

**Agenda Item No 7(h)**

**DERBYSHIRE COUNTY COUNCIL**

**CABINET**

**20 September 2016**

**Report of the Director of Finance**

**TREASURY MANAGEMENT – 2015-16 ACTIVITIES AND 2016-17 MID-YEAR UPDATE  
(COUNCIL SERVICES)**

**1 Purpose of the Report**

To report on Treasury Management activities during the last financial year 2015-16 and to indicate the Council's compliance with the prudential indicators set by Full Council at its meeting of 4 February 2015, in accordance with the terms of the Prudential Code for Capital Finance in Local Authorities.

To provide Members with details on the latest performance of the Treasury Management function.

**2 Information and Analysis**

**Treasury Management Activities 2015-16**

The Financial Regulations of the Council require an annual report to be presented to Members. This is in accordance with the recommendations of the CIPFA Code of Practice on Treasury Management. Under the terms of the Prudential Code the Council is also required to set a series of prudential indicators each year to ensure that any capital expenditure and related borrowing undertaken is prudent, affordable and sustainable. This report compares the outcomes for the year against the prudential indicator levels approved by Full Council in February 2015.

**Interest Rates**

The Bank of England's Monetary Policy Committee (MPC) made no change to policy, maintaining the Bank (Base) Rate at 0.50% throughout 2015-16.

Quantitative Easing (QE) remained at £375 billion throughout 2015-16. QE is the process of a central bank buying assets (usually government bonds) from investors (banks, pension funds and insurance companies) to facilitate lending to business and individuals to invest or spend, which in turn should stimulate growth.

At 31 March 2016, the MPC's most immediate risk was the decision to leave the European Union (EU). The Governor of the Bank of England noted that the Bank would weigh the downside risks to growth against the upside risks to inflation from the fall in the value of sterling.

## Growth

Gross Domestic Product (GDP) growth slowed in 2015-16 to 2% year-on-year to March 2016. Quarter 1 (Jan-Mar 2016) growth was 0.4%.

## Inflation

Consumer Price Inflation (CPI) hovered around 0% in 2015-16. The prolonged spell of low inflation can be attributed to the combination of the collapse in the price of oil from \$67 per barrel in May 2015 to \$28 in January 2016 and the past appreciation of sterling pushing down import prices

## Employment

The labour market continued to improve during 2015-16. In Q1 2016, the Office for National Statistics (ONS) showed the employment rate for 18 to 64 year olds had increased to a record 74.2%. The unemployment rate for 18 to 64 year olds fell to a 12 year low of 5.5%.

Short-term interest rates affect the amount of interest received by the Council on its investments. Long-term interest rates will affect the amount of interest to be paid by the Council on its future borrowing.

The Public Works Loan Board (PWLB) is a statutory body that allows local authorities access to borrow from the National Loans Fund at rates determined by the Treasury. The PWLB uses the published UK Treasury (gilt-edged) stock yield for the relevant duration plus a margin of 100 Basis Points. (A gilt is classified as the risk free return rate, as the UK Government is highly unlikely to default on its debt). All of the Council's borrowing from the PWLB is currently at fixed interest rates.

<b>PWLB interest rates</b>	<b>31 March 2015 %</b>	<b>31 March 2016 %</b>	<b>Change %</b>
5 Year	2.08	1.80	-0.28
10 Year	2.66	2.46	-0.20
25 Year	3.32	3.32	0.00
50 Year	3.30	3.13	-0.17

The Council is eligible for the Certainty Rate discount of 0.20% off the above rates, because it voluntarily provides details of its long term borrowing and associated capital spending plans to the Government.

## Borrowing

Total borrowing remained at all times within the limits approved under the terms of the Prudential Code.

Loans totalling £15m were repaid to the PWLB during 2015-16. No new long term borrowing was taken during 2015-16 as the Council continued to utilise its internal resources in line with its approved strategy. Temporary borrowing of £25m from D2N2 was taken and repaid during 2015-16.

At 31 March 2016 the total amount of loans outstanding relating to historic capital expenditure was £350.4m (nominal value) £345.4m (accounting value). The difference of £5.0m is due to an Effective Interest Rate (EIR) adjustment, whereby the premium incurred on rescheduling previous loans is written off over the duration of the replacement loan).

<b>Debt Charges - 2015-16</b>	<b>£m</b>
Interest Payable	23.7
Minimum Revenue Provision (MRP)	20.7
Transferred Debt (Derby City)	(1.4)
<b>Total Debt Charges</b>	<b>43.0</b>

The Council's average borrowing rate for external debt is 4.65%. The average cost of internal debt is the interest foregone at the marginal rate of return on investments, which was 0.90% at 31 March 2016. The average term remaining on debt at 31 March 2016 was 20.37 years.

As a result of the Local Government Reorganisation in 1997 Derby City became responsible for a share of the Council's debt. At 31 March 2016 the value of this Transferred Debt amounted to £28.8m. Derby City Council was recharged £1.4m for servicing this debt in 2015-16.

## Debt Rescheduling and Early Repayment

In November 2010, the PWLB widened the margin between the repayment rate and new borrowing rate from 0.125% to 1%. This increase significantly reduced the viability of debt rescheduling or early repayment. The Council has not repaid or rescheduled any debt since this amendment, but continues to review the position on a regular basis to take advantage of any opportunities as they arise.

## Lending

Short term lending of revenue funds/capital receipts pending their use earned interest of £4.3m in 2015-16. In March 2016 these funds earned an average rate of 0.90%. Short-term and some long term deposits were placed with a number of financial institutions, from the counterparty list approved by Full Council.

The Council's lending policy is to place security of capital and liquidity ahead of investment return.

Counterparties are constantly monitored and withdrawn from the approved list if they no longer satisfy the Council's criteria.

The Council's investments at 31 March 2016 can be analysed in the following ways:

### Counterparty Type

Type of Institution	£m	%
Banks	122.7	42.9
Building Societies	33.0	11.5
Money Market Fund (MMF)	25.0	8.7
Other Local Authorities	105.5	36.9
<b>Total</b>	<b>286.2</b>	<b>100.0</b>

37% of the Council's investments were to Other Local Authorities. Local Authorities are considered risk free in the short to medium term.

### Liquidity

The Council's access to liquidity is shown in the following table which analyses the term remaining on the Council's lending until maturity date:

Duration	£m	%
Less than 1 month	55.0	19.2
1 to 3 months	49.7	17.4
3 to 6 months	8.5	2.9
6 months to 1 year	145.0	50.7
Over 1 year	28.0	9.8
<b>Total</b>	<b>286.2</b>	<b>100.0</b>

The £30m minimum liquidity buffer of cash available within 35 days for 2015-16 was achieved.

### Credit Rating

The following table shows investments split according to the counterparties' credit ratings. Whilst losses from the Council's counterparties are not expected, the table also shows the historic market level of defaults for each credit rating category and an estimate of the Council's maximum exposure to default based on that experience:

<b>Credit Rating</b>		<b>Historic market level of default</b>	<b>Estimated maximum exposure to default</b>
	<b>£m</b>	<b>%</b>	<b>£m</b>
AAA (MMF)	10.0	0	0.0
AA (Local Authorities)	105.5	0	0.0
AA	36.2	3	1.2
A	118.5	7	5.1
Unrated	16.0	10	1.6
<b>TOTAL</b>	<b>286.2</b>		<b>7.9</b>

### **Prudential Code for Capital Finance & Treasury Management**

On 4 February 2015 Full Council approved the Capital Programme, borrowing limits and other prudential indicators for 2015-16. The levels set by Full Council and the outturns for the year 2015-16 are shown in Appendix 1. All Prudential Indicators have been complied with.

### **Training**

A series of training sessions on financial matters has been suggested for inclusion on the Member Development Groups Training Programme. Treasury Management is included within this programme.

### **Treasury Management Mid-Year Update**

The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA-TM code) requires that Authorities report on the performance of the treasury management function at least twice a year. This report is the mid-year update for 2016-2017.

### **Economic Background**

The EU Referendum on 23 June 2016 resulted in a 52% to 48% vote to leave the EU. The shockwaves caused the Sterling exchange rate index to fall by 9%, equities to fall 7% and 10 year gilts' yields to fall from 1.37% to 0.86% as investors sought a 'safe haven' from riskier assets. The Governor of the Bank of England (BoE) sought to reassure markets and investors on 24 June 2016 and 30 June 2016 that the BoE was ready to support money market liquidity with the possibility of an interest base rate cut and further Quantitative Easing (QE). The Governor noted that the BoE would weigh the downside risks to growth against the upside risks to inflation from a fall in the value of Sterling. The Government announced that the UK wouldn't enact Article 50 to leave the EU in 2016. This has helped to ease the uncertainty in the markets and provide some stability in the short term.

On 4 August 2016 the MPC voted to cut the base rate of interest to 0.25% from 0.5%, the first cut since March 2009. An additional £60 billion of asset purchases (QE) was announced increasing this facility to £435 billion, together with £10 billion of Corporate Bond purchases and a £100 billion Term Funding Scheme.

Growth Q2 1<sup>st</sup> estimate was an improved 0.6% quarterly (0.4%) and 2.2% annually (2%). In the BoE's August inflation report the MPC noted the outlook for growth in short and medium term had weakened markedly.

Consumer Price Inflation (CPI) was -0.1% for the month and 0.6% for the year to July 2016. The August Inflation Report forecasts that the fall in Sterling will hasten inflation towards its 2% target and probably rising above before falling back in to line as the exchange rate effect dissipates.

The International Labour Organisation unemployment rate for the quarter to June 2016 has fallen to 4.9% (the lowest figure since September 2005). The employment rate is 74.5%, the highest since records began. Regular pay excluding bonuses increased by 2.3% (year-on-year) whilst regular pay including bonuses increased by 2.4% (year-on-year).

## **Europe**

Although 50% of the UK's exports are to the EU, the UK imports more than it exports. The German Chancellor Angela Merkel will be a key figure in influencing a suitable compromise. It has been a difficult year for the EU, which has also suffered from terrorist attacks and the migrant crisis. Economically, the Eurozone was showing signs of improvement (1.6% year-on-year growth, 0.1% CPI inflation year-on-year, 10.1% unemployment) but the effects of Brexit may stall momentum.

## **United States**

The US is leading the way globally with strong growth, low CPI inflation and low unemployment. Although the Federal Reserve rate was maintained at between 0.25% and 0.5% Janet Yellen (Chair of the Board of Governors of the Federal Reserve System) commented 'near term risks to the economic outlook diminished'. A September increase cannot be ruled out but it is unlikely that US interest rates will rise until after November's Presidential election.

## **Rest of World**

China's growth was reported as 6.7% annualised in Q2 2016. China is the leading consumer of oil and commodities, so has significant contribution on global growth. The oil price appears to have settled at around \$50 per barrel.

## Interest Rates

Money-market rates have fallen significantly since the result of the EU Referendum and the cut in interest base rate were announced. The Government's Debt Management Office (DMO) reduced its deposit rate to 0.15% for terms up to three months and 0.10% for terms over three months. This implies a further base rate cut later in the year.

Local Authority to Local Authority rates dropped from 0.15% overnight to 0.40% for 364 days. Bank account rates have dropped as low as 0.15%, although some deposits with eligible counterparties are still 1% for 364 days.

The 20 Year PWLB interest rates fell from 3.24% on 1 April 2016 to 2.90% on 24 June 2016 before falling to 2.26% on 24 August 2016. The five year PWLB rates have decreased from 1.82% at 1 April 2016 to 1.56% on 24 June 2016 before falling to 1.23% on 24 August 2016. The Council is eligible for the Certainty Rate discount of 20 basis points on all new PWLB borrowing.

## Borrowing

There was a £55m short term callable borrowing taken from D2N2 LEP on 11 April 2016. This relates to funding received from Government for the Local Growth Fund, which the Council is responsible for managing as accountable body to the Local Enterprise Partnership (LEP).

The Capital Financing Requirement at 31 March 2016 was £498.590m (£492.016m at 31 March 2015). Long-term borrowing (excluding Private Finance Initiative (PFI) and Finance Leases) stands at £350.357m of which £12.5m is due for repayment on 9 December 2016. The average interest rate paid is 4.65% on long term debt and 0.25% on short term debt.

Internal borrowing (use of the Council's available reserves) is being used to fund any shortfall. At 31 March 2016, the Council had £43.293m of internal borrowing. Approximately £0.931m was saved by following this strategy, being the difference between the 3.04% new borrowing rate (3.24% - 0.20% certainty rate discount) and the 0.89% average interest rate received on investment balances.

The relative position of short term and long term interest rates are being constantly monitored. The Council has to assess the savings of locking into long term borrowing when market conditions are advantageous against the cost of carry of borrowing in advance of need. Similarly the Council must also assess any savings generated by repaying borrowing now compared against the anticipated costs of borrowing in the future when interest rates are forecast to be higher.

## Lending

The average return on investments for the period 1 April 2016 to 30 July 2016 was 0.88% (compared to 0.89% in 2015-16). Following the base rate cut to 0.25%, and anticipated cut to 0.10% later in the year, an average interest rate estimate of 0.50% to 31 March 2017 would be prudent.

The average level of Council investments for the year to 31 July 2016 is £359m (2015-16: £362m). The availability of funds for short term lending arises from a combination of front-ended government grants and working capital, with longer term lending funded from the Council's available reserves.

Fitch and Standard and Poor downgraded their credit ratings for the UK, post Brexit, with Moody's giving the UK a negative outlook. Banks continue to build up their capital ratios to meet Basle III requirements. EU regulations limit the support (bail out) a government can provide. Senior unsecured creditors, such as the Council, have to consider the risk of 'bail in' to prevent a failing bank from defaulting.

### **Prudential Indicators**

A summary of the Prudential Indicators set for 2016-2017 as shown in the Cabinet report dated 26 January 2016 is attached as Appendix One. It compares the original limits set by the Cabinet and the actual position at the half-year stage. This shows that all Prudential Indicators are currently being complied with.

## **3 Considerations**

In preparing this report the relevance of the following factors has been considered: financial, legal, prevention of crime and disorder, equality and diversity, human resources, environmental, health, property, transport and social value considerations.

## **4 Background Papers**

Treasury Management Strategy 2015-16.

## **5 Key Decision**

No.

## **6 Is it necessary to waive the call-in period?**

No.



## **7 Officer's Recommendation**

That Cabinet:

- i. notes the annual report on Treasury Management for 2015-2016.
- ii. notes the interim report on Treasury Management for 2016-17.
- iii. notes compliance with the prudential indicators as shown in Appendix Two.

PETER HANDFORD

Director of Finance

## Prudential Code for Capital Finance & Treasury Management

**Compliance with Prudential Indicators 2015-16, as approved by Full Council in February 2015.**

### Capital Expenditure and Capital Financing Requirement

These Indicators show the total capital expenditure and the Capital Financing Requirement (CFR) for the year against the initial estimates approved in January 2015. The CFR is the Council's underlying need to borrow for capital purposes and is therefore dependent on the approved level of capital expenditure.

	<b>2015-16 Estimate Original Jan 15 £m</b>	<b>2015-16 Estimate Revised Jan 16 £m</b>	<b>2015-16 Actual Year End £m</b>
Capital Expenditure	185.09	127.90	94.01
Capital Financing Requirement (CFR)	558.61	502.43	498.59

Capital expenditure was lower than anticipated due to slippage in the capital programme. This is where capital projects are delayed due to unforeseen circumstances.

### The Authorised Limit and the Operational Boundary

The Authorised Limit represents the limit beyond which borrowing is prohibited. This limit would be revised by members if necessary.

The Operational Boundary is an estimate, based upon the probable external debt during the course of the year. As this is not a limit, the actual level of borrowing may exceed this boundary.

<b>Authorised limit for external debt</b>	<b>2015-16 Authorised Limit for external debt £m</b>	<b>2015-16 Operational Boundary for external debt £m</b>	<b>2015-16 Actual external debt £m</b>
Borrowing	505	455	349
Private Finance Initiative (PFI) & finance leases	82	82	79
<b>Total</b>	<b>587</b>	<b>537</b>	<b>428</b>

The above table shows that at the year end actual debt was comfortably within both the Authorised Limit and the Operational Boundary. At no stage during the year did external debt exceed the Authorised Limit.

### Net Borrowing and Capital Financing Requirements

This indicator requires that the Council's net borrowings should not exceed its Capital Financing Requirement. Actual figures for the year ended 31 March 2016 are compared with the initial estimates approved in January 2015.

	<b>2015-16 Estimate Jan 2015 £m</b>	<b>2015-16 Actual Year End £m</b>
Gross Borrowing	370	349.5
Investments	(280)	(286.2)
Net Borrowing	90	63.3
Transferred Debt*	(31.4)	(30.0)
CFR	558.6	498.6

\*Transferred Debt is debt held by the Council on behalf of Derby City Council, Chesterfield Borough Council and Derbyshire Police. PFI and finance lease liabilities of £78.7m are in addition to the Gross/Net Borrowing figures.

As outlined earlier, the use of internal resources as part of the borrowing strategy reduced both external borrowing and investments.

The above total shows that the Council's net borrowings of £63.3m are significantly less than its capital financing requirement.

### Ratio of Financing Costs to Net Revenue Stream

This shows capital financing costs as a proportion of the total revenue stream of 4.7% of total revenue, including Dedicated Schools Grant (DSG) and 8.7% excluding DSG.

### Incremental Impact on Council Tax

The impact in the year of new financing costs was within the estimate.

### Treasury Management Indicators

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

## Security

The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating 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.

	Actual	Minimum
Portfolio average credit rating	AA-	A
Portfolio average credit rating score	4	6

## Liquidity

The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling one month period, without additional borrowing.

	Target £m	Actual £m
Total cash available within 35 days	30	30+

## Fixed and Variable Rate Exposures

Recommended upper limits on the percentage of borrowing and investments held at fixed and variable rates, as required by the Code, are set out below:

	2015-16 Upper Limit %	2015-16 Actual Year End %
<b>Borrowing</b>		
Limits on fixed interest rates	100	92.01
Limits on variable interest rates*	40	7.99
<b>Investments</b>		
Limits on fixed interest rates	25	15.37
Limits on variable interest rates	100	84.63

\*The Council has £28m of Lenders Option Borrowers Option (LOBO) loans, which are fixed rate loans with an option for the lender to vary the interest rate every 6 months. If the lender exercises this option then the Council has the option to repay the loan in full without penalty.

The Council's borrowing and investments remained within the approved limits.

## Maturity Structures

The maturity profile is the rate at which long-term loans have to be repaid to the PWLB (or other lenders). It would be imprudent to have a large proportion of repayments in any one year, thus a spread of redemptions is desirable.

The maturity structure is a prudential indicator under the Prudential Code, with lower and upper limits recommended as shown in the table below. These are set quite widely to ensure that full advantage can be taken of interest rate movements and debt rescheduling opportunities, within an acceptable degree of risk.

<b>Borrowing Maturity Structure Term</b>	<b>Limits Lower- Upper %</b>	<b>£m</b>	<b>2014-15 Actual Year End £m</b>
Under 12 months	0-15	40.50	11.56
12 months - 2 years	0-15	5.00	1.43
2 years - 5 years	0-40	23.00	6.56
5 years - 10 years	0-40	18.00	5.14
10 years - 20 years	10-40	105.00	29.97
20 years - 30 years	10-40	110.51	31.54
30 years and above	10-40	48.35	13.80
<b>Total</b>		<b>350.36</b>	<b>100.00</b>

The above analysis excludes PFI, finance lease liabilities and temporary borrowing.

The Council's debt maturity structure as at 31 March 2016 complied with the limits approved by Full Council.

## Longer Term Investments

The Prudential Code requires councils to set limits for any investments made for more than 364 days. Whilst most of the Council's surpluses are of a temporary nature, others, for example, the insurance fund reserve, could reasonably be invested for periods in excess of one year.

A limit for lending for more than one year is set out below and compared with the total amount on deposit at 31 March 2016. The total includes all loans outstanding at 31 March 2016 which, at inception, had over 1 year to maturity.

	<b>2015-16 Limit £m</b>	<b>2015-16 Actual £m</b>
Maximum principal sums invested for more than 364 days	100	44

Longer term investments complied with the limit approved by Full Council.

## Former Performance Indicators:

### Borrowing

The Council's performance is measured against the average rate of interest paid by county councils for the latest financial year. Arlingclose, the Council's Treasury Management advisers, have provided a benchmark of their 15 English County Council clients.

<b>Performance Indicator (L/T Borrowing) – 2015-16</b>	<b>%</b>
Derbyshire County Council - (20 Year Average Term)	4.65
English County Councils Average – Arlingclose Clients (Average Term – 19.5 Years)	4.12
PWLB 25 Year Rate - (Average 2015-16 rate) - ( PWLB)	3.55

The table shows that the Council paid 1.10% above the average 25 year PWLB rate for 2015-16. This is due to borrowing being taken when interest rates were higher than the current low rates. Similarly the Council pays 0.53% above the county council average of all Arlingclose English county council clients.

### Investments

The Council's performance is measured against a benchmark market rate of interest (the 3 month London Inter-Bank Deposit (LIBID) bid rate). In 2015-16, the average rate received on the Council's investments was 0.80% compared to the benchmark average of 0.46%.

<b>Prudential Indicators Monitoring</b>	<b>2016-17 Estimate or Limit</b>	<b>Actual at 31 July 2016</b>
Ratio of financing costs to net revenue stream	5.20%	No change
Incremental impact on Council Tax of capital programme	£8.05	No change
Capital expenditure – estimate	£186.92m	£22.7m (Q1)

<b>Gross Borrowing Capital Financing Requirement</b>	<b>£m</b>	<b>£m</b>
Gross Borrowing (including PFI, Leases, excluding net Transferred debt) + Temporary (D2N2) debt	<b>391.5</b> 312.5 PWLB/LOBO's 79 – PFI/Leases Nil – Derby City Nil – D2N2	<b>457.5</b> 350 – PWLB/LOBO's 82 – PFI/Leases -26 – Derby City 51.5 - D2N2
Capital Financing Requirement – estimate	585.65	585.65
Gross Borrowing < Capital Financing Requirement	Yes	Yes

<b>External Debt</b>	<b>£m</b>	<b>£m</b>
Authorised limit	615	615
Operational boundary	565	565
External debt – actual (including PFI, Leases, D2N2)	79 (PFI)	133.5 (82 PFI, 51.5 D2N2)

<b>Treasury Management</b>		
Adoption of CIPFA code of practice	Confirmed	Confirmed

<b>Interest rate exposures</b>	<b>Limit %</b>	<b>Actual %</b>
<b>Borrowing</b>		
Fixed – upper limit	100	82.7
Variable – upper limit	40	17.3
<b>Investment</b>		
Fixed – upper limit	25	14.3
Variable – upper limit	100	85.7

<b>Maturity Structure – Borrowing (years)</b>	<b>Limit %</b>	<b>Actual %</b>
Temporary (D2N2)	0 – 15	12.83
<1	0 – 15	3.11
>1 – 2	0 – 15	1.25
>2 – 5	0 – 40	5.73
>5 – 10	0 – 40	4.48
>10 – 20	10 – 40	26.16
>20 – 30	10 – 40	34.48
>30	10 – 40	11.96
Average maturity of external borrowing (not PFI/Leases)	10 – 35 years	20.38 years

<b>Investments (County Fund)</b>		
<b>Security:</b>		
Average Credit Rating	A- (Minimum)	AA-
<b>Liquidity:</b>		
Cash available within 1 month	£30m (Minimum)	£81m
Long Term Investments > 1 year	£100m (Maximum)	£59m
<b>Yield:</b>		
Average Base Rate v Actual Return	0.45%	0.88%