00	364	2
Annual Averages	**0.91%**	**732**	**115**	**94**	**1.28%**	**0.38**	**324**	**24**
Benchmark	0.32%				0.32%			

It can clearly be seen that both categories of investments exceeded the annual benchmark comparisons for the year, although it should be noted that the official benchmark, which is largely driven by the bank base rate, continued to remain at an all-time low throughout the year and so does make a simple comparison to the defined benchmark less relevant.

The table shows that the council's in-house team achieved a lower average rate of return during the year from its investments placed than that of the external fund manager, however the table also shows that the 'duration' of investments placed by each team differs significantly, and it is this factor which impacts on the interest rate achieved with the yield curve offering higher rates of return for longer investment periods.

As noted above, the primary function of the council's treasury team is to mange cash-flows which means that although cash balances can be high at the start of any given week, they may easily be required in the next week, meaning that the council can only invest them for a limited duration, often at very low rates. The majority of the council's returns are generated at the start of the financial year when durations of term deposits are maximised to coincide with the council's cash flow profile and where yields are higher.

Investment Interest Budgets 2015/16

The table below shows that the council achieved £1.211m in interest during the year, which is £0.250m more than budgeted. The increase in investment balances during the year helped generate additional returns in comparison with the previous year. With returns on internally managed investments increasing to £0.732m from £0.640m in 2014/15.

	In-House – Cash Deposits £000	In-House – MM Funds £000	Tradition UK Ltd £000	CCLA Prop Fund £000	**TOTAL £000**
Actual Interest Generated	732	17	386	79	**1,214**

Investment Interest Budget	509	20	435	**0**	**964**
Variance to Budget	+223	-3	-49	**+79**	**250**

As mentioned above, the external fund manager does not have any of the daily constraints of managing the council's financial activities and was therefore more able to respond to investment opportunities within the market-place or lock funds away for longer durations, thereby enabling the council to maximise higher returns during this period. The recent changes will impact on these returns going forward.

The council also utilises the CCLA property fund to generate higher returns on a smaller proportion of the council's balances. However, there are currently no plan to increase the size of this investment due to the economic uncertainty in the market place, as Members will have seen, share prices have fallen sharply in some areas over recent months and the council is unable to sustain significant capital investment losses.

Members should note that forecasts of returns for the 2016/17 financial are currently being calculated as well as scenario planning of possible outcomes from potential interest rate cuts going forward as the first quarter of the year has seen much change within the financial markets.

Long-term Borrowing 2015/16

During the year the council repaid the following loans which had reached their maturity dates. No new loans were taken out during the year.

Long-term Borrowing repaid during 2015/16				
	Ref	Principal £m	Interest Rate %	Maturity Date
Loan repaid at maturity	PWLB 18	5.0m	4.75%	31/3/2016
Loan repaid at maturity	PWLB 39	0.27m	3.69%	31/3/2016

As can be seen from the table below, the council's long-term debt totals £118.96m and is profiled for repayment between March 2017 and March 2052 with no more than £7.3m repayable in any one year. This is in accordance with the council's current borrowing policy and is structured in a way to reduce exposure to significant cash-flow movements and adverse interest rates at the time each loan matures.

Repayment periods	PWLB £m	Ave Rate %
Less that 1 year	3.40	3.81%
Between 1 and 2 years	5.00	5.38%
Between 2 and 5 years	1.10	4.59%
Between 5 and 10 years	13.34	5.02%
Over 10 years	96.12	4.23%

Prudential Indicators

A key element of control under the Local Government Act 2003 capital financing system is that exercised by the statutory CIPFA Prudential Code. Under this system individual authorities are responsible for deciding the level of their affordable borrowing as opposed to the previous system of credit approvals issued by the Government.

Under the Code councils are required to establish certain key Prudential Indicators for both Treasury Management and Capital Financing activities. The actual level of these indicators for 2015/16 are shown in Appendix 1.

As can be seen from this Appendix the actual indicators for the year were within the budgeted levels approved by Council in February 2015, as part of the MTFP process.

Minimum Revenue Provision (MRP) 2015/16

When the council funds capital expenditure by long-term borrowing, the costs are charged to the council tax payer in future years, reflecting the long-term use of the assets. There are two elements to this cost;

- the interest on actual borrowing undertaken is charged in the year it is payable, and
- the principal (or capital) repayment element is charged as a “minimum revenue provision” (MRP).

Statutory regulations prescribe the minimum levels which must be charged to the councils revenue budget each year, however in addition to this ‘minimum’ payment, the council is also required to make additional voluntary repayments of capital for new loans entered into using the prudential borrowing powers, first having demonstrated that such borrowing is prudent, affordable and sustainable.

The council is required to approve an annual statement which details its policy for determining the level of capital repayments to be charged to its revenue accounts. The statement below covers the 2015/16 charges within the revenue accounts, in accordance with these requirements.

The MRP charge for 2015/16 of £4.576m was calculated using the methodology prescribed by the regulations in force during this time, which spreads the repayment of capital evenly, with a minimum being over a 25 year period.

In addition, the council made a Voluntary Provision of £3.384m, based upon the useful economic lives of assets financed by unsupported borrowing prior to 2014/15, thereby following the prudent approach included within the guidance which is intended to match the borrowing liability to the benefits of the capital assets acquired using this source of finance, rather than over the minimum period of 25 years.

	Useful Life	Capital Spend £m	MRP Charge 2014/15 £m	MRP Charge 2015/16 £m
Statutory	25	n/a	4.777	4.576
Office Amalgamation	25	12.600	0.504	0.504
Waste Containers	7	2.615	0.373	0.373
Town Hall Redevelopment	25	4.400	0.176	0.176
Learning Disability Accommodation	0	0.000	0.263	0.000
NS Enterprise & Tech College	1	0.392	0.000	0.392
Leisure & Cultural Facilities	1	0.524	0.000	0.524

Schools – Milton, St Andrews, Trinity & Yeo Moor, Winford, Bourneville	25	6.921	0.277	0.277
Vehicles	3-5		0.106	0.142
Other – prior years	Various		0.580	0.996
Total Voluntary Provision			**2.279**	**3.384**

Review of the Treasury Management Strategy

As mentioned above, the council introduced operational changes within the final quarter of 2015/16 regarding the interpretation of the Investment Strategy with a view to reducing its use of banks and building societies which may have had exposure to the risk of EU Bail In requirements. Although this strengthened the risk levels of the council's counter-party listing, it did have the effect of reducing investment returns.

It is proposed that the council continue with this course of action within the current financial year in order to further improve the credit quality of the investment portfolio. This means that more investments will be diversified into overseas 'AA' rated banks instead of fully using UK banks and building societies. It is estimated that this operational change will reduce returns by £0.100m in the current financial year.

These actions were prior to the BREXIT result which Members will be aware, has had a significant impact on both the financial markets as well as the overall economic outlook.

Since the current treasury strategy was approved in February 2016, credit (or counter-party) risk and interest rate risk for the council has increased following the uncertainty created in the markets from voting to leave the European Union. With Sterling falling to a 31 year low against the Dollar and the Euro, the suspension of property funds and volatile share prices all pointing towards a slowing down of the UK economy. This in turn has resulted in a downgrading of the UK's sovereign credit rating to AA and all UK financial institutions being placed on a negative outlook.

The forecast slowing of the economy will more than likely to lead to intervention from the Bank of England with a reduction in interest rates of 0.25% having already been taken and further reductions considered highly likely. Although at this stage it is unclear whether this will be a full 0.25% or just a 0.15% reduction or whether it will just take the form of quantitate easing. Whatever action is taken the yield of the council's investment returns will be adversely affected. The rates being quoted on fixed term deposits since the referendum are already 30% lower and are forecast to fall further.

It is estimated that the risk of interest rate reductions could have an estimated impact in excess of £0.070m to the council's revenue budget in 2016/17, falling to £0.500m in 2017/18 when current longer-term loans on favourable rates mature. This forecast is dependent upon many factors, including items such as; the severity of interest rate cuts; the performance of the CCLA property fund; the levels of cash balances held; the amount of capital expenditure financed from borrowing.

To help reduce the councils exposure to risk and in particular the risk associated with the EU Bail-in and the BREXIT amendments to the councils investments strategy will be proposed in a separate report to the Executive.

4. CONSULTATION

None

5. FINANCIAL IMPLICATIONS

Financial implications are contained throughout the report.

It should be noted that both the investment and borrowing values shown throughout the report reflect the principal sums of the investments held by the council at the end of the financial year, however accounting legislation requires the council to reflect either the fair and amortised cost valuations within its Statement of Accounts, which means that the figures will be presented differently there.

6. RISK MANAGEMENT

The council does face significant types and degrees of risk in this area, from both internal and external sources. However the council has implemented, and adheres to, strict policies and internal controls in order to mitigate such risks.

The council's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds before seeking the best rate of return. The majority of its surplus cash is therefore held as short-term investments, and utilises the UK Government and highly rated banks and pooled funds where appropriate.

The council's primary objective for the management of its debt is to ensure its long-term affordability. The majority of its loans have therefore been borrowed from the Public Works Loan Board at long-term fixed rates of interest.

However, the combination of short duration investments and long duration debt can expose the council to the risk of falling investment income during periods of low interest rates. This risk is partially mitigated by the inclusion of some longer-term investments and the option to prematurely repay some long-term loans.

The council measures its exposure to credit risk by monitoring the individual credit ratings of each investor within its portfolio on at least a monthly basis.

7. EQUALITY IMPLICATIONS

None

8. CORPORATE IMPLICATIONS

None

9. OPTIONS CONSIDERED

N/a

AUTHOR

James Bidwell, Project Accountant (Treasury), 01275 884142
Melanie Watts, Corporate Accountancy Manager, 01934 634618

BACKGROUND PAPERS

Cash Manager reports from Tradition UK

PRUDENTIAL INDICATORS

1.1 Introduction

The CIPFA Prudential Code for Capital Finance in Local Authorities sets out the factors, or indicators that must be considered by each local authority when making decisions about capital investment and associated borrowing.

1.2 Treasury Management Prudential Indicators

The following Treasury Management prudential indicators were set for 2015/16 as part of the MTFP process. The estimates are shown below together with the actual indicators for 2015/16.

1.2.1 In respect of its external debt, the council approved the following authorised limit for its total external debt gross of investments for 2015/16. This limit separately identifies borrowing from other long-term liabilities such as finance leases or lease premium incentives. The actual level of external debt is shown, and is well within the limits set at the start of the year.

Authorised Limit for External Debt	**2015/16 Limit £m**	**2015/16 Actual £m**
Borrowing – NSC	190.00	118.96
Other Long Term Liabilities (avon debt, leases, temporary borrowing etc)	51.00	23.10
Authority Total	**241.00**	**142.06**

1.2.2 The council also approved the following operational boundary for external debt for the same period. The operational boundary for external debt was based on the same estimates as the authorised limit, but reflected estimates of the most likely, prudent, but not worst case scenario, without the additional headroom included within the authorised limit to allow for unusual cash movements. As can be seen below, the actual level of external debt is well within the operational boundary set at the start of the year.

Operational Limit for External Debt	**2015/16 Limit £m**	**2015/16 Actual £m**
Borrowing – NSC	200.00	118.96
Other Long Term Liabilities (avon debt, leases, temporary borrowing etc)	55.00	23.10
Authority Total	**255.00**	**142.06**

1.2.3 North Somerset Council has adopted CIPFA's Code of Practice for Treasury Management in the Public Services. In accordance with this Code the council set an upper limit on its variable interest rate exposures for 2015/16 debt. The upper limit was set at 20% of its net outstanding principal sums. The actual percentage of variable interest rate exposure was 0% for 2015/16 as the council does not have any long-term debt secured using variable rates.

The upper limit set for 2015/16 fixed interest rate exposures was £223m and the actual value of long-term debt at the year-end was £142.060m.

The council also set upper and lower limits for the maturity structure of its borrowings for 2015/16. These limits are shown below, together with the actual percentage of borrowing that is maturing in each period.

Maturity Structure of Borrowing	Upper Limit	Lower Limit	Actual 2015/16
Under 12 months	20%	0%	2.9%
12 months and within 24 months	30%	0%	4.2%
24 months and within 5 years	40%	0%	0.9%
5 years and within 10 years	50%	0%	11.2%
10 years and above	100%	10%	80.8%

1.2.4 The purpose of the prudential indicator in respect of investments is to contain the exposure to a loss in the event that early redemption of an investment is required. The council is required to set a maximum amount to be invested beyond the end of the financial year for the forthcoming financial year and the following two years.

	2015/16 Limit	2015/16 Actual
Upper Limit of Principal sums invested beyond the year	£85m	£7m

1.3 Other Prudential Indicators

The first indicator details the Capital Expenditure incurred by the council and charged to the capital programme. The actual spend for 2015/16 is shown below, alongside the revised estimated spend for 2015/16. The lower actual figure is due to slippage of the capital programme.

Capital Expenditure	2015/16 Revised £000	2015/16 Actual £000
Total Spend	55,155	50,222

1.3.2 The ratio of financing costs to net revenue stream for 2015/16 is shown below. Reduced levels of capital expenditure and external borrowing undertaken during the year, have resulted in a ratio lower to that estimated.

Ratio of Financing Costs to Net Revenue Stream	2015/16 Estimate %	2015/16 Actual %
Ratio	10.36	9.03

1.3.3 The actual capital financing requirement for the authority at 31st March 2016, together with the estimated requirement is shown below;

Capital Financing Requirement	2015/16 Estimate £000	2015/16 Actual £000
CFR Total	114,410	131,563

1.3.4 The capital financing requirement measures the authority's underlying need to borrow for a capital purpose. In accordance with best professional practice, North Somerset Council does not associate borrowing with particular items or types of expenditure. The council has, at any point in time, a number of cash-flows, both positive and negative, and manages its treasury position in terms of its borrowings and investments in accordance with its approved treasury management strategy and practices. In day-to-day cash management, no distinction can be made between revenue cash and capital cash. External borrowing arises as a consequence of all the financial transactions of the authority and not simply those arising from capital spending. In contrast, the capital financing requirement reflects the authority's underlying need to borrow for a capital purpose.

1.3.5 CIPFA's *Prudential Code for Capital Finance in Local Authorities* includes the following as a key indicator of prudence:

> "In order to ensure that over a medium term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any two additional capital financing requirement for the current and next two financial years."

The Head of Finance & Property as the council's S151 Officer, reports that the authority has met this requirement in 2015/16.