



POLICY AND RESOURCES SCRUTINY COMMITTEE – INFORMATION ITEM

SUBJECT: TREASURY MANAGEMENT AND CAPITAL FINANCING PRUDENTIAL INDICATORS QUARTER 1 AND QUARTER 2 MONITORING REPORT (1ST APRIL 2016 TO 30TH SEPTEMBER 2016)

REPORT BY: ACTING DIRECTOR OF CORPORATE SERVICES AND SECTION 151 OFFICER

1. PURPOSE OF REPORT

- 1.1 To present Members with details of Treasury Management activities and Capital Financing, together with the related Prudential Indicators for the period 1st April 2016 to 30th September 2016.
- 1.2 To review the Treasury Management Strategy for 2016/17 as set out in the Annual Investment Strategy and Capital Financing Prudential Indicators Report.

2. SUMMARY

- 2.1 The Code of Practice on Treasury Management in the Public Services 2009, which was adopted by the Council on 12th October 2010, sets out a framework of operating procedures, which is encompassed in the Treasury Management Practices (TMPs). TMP6 (Reporting Requirements and Management Information Arrangements) provides for the submission of monitoring reports to the appropriate Committee on a quarterly basis.
- 2.2 Under the provisions of the Local Government Act 2003, The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 [The Capital Regulations], and the CIPFA's "The Prudential Code for Capital Finance in Local Authorities" [the Code], the Authority is obliged to approve and publish a number of indicators relevant to Capital Finance and Treasury Management.
- 2.3 The Authority's Annual Investment Strategy and Capital Financing Prudential Indicators for 2016/17 were approved by Council on 24th February 2016.

3. LINKS TO STRATEGY

- 3.1 Treasury Management Strategy 2016/17 as agreed by Council on 24th February 2016.
- 3.2 Prudent financial management contributes to the following Well-being Goals within the Well-being of Future Generations Act (Wales) 2016:-
 - A prosperous Wales.
 - A resilient Wales.
 - A healthier Wales.

- A more equal Wales.
- A Wales of cohesive communities.
- A Wales of vibrant culture and thriving Welsh Language.
- A globally responsible Wales.

4. THE REPORT

4.1 Treasury Management

4.1.1 Borrowing Activity

The current policy of internal borrowing is not sustainable in the long-term, but where prudent the policy of internal borrowing will be utilised. As at the 31st March 2016 the internal borrowing position was £16m.

The Annual Treasury Management Strategy was approved by Council in February 2016 and indicated that there would be a need to borrow £14.2m in 2016/17 to part fund the General Fund capital programme. As at the 30th September 2016 no new long-term loans were raised as cash balances are being utilised in the short-term.

Following the EU referendum result gilt yields fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. The yield on the 10-year gilt fell from 1.37% on 23rd June to a low of 0.52% in August, a quarter of what it was at the start of 2016. The 10-year gilt yield has since risen to 0.69% at the end of September. The fall in gilt yields was reflected in the fall in PWLB borrowing rates to record low levels. The rate for a 25 year annuity loan averaged at 2.44% for the reported period and a low of 1.88%.

During the period covered by this report, PWLB loans to the value of £3.02m were repaid on maturity. Such loans had an average interest rate of 3.98%. £30k of the WRU Loan was also repaid. Two Temporary loans totalling £5.91m were raised during the reported period. £4.91m was repaid in September and was held for 20 days. £1m was raised at the end of September and matured in October 2016. Both loans were raised for the purpose of cashflow requirements as investments were tied in. Total debt outstanding as at 30th September 2016 was £285.4m and comprised of £244.2m PWLB loans; £30m market loans (LOBOs); £10m Bank loan, £1m local authority loan and £210k WRU loan.

Previously the Authority held four LOBO (Lender's Option Borrower's Option) loans with a total value of £40m. However in June 2016, a lender converted a LOBO loan to a fix rate loan (long-term bank loan) at no cost to the Authority and with no further changes to the original loan terms. This removes the uncertainty of future rate changes. With respect to the remaining three LOBO loans the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. Two of the LOBO loans with a total value of £20m had options reviewed during quarter one, none of which were exercised by the lender. As at 30th September the LOBO loans will be reviewed again in 2016/17 by the lenders, with a total value of £30m that is exposed to variable interest rate movement. This represents 10.5% of the Authority's debt portfolio, which is within the Council's determination of 30%. The Authority acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

4.1.2 Rescheduling

The Annual Strategy allows for the utilisation of debt rescheduling providing for both in year and future year savings and additional revenue resources. No rescheduling opportunities presented themselves during the period covered by this report.

4.1.3 Investments

During the reported period the Authority was holding £37m of long-term investments where the maturity date is greater than 364 days. These investments are in accordance with the approved Investment Strategy. The long-term investments comprise of covered bonds with UK banks/ building societies and have an AAA rating; UK Gilts and supranational bonds. The covered bonds are secured investments and collateralised against the counterparty's pool of assets. The value of short-term deposits as at 30th September 2016 was £88.07m.

The total investments held as at 30th September 2016 was £125.07m, and had an average rate of return equating to 0.75%, which is a significant improvement over placing deposits with the Debt Management Office (DMO) who continue to pay a rate of 0.15%. The rate of return is above the target rate, as detailed in the Annual Treasury Management Strategy report to Council, of 0.25%. The improvement in returns reflect the Authority's change in investment strategy and lending to high creditworthy counterparties that consist of banks; building societies; supranational institutions; the DMO, local authorities; and corporates using a range of investment products such as corporate bonds; covered bonds; cash deposits and treasury bills. Whilst the returns have improved, the riskiness of the investment portfolio has been quantified with a weighted average credit score equivalent to an AA+ rating. The UK government is currently rated by two credit rating agencies at AA. Therefore the Authority's portfolio is one notch above the UK Government rating.

The portfolio as at 30th September 2016 comprised of the following types of investments:

Counterparty	Investment Product	Sector	£m
Banks	Certificate of Deposits	Financial	19.00
Banks & building societies	Fixed-term cash deposits	Financial	18.42
Banks & building societies	Covered bonds	Financial	31.32
Corporates	Bonds	Automobile/ Transport Infrastructure/ Utilities/ Financial	21.10
Debt Management Office	Fixed-term cash deposits	UK Government	8.06
Supranational Institutions	Bonds	Sovereign/ Financial	13.97
UK Government	Gilts	UK Government	10.00
UK Government	Treasury Bills	UK Government	3.20
Total Investments as at 30th September 2016			125.07

4.1.4 Economic Outlook

The preliminary estimate of Q2 2016 GDP showed reasonably strong growth as the economy grew 0.7% quarter-on-quarter, compared to 0.4% in Q1 and year on year growth running at 2.2%. However the UK economic outlook changed significantly on 23rd June 2016. The surprise result of the EU referendum prompted forecasters to disregard previous projections. Growth forecasts had already been downgraded as 2016 progressed, as the very existence of the referendum dampened business investment, but the crystallisation of the risks and the subsequent political turmoil prompted a sharp decline in household, business and investor sentiment.

The repercussions of the referendum resulted in the Bank of England cutting the Bank Rate to 0.25%; restarting Quantitative Easing (QE) programme by gilt and corporate bond purchases; and providing cheap funding for banks (Term Funding Scheme) to maintain the supply of credit to the economy. The minutes of the September meeting also suggested that the slowdown in the economy was less severe than previously forecasted and see inflation

reaching 2% in the first half of 2017.

Whilst the economic growth consequences of BREXIT remain speculative, there is uniformity in expectations that uncertainty over the UK's future trade relations with the EU and the rest of the world will weigh on economic activity and business investment, dampen investment intentions and tighten credit availability, prompting lower activity levels and potentially a rise in unemployment. These effects will impact on economic growth through the second half of 2016 and in 2017.

Inflation is expected to pick up due to a rise in import prices, diminish real wage growth and real investment returns. Inflation is currently at 1% and it is anticipated to rise closer to the Bank's 2% target in early 2017 as previous rises in commodity prices and the sharp depreciation in sterling begin to drive up imported material costs for companies.

Arlingclose has changed its central case for the path of Bank Rate over the next three years. Any currency-driven inflationary pressure will be looked through by Bank of England policymakers. Arlingclose's central case is for Bank Rate to remain at 0.25%, but there is a 40% possibility of a drop to close to zero, with a small chance of a reduction below zero. Gilt yields are forecast to be broadly flat from current levels, albeit experiencing short-term volatility.

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

4.1.5 Counterparty Update

Various indicators of credit risk reacted negatively to the result of the EU referendum on the UK's membership of the European Union. UK bank credit default swaps saw a modest rise but bank share prices fell sharply, on average by 20%, with UK-focused banks experiencing the largest falls. Non-UK bank share prices were not immune although the fall in their share prices was less pronounced.

There was no immediate change to Arlingclose's credit advice on UK banks and building societies as a result of the referendum result. Our advisor believes there is a risk that the uncertainty over the UK's future trading prospects will bring forward the timing of the next UK recession. Arlingclose believes that the Government and the Bank of England have both the tools and the willingness to use them to prevent market-wide problems leading to bank insolvencies. The cautious approach to credit advice means that the banks currently on the Authority's counterparty list have sufficient equity buffers to deal with any localised problems in the short term.

Fitch downgraded the UK's sovereign rating by one notch to AA from AA+, and Standard & Poor's downgraded its corresponding rating by two notches to AA from AAA.

4.2 **Prudential Indicators**

4.2.1 Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose. In accordance with best professional practice, the Authority does not associate borrowing with particular items or types of expenditure. In practice, the raising and repaying of loans is determined primarily by professional / expert advice, and may not necessarily take place in the relevant year. In order to create an operating environment within which the Treasury Manager can legitimately react to appropriate advice, the various authorised limits as identified in Appendix 1 are set at a level in excess of the CFR. In the financial year to date, the Authority has been operating within the approved limits.

Appendix 1 shows a revised projected CFR value of £331.52m as at 31st March 2017. The actual CFR as at 31st March 2016 was £344.57m.

4.2.2 Prudential Indicators – “Prudence”

The Prudential Indicators for Treasury Management are shown in Appendix 1, and the Authority is currently operating within the approved limits.

4.2.3 Prudential Indicators – “Affordability”

There is a requirement to analyse and report the capital financing costs, and express those costs as a percentage of the net revenue streams of the Authority. These are identified in Appendix 2, and currently show a projected reduction from the original budget as a consequence of deferred borrowing.

4.2.4 Capital Expenditure and Funding

A summary of capital expenditure and funding is attached at Appendix 3 and shows no change against the planned position.

5. WELL-BEING OF FUTURE GENERATIONS

- 5.1 The effective management of the Authority’s borrowing and investments are key in ensuring that the Well-being Goals within the Well-being of Future Generations Act (Wales) 2016 are met.

6. EQUALITIES IMPLICATIONS

- 6.1 This report is for information purposes, so the Council's Equalities Impact Assessment (EqIA) process does not need to be applied.

7. FINANCIAL IMPLICATIONS

- 7.1 As detailed throughout the report.

8. PERSONNEL IMPLICATIONS

- 8.1 There are no direct personnel implications arising from this report.

9. CONSULTATIONS

- 9.1 There are no consultation responses that have not been reflected in this report.

10. RECOMMENDATIONS

- 10.1 Members are asked to note the contents of this report.

11. REASONS FOR THE RECOMMENDATIONS

- 11.1 Compliance with the CIPFA “Code of Practice for Treasury Management in the Public Services”.

12. STATUTORY POWER

12.1 Local Government Acts 1972 and 2003.

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Appendices:
Appendix 1 – Treasury Management Prudential Indicators – Prudence
Appendix 2 – Capital Finance Prudential Indicators – Affordability
Appendix 3 – Capital Expenditure and Funding

Appendix 1 Treasury Management Prudential Indicators- Mid Year report (Quarters 1 & 2)

	Budget 2016-17	Estimated 2016-17
	£000	£000
Authorised limit for external debt -		
Borrowing	366,267	366,267
Other long term liabilities	35,599	35,599
Total	401,867	401,867
Operational boundary for external debt -		
Borrowing	293,014	283,852
Other long term liabilities	35,599	35,599
Total	328,613	319,451
Capital Financing Requirement	338,941	331,512
Upper limits for interest rate exposure		
Principal outstanding on borrowing	293,014	283,852
Principal outstanding on investments	110,000	110,000
Net principal outstanding	183,014	173,852
Fixed rate limit – 100%	183,014	173,852
Variable rate limit – 30%	54,904	52,156
Upper limit for total invested for over 364 days	50,000	50,000

Maturity structure of fixed rate borrowing	Upper Limit	Lower Limit
Under 12 months	35%	0%
Over 12 months and within 24 months	40%	0%
Over 2 years and within 5 years	50%	0%
Over 5 years and within 10 years	75%	0%
Over 10 years	100%	0%

	Budget 2016-17	Estimated 2016-17
Gross Debt and Net Debt	00	0
Outstanding Borrowing	293,014	283,852
Other long term liabilities	35,599	35,599
Gross Debt	328,613	319,451
Less investments	110,000	110,000
Net Debt	218,613	209,451

	Budget 2016-17	Estimated 2016-17
Gross and The CFR	00	0
Gross Debt	328,613	319,451
CFR	338,941	331,512
CFR Breached?	No	No

Appendix 2 - Prudential Indicators - Capital Finance- Mid Year report (Quarters 1 & 2)

Ratio of Financing costs to net revenue stream	Budget 2016-17	Estimated 2016-17
General Fund	00	0
Principal repayments	7,740	7,861
Interest costs	8,667	8,130
Debt Management costs	45	45
Rescheduling discount	-226	-226
Investment income	-583	-600
Interest applied to internal balances	745	783
Total General Fund	16,388	15,994
Net revenue stream	322,984	322,984
Total as percentage of net revenue stream	5.07%	4.95%
Housing Revenue Account		
Principal repayments	2,340	2,330
Interest costs	5,646	5,475
Rescheduling discount	-58	-58
Debt Management costs	23	23
Total HRA	7,951	7,771
Net revenue stream	44,710	44,710
Total as percentage of net revenue stream	17.78%	17.38%

Estimate of <u>incremental impact</u> of capital investment on Council Tax and Housing Rents	Budget 2016-17	Estimated 2016-17
General Fund	00	0
Unsupported borrowings - principal	366	366
- interest	441	441
Loss of investment income	35	35
Total	842	842
Impact on Band D council tax	14.20	14.20
Housing Revenue Account		
Loss of investment income	438	438
Unsupported borrowings - principal	0	0
- interest	0	0
0	0	0
Total	438	438
Impact on average weekly rent	0.04	0.04

This is a notional calculation

Capital financing requirement [end of year position]	Budget 2016-17	Estimated 2016-17
	00	0
Council Fund	225,024	218,137
Housing Revenue Account	113,916	113,375
Total Authority	338,941	331,512

Appendix 3 - Capital Expenditure and Funding- Mid Year report (Quarters 1 & 2)

	Budget 2016-17	Estimated 2016-17
Expenditure	00	0
Council Fund	17,099	17,099
Housing Revenue Account	36,022	36,022
Total	53,121	53,121
Funding		
Surplus/ (Deficit) Balance b/f	1,971	1,971
Borrowings - Supported (GF)	4,992	4,990
General Capital Grant - WG	3,038	3,037
RCCO Budget	128	128
Capital underspends frm previous years	657	657
Ring-fenced uncommitted capital budgets	610	610
Capital Receipts 2015/16	829	829
General Fund Working Balances	5,845	5,845
RCCO- (HRA)	28,676	28,676
Major Repairs Allowance (HRA)	7,345	7,345
Total	54,092	54,089
Surplus C/f	971	968