Treasury Management Annual Report 2016/17 and Prudential indicators

Wards affected: All

Officer Contact: Hasina Shah Email: Hasina.shah@wycombe.gov.uk

Shaina Aziz Email: Shaina.aziz@wycombe.gov.uk

Proposed Decision

That the treasury management report for 2016/17 be considered and noted.

Corporate implications

To promote effective financial management and comply with the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 and other relevant guidance.

Background

1. 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).

2. 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 25/02/2016
   - a mid-year (minimum) treasury update report Audit Committee 12/12/2016
   - an annual review following the end of the year describing the activity compared to the strategy (this report)

3. 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.

4. This Council 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.

5. The Treasury Management Annual Report covers two main areas summarised below:

   Capital activity

   - Capital spending;
   - Capital Financing Requirements (CFR)

Treasury

- Prudential and treasury indicators;
- Overall treasury position;
- Overall investment activity;
- Summary of interest rate movements.

The Council's Capital Expenditure and Financing 2016/17

6. The Council undertakes capital expenditure on long-term assets. These can be financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.) or if insufficient financing is available from those sources or a decision is taken not to use those resources, the expenditure will give rise to a borrowing need.

7. The capital expenditure statement forms one of the required prudential indicators. The table below shows how capital expenditure was financed:

Table 1: Capital Expenditure and Financing of the Capital Programme

Capital Expenditure Indicator	2015/16 Actual £m	2016/17 Actual £m
Total Capital Expenditure	**29.606**	**14.017**
Financed by:		
Capital Receipts	(27.685)	(4.900)
Capital grants and contributions	(1.921)	(2.213)
Revenue	0.00	(6.904)

Capital Financing Requirements

8. The Council's underlying need to borrow for Capital Expenditure is called the Capital Financing Requirement (CFR). It represents the cumulative 2016/17 and previous years' net capital expenditure which has not yet been funded by revenue nor other resources, but has been paid for by borrowing either externally or by borrowing internal existing cash balances.

9. The CFR is reduced each year by a statutory revenue charge (called the Minimum Revenue Provision - MRP). This CFR can also be reduced by the application of additional capital resources such as capital receipts or charging more than the statutory revenue charge (MRP), through a Voluntary Revenue Provision (VRP).

10. The MRP policy is required to be approved by Council annually and this was approved for 2016/17 on 25th February 2016 by Council.

11. The Council's CFR for the year is shown below, and represents a key

prudential indicator. It includes leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.

Table 2: Movement in the Council's Capital Financing Requirement (CFR)

Capital Financing Requirement	31 March 2016 Actual £m	31 March 2017 Actual £m
Opening Balance	9.239	8.188
Less MRP (Waste Contract leases)	(1.051)	(1.326)
Closing Balance	**8.188**	**6.862**

12. **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 (2016/17) plus the estimates of any additional capital financing requirement for the current (2017/18) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator as detailed in the table 3**.**

13. **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.

14. **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.

Table 3: Borrowing and Capital Financing Requirements

	31 March 16 Actual	31 March 17 Actual
Gross borrowing	£3.998m	£3.186m
CFR	£8.188m	£6.862m
Authorised Limit	£19.000m	£19.000m
Operational Boundary	£18.000m	£18.000m
Financing costs - proportion of net revenue stream	2.63%	4.58%

Treasury Position as at 31 March 2017

15. 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 both through member reporting detailed in the summary, and through officer activity detailed in the Council’s Treasury Management Practices. At the end of 2016/17 the Council did not have any external borrowing and the treasury investments were £74.627m (2015/16 £67.200m) earning an average rate of return at 0.67% (2015/16 0.72%). The maturity structure of the investment portfolio was as follows:-

	31 March 16 Actual £m	**31 March 17 Actual £m**
Longer than 1 year	4.000	6.000
Under 1 year	63.200	68.627
Total	67.200	74.627

The Strategy for 2016/17

16. The expectation for interest rates within the treasury management strategy for 2016/17 anticipated low but rising Bank Rate, 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.

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. The Council continued to face a challenging environment earning yields on investments.

18. 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. In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

The Economy and Interest Rates (Provided by Council's adviser Capita Asset Services)

19. The two major landmark events that had a significant influence on financial markets in the 2016/17 financial year were 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.

20. 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.

21. **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%.

22. **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.

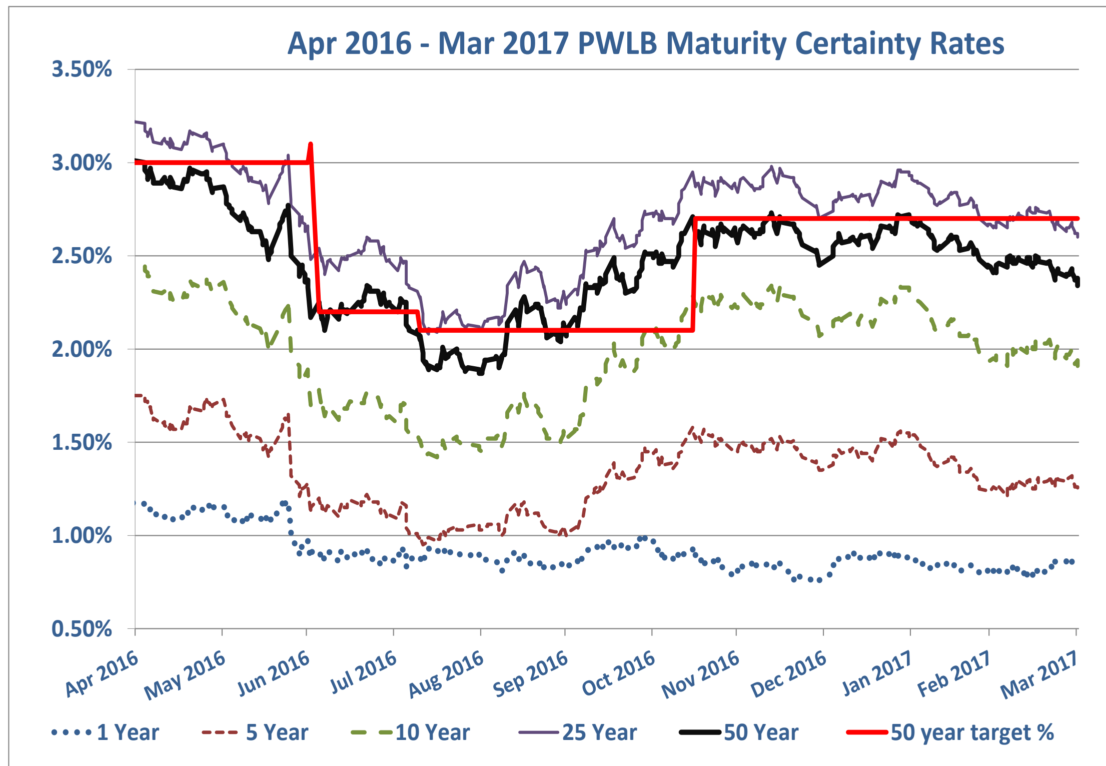
23. On the other hand, President Trump's election and promise of fiscal stimulus, which are likely to increase growth and inflationary pressures in the US, have resulted in Treasury yields rising sharply since his election. Gilt yields in the UK have been caught between these two influences and the result 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.

24. **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.

25. **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.

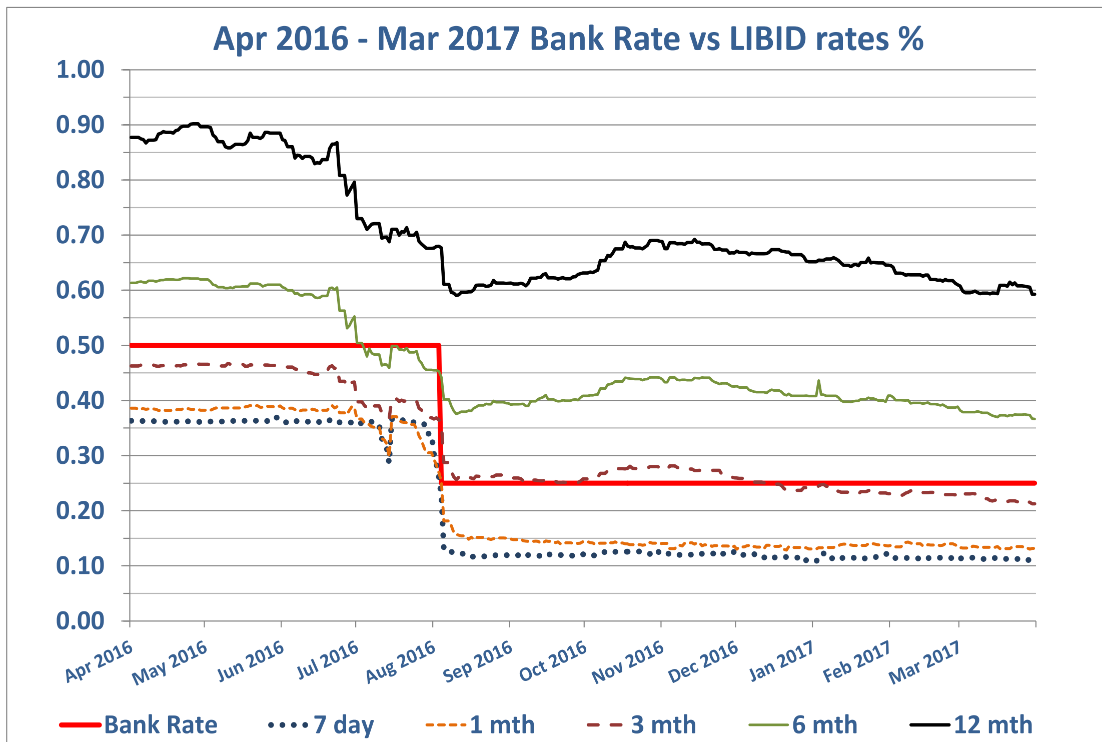
26. **Equity markets.** The result of the referendum, and the consequent devaluation of sterling, boosted the shares of many FTSE 100 companies which had major earnings which were not denominated in sterling. The overall trend since then has been steeply upwards and received further momentum after Donald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

27. During 2016-17, PWLB rates fell from April to June and then gaining fresh downward impetus after the referendum and Bank Rate cut, before staging a partial recovery through to December and then falling slightly through to the end of March. The graphs for PWLB rates below, show, for a selection of maturity periods, the average borrowing rates, the high and low points in rates, spreads and individual rates at the start and the end of the financial year.



Investment Rates in 2016/17

28. 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 as shown in the graph on the next page.



Investment Outturn for 2016/17

29. Investment Policy – the Council's investment policy is governed by CLG guidance, which has been implemented in the annual investment strategy approved by the Council on 25th 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.).

30. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

31. All the funds were managed by the Council internally and maintained an average balance of £88.8m. The fund earned an average rate of return of 0.67%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.32%. This compares with a budget assumption of £85.4m investment balances earning an average rate of 0.70%.

32. On five occasions the Council exceeded its £4m limit with its own banking services provider NatWest Plc. This is an internal limit set by the Council's treasury strategy and the excess balance position arose due to unexpected cash being received late in the day and treasury staff not being able to place the funds in another suitable counterparty due to the financial markets being closed. On each occasion investments with NatWest Plc were brought within the approved limit at the first available opportunity. Aside from these five occasions the Council has complied with its approved investment strategy

33. In the first quarter of 2016/17 the Council continued to have £0.5m invested in an escrow account in Iceland following the collapse of the Glitnir Icelandic bank in October 2008. The amounts were held pending relaxation of Icelandic Central Bank (ICB) restrictions over Icelandic Krona transferring offshore. On 16th June 2016 the Council successfully sold its Icelandic Krona through an ICB auction raising 600,147 Euros. The funds were received by the Council on 1st July 2016 and converted to £500,950.

Background Papers

Treasury Management Strategy 2016/17