Appendix H

Annual Treasury Management Report

2016/17

For Noting by Cabinet 26 June 2017

Annual Treasury Management Review 2016/16

Purpose

The 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).

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 02 March 2016)
- a mid-year (minimum) treasury update report (Council 14 December 2016)
- an annual review following the end of the year describing the activity compared to the strategy (this report).

In addition, Members have received quarterly treasury management update reports that were presented to Cabinet and Budget and Performance Panel.

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.

The Council confirms that it has complied with the requirement under the Code to give prior scrutiny (by Budget and Performance Panel) to all of the above treasury management reports before they were reported to full Council.

Introduction and Background

This report summarises the following:-

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

1. The Council's Capital Expenditure and Financing 2016/17

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- if insufficient financing is available from the above sources, or a decision is taken not to apply such resources, the capital expenditure will give rise to a borrowing need (also referred to as "unfinanced", within the tables and sections below).

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

General Fund (GF) £M	2015/16 Actual	2016/17 Estimate	2016/17 Actual
Capital expenditure	**7.52**	**14.50**	**12.63**
Financed in year	3.10	7.58	6.18
Unfinanced capital expenditure (i.e. reliant on an increase in underlying borrowing need)	**4.42**	**6.92**	**6.45**

HRA £M	2015/16 Actual	2016/17 Estimate	2016/17 Actual
Capital expenditure	**4.88**	**4.31**	**4.08**
Financed in year	4.88	4.31	4.08
Unfinanced capital expenditure (i.e. reliant on an increase in underlying borrowing need)	**0.000**	**0.000**	**0.000**

2. The Council's Capital Financing Requirement 2016/17

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2016/17 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury function organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need (there is no statutory requirement to reduce the HRA CFR). This differs in purpose from other treasury management arrangements, which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

The Council's 2016/17 MRP Policy (as required by Government Guidance) was approved as part of the Treasury Management Strategy Report for 2016/17 on 02 March 2016.

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 effectively increase the Council's borrowing need. No borrowing is actually required against these schemes, however, as a borrowing facility is included in the contract (if applicable).

CFR (£M): General Fund	31 March 2016 Actual	31 March 2017 Estimate	31 March 2017 Actual
Opening balance	**32.52**	**35.38**	**35.37**
Add unfinanced capital expenditure (as above)	4.42	6.92	6.45
Less MRP	(1.46)	(1.12)	(1.12)
Less finance lease repayments	(0.11)	(0.10)	(0.08)
Closing balance	**35.37**	**41.08**	**40.62**

CFR (£M): HRA	31 March 2016 Actual	31 March 2017 Estimate	31 March 2017 Actual
Opening balance	**43.59**	**42.52**	**42.52**
Add unfinanced capital expenditure (as above)	0.00	0.00	0.00
Less Debt Repayment	(1.07)	(1.04)	(1.07)
Closing balance	**42.52**	**41.48**	**41.45**

CFR (£M): Combined	31 March 2016 Actual	31 March 2017 Estimate	31 March 2017 Actual
Opening balance	**76.11**	**77.90**	**77.89**
Add unfinanced capital expenditure (as above)	4.42	6.92	6.45
Less Debt Repayment, Finance Leases and MRP	(2.64)	(2.26)	(2.26)
Closing balance	**77.89**	**82.56**	**82.07**

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

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 helps to demonstrate that the Council is not borrowing to support revenue expenditure, whilst allowing some flexibility in 2016/17 to borrow in advance of future capital needs. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with the legal requirements underpinning this prudential indicator.

	31 March 2016 Actual	31 March 2017 Estimate	31 March 2017 Actual
Gross borrowing position	£66.42M	£65.29M	£65.29M
CFR	£77.89M	£82.55M	£82.07M

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. The table below demonstrates that during 2016/17 the Council has maintained gross borrowing within its authorised limit.

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 are acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator helps identify the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2016/17 Actual
Authorised limit	£100.000M
Maximum gross borrowing position	£66.29M
Operational boundary	£83.53M
Average gross borrowing position	£65.94M
Financing costs as a proportion of net revenue stream - GF	13.9%
Financing costs as a proportion of net revenue stream - HRA	17.4%

3. Treasury Position as at 31 March 2017

The Council's debt and investment position is administered 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's treasury (excluding borrowing relating to finance leases) position was as follows:

	31 March 2016 Principal	Average Rate	Average Life yrs	31 March 2017 Principal	Average Rate	Average Life yrs
Fixed rate funding:						
PWLB	£66.29M	4.59%	37	£65.25m	4.61%	36
Total debt	**£66.29M**			**£65.25M**		
CFR	**£77.89M**			**£82.07M**		
Over / (under) borrowing	**(£11.60M)**			**(£16.82M)**		
Total investments	**£39.22M**	**0.47%**		**£30.25M**	**0.37%**	

All investments were placed for under one year.

The loan repayment schedule is as follows:

	31 March 2016 actual	31 March 2017 actual
Under 12 months	£1.04M	£1.04M
12 months and within 24 months	£1.04M	£1.04M
24 months and within 5 years	£3.12M	£3.12M
5 years and within 10 years	£5.21M	£5.21M
10 years and within 20 years	£10.41M	£10.41M
20 years and within 30 years	£10.41M	£10.41M
More than 30 years	£34.01M	£32.98M

The average rate of interest payable on PWLB debt in 2016/17 was 4.61%. A total of £3.04M interest was incurred during the year, of which £1.95M was recharged to the HRA.

Interest Payable

	2016/17
Estimate	£3.07M
Actual	£3.04M

Prudential Indicators also provide exposure limits that identify the maximum limit for variable / fixed interest rate exposure, based upon the debt position. The table below shows that the outturn position was within the limits set by Members at the beginning of the year. The Council currently only has fixed interest rate debt, although again this could change in future if market conditions warrant or facilitate it.

Fixed/Variable rate limits

	Prudential Indicator (%)	Actual (%)
Fixed Rate	100	100
Variable Rate	30	0

4. Interest Rates: Investment Strategy for 2016/17

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

5. The Economy and Interest Rates (supplied by Capita Asset Services)

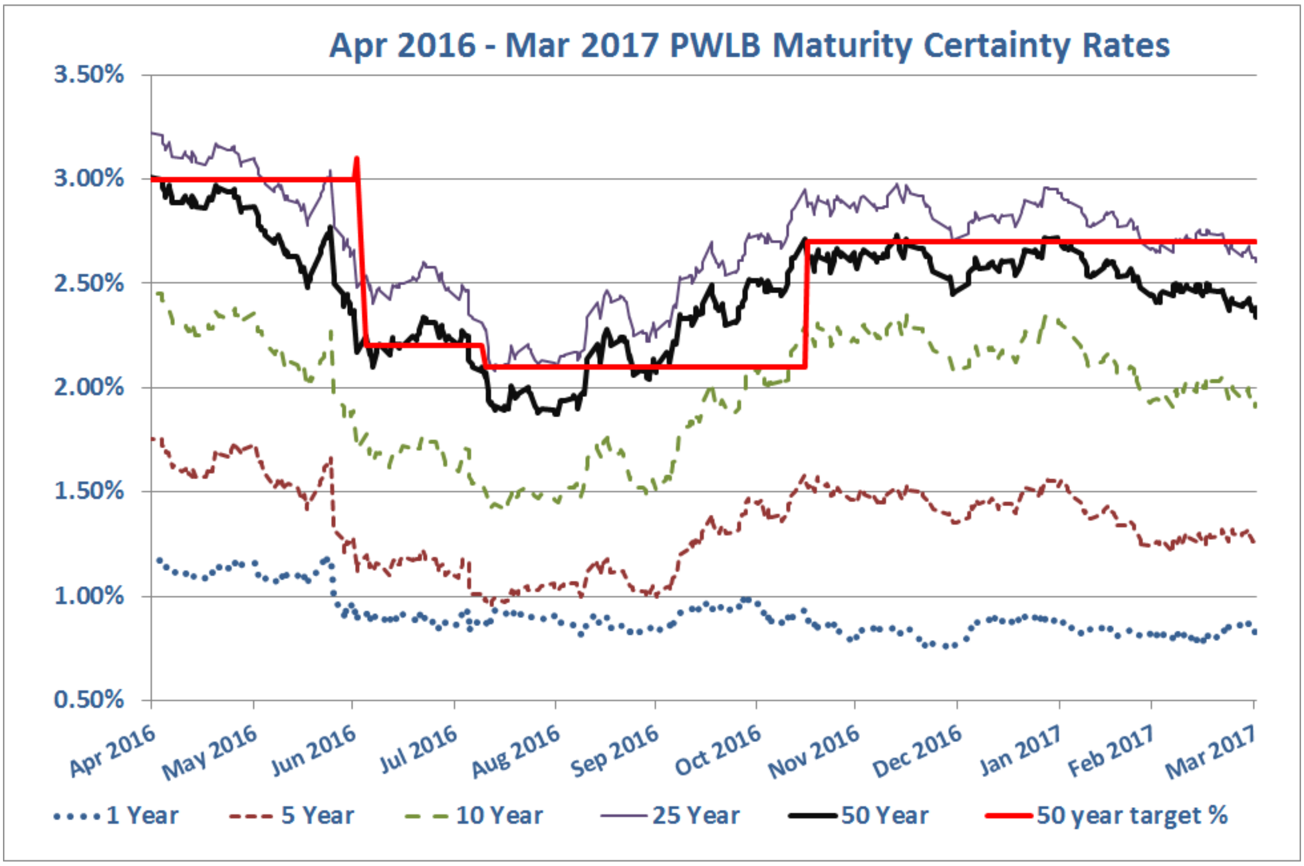
The UK GDP annual growth rates in each calendar year 2013 – 2016 of 1.9%, 3.1%, 2.2% and finally 1.8%, have all been the top rate, or near top rate, of any of the G7 countries in every year. It is particularly notable that this UK performance was repeated in 2016, a year in which the Bank of England had forecast in August that growth would be near to zero in the second half of the year due to the economic shock it expected from the result of the Brexit referendum in June. However, it has had to change its mind and in its February 2017 Inflation Report, the Bank again upgraded its forecasts for growth in 2017 and 2018 to 2.0% and 1.6%. However over this two year period, it also expects inflation to accelerate towards nearly 3% as increases in costs as a result of the fall in the value of sterling since the referendum, gradually feeds through into the economy. This fall has been steepest against the US dollar where its value has fallen 17%. Provided those cost pressures do not feed through into significantly higher domestically generated inflation within the UK, the MPC is expected to 'look though' this one off blip upwards in inflation. Wage inflation, which is a key driver of domestically generated price pressures, is currently subdued.

The Monetary Policy Committee, (MPC), cut Bank Rate from 0.50% to 0.25% on 4th August 2016 in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016. At that juncture, it also gave a strong steer that it was likely to cut Bank Rate again by the end of 2016. However, since August, growth has been robust; also, inflation forecasts have risen substantially as a result of the sharp fall in the value of sterling since the referendum. Consequently, Bank Rate has not been cut again, and, on current trends, it now appears unlikely that there will be another cut. Nevertheless, that cannot be completely ruled out if there was a significant dip downwards in economic growth. During the two-year period 2017 – 2019, when the UK is negotiating the terms for withdrawal from the EU, it is unlikely that the MPC will do anything to dampen growth prospects, (i.e. by raising Bank Rate), which will already be adversely impacted by the uncertainties of what form Brexit will eventually take. Accordingly, a first increase to 0.50% is not tentatively pencilled in, as in the table above, until quarter 2 2019, after those negotiations have been concluded, (though the period for negotiations could be extended). However, if strong domestically generated inflation, (e.g. from wage increases within the UK), were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.

The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%	0.75%
5yr PWLB rate	1.40%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%	2.00%
10yr PWLB rate	2.10%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%
25yr PWLB rate	2.70%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%
50yr PWLB rate	2.50%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%

PWLB certainty maturity borrowing rates - the graphs and table 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.

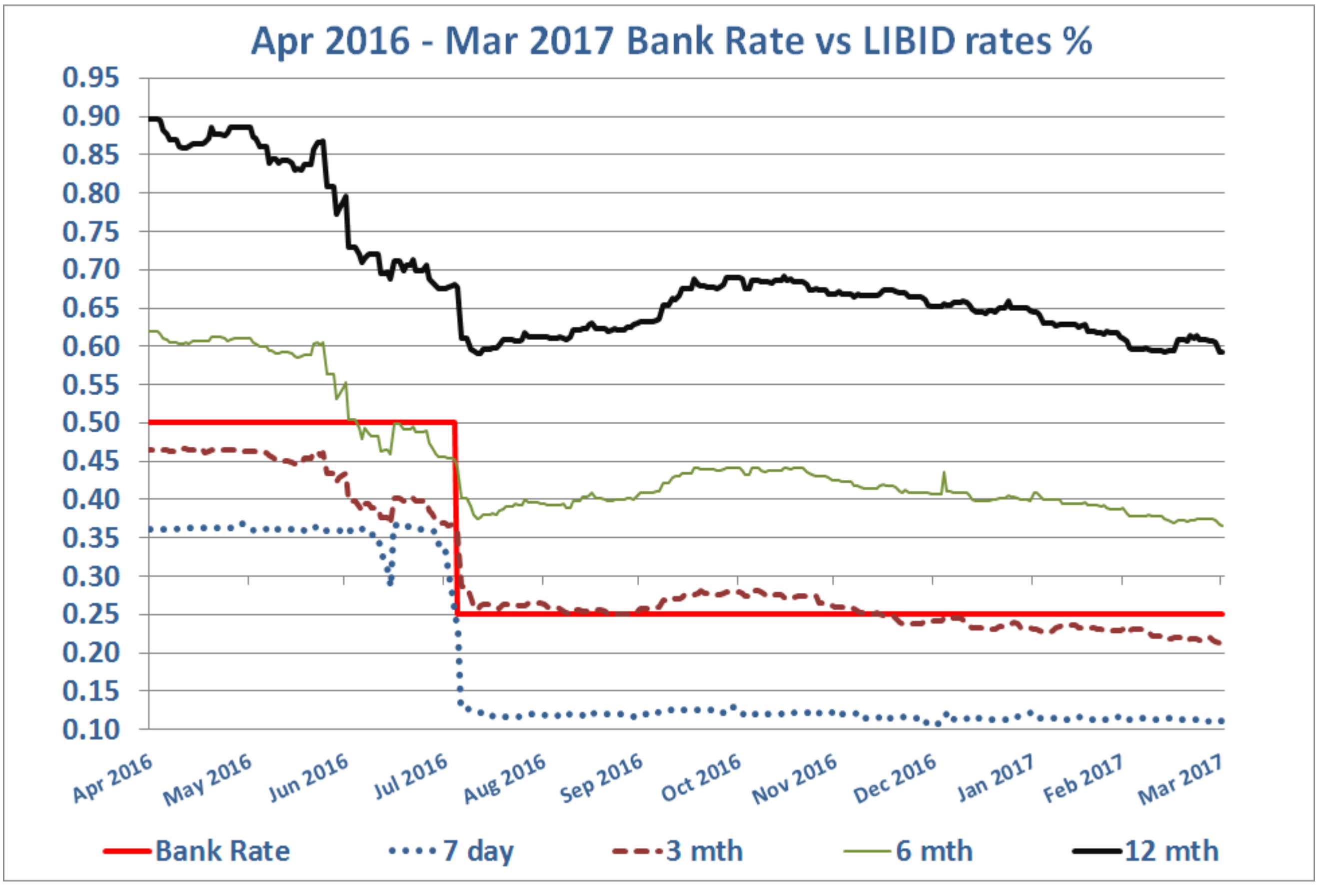


No actual borrowing was undertaken during the year.

Rescheduling
No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

8. Investment Rates in 2016/17

The Bank Rate was cut on 04 August from its then historic low of 0.5% to 0.25%. Investment rates available in the market fell sharply during the first quarter of the year before partially recovering but then subsiding gently again in the final quarter.



9. Investment Outturn for 2016/17

Investment Policy – the Council's investment policy is governed by Government investment guidance, which underpins the annual investment strategy approved by the Council on 02 March 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.).

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

Resources – the Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources were comprised of the following:

Balance Sheet Resources (£M)	General Fund		HRA		**TOTAL**	
	31/03/16	**31/03/17**	**31/03/16**	**31/03/17**	**31/03/16**	**31/03/17**
Balances	4.46	4.73	1.69	1.94	**6.15**	**6.67**
Earmarked reserves	6.51	6.61	10.57	10.71	**17.08**	**17.32**
Provisions	0.56	0.50	0.00	0.00	**0.56**	**0.50**
Working Capital	24.07	20.13	3.01	2.56	**27.08**	**22.69**
Total Resources	**35.60**	**31.97**	**15.27**	**15.21**	**50.87**	**47.18**
Amount Over / (Under) Borrowed					**(11.60)**	**(16.82)**
Baseline Investment Balances					**39.27**	**30.36**

Actual Investment Balances	**39.22**	**30.25**

Investments held by the Council - the Council maintained an average investment balance of £47.2M of internally managed funds. The average rate of interest earned was 0.37% is compared to the base rate and average 3-month LIBID rate as set you below.

	2015/16	2016/17
Lancaster CC Investments	0.47%	0.37%
Base Rate	0.50%	0.25%
3 Month LIBID	0.46%	0.32%

In terms of performance against budget the actual interest earned in 2016/17 was £173K compared to a budget of £161K.

10. Other Risk Management Issues

Many of the risks in relation to treasury management are managed through the setting and monitoring of performance against the relevant Prudential and Treasury Indicators and the approved Investment Strategy, as discussed above.

The Authority's Investment Strategy is designed to engineer risk management into investment activity by reference to credit ratings and the length of deposit to generate a pool of counterparties, together with consideration of other creditworthiness information to refine investment decisions. The Council is required to have a strategy is required under the CIPFA Treasury Management Code, the adoption of which is another Prudential Indicator. The strategy for 2016/17 complied with the latest Code of Practice (November 2011) and relevant Government investment guidance.

11. Conclusion

The Council's treasury activities were in line with its approved policies and strategies. With respect to investments, some longer fixed term investments were placed with other Local Authorities which helped to increase the average yield for the year. Cash balances have, however, reduced significantly during the year following the completion of transactions relating to business rate appeals. This in turn will reduce investment interest going forward, something which has already been factored into future forecasts.

Annex A

LANCASTER CITY COUNCIL

TREASURY MANAGEMENT POLICY STATEMENT

Last reported to Council on 02 March 2016

This reflects the revised CIPFA Treasury Management Code of Practice (Code updated in 2011).

1. This organisation defines its treasury management activities as:

   "The management of the authority'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. This organisation regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation and any financial instruments entered into to manage these risks.

3. This organisation acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

Treasury Management Glossary of Terms

- **Annuity –** method of repaying a loan where the payment amount remains uniform throughout the life of the loan, therefore the split varies such that the proportion of the payment relating to the principal increases as the amount of interest decreases.

- **CIPFA** – the Chartered Institute of Public Finance and Accountancy, is the professional body for accountants working in Local Government and other public sector organisations, also the standard setting organisation for Local Government Finance.

- **Call account** – instant access deposit account.

- **Counterparty** – an institution (e.g. a bank) with whom a borrowing or investment transaction is made.

- **Credit Rating** – is an opinion on the credit-worthiness of an institution, based on judgements about the future status of that institution. It is based on any information available regarding the institution: published results, Shareholders' reports, reports from trading partners, and also an analysis of the environment in which the institution operates (e.g. its home economy, and its market sector). The main rating agencies are Fitch, Standard and Poor's, and Moody's. They currently analyse credit worthiness under four headings (but see changes referred to in the strategy):

    - **Short Term Rating** – the perceived ability of the organisation to meet its obligations in the short term, this will be based on measures of liquidity.

    - **Long Term Rating** – the ability of the organisation to repay its debts in the long term, based on opinions regarding future stability, e.g. its exposure to 'risky' markets.

    - **Individual/Financial Strength Rating** – a measure of an institution's soundness on a stand-alone basis based on its structure, past performance and credit profile.

    - **Legal Support Rating –** a view of the likelihood, in the case of a financial institution failing, that its obligations would be met, in whole or part, by its shareholders, central bank, or national government.

  The rating agencies constantly monitor information received regarding financial institutions, and will amend the credit ratings assigned as necessary.

- **DMADF and the DMO –** The DMADF is the 'Debt Management Account Deposit Facility'; this is highly secure fixed term deposit account with the Debt Management Office (DMO), part of Her Majesty's Treasury.

- **EIP –** Equal Instalments of Principal, a type of loan where each payment includes an equal amount in respect of loan principal, therefore the interest due with each payment reduces as the principal is eroded, and so the total amount reduces with each instalment.

- **Gilts** – the name given to bonds issued by the U K Government. Gilts are issued bearing interest at a specified rate, however they are then traded on the markets like shares and their value rises or falls accordingly. The Yield on a gilt is the interest paid divided by the Market Value of that gilt.

E.g. a 30 year gilt is issued in 1994 at £1, bearing interest of 8%. In 1999 the market value of the gilt is £1.45. The yield on that gilt is calculated as 8%/1.45 = 5.5%.
See also PWLB.

- **LIBID** – The London Inter-Bank Bid Rate, the rate which banks would have to bid to borrow funds from other banks for a given period. The official rate is published by the Bank of England at 11am each day based on trades up to that time.

- **LIBOR** – The London Inter-Bank Offer Rate, the rate at which banks with surplus funds are offering to lend them to other banks, again published at 11am each day.

- **Liquidity** – Relates to the amount of readily available or short term investment money which can be used for either day to day or unforeseen expenses. For example Call Accounts allow instant daily access to invested funds.

- **Maturity** – Type of loan where only payments of interest are made during the life of the loan, with the total amount of principal falling due at the end of the loan period.

- **Money Market Fund (MMF)** – Type of investment where the Council purchases a share of a cash fund that makes short term deposits with a broad range of high quality counterparties. These are highly regulated in terms of average length of deposit and counterparty quality, to ensure AAA rated status.

- **Policy and Strategy Documents** – documents required by the CIPFA Code of Practice on Treasury Management in Local Authorities. These set out the framework for treasury management operations during the year.

- **Public Works Loans Board (PWLB)** – a central government agency providing long and short term loans to Local Authorities. Rates are set daily at a margin over the Gilt yield (see Gilts above). Loans may be taken at fixed or variable rates and as Annuity, Maturity, or EIP loans (see separate definitions) over periods of up to fifty years. Financing is also available from the money markets, however because of its nature the PWLB is generally able to offer better terms.

- **Capita Asset Services** – Capita Asset Services are the City Council's Treasury Management advisors. They provide advice on borrowing strategy, investment strategy, and vetting of investment counterparties, in addition to ad hoc guidance throughout the year.

- **Yield** – see Gilts

Members may also wish to make reference to *The Councillor's Guide to Local Government Finance.*