CABINET - 5 JULY 2017 **PORTFOLIO: FINANCE AND EFFICIENCY**

TREASURY MANAGEMENT ANNUAL OUTTURN REPORT 2016/17

1. PURPOSE

1.1. New Forest District Council adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes an annual report on the treasury management strategy after the end of each financial year.

2. SUMMARY

2.1. Treasury management in the context of this report is defined as:

"The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2.2. This annual report sets out the performance of the treasury management function during 2016/17, to include the effects of the decisions taken and the transactions executed in the past year.

2.3. Hampshire County Council's Investments & Borrowing Team has been contracted to manage the Council's treasury management balances since March 2014 but overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

2.4. All treasury activity has complied with the Council's Treasury Management Strategy and Investment Strategy for 2016/17, and all relevant statute, guidance and accounting standards. In addition the Council's treasury advisers, Arlingclose, provide support in undertaking treasury management activities.

2.5. The Council has complied with all of the prudential indicators set in its Treasury Management Strategy; these are detailed fully in Appendix 1.

3. EXTERNAL CONTEXT

3.1. The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions were made in 2016/17.

Economic Background

3.2. Politically, 2016/17 was an extraordinary 12 month period which defied expectations when the UK voted to leave the European Union and Donald Trump was elected the 45th President of the USA.

3.3. UK inflation has been subdued in the first half of 2016 as a consequence of weak global price pressures, past movements in sterling and restrained domestic price growth. However the sharp fall in the Sterling exchange rate following the referendum had an impact on import prices which, together with rising energy prices, resulted in CPI rising from 0.3% year on year in April 2016 to 2.3% year on year in March 2017.

3.4. In addition to the political fallout, the referendum's outcome also prompted a decline in household, business and investor sentiment. The repercussions on economic growth were judged by the Bank of England to be sufficiently severe to prompt its Monetary Policy Committee to cut the Bank Rate to 0.25% in August and embark on further gilt and corporate bond purchases.

3.5. Despite growth forecasts being downgraded, economic activity was fairly buoyant and GDP grew 0.6%, 0.5% and 0.7% in the second, third and fourth calendar quarters of 2016, and in February the unemployment rate dropped to 4.75%; its lowest level in 11 years.

Financial Markets

3.6. After recovering from an initial sharp drop in Quarter 2, equity markets rallied, although displaying some volatility at the beginning of November following the US presidential election result. Commercial property values fell around 5% after the referendum, but had mostly recovered by the end of March. Overnight money market rates have remained low since Bank Rate was cut in August.

Credit Background

3.7. Various indicators of credit risk reacted negatively to the result of the referendum on the UK's membership of the European Union. Fitch and Standard & Poor's downgraded the UK's sovereign rating to AA. Fitch, S&P and Moody's have a negative outlook on the UK. Moody's has a negative outlook on those banks and building societies that it perceives to be exposed to a more challenging operating environment arising from the 'leave' outcome.

4. LOCAL CONTEXT

4.1. At 31/03/2017 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £147.9m, while usable reserves and working capital which are the underlying resources available for investment were £62.8m (principal invested plus gains on investments with a variable net asset value).

4.2. At 31/03/2017, the Council had £144.1m of borrowing and £62.0m of principal invested. The Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, however the Council will be looking to borrow up to a further £12m to part-finance direct commercial property investment in both 2018/19 and 2019/20.

4.3. The Council's General Fund's CFR is forecast to increase by £13.2m in the period to 31 March 2019; this is principally to allow for the potential of direct commercial property investment. The updated prudential indicators attached as appendix 1 take this revised CFR into account. The Council's HRA CFR is currently expected to reduce by £4.1m per year from 2017/18, as instalments of the HRA settlement become due for repayment.

5. BORROWING STRATEGY

5.1. At 31/03/2017 the Council held £144.1m of loans, (a decrease of £0.2m on 31/03/2016 due to repayment) with the vast majority of the loan being in relation to the resettlement of the HRA in 2012/13.

5.2. The Council's chief objective when borrowing has been to strike 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 being a secondary objective.

5.3. Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing.

5.4. The Council's portfolio of long-term debt is in the form of loans from the Public Works Loan Board (PWLB). A cautious approach has been applied in terms of take-up of new borrowing to minimise debt interest payments without compromising the long-term stability of the portfolio. No new borrowing took place during 2016/17. Internal resources in lieu of external borrowing have been used to lower overall treasury risk by reducing both external debt and temporary investments.

Table 1: Borrowing Activity in 2016/17

	Balance on 31/03/2016 £m	Net New Borrowing £m	Balance on 31/03/2017 £m
CFR	147.8		147.9
Short Term Borrowing[1]	0.2	4.1	4.3
Long Term Borrowing	144.1	(4.3)	139.8
TOTAL BORROWING	144.3	(0.2)	144.1
TOTAL EXTERNAL DEBT	144.3	(0.2)	144.1
Increase/ (Decrease) in Borrowing £m			(0.2)

Debt Rescheduling

5.5. The premium charged for early repayment of PWLB debt remained relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

6. INVESTMENT ACTIVITY

6.1. The combined effect of the EU Bank Recovery and Resolution Directive and the UK's Deposit Guarantee Scheme Directive is to promote deposits of individuals and SMEs above those of public authorities, large corporates and financial institutions. Other EU countries, and eventually all other developed countries, are expected to adopt similar approaches in due course.

6.2. The outlawing of bail-outs, the introduction of bail-ins, and the preference being given to large numbers of depositors other than local authorities, means that the risk of making unsecured deposits rose relative to other investment options. Since 2014/15 the Council therefore increasingly favoured secured investment options or diversified alternatives such as covered bonds, non-bank investments and pooled funds over unsecured bank and building society deposits.

6.3. The Council has held invested funds representing income received in advance of expenditure plus balances and reserves held. During 2016/17 the Council's investment balances have ranged between £57.0 and £88.9 million.

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[1] Loans with maturities less than 1 year.

Table 2: Investment Activity in 2016/17

Investments	Balance on 31/03/2016 £m	Balance on 31/03/2017 £m	Average Rate/Yield on 31/03/17 %	Average Life on 31/03/17 years
Short term Investments				
- Banks and Building Societies:				
- Unsecured	8.3	7.0	0.61	0.14
- Secured	4.8	8.8	0.56	0.51
- Money Market Funds	11.0	12.3	0.25	0.00
- Local Authorities	8.0	12.0	0.82	0.45
- Corporate Bonds	1.0	2.6	0.54	0.50
- Government Bonds	3.0	-	-	-
	36.1	**42.7**	**0.55**	**0.28**
Long term investments				
- Banks and Building Societies:				
- Secured	9.5	11.8	0.80	1.74
- Local Authorities	7.0	3.0	1.40	1.40
	16.5	**14.8**	**0.92**	**1.67**
High yield investments				
- Pooled Property Funds	3.2	3.2	4.53	n/a
- Pooled Equity Funds	-	2.1	1.88*	n/a
	3.2	**5.3**	**3.48***	**n/a**
TOTAL INVESTMENTS	**55.8**	**62.8**	**0.88***	**0.64**
Increase/ (Decrease) in Investments £m		7.0		

* The yields provided for pooled funds include investments that were held for part of the year, and therefore do not represent a full 12 month yield.

6.4. Both the CIPFA Code and the government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

6.5. Over the year the Council reduced its exposure to unsecured bank and building society investments by increasing its exposure to secured bank and building society investments, and corporate bonds. The Council has also invested in further high yield investments by investing in pooled equity funds

6.6. The investments in pooled property and equity funds allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. The funds which are operated on a variable net asset value (VNAV) basis offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short-term. All of the Council's pooled fund investments are in the funds' distributing share classes which pay out the income generated.

6.7. Although money can be redeemed from the pooled funds at short notice, the Council's intention is to hold them for at least the medium term. Their performance and suitability in meeting the Council's investment objectives are monitored regularly and discussed with Arlingclose.

6.8. Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2016/17.

6.9. Counterparty credit quality was assessed and monitored with reference to credit ratings, for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

6.10. The Council will also consider the use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

6.11. The Council maintained a sufficient level of liquidity through the use of call accounts and money market funds. The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate has been maintained at 0.25% since August 2016 and short-term money market rates have remained at relatively low levels which continued to have a significant impact on cash investment income.

6.12. The Council's average cash balances were £70.1m during the year and interest earned for the year was £0.670m, giving an average yield of 0.96% (in comparison to 0.91% in 2015/16).

7. COMPLIANCE WITH PRUDENTIAL INDICATORS

7.1. The Council confirms compliance with its Prudential Indicators for 2016/17, which were set in February 2016.

8. Treasury Management Indicators

8.1. The Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

8.2. This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed will be:

Table 3: Interest Rate Exposures

	Approved limits for 2016/17	Maximum during 2016/17	Compliance with limits:
Upper limit on fixed interest rate investment exposure	£25.0m	£9.0m	Yes
Upper limit on variable interest rate investment exposure	£90.0m	£83.9m	Yes
Upper limit on fixed interest rate borrowing exposure	£178.1m	£144.3m	Yes
Upper limit on variable interest rate borrowing exposure	£178.1m	£2.0m	Yes

8.3. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing

8.4. This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 4: Maturity Structure of Borrowing

	Upper	Lower	Actual
Under 12 months	25%	0%	3.0%
12 months and within 24 months	25%	0%	3.0%
24 months and within 5 years	25%	0%	9.0%
5 years and within 10 years	25%	0%	14.5%
10 years and above	100%	0%	70.5%

Principal Sums Invested for Periods Longer than 364 days

8.5. The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2016/17	2017/18	2018/19
Limit on principal invested beyond year end	£25m	£25m	£25m
Maximum invested during the financial year	£21.3m		

9. CRIME AND DISORDER AND ENVIRONMENTAL IMPLICATIONS

9.1. None arising directly from this report.

10. RECOMMENDATION

(a) That the Cabinet consider the performance of the treasury management function detailed in this report.

(b) That it be a recommendation to the Council that the revised prudential indicators for 2017/18 – 2018/19 as set out in the report be approved.

Further information	**Background papers**
Please contact Andrew Boutflower (HCC), or Alan Bethune	The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance
	Local Government Act 2003
email: andrew.boutflower@hants.gov.uk alan.bethune@nfdc.gov.uk	SI 2003/3146 Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
	Treasury Management Strategy Report 2016/17 Audit Committee – 22 January 2016 Council - 22 February 2016 Treasury Management Strategy Report 2017/18 Audit Committee – 27 January 2017 Council – 20 February 2017 Treasury Management Mid-Year Monitoring Report 2016/17 Audit Committee – 23 September 2016 Treasury Management Annual Outturn Report 2015/16 Audit Committee – 28 June 2016 Cabinet – 6 July 2016 Council – 11 July 2016
	Published Papers

PRUDENTIAL INDICATORS 2016/17

The Local Government Act 2003 requires the Council to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Estimates of Capital Expenditure

The Council's planned capital expenditure and financing may be summarised as follows.

Capital Expenditure and Financing	2016/17 Approved £m	2016/17 Revised £m	2016/17 Actual £m	2017/18 Estimate £m	2018/19 Estimate £m
General Fund	4.1	6.4	**4.2**	7.9	20.4
HRA	16.6	13.4	**13.9**	15.4	21.3
Total Expenditure	**20.7**	**19.8**	**18.1**	**23.3**	**41.7**
Capital Receipts	1.3	3.0	**4.4**	3.0	3.0
Grants	1.6	2.4	**1.4**	3.9	3.3
Reserves	2.5	2.0	**-**	4.5	12.4
Revenue	13.7	10.6	**10.5**	9.1	9.1
Developers Contributions	0.8	0.4	**0.7**	0.9	0.4
Borrowing	0.8	1.4	**1.1**	1.9	13.5
Total Financing	**20.7**	**19.8**	**18.1**	**23.3**	**41.7**

Estimates of Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31.03.17 Approved £m	31.03.17 Revised £m	31.03.17 Actual £m	31.03.18 Estimate £m	31.03.19 Estimate £m
General Fund	3.5	3.5	**3.3**	4.0	16.5
HRA	144.6	144.6	**144.6**	140.5	136.4
Total CFR	**148.1**	**148.1**	**147.9**	**144.5**	**152.9**

The General Fund CFR is forecast to rise by £13.2m over the next two years as capital expenditure financed by debt outweighs resources put aside for debt management, but the HRA CFR will fall by £8.2m as the first instalments of the Self Financing Settlement borrowing are repaid.

Gross Debt and the Capital Financing Requirement

In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	31.03.17 Forecast £m	31.03.17 Revised £m	31.03.17 Actual £m	31.03.18 Estimate £m	31.03.19 Estimate £m
Borrowing	144.1	144.1	**144.1**	139.8	147.5

Total debt is expected to remain below the CFR during the forecast period.

The actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt, below.

Operational Boundary 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.

Operational Boundary	2016/17 Approved £m	2016/17 Revised £m	2016/17 Actual £m	2017/18 Estimate £m	2018/19 Estimate £m
Borrowing	163.1	163.0	**144.1**	159.4	167.8

Authorised Limit for External Debt

The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	2016/17 Approved £m	2016/17 Revised £m	2016/17 Actual £m	2017/18 Estimate £m	2018/19 Estimate £m
Borrowing	178.1	178.0	**144.1**	174.4	194.8

The increase in authorised limit for external debt for 2018/19 is reflective of the total potential borrowing as a result of the Council's approved Commercial Property Investment strategy.

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.

Ratio of Financing Costs to Net Revenue Stream	2016/17 Approved %	2016/17 Revised %	2016/17 Actual %	2017/18 Estimate %	2018/19 Estimate %
General Fund	0.6	0.6	**0.1**	0.8	2.3
HRA	0.0	0.0	**0.0**	0.0	(0.2)

In 2018/19 it is estimated that the ratio of financing costs to Net Revenue Stream for the HRA will be -0.2%. This reduction reflects the decrease in interest payable on the HRA loan, due to the commencement of repayment of principal from 2017/18.

Adoption of the CIPFA Treasury Management Code

The Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition in February 2002 and complies with all revisions of the Code.