MEETING:	**AUDIT COMMITTEE**
DATE:	**29 SEPTEMBER 2016**
TITLE:	**TREASURY MANAGEMENT 2016/17 – MID YEAR REVIEW**
PURPOSE:	**CIPFA's Code of Practice recommends that a report on the Council's actual Treasury Management during the current financial year is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
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EXECUTIVE SUMMARY

During the five month period between 1 April and 31 August 2016, the Council's borrowing remained well within the limits originally set. There were no new defaults by banks in which the Council deposited money.

1. INTRODUCTION

The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that Authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end). This report provides a mid-year update.

The Council's Treasury Management Strategy for 2016/17 was approved by full Council on 3 March 2016 which can be accessed on https://democracy.cyngor.gwynedd.gov.uk/ielistdocuments.aspx?cid=130&mid=286&ver=4

The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk.

2. EXTERNAL CONTEXT

As we entered 2016, there was a significant uncertainty about the outlook for global growth. The slowdown in the Chinese economy and the knock-on effects for both trading partners and commodity prices, the uncertainty over the outcome of the US presidential election (no clear party or candidate being identified as an outright winner) and the impending referendum on the UK's future relationship with the EU, all resulted in nervousness and a shaky start for markets.

Fluctuations in the opinion polls on the EU referendum prompted pronounced volatility in exchange rates, gilts, corporate bonds and equities as the result became increasingly uncertain. Immediately prior to the result, financial market sentiment shifted significantly in favour of a Remain outcome, a shift swiftly reversed as the results came in. The vote to leave the EU sent shockwaves through the domestic, European and global political spectrum, the most immediate impact being the resignation of Prime Minister David Cameron.

Between 23rd June and 1st July the sterling exchange rate index fell by 9% and short-term volatility of sterling against the dollar increased significantly. Worldwide, markets reacted very negatively with a big initial fall in equity prices. Government bond yields also fell sharply by 20-30 bps across all maturities (i.e. prices rose) as investors sought safe haven from riskier assets. The 10-year benchmark gilt yield fell from 1.37% to 0.86%.

Yet, a week on from the result the overall market reaction, although significant, was less severe than some had feared. The 5-year CDS for the UK (the cost of insuring against a sovereign default) rose from 33.5 basis points to 38.4 basis points. The FTSE All Share index, having fallen sharply by 7% from 3,481 points on 23rd June to 3,237 after the result, had subsequently risen to 3,515 by the end of the month.

The Bank of England sought to reassure markets and investors. Governor Mark Carney's speeches on 24th and 30th June in response to the referendum result stressed that the Bank was ready to support money market liquidity and raised the likelihood of a cut in policy rates 'in the summer'. In August the Bank cut the base rate to 0.25% and the impact of this will take some time to work through the system.

3. LOCAL CONTEXT

At 31/3/2016 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £173.5m, while usable reserves and working capital which are the underlying resources available for investment were £68.5m. The Council had £114.8m of borrowing and £66.4m of investments.

The Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

4. BORROWING STRATEGY

At 31/8/2016 the Council held £111.7m of loans, (a decrease of £3.2m on 31/3/2016), as part of its strategy for funding previous years' capital programmes.

The Council does not expect to borrow in 2016/17.

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. As short-term interest rates have remained, and are likely to remain, lower than long-term rates, the Council determined it was more cost effective in the short-term to use internal resources instead.

The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with this 'cost of carry' and breakeven analysis.

Borrowing Activity in 2016/17

	Balance on 01/04/16 £m	**Maturing Debt £m**	**New Borrowing £m**	**Balance on 31/08/15 £m**	**Avg Rate %**
CFR	173,503				
Short Term Borrowing[1]	2,757	(1,767)	-	990	0
Long Term Borrowing	113,676	-	-	113,676	5.78
TOTAL BORROWING	**116,433**	**(1,767)**	**-**	**114,666**	**5.77**
Other Long Term Liabilities	2,127	-	-	2,127	6.17
TOTAL EXTERNAL DEBT	**118,560**	**(1,767)**	**-**	**116,793**	**5.78**
Increase/ (Decrease) in Borrowing £m				(1,767)	

PWLB Certainty Rate and Project Rate Update

The Council qualified for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 1 November 2015. In September the Council submitted its application to the Treasury to access this reduced rate for a further 12 month period from 1 November 2016.

[1] Loans with maturities less than 1 year.

LOBO

The Council held a £16.2m LOBO (Lender's Option Borrower's Option) loan where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost.

In June Barclays Bank informed the Council of its decision to cancel all the embedded options within standard LOBO loans. This effectively converts £16.2m of the Authority's Barclays LOBO loans to fixed rate loans removing the uncertainty on both interest cost and maturity date. This waiver has been done by 'deed poll'; it is irreversible and transferable by Barclays to any new lender.

Debt Rescheduling

The premium charge 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.

Changes in the debt portfolio over the period have achieved a reduction in the level of borrowing as well as a reduction in credit risk by repaying loans from investment balances.

5. INVESTMENT ACTIVITY

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held.

The Welsh Government's Investment Guidance gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

The transposition of European Union directives into UK legislation places the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors through potential bail-in of unsecured bank deposits.

Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the Council's aim to further diversify into more secure and/or higher yielding asset classes during 2016/17. The majority of the Council's surplus cash has been invested in short-term unsecured bank deposits, certificates of deposit and money market funds. Diversification into securities with underlying collateral and investments with organisations which are not subject to bail-in will represent develop going forward.

Investment Activity in 2016/17

Investments	Balance on 01/04/16 £'000	Investments Made £'000	Maturities/ Investments Sold £'000	Balance on 31/08/16 £'000	Average Rate %
Unsecured Investments with financial institutions rated A- or higher - call accounts - deposits and CDs	*	*	*	*	*
Secured Investments with financial institutions - covered bonds	*	*	*	*	*
Investments with Corporates - corporate bonds issued by companies	*	*	*	*	*
Money Market Funds	*	*	*	*	*
TOTAL INVESTMENTS					
Increase in Investments				*	

* Figures will be presented on the day of the Committee

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.

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Credit Risk

Counterparty credit quality as measured by credit ratings is summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/16	4.34	AA-	3.57	AA-
30/06/16	4.49	AA-	3.43	AA

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 26
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Investments were made with banks and building societies and included call accounts, fixed-rate term deposits and certificates of deposit, Money Market Funds and covered bonds.

Counterparty Update

Various indicators of credit risk reacted negatively to the result of the 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.

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. Fitch, S&P and Moody's have a negative outlook on the UK. S&P took similar actions on rail company bonds guaranteed by the UK Government.

Moody's affirmed the ratings of nine UK banks and building societies and revised the outlook to negative for those banks and building societies that it perceived to be exposed to a more challenging operating environment arising from the 'leave' outcome.

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. In the coming weeks and months Arlingclose will therefore review all UK based institutions, and it is likely that, over time, will advise shortening durations on those institutions considered to be most affected.

Earlier in the year Moody's downgraded Deutsche Bank's long-term rating from Baa1 to Baa2 reflecting the agency's view of increased execution risks for the implementation of Deutsche Bank's strategic plan. In June Moody's downgraded Finland from Aaa to Aa1 on its view that Finnish economic growth will remain weak over the coming years, reducing the country's ability to absorb economic shocks.

Fitch upgraded the long-term rating of ING Bank from A to A+ based on Fitch's view of the bank's solid and stable financial metrics and its expectation that that the improvement in earnings will be maintained. Fitch also upgraded Svenska Handelsbanken's long-term rating from AA- to AA reflecting the agency's view that the bank's earnings and profitability will remain strong, driven by robust income generation, good cost efficiency and low loan impairments.

Budgeted Income and Outturn

The average cash balances were £*m (* figure will be presented on the day of the Committee) during the five months. The UK Bank Rate had been maintained at 0.5% since March 2009 but on 4th August 2016 the rate was changed to 0.25%. This even lower rate will have an impact on the interest earned in the future although the fixed deposits currently held will reduce the effect in the short term.

All investments will be impacted going forward and we will work closely with our advisors to use appropriate investments to maximise the interest whilst following the principal aim which is to protect the sum invested.

The Council's budgeted investment income for the year is estimated at £0.36m. based on an investment outturn of 0.5% for the whole year.

The Bank Rate is expected to be cut further towards zero in the coming months, which will in turn lower the rates short-dated money market investments with banks and building societies. As some of the Council's surplus cash continues to be invested in short-dated money market instruments, it will most likely result in a fall in investment income over the year.

Update on Investments with Icelandic Banks

The Council has now received repayment of 98% of the investment in Heritable Bank. The outstanding amount is now £80,376. It is likely that a further distribution will be received although the administrator has not yet made an official estimate of the final recovery.

Compliance with Prudential Indicators

The Council confirms compliance with its Prudential Indicators for 2016/17, which were set in March 2016 as part of the Council's Treasury Management Strategy Statement.

Treasury Management Indicators

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

Interest Rate Exposures: 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 proportion of net principal borrowed will be:

	2016/17	2017/18	2018/19
Upper limit on fixed interest rate exposure	100%	100%	100%
Actual	100%		
Upper limit on variable interest rate exposure	50%	50%	50%
Actual	0%		

Maturity Structure of Borrowing: 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:

	Upper	Lower	Actual
Under 12 months	25%	0%	0%
12 months and within 24 months	25%	0%	2.25%
24 months and within 5 years	50%	0%	16.24%
5 years and within 10 years	75%	0%	10.06%
10 years and within 20 years	100%	0%	32.00%

20 years and within 30 years	100%	0%	13.62%
30 years and within 40 years	100%	0%	1.56%
40 years and within 50 years	100%	0%	22.53%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days: 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	£40m	£20m	£10m
Actual	£2.18m	£2.18m	£2.18m

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating or credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target	**Actual**
Portfolio average credit score	6.0	3.43

7. Investment Training

During the period officers have attended investment training with Arlingclose and CIPFA relevant to their roles.

8. Outlook for the Remainder of 2016/17

Following the UK's vote to leave the European Union, the economic outlook for the UK has immeasurably altered. It will to a large extent be dependent on the nature of the future relationship negotiated with the EU, particularly in relationship to trade. The negotiations crucially hinge on domestic politics which, at the end of the June quarter, were unsettled themselves.

The domestic outlook is uncertain, but likely to be substantially weaker in the short term than previously forecast. Arlingclose has changed its central case for the path of Bank Rate over the next three years. Arlingclose believes any currency-driven inflationary pressure will be looked through by Bank of England policymakers.

	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
Official Bank Rate													
Upside risk	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
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	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

Arlingclose believes that the Government and the Bank of England have both the tools and the willingness to use them to prevent any immediate 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.

Appendix 1

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	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate* £m
General Fund Expenditure	**35.5**	**29.8**	**19.5**	**10.9**
Capital Receipts	1.6	0.9	0.8	0.1
Government Grants	17.6	10.8	5.9	2.5
Reserves	6.1	2.3	1.6	4.3
Revenue	4.1	5.0	3.2	0.0
Borrowing	1.9	10.8	8.0	4.0
Total Financing	**35.5**	**29.8**	**19.5**	**10.9**

* The estimate for 2017/18 does not include new schemes as they have not yet been approved.

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	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate* £m
General Fund	**173.5**	**178.3**	**182.1**	**180.4**

The CFR is forecast to rise by £4.6m over the next three years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

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	31/03/16 Actual £m	31/08/16 Actual £m	31/03/17 Estimate £m	31/03/18 Estimate £m	31/03/19 Estimate* £m
Borrowing	113.4	111.3	111.1	109.1	106.6
Finance leases	2.3	2.5	2.3	2.2	2.1
Total Debt	**115.7**	**113.8**	**113.4**	**111.4**	**108.7**

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	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Borrowing	175	175	175	175
Other long-term liabilities	0	0	0	0
Total Debt	**175**	**175**	**175**	**175**

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	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Borrowing	195	195	195	195
Other long-term liabilities	0	0	0	0
Total Debt	**195**	**195**	**195**	**195**

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	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate* £m
General Fund	5.07	5.91	5.60	5.73

Incremental Impact of Capital Investment Decisions: This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme proposed.

Incremental Impact of Capital Investment Decisions	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate* £m
General Fund - increase in annual Band D Council Tax	0	0	0

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 March 2011.