Treasury Management Annual Report 2016/17

1.1 Introduction

1.1.1 This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activity and the actual prudential and treasury indicators for 2016/17 **[Appendix 1]**. 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).

1.1.2 During 2016/17 the minimum reporting requirements were that full Council should receive the following reports:

- an annual treasury strategy in advance of the year;
- a mid-year treasury update; and
- an annual review following the end of the year describing the activity compared to the strategy (this report).

In addition, treasury management updates have been presented to each meeting of the Audit Committee throughout the 2016/17 financial year. Treasury performance was also considered at the Finance, Innovation and Property Advisory Board through the regular Financial Planning and Control reports.

1.1.3 Changes in the regulatory environment place a much greater onus on Members for the review and scrutiny of treasury management policy and activities. This report is 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.

1.1.4 This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit Committee before they were reported to full Council.

1.2 The Economy and Interest Rates

1.2.1 The outcome of the June 2016 EU referendum and subsequent action by the Bank of England's Monetary Policy Committee (MPC) in August had a significant impact on interest rate expectations by the financial markets. Forecasts contained in the Bank of England's August inflation report anticipated economic growth in the UK was likely to fall close to zero in the second half of 2016. In response the MPC, at its meeting on 4 August, cut the Bank Rate from 0.5% to 0.25%, restarted the Bank's programme of quantitative easing (buying back Gilts) and introduced Term Funding (cheap financing made available to banks). The MPC also warned that a second cut in Bank Rate may be required later in 2016.

1.2.2 Actual economic activity in the second half of 2016 confounded the Bank's pessimistic August forecast. Whilst GDP grew by only +0.2% in Q1 2016, growth in the following three quarters returned to recent norms with +0.6%, +0.5% and +0.7% respectively. Growth for 2016 as a whole at 1.8%, whilst a little below the 2.2% produced in 2015, bettered that achieved by the majority of G7 countries.

1.2.3 Inflation, however, has risen rapidly following the devaluation of sterling after the referendum. By the end of March 2017, sterling was 17% down against the dollar. In February 2017, CPI inflation had risen above the MPC's 2% inflation target to 2.3%. Markets expect the MPC to set aside near term supply side driven inflation and not raise Bank Rate provided domestically generated inflation (i.e. wage inflation) continues to remain subdued. Current market expectation is for Bank Rate to rise mid-2019.

1.3 Treasury Position at 31 March 2017

1.3.1 At the beginning and the end of 2016/17 the Council's debt and investment position was as follows:

	31 March 2016 £m	Rate / Return %	Average duration Days	31 March 2017 £m	Rate / Return %	Average duration Days
Variable rate debt:						
Overdraft	0.00	-	-	0.00	-	-
Total debt	**0.00**	-	-	**0.00**	-	-
Fixed rate investments:						
Cash flow	2.00	0.85	204	-	-	-
Core funds	8.75	0.87	139	17.00	0.69	118
Variable rate investments:						
Cash flow	6.62	0.59	1	6.10	0.50	61
Core funds	6.85	0.73	89	7.00	0.65	114
Total investments	**24.22**	**0.75**	**92**	**30.10**	**0.64**	**105**

1.3.2 The rise in investment balances between the start and end of the financial year runs counter to the expectation that core cash will be consumed over time as a proportion is used each year to finance capital expenditure and to finance the revenue account deficit until such time as the authority achieves a balanced budget. The rise in investment balances is wholly attributed to provisions under the Business Rates Retention Scheme to meet the cost of appeals which have yet to be determined by the Valuation Office. As at 31st March 2017, the provision to meet business rate appeals was some £7m.

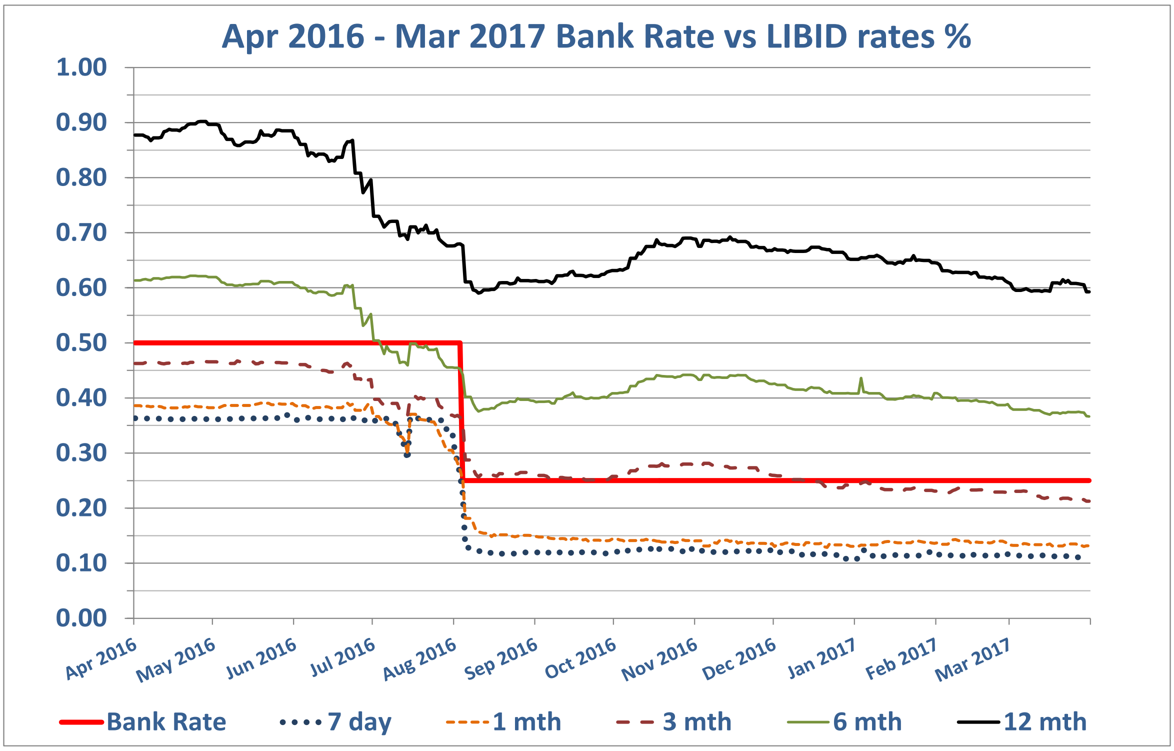
1.4 The Strategy for 2016/17

1.4.1 The expectation for interest rates within the treasury management strategy for 2016/17 anticipated a low but rising Bank Rate starting in quarter 2 of 2016. In addition, 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. Events that have taken place since the Strategy was prepared

(December 2015) have pushed back the anticipated rise in Bank Rate to mid-2019.

1.5 Investment Rates in 2016/17

1.5.1 The Bank Rate having remained at a historic low of 0.5% for over seven years was cut to 0.25% in August 2016. The impact the EU referendum and subsequent Bank Rate cut had on investment returns in 2016/17 is demonstrated in the table below.



1.6 Investment Outturn for 2016/17

1.6.1 The Council's investment policy sets out the approach for choosing investment counter-parties and is based on credit ratings provided by the three main credit rating agencies. This is supplemented by additional market information including credit rating outlooks and credit default swap data (CDS). The 2016/17 Annual Investment Strategy was approved by Council in February 2016 and was subjected to a mid-year review in September 2016. In undertaking the review, no changes were made to the Council's minimum counter-party credit requirement (Fitch A-, F1 unless UK state owned) or counter-party exposure limits (20% for non-UK state owned financial institutions). Discretion to extend investment duration by up to three months over the Council's external treasury advisor's suggested duration was also retained albeit pending further review. At the January 2017 meeting of Audit Committee Members amended the discretion to six months subject to a number of constraints (only to applicable to UK institutions; overall duration not to exceed twelve months; and the institutions CDS to be below bank average at the time of placing the deposit).

1.6.2 The mid-year review was undertaken just after the MPC's August Bank Rate meeting. Provided there was no subsequent action by the MPC, the Council's investment income forecasts at the time anticipated income for the year as a whole would be in-line with budget. This reflected a combination of higher than expected balances available for investment and action taken in advance of the referendum to invest as much of the Council's cash surpluses in term deposits as was practical. Investment income for 2016/17 was confirmed at £206,000 (as originally estimated) when the revised estimates were subsequently approved by Council in February 2017.

1.6.3 **Cash Flow Investments**. The Council maintained an average balance of £16.0m in cash flow funds. These funds earned an average rate of return of 0.57%. The average 7-day LIBID rate, used to compare performance, was 0.20%. The majority of cash flow funds are required to meet our regular payment obligations and as a consequence are invested overnight in bank deposit accounts and money market funds which allow next day access. However, the opportunity to invest for longer durations and generate additional yield is taken when cash flow surpluses permit. Throughout 2016/17 cash balances were higher than budget reflecting a continuation of the beneficial change by Government to the pattern of business rates paid to them, KCC and Kent Fire and Rescue.

1.6.4 **Core Fund Investments**. The Council maintained an average balance of £19.8m in core funds. These funds earned an average rate of return of 0.71%. The 3-month LIBID rate used as a comparator was 0.34%. Unlike cash flow, core fund balances are not required to meet our regular payment obligations and are available to invest for longer durations including durations exceeding one year. This added flexibility allows core funds to generate a better return relative to cash flow investments.

1.6.5 Performance for the financial year as a whole is summarised in the table below:

	2016/17 Average Balance £m	Return %	2016/17 Interest Earned £	2016/17 Original / Revised Estimate £	Variance Better (worse) £
Cash flow	16.0	0.57	91,500	82,000	9,500
Core funds	19.8	0.71	140,000	124,000	16,000
Total	35.8	0.65	231,500	206,000	25,500

1.6.6 The combined performance of the Authority's cash flow and core funds bettered the original / revised estimates by £25,500.

1.7 Compliance with the Annual Investment Strategy

1.7.1 The Annual Investment Strategy aims to limit the Council's exposure to investment risks by prescribing: minimum counter-party credit criteria; maximum exposure limits in respect of sovereigns, counter-parties and group of related counter-party; the type of investment instrument that can be used; and investment duration limits. Throughout the period April 2016 to March 2017 the requirements set out in the Annual Investment Strategy for 2016/17, as amended by Council in February 2017, were complied with. No liquidity issues were experienced resulting in nil borrowing throughout 2016/17.

Financial Services
May 2017