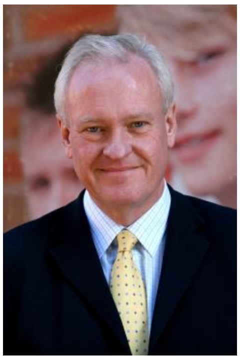


Cabinet Meeting on the 19 July 2017

Treasury Management Report for the Year Ended 31 March 2017

Report Summary from Ian Parry, Deputy Leader and Cabinet Member for Finance and Corporate Matters

Ian Parry said: "The historic Brexit vote in 2016/17 meant that uncertainties associated with the UK economy continued. The County Council still faced risks in undertaking its treasury management activities and retained its policy of not borrowing money, choosing to use internal cash balances instead. This has delivered significant savings for taxpayers, as the infrastructure to deliver more skilled, better-paid jobs is being funded at a lower cost."

1. This report is a summary of the County Council's investment and borrowing activity during 2016/17. It considers both borrowing and investment decisions taken throughout the year in the light of the interest rates and economic conditions prevailing at the time.

2. These activities involve large sums of money and reflect the huge scale of the County Council's operations. As at the 31 March 2017, the County Council's overall debt level stood at £570 million, which reflects capital expenditure decisions made in the past. Temporary investments totalled £89 million.

3. The attached report shows that our treasury management activities were carried out prudently during the year and our policy of funding new borrowing from internal cash balances continues to generate significant savings.

4. As well as being prudent, our low risk investment strategy which focuses on lending to low risk institutions and the need for liquidity and diversification, will ensure the County Council is strategically placed to deal with any market challenges arising from negotiations for the UK to leave the European Union.

5. I am therefore recommending to Cabinet that the report be noted and accepted.

Recommendations:

a) That the treasury management activities for the year ended 31 March 2017, including the Prudential Indicators outturn detailed in Appendix 4, be noted.

b) That Cabinet approve the use of the Minimum Revenue Provision at 31 March 2017 as set out in **paragraphs 33 and 34**.

c) That Cabinet note the current Annual Investment Strategy is considered prudent and sufficiently robust to meet any market challenges created by the vote for the UK to leave the European Union (**paragraph 41)** and that Officers will continue to monitor the position.

Local Members Interest
N/A

CABINET – 19 JULY 2017

TREASURY MANAGEMENT REPORT FOR THE YEAR ENDED 31 MARCH 2017

Recommendations of Deputy Leader and Cabinet Member for Finance and Corporate Matters

1. That the treasury management activities for the year ended 31 March 2017, including the Prudential Indicators outturn detailed in Appendix 4, be noted.

2. That Cabinet approve the use of the Minimum Revenue Provision at 31 March 2017 as set out in **paragraphs 33 and 34**.

3. That Cabinet note the current Annual Investment Strategy is considered prudent and sufficiently robust to meet any market challenges created by the vote for the UK to leave the European Union (**paragraph 41**) and that Officers will continue to monitor the position.

Report of the Director of Finance and Resources

Reasons for recommendations

4. At their meeting on 18 January 2012, Cabinet adopted the revised CIPFA Code of Practice for Treasury Management in the Public Services. This report details the treasury management activities for the 12 month period ended 31 March 2017, which is a requirement of this code.

5. This report provides a summary of the County Council's treasury management activities for 2016/17, in the context of the strategy for the year, which was agreed by Cabinet on 20 January 2016. It considers both the borrowing and investment decisions taken throughout the year in the light of the interest rates and economic conditions prevailing at the time.

The economy in 2016/17

6. Despite the uncertainty created by Britain's decision to leave the EU, the UK economy grew by 2% in 2016/17; this surpassed the GDP growth of 1.7% registered the previous financial year. Economic growth was largely driven by strong consumer spending and a buoyant service sector. However growth in the last quarter of 2016/17 came in below expectations at 0.2%, indicating the UK economy may have started to experience the Brexit related slowdown many commentators had predicted.

7. Investor uncertainty, as Britain considers the complex negotiations required to withdraw from the EU, caused the UK pound (£) to fall sharply; the pound declined by over 13% in 2016/17. The resulting higher import costs combined with higher crude oil prices has lifted inflation to its highest level for more than three years – the Consumer Prices Index (CPI) was at 2.3% in March 2017, above the 2% Bank of England target. Many economists expect a further

slowdown in the economy as higher inflation dents consumer spending, a key driver for the UK economy.

8. Due to the perceived negative impact of Brexit, the Bank of England had initially cut Bank rate to 0.25% in August 2016. Although inflation has been rising since, the Bank of England has so far resisted the move to raise rates; its monthly monetary policy meetings note the rise in inflation is linked to Brexit and above target inflation can be tolerated temporarily. However the Bank has stressed there are limits to the current policy and would raise rates if required.

9. Meanwhile the US economy continued to show strength; markets were buoyed further by Trump's election as President in November 2016, as investors priced in lower tax rates and higher government spending. As the Federal Reserve neared its targets in terms of inflation and employment, it raised interest rates in December 2016 and March 2017. With the US poised for more robust growth, the Federal Reserve is likely to continue on a path of regular rate increases.

10. In Europe, growth remained sluggish as political uncertainty and concerns over the banking sector led the European Central Bank (ECB) to continue with its quantitative easing programme. However the second half of the year saw economies in Europe show some signs of recovery, especially Germany, with some speculating the ECB may raise rates next year.

11. The impact this had on the investments and debt held by the County Council is detailed in the paragraphs that follow.

Long-term borrowing 2016/17

12. The Treasury Management Strategy Report for 2016/17, approved by Cabinet on 20 January 2016, outlined the long-term borrowing strategy for the year, which was:

> "The use of cash in lieu of borrowing required in 2016/17 and as a contingency the ability to borrow new loans"

13. The ability to borrow new loans was as a result of unexpected changes in;
   - the capital programme;
   - the level of cash balances;
   - the repayment of Lender Option Borrower Option loans (LOBOs).

14. The following table summarises the use of cash for 2016/17:

2016/17	**£m**
Balance funded from cash brought forward	**89.411**
New debt	14.684
Minimum Revenue Provision (MRP) *	(21.453)
Loan repayments at maturity	0.034
Loans repaid early	0.000
Balance funded from cash carried forward	**82.676**

** £19.303m of the MRP is payable by the County Council, but the treasury team manage the entire position, including MRP for transferred services.*

15. In 2016/17, the amount of debt funded from internal cash balances has reduced from £89.411m at the start of the financial year to £82.676m by the end of the year. New debt created was less than MRP, there was a small maturing loan and no early repayments; so the overall the use of cash decreased.

16. New debt was lower than originally forecast as a significant portion of the capital programme had been moved to the following financial year. In accordance with the strategy, no new loans were borrowed in 2016/17 as the lower need for new debt meant contingency arrangements were not required.

17. The strategy of using cash continues to rely upon two main factors:
    - interest rates, and in particular the difference between short-term investment rates and longer term borrowing rates.
    - having cash available to fund the strategy.

Interest rates

18. The Bank rate, set by the Bank of England, has been at 0.25% since August 2016. Investment rates are not necessarily pegged to this rate as they reflect supply and demand and the markets assessment of future interest rates. The Investment rates for up to 3 months were still below Bank rate in 2016/17.

19. The Bank of England believes interest rates are likely stay at current levels unless inflation and economic activity increase; the market currently supports this view. During 2016/17, the County Council's treasury advisor, Arlingclose, amended its interest rate forecast. Arlingclose estimates the Bank rate will remain at 0.25% with a low possibility of a drop close to zero.

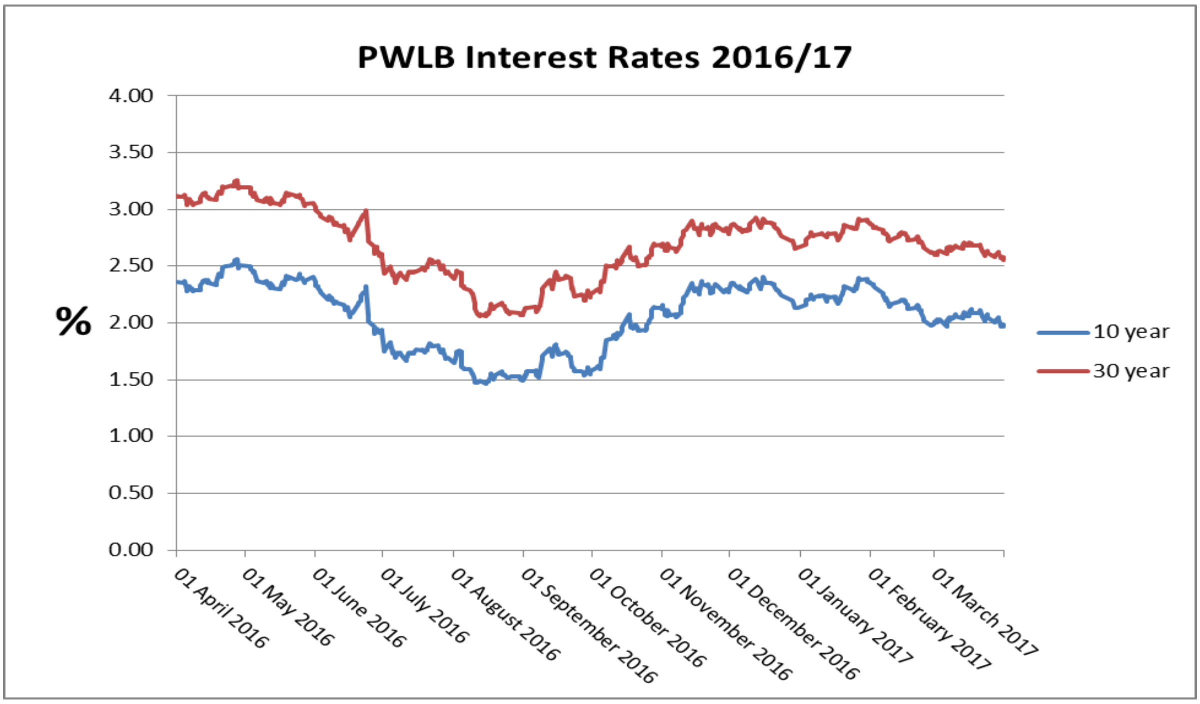
20. Whilst the economic future is not certain, the strategy of using cash remains supported by the current economic situation and the forecast for low interest rates in the future.

21. Longer term interest rates are more relevant when the County Council wants to take up a new loan; these are mainly sourced from the Public Works Loan Board (PWLB) whose loan interest rates vary daily reflecting changes in gilt yields in the UK Government bond market.

22. In August 2016, the Government undertook a consultation whereby it set out reforms to transfer the powers of the PWLB to the Treasury. This included the transfer of all existing loans and securities, and responsibilities for lending policy and setting interest rates for loans. The majority of responses to the consultation agreed with the proposals and the Government announced in November 2016 that it plans to go ahead with the proposed changes. However it is important to note that the proposals should have no real effect on the Council's existing PWLB loans or on local authority lending policy from Central Government.

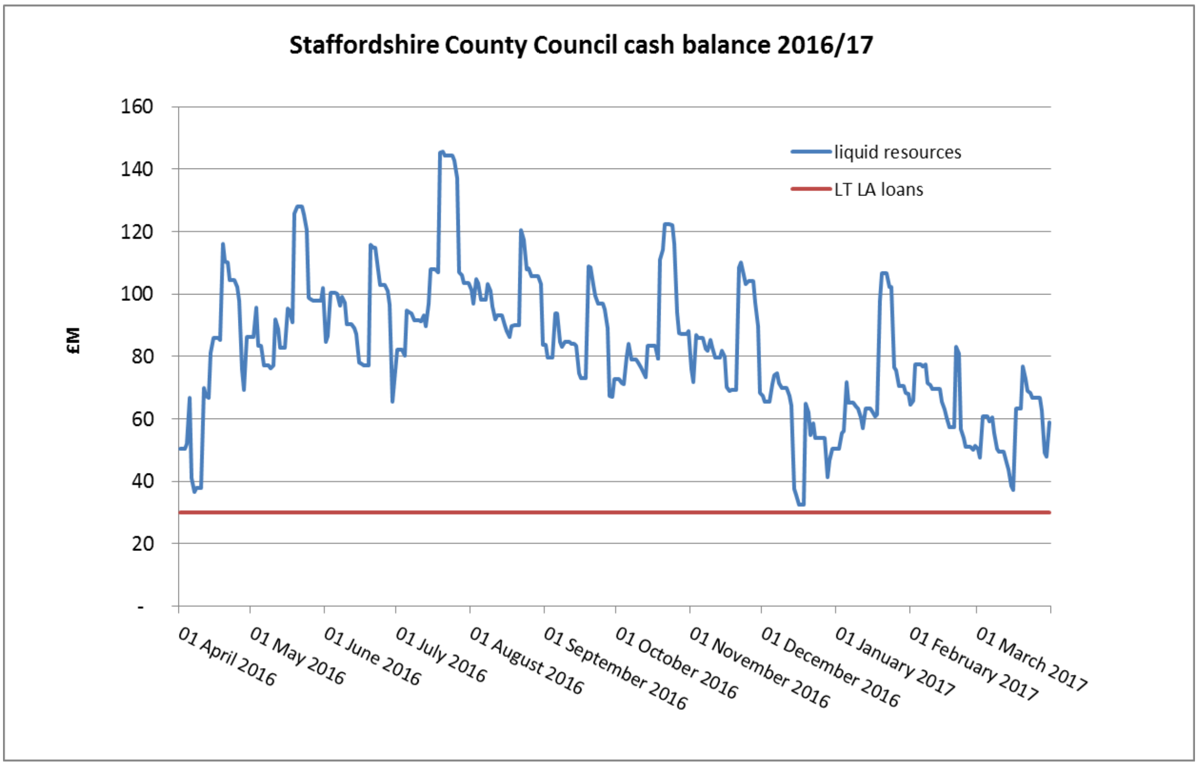
23. The following graph shows PWLB interest rates (at certainty rate) for two indicative loans throughout 2016/17. PWLB loans are priced with reference to gilt yields and it can be seen that after falling to a low in August 2016, gilt yields rose before tailing off towards the end of the financial year. The rise reflected lower demand for UK Government debt (when gilt prices decrease,

yields rise), as worries about the UK economy emerged following the decision to leave the EU.



24. It is important to consider the relationship between short-term investment rates and longer term rates. If borrowing in the form of a loan is taken, the proceeds have to be invested at rates significantly lower than the cost of the borrowing. At the moment this difference would be around 1.6%, conversely, avoiding new loans results in a significant saving (**see paragraph 28**).

25. An equally important consideration, behind the policy of using cash in lieu of borrowing, is whether cash is available. The following graph shows the investment balances for 2016/17 which were sufficient to fund the use of cash of £82.676m (**see paragraph 14**).



26. The following table shows the average interest rate incurred on the County Council's loan portfolio, and an adjustment to this to reflect the use of cash.

	2015/16 %	**2016/17 %**
Weighted average rate of interest for external loans	4.78%	4.78%
Adjusted for the use of cash	4.22%	4.22%

27. The average rate on external loans is the same as last year as there have been very few loan maturities in 2016/17. The rate does not change after the use of cash is included; this is because the County's Council's decrease in the use of cash was not significant enough to change the rate (**see paragraph 14**).

28. On average, internally funding from cash balances in lieu of borrowing has saved the County Council £1.4 million in interest payments this year.

29. A graph illustrating the maturity profile of the long-term debt at 31 March 2017 is provided at **Appendix 2**.

30. The financing of the County Council's long-term debt at 31 March 2017 is summarised in the following table.

	£m	**% of Total**
PWLB fixed maturity loans and other	406.221	71
Lender Option Borrower Option (LOBO) loans	81.500	14
Internal funding from cash	82.676	14
Total debt position	**570.397**	**100**

Loan rescheduling in 2016/17

31. Movements in interest rates over time may provide opportunities to restructure the loan portfolio in one of two ways:
- to replace existing loans with new loans at a lower rate (known as loan rescheduling).
- to repay loans early, without replacing the loans. This would increase the use of cash.

32. A combination of factors throughout 2016/17 meant that loan restructuring was not financially viable:
- gilt yields were still near historical lows, which means a large penalty would be payable;
- Government policy is to apply a margin to the early repayment of a PWLB loan, which further increases the penalty payable; and
- the large gap between short-term interest rates and longer-term interest rates meant that no LOBO loans were called.

Annual provision for principal repayments (Minimum Revenue Provision)

33. Under the Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2008, local authorities are given some flexibility in making an annual revenue provision for the repayment of debt.

34. In accordance with the approved policy, the Minimum Revenue Provision of £21.453 million has been used to reduce the County Council's level of debt.

Annual Investment Strategy - Approved lending list

35. The Annual Investment Strategy (AIS) sets out the parties the County Council will lend its money to. The AIS sets out the requirements of government guidance and the CIPFA Code of Practice for Treasury Management. Both of these documents set out two prime risk issues:
    - the security of capital.
    - the liquidity of investments.

36. The following characteristics underpin the AIS.
    - the use of regulation investments and counterparties recommended by the treasury adviser (high level of security).
    - the use of diversified sterling "AAA" Money Market Funds (MMFs) and same day liquidity accounts (high level of security and liquidity).
    - a maximum duration of 12 months for bank and building society investments (high level of security).

Credit risk management and the Treasury Management Panel

37. The treasury team monitor the markets as part of a risk management strategy. Regular reports are provided to the Director of Finance and Resources, who chairs the Treasury Management Panel ('the Panel') which is attended by senior finance officers, and treasury staff.

38. Bail-in legislation has increased the risk for a local authority making unsecured investments with banks. Under the Bank Recovery and Resolution Directive (BRRD), a "bail in" of current investors will be forced upon the bank instead of a government "bail out". The risk of loss for local authorities in a bail-in situation is much greater, as any unsecured fixed-term deposits would be ranked near the bottom of the capital structure, and therefore, one of the first to suffer losses.

39. During the year, the Panel reviewed regular bail-in analysis reports provided by Arlingclose, the County Council's Treasury Management Advisor. For 2016/17 the Panel also considered and approved adopting Arlingclose's recommendation of limiting investments in unsecured bank or building society deposits to 5% of available cash balances, a reduction of 5% from the previous limit of 10%.

40. In January 2017, the UK Prime Minister indicated the UK would need to leave the European Single Market as part of its negotiation to leave the European Union. A 'hard Brexit' poses greater risks for Treasury Management in general, due to the negative impact of uncertainty on financial markets and economic growth.

41. The Panel closely monitored Brexit developments with Arlingclose. The County Council's long term investment strategy is already low risk, with a focus on safeguarding assets by investing in low risk institutions, with a view to liquidity and diversification. The Panel considered there was no immediate need to change this strategy.

42. The Panel also dealt with the following issues in 2016/17:
- reviewed the results of bank stress tests undertaken by the Bank of England.
- discussed exposure to Deutsche Bank following concern in September 2016 and the potential for a bail-in.
- assessed the results of the Treasury Management Adviser tender exercise and subsequently agreed to the reappointment of Arlingclose as the County Council's Treasury Management Advisor in February 2017.
- evaluated the impact of forthcoming changes in regulations for Money Market Funds and the revised Markets in Financial Instruments Directive (known as MiFID II)

43. The following table sets out the credit ratings awarded by credit rating agencies for the counterparties that the County Council was invested with at 31 March.

Credit Rating	**31 March 2016**	**31 March 2017**
	£m	**£m**
AAA	35.0	50.0
'A' range (including 'A+' and 'A-')	6.5	9.0
Local authorities	30.0	30.0
Total investments	**71.5**	**89.0**

44. The 2016/17 AIS set the minimum credit-rating of a counterparty at a long-term rating of "BBB" (where available). Counterparties rated below this level were automatically precluded from being on the lending list. From the table above, the highest rating ("AAA") was that given to MMF's, whilst the bank investments were graded in the "A" range.

45. Whilst most local authorities are unrated by credit rating agencies, both regulations (which list local authorities as acceptable bodies to invest in) and their status as tax raising bodies make them highly creditworthy.

46. A copy of the current lending list (at the time of writing this report) is attached at **Appendix 3**.

Treasury Management - Investment transactions 2016/17

47. Surplus cash is invested in money market instruments to earn interest in accordance with the AIS. All investments must comply with Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 which ensure authorities cannot 'speculate' with public funds, for example, authorities cannot invest surplus cash directly in the stock market.

48. The AIS allows investments in Non-specified investments subject to approval from the Panel chaired by the Director of Finance and Resources. Collective

Investment Schemes are a category within Non-specified investments that include Enhanced MMFs.

49. As a result of higher cash balances in 2016/17, the Panel approved an investment of £10m in the Royal London Cash Plus MMF in April 2017. This Enhanced MMF has the same characteristics as same day liquidity MMF's, but has a 3 day notice period and a recommended investment duration of at least 6 months, due to a longer investment horizon. The Royal London Cash Plus MMF should allow the Council to earn an increased yield in a low interest rate environment.

50. The following table summarises some key facts about the investment transactions over the last two years.

	2015/16	**2016/17**
Transactions in year	£1.553 billion	£1.663 billion
Interest receipts	£1.570 million	£1.522 million
Average return on investments	1.56%	1.36%
7 day LIBID ** (benchmark)	0.36%	0.20%
Additional return generated	1.20%	1.16%
* Adjusted without long-term local authority investments	0.52%	0.39%

*** London Interbank BID interest rate*

51. The table above shows that the level of transactions in 2016/17 was higher than in the previous year. However interest receipts and the average return on investments was lower, mainly because interest rates fell in year.

52. The interest receipt figure includes the interest receipts from £30m of local authority investments (see **paragraph 54**). These were made at an average rate of 4.02%.

53. Excluding the local authority investments, the yield was lower in 2016/17. Money market rates decreased during the year following the cut in Bank rate, and this fed through to the County Council receiving a lower return.

54. Local authority investments were originally approved by Cabinet in 2013, for a maximum of £45m. No further investments were made in 2016/17, due to a lack of demand from borrowers and the County Council having lower cash balances than when the original Cabinet decision was made.

55. Overall, the final net cost of managing the county councils debt and investment portfolio's (interest paid less interest receipts) in 2016/17 was £0.001 below budget.

56. Approved investments at 31 March 2017 stood at £88.955 million (£71.485 million at 31 March 2016) and these can be analysed as follows:

Long-term local authority	£m	Term
Derby City Council	7.500	28/11/2030
Derby City Council	7.500	28/11/2031
Redcar and Cleveland Borough Council	7.500	29/11/2032
Redcar and Cleveland Borough Council	7.500	29/11/2033
Banks and building societies		
Lloyds (as banking provider)	3.955	Instant Access
Santander	5.000	Instant Access
Money Market Funds		
Black Rock	8.000	Instant Access
Insight	7.000	Instant Access
Federated	10.000	Instant Access
Standard Life	10.000	Instant Access
State Street	5.000	Instant Access
Enhanced Money Market Funds		
Royal London Cash Plus	10.000	3 day notice
TOTAL	**88.955**	

Compliance with Prudential Indicators, treasury limits and other matters

57. The following can be confirmed:

(i) In accordance with financial regulations, the Treasury Management Panel, chaired by the Director of Finance and Resources and comprising other senior finance officers, met regularly to consider treasury matters.

(ii) All treasury related transactions were undertaken by authorised officers and within the limits approved by the County Council.

(iii) All investments were to counterparties on the approved lending list current at the time and fully met the requirements of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2008.

(iv) The County Council operated within the limits and Prudential Indicators for treasury management as set out in the County Council's Treasury Management Practices. The outturn for all Prudential Indicators is shown in **Appendix 4**.

Appendix 1

Equalities implications – There are no equalities implications arising from this report.

Legal implications – There are no legal implications arising from this report.

Resource and value for money implications – The resource and value for money implications are contained within the body of the report.

Risk implications – Counterparty, interest rate and refinancing risk arising as a result of treasury management activity have been considered in the body of this report.

Climate change implications – There are no climate change implications arising from this report.

Health impact assessment screening – There are no health impact assessment implications arising from this report.

Report Author:
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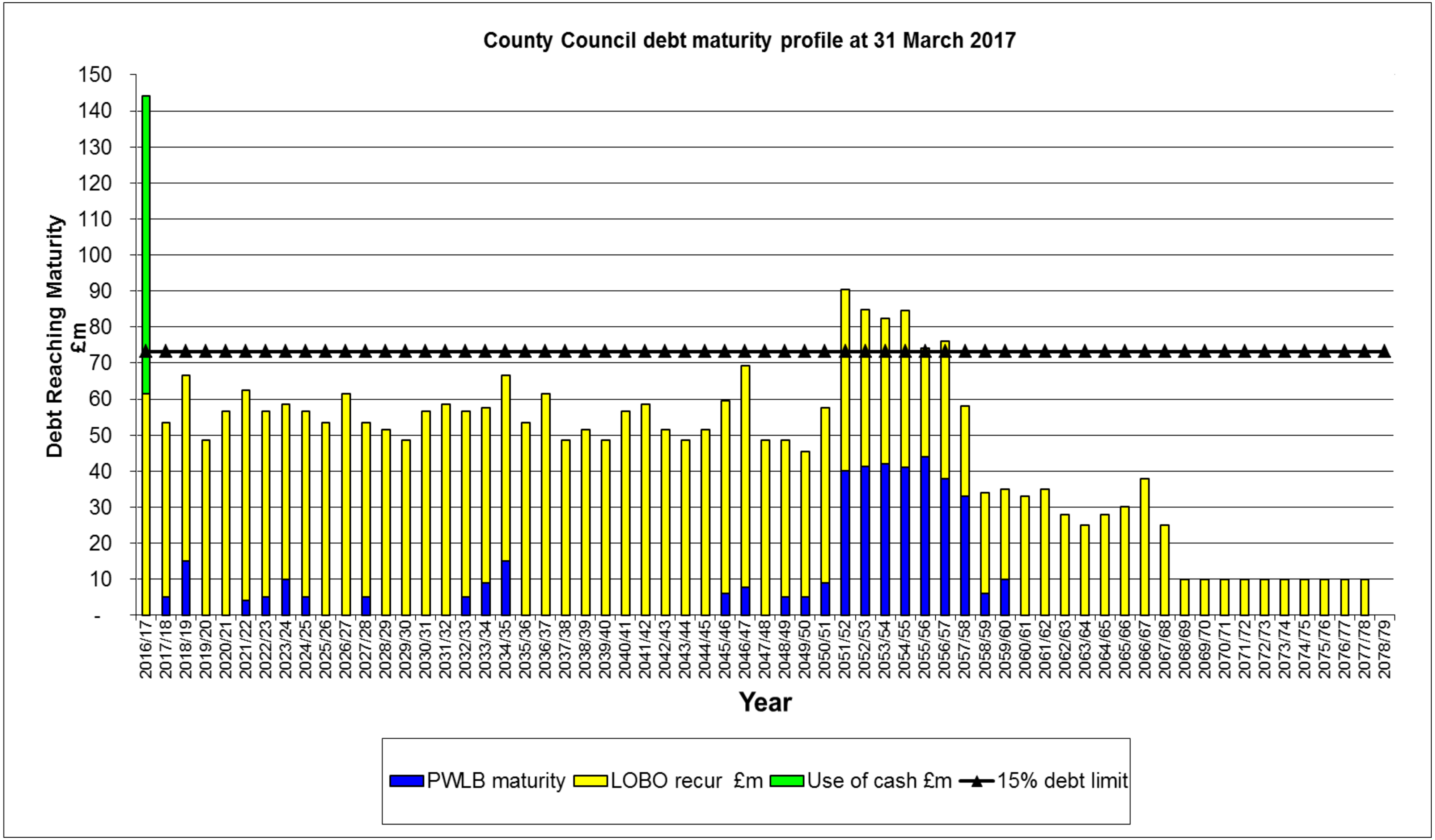
Ext. Number: 276011
Location: Staffordshire Place 2, Floor 2

List of background papers

1. Treasury Management in the Public Services: Code of Practice (CIPFA) (2011)
2. Prudential Code for Capital Finance in Local Authorities (CIPFA) (2011)
3. Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
4. Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2008
5. Local Government Investments - Guidance under Section 15(1) of the Local Government Act 2003 issued by the Secretary of State
6. Local Government Act 2003 - Guidance issued under section 21(1a) (re MRP policy)

Appendix 2



County Council debt maturity profile at 31 March 2017
Debt Reaching Maturity £m
Year
PWLB maturity
LOBO recur £m
Use of cash £m
15% debt limit

Appendix 3

Cabinet – 19 July 2017

Approved lending list - June 2017	
	Time limit
Regulation investments	
DMADF account	6 months
UK Government Treasury Bills	6 months
UK local authority	12 months
Banks and building societies	
Barclays	100 days
Lloyds	13 months
Nationwide	6 months
Santander	6 months
MMF's	
Black Rock	same day
Insight	same day
Federated	same day
Standard Life	same day
State Street	same day
Enhanced MMF's	
Royal London Cash Plus	3 day notice

Appendix 4

Cabinet – 19 July 2017

Prudential Indicators for Treasury Management

Indicator	Estimate 2016/17	Actual Position at 31/03/17
1. CIPFA Code of Practice for Treasury Management in the Public Services	The County Council has adopted the CIPFA Code of Practice on Treasury Management.	
This indicator identifies whether an authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services.		
2. External debt		
Authorised Limit for borrowing	£671m	£488m
Authorised Limit for other liabilities	£238m	£228m
TOTAL	**£909m**	**£716m**
Operational Boundary for borrowing	£556m	£488m
Operational Boundary for other liabilities	£238m	£228m
TOTAL	**£794m**	**£716m**
External loans	**£518m**	**£488m**
The Authorised Limit is the maximum level of external borrowing which should not be exceeded. It is linked to the estimated level of borrowing assumed in the Capital Programme. *The Operational Boundary represents the Director of Finance and Resources estimate of the day to day limit for treasury management activity based on the most likely i.e. prudent but not worst case scenario.* *"Other liabilities" relate to PFI schemes which are recorded in the County Council's accounts.*		
3. Interest rate exposures		
a. Upper Limit (Fixed)	£596m	£458m
b. Upper Limit (Variable)	(£180m)	(£59m)
Upper limits of fixed and variable borrowing and investments are required to be set. The effect of setting these upper limits is to provide ranges within which the County Council will manage its exposure to fixed and variable rates of interest. Negative figures are shown in brackets; these relate to the" high- point" of investments at a variable rate which are not offset by variable borrowings. The exposure to variable rate movements has been reduced by funding new borrowing from cash balances.		
4. Maturity structure of borrowing		
See Graph at **Appendix 2**		
This indicator relates to the amount of loans maturing in specified periods. The overarching principle is that steps should be taken from a risk management point of view to limit exposure to significant refinancing risk in any short period of time. The County Council currently applies the practice of ensuring that no more than 15% of its total gross fixed rate loans mature in any one financial year. *Because this is a complex situation for the County Council, involving PWLB loans, LOBO loans with uncertain call dates and the use of internal cash, specific indicators have not been set. Instead the County Council will manage its exposures within the limits shown on the graph at Appendix 2. This graph shows all LOBO call options on a cumulative basis; the actual pattern of repayment, although uncertain, will not be of this magnitude.*		
5. Upper limit for total principal sums invested for over 364 days (per maturity date)		
Any investments made for over 364 days will be in accordance with the County Council's limits on non-specified investments.	£95m	£30m
6. Borrowing in advance of need (maximum debt)	100%	100%
This indicator sets the maximum loans as a proportion of the borrowing need. In 2016/17 the strategy was not to borrow in advance, hence the indicator was set at 100%.		