HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Audit Committee
Date:	22 June 2017
Title:	Annual Treasury Outturn Report 2016/17
Report From:	Director of Corporate Resources – Corporate Services

Contact name: Gemma Farley

Tel: 01962 847540 **Email:** gemma.farley@hants.gov.uk

1. Purpose

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

2. Summary

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

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

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

2.4. Overall responsibility for treasury management remains with the County Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the County Council’s treasury management objectives.

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

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

3. External Context

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

Economic Background

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

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

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

3.5. Despite growth forecasts being downgraded, economic activity was fairly buoyant and GDP grew 0.6%, 0.5% and 0.7% in the second, third and fourth calendar quarters of 2016, and in February the unemployment rate dropped to 4.7%, its lowest level in 11 years.

Financial Markets

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

Credit Background

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

4. Local Context

4.1. At 31/03/2017 the County Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £755m, while usable reserves and working capital which are the underlying resources available for investment were £522m (principal invested plus gains on investments with a variable net asset value).

4.2. At 31/03/2017, the County Council had £333m of borrowing and £513m of principal invested. The County Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

4.3. The County Council's CFR is forecast to increase in 2017/18 and its capital programme does not include any need to borrow externally over the forecast period. Investments are forecast to fall as capital receipts and internal borrowing from reserves are used to finance capital expenditure.

5. Borrowing Strategy

5.1. At 31/03/2017 the County Council held £333m of loans, (a decrease of £13m on 31/03/2016) as part of its strategy for funding previous years' capital programmes.

5.2. The County Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the County Council's long-term plans change being a secondary objective.

5.3. Affordability and the "cost of carry" remained important influences on the County 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 at least over the forthcoming two years, lower than long-term rates, the County Council determined it was more cost effective in the short-term to use internal resources instead of taking out new borrowing.

5.4. 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 County Council with the monitoring of internal and external borrowing.

Table 1: Borrowing Activity in 2016/17

	Balance on 01/04/2016 £m	Net New Borrowing £m	Balance on 31/03/2017 £m
CFR	755.7		755.4
Short Term Borrowing[1]	12.5	1.0	13.5
Long Term Borrowing	333.3	(13.6)	319.7
TOTAL BORROWING	**345.8**	**(12.6)**	**333.2**
Other Long Term Liabilities	175.5	(4.5)	171.0
TOTAL EXTERNAL DEBT	**521.3**	**(17.1)**	**504.2**
Increase/ (Decrease) in Borrowing £m			(12.6)

5.5. During 2016/17 the County Council repaid £12.54m of maturing PWLB debt, and did not replace this borrowing. This will reduce the future cost of interest payments on the County Council's external debt.

6. LOBOs

6.1. The County Council holds £60m of LOBO loans (down from £73m due to the conversion of Barclays LOBO loans, which is further explained in paragraph 5.7) where the lender has the option to propose an increase in the interest rate at set dates, following which the County Council has the option to either accept the new rate or to repay the loan at no additional cost. None of the LOBO loan options were exercised by the lender in the year.

6.2. In June 2016 Barclays Bank informed the County Council of its decision to cancel all the embedded options within standard LOBO loans. This effectively converts £13m of the County Council'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.

7. Debt Rescheduling

7.1. The premium charged for early repayment of PWLB debt remained relatively expensive for the loans in the County Council's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence. However, consideration continues to be given to

[1] Loans with maturities less than 1 year – the increase reflects more loans falling into this category in the last financial year, rather than new borrowing.

any advantageous opportunity for the County Council to reduce or restructure its debt portfolio.

8. Investment Activity

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

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

8.3. The County Council has held invested funds representing income received in advance of expenditure plus balances and reserves held. During 2016/17 the Council's investment balances have ranged between £496 and £645 million.

Table 2: Investment Activity in 2016/17

Investments	Balance on 01/04/2016 £m	Balance on 31/03/2017 £m	Average Rate / Yield on 31/03/2017 %	Average Life on 31/03/2017 years
Short term Investments				
- Banks and Building Societies:				
o Unsecured	55.7	35.7	0.56	0.08
o Secured	27.8	20.0	0.57	0.62
- Money Market Funds	66.1	61.7	0.26	0.00
- Local Authorities	92.5	116.8	0.68	0.39
- Corporate Bonds	10.0	1.3	0.37	0.19
	252.1	**235.5**	**0.54**	**0.26**
Long term Investments				
- Banks and Building Societies:				
o Secured	65.0	70.0	0.88	1.58
- Local Authorities	113.5	97.5	2.11	1.56
	178.5	**167.5**	**1.59**	**1.57**
Long term Investments – high yielding strategy				
- Local Authorities				
o Fixed deposits	20.0	20.0	3.96	16.97
o Fixed bonds	10.0	10.0	3.78	16.77
- Pooled Funds				
o Pooled property	35.0	45.0	3.85	n/a
o Pooled equity	-	20.0	3.04	n/a
o Pooled multi-asset	-	10.0	0.89	n/a
- Registered Provider	-	5.0	3.40	2.08
	65.0	**110.0**	**3.43**	**14.79**
TOTAL INVESTMENTS	**495.6**	**513.0**	**1.50**	**1.92**
Increase/ (Decrease) in Investments £m		17.4		

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

8.5. Over the year the County Council reduced its exposure to unsecured bank and building society investments by increasing its exposures to other local authorities. The County Council has also invested more of the allocation to the high yield strategy through further investing in pooled property funds, and new investments in pooled equity and multi-asset funds, as well as a new investment with a Registered Provider.

8.6. As part of the 2017/18 Investment Strategy the total amount targeted towards high yielding investments was increased to £200m. Investments yielding higher returns will contribute additional income to the County Council, although some come with the risk that they may suffer falls in the value of the principal invested.

8.7. Of the £200m available £110m has been invested (an increase of £45m since 31 March 2016). However the fall in long term interest rates since the decision to target higher returns has limited the opportunities that have been available for advantageous long term investments.

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

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

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

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

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

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

8.14. The County Council's average cash balances were £564.5m during the year and interest earned for the year was £8.6m, giving a yield of 1.52%.

9. Compliance with Prudential Indicators

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

10. Treasury Management Indicators

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

Interest Rate Exposures

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

Table 3 – Interest Rate Exposures

	Approved limits for 2016/17	Maximum during 2016/17	Compliance with limits:
Upper limit on fixed interest rate investment exposure	£350m	£172m	Yes
Upper limit on variable interest rate investment exposure	£700m	£473m	Yes
Upper limit on fixed interest rate borrowing exposure	£780m	£442m	Yes
Upper limit on variable interest rate investment exposure	£780m	£120m	Yes

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

Maturity Structure of Borrowing

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

Table 4 – Maturity Structure of Borrowing

	Upper	Lower	Actual
Under 12 months	50%	0%	4.0%
12 months and within 24 months	50%	0%	2.3%
24 months and within 5 years	50%	0%	9.1%
5 years and within 10 years	75%	0%	13.3%
10 years and within 20 years	75%	0%	50.9%
20 years and within 30 years	75%	0%	20.4%
30 years and above	100%	0%	0.0%

Principal Sums Invested for Periods Longer than 364 days

10.5. The purpose of this indicator is to control the County 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:

Table 5 – Principal Sums Invested for Periods Longer than 364 days

	2016/17	**2017/18**	**2018/19**
Limit on principal invested beyond year end	£350m	£300m	£300m
Actual	£278m		

11. Recommendation

11.1. The Audit Committee are asked to note the contents of this outturn report that is being reported to Cabinet and Full Council.

CORPORATE OR LEGAL INFORMATION:

Links to the Corporate Strategy

This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because the management of the County Council's cash balance needs to be decided.

Other Significant Links

Links to previous Member decisions:	
Title	Date
Direct links to specific legislation or Government Directives	
Title	Date

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

Document	Location
None	

IMPACT ASSESSMENTS:

1. Equality Duty

1.1. The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited under the Act;
- Advance equality of opportunity between persons who share a relevant protected characteristic (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, gender and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

Due regard in this context involves having due regard in particular to:

a) The need to remove or minimise disadvantages suffered by persons sharing a relevant characteristic connected to that characteristic;

b) Take steps to meet the needs of persons sharing a relevant protected characteristic different from the needs of persons who do not share it;

c) Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity which participation by such persons is disproportionally low.

1.2. **Equalities Impact Assessment:**

Equalities objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

2.1. This proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

a) How does what is being proposed impact on our carbon footprint / energy consumption*?*

No specific impact.

b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

Prudential Indicators 2016/17

The Local Government Act 2003 requires the County 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 County 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 County Council's planned capital expenditure and financing may be summarised as follows. Further detail is provided in the capital programme report.

Capital Expenditure and Financing	2016/17 Approved £m	2016/17 Revised £m	2016/17 Actual £m	2017/18 Estimate £m	2018/19 Estimate £m
Total expenditure	**237**	**209**	**173**	**283**	**250**
Capital receipts	6	8	**4**	8	6
Grants and other income	195	102	**132**	209	187
Revenue contributions	21	69	**10**	18	33
Contributions from reserves	2	10	**15**	9	2
Total financing	**224**	**189**	**161**	**244**	**228**
Prudential borrowing	22	25	**16**	49	34
Less repayments from capital receipts etc	(9)	(5)	**(4)**	(10)	(12)
Total funding	**13**	**20**	**12**	**39**	**22**
Total financing and funding	**237**	**209**	**173**	**283**	**250**

Estimates of Capital Financing Requirement

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

Capital Financing Requirement	**31.03.17 Approved £m**	**31.03.17 Revised £m**	**31.03.17 Actual £m**	**31.03.18 Estimate £m**	**31.03.19 Estimate £m**
General Fund	739	763	**755**	788	795

The CFR is forecast to rise by £32m over the next two years as capital expenditure financed by debt is outweighed by 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 County Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	**31.03.17 Forecast £m**	**31.03.17 Revised £m**	**31.03.17 Actual £m**	**31.03.18 Estimate £m**	**31.03.19 Estimate £m**
Borrowing	330	330	**333**	316	309
PFI liabilities	168	172	**171**	166	159
Total Debt	**498**	**502**	**504**	**482**	**468**

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 County Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

Operational Boundary	**2016/17 Approved £m**	**2016/17 Revised £m**	**2016/17 Actual £m**	**2017/18 Estimate £m**	**2018/19 Estimate £m**
Borrowing	610	660	**333**	690	700
Other long-term liabilities	170	180	**171**	170	160
Total Debt	**780**	**840**	**504**	**860**	**860**

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 County Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	2016/17 Approved £m	2016/17 Revised £m	2016/17 Actual £m	2017/18 Estimate £m	2018/19 Estimate £m
Borrowing	640	720	**333**	750	770
Other long-term liabilities	210	220	**171**	210	200
Total Debt	**850**	**940**	**504**	**960**	**970**

Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2016/17 Approved %	2016/17 Revised %	2016/17 Actual %	2017/18 Estimate %	2018/19 Estimate %
General Fund	5.73	4.22	**4.07**	3.99	4.01

Adoption of the CIPFA Treasury Management Code

The County Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* in February 2010.