North Somerset Council

REPORT TO THE AUDIT COMMITTEE

DATE OF MEETING: 6TH OF SEPTEMBER 2017

SUBJECT OF REPORT: TREASURY MANAGEMENT OUT-TURN 2016/17

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 2016/17

1. SUMMARY OF REPORT

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

- treasury management activities during 2016/17, 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 2016/17, *as required by CIPFA's Prudential Code for Capital Finance in Local Authorities*.

2. POLICY

Treasury activities during 2016/17 were carried out in accordance with the Treasury Management Policy approved by Council in February 2016.

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.

Arlinglose have been appointed as the council's treasury management advisors. Advice is provided on the credit quality of counterparties as well as recommended investment durations and maximum exposures. Following benchmarking during the year a decision was taken to reduce both durations of investments and available counterparties in line with Arlingclose advice.

This has the clear benefits of increasing the credit worthiness of the portfolio and reducing risk. Although this will reduce returns as a result of falling rates and duration periods.

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 2016/17 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 limit the level of interest return available in a low interest rate environment.

The remaining 6% of the council's investment portfolio was held in the CCLA property fund. Which provides diversity within the portfolio and an opportunity to increase returns in a managed way.

External Investment Balances

At the year-end the council's external investments totalled £80.5m, which is a minor reduction on the £88.5m 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 this reduction is the result of revenue overspends and under borrowing when compared to the capital financing requirement.

Analysis of Investments (principal sums placed)			
	NSC Cash Deposits £m	Tradition UK Ltd £m	**TOTAL £m**
Investments maturing in less than 1 year	55.5	20.0	**75.5**
Investments maturing after 1 year	5.0	0.0	**5.0**
Investment Balance – 31 March 2017	**60.5**	**20.0**	**80.5**
Investments maturing in less than 1 year	53.5	28.0	**81.5**
Investments maturing after 1 year	5.0	2.0	**7.0**
Investment Balance - 31 March 2016	**58.5**	**30.0**	**88.5**

The table below shows further analysis of the principal sums of investments held at 31 March 2017, compared to the same period last year.

	31/3/2017 £m	**31/3/2016 £m**	Movement £m
UK Banks	**23.0**	**23.0**	0.0
Overseas Banks	**27.5**	**6.0**	21.5
UK Building Societies	**15.0**	**43.0**	-28.0
Local Authorities	**10.0**	**8.0**	2.0
Debt Management Office	**0.0**	**3.5**	-3.5
CCLA (*)	**5.0**	**5.0**	0.0
TOTAL INVESTMENTS 31 March	**80.5**	**88.5**	**-8.0**

(*) 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 £4.602m, which is a reduction of 0.398m compared to its purchase price. The reduction is largely a result of the spread between the bid and offer price or the difference between the purchase and sale price, and incorporates the results of the revaluation of the fund in June 2106 following the results of the EU referendum.

If the investment had been sold at this date, then a loss of £0.398m 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.

<u>Investment Performance in 2016/17</u>

The table below shows the average rates of return achieved during 2016/17 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 (£m)	Ave Duration (days)	Ave Loans (No.)
Qtr 1 – b/fwd & to Jun 15	0.66%	0.62	174	39	0.88%	0.26	202	14
Qtr 2 – to Sept 15	0.06%	0.04	12	18	0.06%	0.02	19	8
Qtr 3 – to Dec 15	0.14%	0.09	39	17	0.07%	0.02	22	5
Qtr 4 – to Mar 16	0.00%	0.00	0.05	4	0.04%		0.2	3
Annual Average for Fixed Term deposits	**0.86%**	**0.75**	**225**	**78**	**1.02%**	**0.30**	**245**	**30**
Benchmark	0.32%				0.32%			
CCLA pooled fund	**4.86%**	**0.24**	**365**	**NA**	**NA**	**NA**	**NA**	**NA**

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. The CCLA offers a significantly higher return than traditional cash deposits

<u>Investment Interest Budgets 2016/17</u>

The table below shows that the council achieved £1.082m in interest during the year, which is £0.069m more than budgeted. However this is £0.132m lower than the level achieved in 2015/16. The reduction in in investment balances during the year as well as the drop in the base rate from 0.50% to 0.25% resulted in reduced returns in comparison with the previous year. With returns on internally managed investments falling from £0.732m to £0.518m and Traditions investments dropping from £0.386m to £0.304m.

The majority of the investments placed in 2016/17 were made prior to the drop in interest rates and at a rate of return double that currently being quoted on todays market. That coupled with reduced durations through strict adherence to Arlinsclose's advice will have a greater impact in 2017/18 as the full year effect of these changes begin to impact upon returns.

	In-House – Cash Deposits £000	In-House – MM Funds £000	Tradition UK Ltd £000	CCLA Prop Fund £000	**TOTAL £000**
Actual Interest Generated	518	16	304	244	**1082**
Investment Interest Budget	480	16	405	250	**1151**
Variance to Budget	38	0	-101	-6	**-69**

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 as the council reduces durations with a view to reducing the balance over the longer term.

The council also utilises the CCLA property fund to generate higher returns on a smaller proportion of the council's balances. Within the next financial year additional investments will be made into pooled funds of a different asset class to provide additional diversification and protection against EU bail-in risk whilst generating greater returns. This will be achieved by reducing the balance held with Tradition from £30m to £20m.

Long-term Borrowing 2016/17

During the year the council repaid the following loans which had reached their maturity dates and took out additional loans totalling £7.76m to fund vehicle purchases under the new waste contract.

Long-term Borrowing repaid during 2016/17				
	Ref	Principal £m	Interest Rate %	Maturity Date
Loan repaid at maturity	PWLB 35	3.4	3.81	31/03/2017

Long-term Borrowing arranged during 2016/17				
	Ref	Principal £m	Interest Rate %	Maturity Date
Waste Vehicles	PWLB 53 PWLB 54	5.0 2.76	1.81 2.12	31/03/2023 31/03/2025

As can be seen from the table below, the council's long-term PWLB debt totals £123.322m and is profiled for repayment between April 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	5.0	5.38
Between 1 and 2 years	0.1	2.11
Between 2 and 5 years	5.34	5.08
Between 5 and 10 years	19.00	4.91
Over 10 years	93.88	3.96

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 2016/17 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 2016, as part of the MTFP process.

Minimum Revenue Provision (MRP) 2016/17

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 2016/17 charges within the revenue accounts, in accordance with these requirements.

The MRP charge for 2016/17 of £4.455m was calculated using a new methodology, which spreads the repayment of capital evenly, using an average asset life of 33 years. However the budget was based on the old methodology from the previous year prescribed in legislation and therefore generated an underspend of circa £1m.

In addition, the council made a Voluntary Provision of £3.489m, based upon the useful economic lives of assets financed by unsupported borrowing prior to 2015/16, 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 average asset life used under the statutory provision.

	Useful Life	Capital Spend £m	MRP Charge 2015/16 £m	MRP Charge 2016/17 £m
Statutory	33		4.576	4.455
Office Amalgamation	25	12.6	0.504	0.504
Waste Containers	7	2.6	0.373	0.373
Town Hall Redevelopment	25	4.4	0.176	0.176
NS Enterprise & Tech College	1	0.9	0.392	0.947
Leisure & Cultural Facilities	1	0.2	0.524	0.169
Schools – Milton, St Andrews, Trinity & Yeo Moor, Winford, Bourneville	25	6.9	0.277	0.277
Vehicles	3-5		0.142	0.152
Other – prior years	Various		0.996	0.891
Total Voluntary Provision			**3.384**	**3.489**

Review of the Treasury Management Strategy

Economic background

Interest rates fell from 0.50% in August last year to an all-time low of 0.25%. Whilst in this period of low interest rates inflation has been rising and as at the end of the councils financial year CPI was at 2.9%, its highest since 2013. Although fuel prices fell during this period, the fall in the value of the pound resulted in higher import prices and lead to an overall increase to inflation. GDP also fell and showed economic activity to be growing at a much slower pace as at year end. Overseas interest in property through the weaker pound has boosted the recovery in the property sector and helped bolster returns in this area.

Portfolio Performance

2016/17 was the first full year of investment in the CCLA property fund. The fund generated returns of 4.86% or £0.243m, accounting for a quarter of total returns from the council's investment portfolio.

Returns from traditional fixed term deposits both internally and externally were largely comparable to the budget, although lower than the previous year, with NSC managed investments achieving £0.038m more than the £0.480m budget and externally managed funds generating £0.101m less than the £0.405m budget.

These fixed term deposits are becoming increasingly challenging to generate returns in line with budgeted expectations due the current economic conditions. The average rate of return achieved in 2016/17 of 0.86% is unlikely to be repeated in 2017/18 with 12 month deposits currently being quoted at 0.40% and 6 month deposits being quoted at around 0.30%.

Additional pressure has been created through reductions in the recommended durations from Arlingclose for the majority of counterparties to 6 month periods. This follows the downgrading of Canadian banks in May 2017 and uncertainties surrounding the requirement to separate retail banking from investment banking in the UK. This leaves only Singapore and one bank in the Netherlands where deposits can be placed for 12 months durations.

Current forecasts for interest rates do not anticipate any increase to the Bank of England's base rate until late 2018. As mentioned above the council is looking at offsetting reduced returns as a result of this by diversifying its investments into areas such as multi-asset funds and will look at other options available.

Borrowing

Additional borrowing was undertaken at the end of 2016/17 to fund the purchase of new waste vehicles undertaken at rates well below the debt portfolios 4.2% average whilst £3.4m matured in year resulting in a net increase to borrowing of £4.36m.

The council's long term debt will increase in 2017/18 with £12.097m approved in the capital programme through unsupported borrowing and also the approval of a £50m commercial investment fund.

Although measures have been taken to mitigate against fluctuating interest rates in 2017/18, with £5m being placed in a multi asset fund and £6m being invested in a hotel construction, a review of the 2017/18 investment strategy is currently being undertaken with a view to addressing the falling returns and the additional borrowing requirement.

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 2016/17 as part of the MTFP process. The estimates are shown below together with the actual indicators for 2016/17.

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 2016/17. 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	**2016/17 Limit £m**	**2016/17 Actual £m**
Borrowing – NSC Other Long Term Liabilities (avon debt, leases, temporary borrowing etc)	218 55	123.3 33.5
Authority Total	**273**	**156.9**

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	**2016/17 Limit £m**	**2016/17 Actual £m**
Borrowing – NSC Other Long Term Liabilities (avon debt, leases, temporary borrowing etc)	207 51	123.3 33.5
Authority Total	**258**	**156.9**

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 2016/17 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 2016/17 as the council does not have any long-term debt secured using variable rates.

The upper limit set for 2016/17 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 2016/17. 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 2016/17
Under 12 months	20%	0%	14%
12 months and within 24 months	30%	0%	0%
24 months and within 5 years	40%	0%	4%
5 years and within 10 years	50%	0%	14%
10 years and above	100%	10%	67%

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.

	2016/17 Limit	2016/17 Actual
Upper Limit of Principal sums invested beyond the year	£85m	£5m

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 2016/17 is shown below, alongside the revised estimated spend for 2016/17. The lower actual figure is due to slippage of the capital programme.

Capital Expenditure	2016/17 Revised £000	2016/17 Actual £000
Total Spend	60,287	54,244

1.3.2 The ratio of financing costs to net revenue stream for 2016/17 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	2016/17 Estimate %	2016/17 Actual %
Ratio	10.36	8.32

1.3.3 The actual capital financing requirement for the authority at 31st March 2017, together with the estimated requirement is shown below;

Capital Financing Requirement	2016/17 Estimate £000	2016/17 Actual £000
CFR Total	111,373	134,779

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 2016/17.