Bath & North East Somerset Council

MEETING:	**Corporate Audit Committee**	
MEETING DATE:	**8th December 2016**	
TITLE:	**Treasury Management Monitoring Report to 30th September 2016**	EXECUTIVE FORWARD PLAN REFERENCE: E 2867
WARD:	All	

AN OPEN PUBLIC ITEM

List of attachments to this report:

Appendix 1 – Performance Against Prudential Indicators
Appendix 2 – The Council's Investment Position at 30th September 2016
Appendix 3 – Average monthly rate of return for 1st 6 months of 2016/17
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Appendix 5 – Arlingclose's Economic & Market Review Q2 of 2016/17
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1 THE ISSUE

1.1 In February 2012 the Council adopted the 2011 edition of the CIPFA Treasury Management in the Public Services: Code of Practice, which requires the Council to approve a Treasury Management Strategy before the start of each financial year, review performance during the year, and approve an annual report after the end of each financial year.

1.2 This report gives details of performance against the Council's Treasury Management Strategy and Annual Investment Plan 2016/17 for the first six months of 2016/17.

2 RECOMMENDATION

The Committee agrees that:

2.1 the Treasury Management Report to 30th September 2016, prepared in accordance with the CIPFA Treasury Code of Practice, is noted

2.2 the Treasury Management Indicators to 30th September 2016 are noted.

3 RESOURCE IMPLICATIONS

3.1 The financial implications are contained within the body of the report.

4 STATUTORY CONSIDERATIONS AND BASIS FOR PROPOSAL

4.1 This report is for information only.

5 THE REPORT

Summary

5.1 The average rate of investment return for the first six months of 2016/17 is 0.50%, which is 0.13% above the benchmark rate.

5.2 The Council's Prudential Indicators for 2016/17 were agreed by Council in February 2016 and performance against the key indicators is shown in **Appendix 1**. All indicators are within target levels.

Summary of Returns

5.3 The Council's investment position as at 30th September 2016 is given in **Appendix 2**. The balance of deposits as at 30th June 2016 and 30th September 2016 are also set out in the pie charts in this appendix.

5.4 The Council is the accountable body for the West of England Revolving Investment Fund (RIF) and received grant funding of £57 million at the end of the 2011/12 financial year, the value of the fund as at 30th September 2016 is £30.7 million. The Council acts as an agent and holds these funds until they are allocated in the form of repayable grants to the constituent Local Authorities to meet approved infrastructure costs. These funds are invested separately from the Council's cash balances they are therefore excluded from all figures given in this report.

5.5 The Council also continues to act as Accountable Body for the West of England Local Enterprise Partnership (WoE LEP). In 2016/17 it has received £42.407m of Local Growth Fund (LGF) from Central Government following submission of its Strategic Economic Plan. This sum, prior to distribution, is being invested in line with the Council's overall Treasury Management Strategy, with the interest earmarked to fund support and governance costs. The balances related to the LGF are included in the figures given in this report.

5.6 Gross interest earned on investments for the first six months totalled £223k. Net interest, after deduction of amounts due to Schools, Local Growth Fund and other internal balances, is £107k. **Appendix 3** details the investment performance, showing the average rate of interest earned over this period was 0.50%, which was 0.11% above the benchmark rate of average 7 day LIBID +0.05% (0.39%).

Summary of Borrowings

5.7 No new borrowing has taken place in the three months to 30th September 2016. The Council repaid £5m during the quarter reducing the current borrowing to £128.3M.

5.8 The Council's Capital Financing Requirement (CFR) as at 31st March 2016 was £182.5 million with a projected total of £266 million by the end of 2016/17 based on the capital programme approved at February 2016 Council. This represents the

Council's underlying need to borrow to finance capital expenditure, and demonstrates that the borrowing taken to date relates to funding historical capital spend.

5.9 Following Local Government Reorganisation in 1996, Avon County Council's residual debt is administered by Bristol City Council. All successor Unitary Authorities make an annual contribution to principal and interest repayment, for which there is a provision in the Council's revenue budget. The amount of residual debt outstanding as at 31st March 2016 apportioned to Bath & North East Somerset Council is £13.40m. Since this borrowing is managed by an external body and treated in the Council's Statement of Accounts as a deferred liability, it is not included in the borrowing figures referred to in paragraph 5.7.

5.10 The borrowing portfolio as at 30th September 2016 is shown in **Appendix 4**.

Strategic & Tactical Decisions

5.11 As shown in the charts at **Appendix 2**, the investment portfolio has been diversified across UK Banks and Building Societies, Local Authorities and very highly rated Foreign Banks. The Council also uses AAA rated Money Market funds to maintain very short term liquidity. The Council has £18.7M invested in Money Market Funds as at 30th September 2016.

5.12 The Council does not hold any direct investments with banks in countries within the Eurozone reflecting both on the underlying debt issues in some Eurozone countries and the low levels of interest rates. The Council's investment counterparty list does not currently include any banks from Portugal, Ireland, Greece, Spain and Italy.

5.13 The Council's current average investment return is in broadly line with the budgeted level of 0.45%.

Future Strategic & Tactical Issues

5.14 Our treasury management advisors economic and market review for the second quarter 2016/17 is included in **Appendix 5**.

5.15 The Bank of England base rate was reduced to 0.25% on 4th August 2016. In the opinion of the Council's treasury advisors there is unlikely to be a rate rise until Q2 2018.

5.16 These lower rates reinforce the benefits of the Council's current policy of internal borrowing (although could adverse impact elsewhere including pension liabilities), and this continues to be monitored regularly against the likelihood that long term borrowing rates are forecast to rise in future years. The focus is now on the rate of increase and the medium-term peak and, in this respect, the current forecast remains that rates will rise slowly and to a lower level than in the past.

Budget Implications

5.17 A breakdown of the revenue budget for interest and capital financing and the forecast year end position based on the period April to September is included in **Appendix 6** and shows a forecast underspend of 560,000 reflecting savings from capital programme slippage delaying the need to borrow and a lower Minimum Revenue Provision (MRP) requirement

5.18 This position will be kept under review during the remainder of the year, taking into account the Council's cash-flow position and the timing of any new borrowing required.

6 RATIONALE

6.1 The Prudential Code and CIPFA's Code of Practice on Treasury Management requires regular monitoring and reporting of Treasury Management activities.

7 OTHER OPTIONS CONSIDERED

7.1 None.

8 CONSULTATION

8.1 Consultation has been carried out with the Cabinet Member for Community Resources, Section 151 Finance Officer and Monitoring Officer.

8.2 Consultation was carried out via e-mail.

9 RISK MANAGEMENT

9.1 The Council's lending & borrowing list is regularly reviewed during the financial year and credit ratings are monitored throughout the year. All lending/borrowing transactions are within approved limits and with approved institutions. Investment and Borrowing advice is provided by our Treasury Management consultants Arlingclose.

9.2 The CIPFA Treasury Management in the Public Services: Code of Practice requires the Council nominate a committee to be responsible for ensuring effective scrutiny of the Treasury Management Strategy and policies. The Corporate Audit Committee carries out this scrutiny.

9.3 In addition, the Council maintain a risk register for Treasury Management activities, which is regularly reviewed and updated where applicable during the year.

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Background papers	*2016/17 Treasury Management & Investment Strategy*
Please contact the report author if you need to access this report in an alternative format	

APPENDIX 1
Performance against Treasury Management Indicators agreed in Treasury Management Strategy Statement

1. Authorised limit for external debt
These limits include current commitments and proposals in the budget report for capital expenditure, plus additional headroom over & above the operational limit for unusual cash movements.

	2016/17 Prudential Indicator	**Actual as at 30th September 2016**
	£'000	£'000
Borrowing	266,000	128,300
Other long term liabilities	2,000	0
Cumulative Total	**268,000**	**128,300**

2. Operational limit for external debt
The operational boundary for external debt is based on the same estimates as the authorised limit but without the additional headroom for unusual cash movements.

	2016/17 Prudential Indicator	**Actual as at 30th September 2016**
	£'000	£'000
Borrowing	229,000	128,300
Other long term liabilities	2,000	0
Cumulative Total	**231,000**	**128,300**

3. Upper limit for fixed interest rate exposure
This is the maximum amount of total borrowing which can be at fixed interest rate, less any investments for a period greater than 12 months which has a fixed interest rate.

	2016/17 Prudential Indicator	**Actual as at 30th September 2016**
	£'000	£'000
Fixed interest rate exposure	**229,000**	**108,300***

* The £20m of LOBO's are quoted as variable rate in this analysis as the Lender has the option to change the rate at 6 monthly intervals (the Council has the option to repay the loan should the Lender exercise this option to increase the rate).

4. Upper limit for variable interest rate exposure
While fixed rate borrowing contributes significantly to reducing uncertainty surrounding interest rate changes, the pursuit of optimum performance levels may justify keeping flexibility through the use of variable interest rates. This is the maximum amount of total borrowing which can be at variable interest rates.

	2016/17 Prudential Indicator	Actual as at 30th September 2016
	£'000	£'000
Variable interest rate exposure	**141,000**	**20,000**

5. Upper limit for total principal sums invested for over 364 days
This is the maximum amount of total investments which can be over 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.

	2016/17 Prudential Indicator	Actual as at 30th September 2016
	£'000	£'000
Investments over 364 days	**50,000**	**0**

6. Maturity Structure of borrowing
This indicator is set to control the Council's exposure to refinancing risk.

	Upper Limit	Lower Limit	Actual as at 30th September 2016
	%	%	%
Under 12 months	50	Nil	30*
12 months and within 24 months	75	Nil	0
24 months and within 5 years	75	Nil	8
5 years and within 10 years	100	Nil	0
10 years and above	100	Nil	62

* The CIPFA Treasury management Code now requires the prudential indicator relating to Maturity of Fixed Rate Borrowing to reference the maturity of LOBO loans to the earliest date on which the lender can require payment, i.e. the next call date (which are at 6 monthly intervals for the £20m of LOBO's). However, the Council would only consider repaying these loans if the Lenders exercised their options to alter the interest rate.

7. Average Credit Rating
The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the weighted average credit rating of its investment portfolio. A summary guide to credit ratings is set out at **Appendix 7**.

	2016/17 Prudential Indicator	Actual as at 30th September 2016
	Rating	Rating
Minimum Portfolio Average Credit Rating	**A-**	**AA+**

APPENDIX 2

The Council's Investment position at 30th September 2016
The term of investments, from the original date of the deal, are as follows:

As per Weekly	**Balance at 30th September 2016**
	£'000's
Notice (instant access funds)	26,744
1 month to 3 months	23,000
Over 3 months	37,000
Total	**86,744**

The investment figure of £96.7 million is made up as follows:

	Balance at 30th September 2016
	£'000's
B&NES Council	41,239
West Of England Growth Points	134
Local Growth Fund	39,004
Schools	6,367
Total	**86,744**

The Council had a total average net positive balance of £89.235m during the period April 2016 to September 2016.

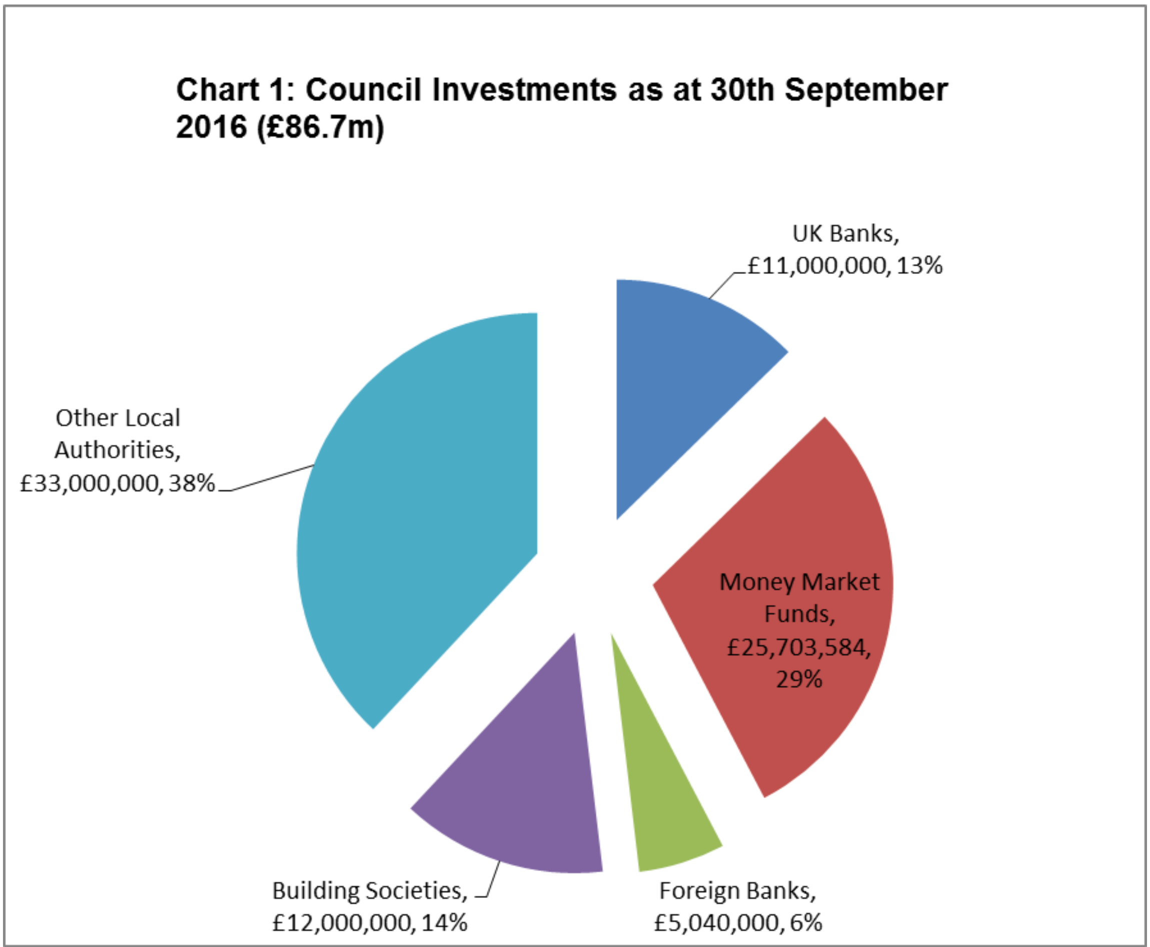


Chart 1: Council Investments as at 30th September 2016 (£86.7m)
UK Banks, £11,000,000, 13%
Other Local Authorities, £33,000,000, 38%
Money Market Funds, £25,703,584, 29%
Building Societies, £12,000,000, 14%
Foreign Banks, £5,040,000, 6%

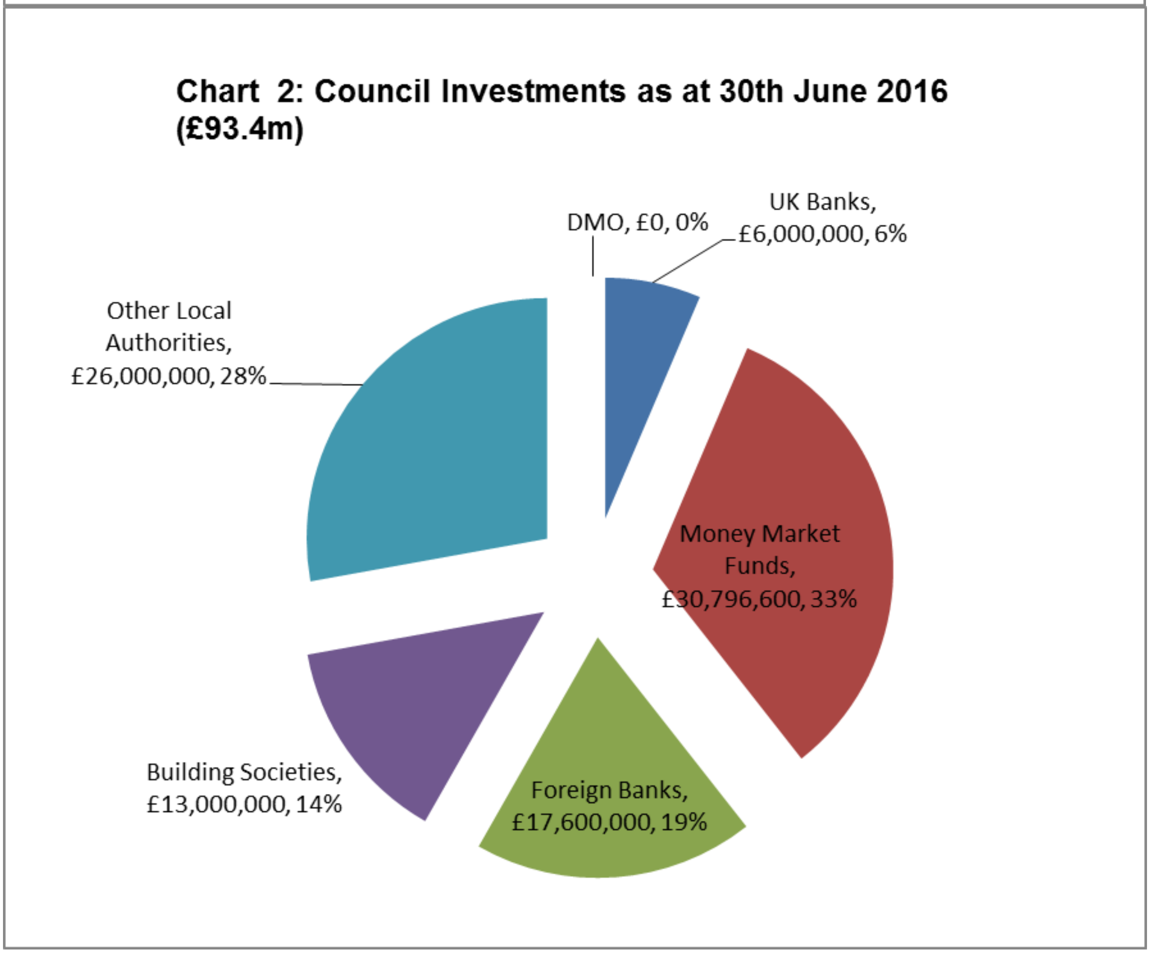


Chart 2: Council Investments as at 30th June 2016 (£93.4m)
DMO, £0, 0%
UK Banks, £6,000,000, 6%
Other Local Authorities, £26,000,000, 28%
Money Market Funds, £30,796,600, 33%
Building Societies, £13,000,000, 14%
Foreign Banks, £17,600,000, 19%

Chart 3: Council Investments per lowest equivalent Long Term credit rating (£86.7m) 30th September 2016

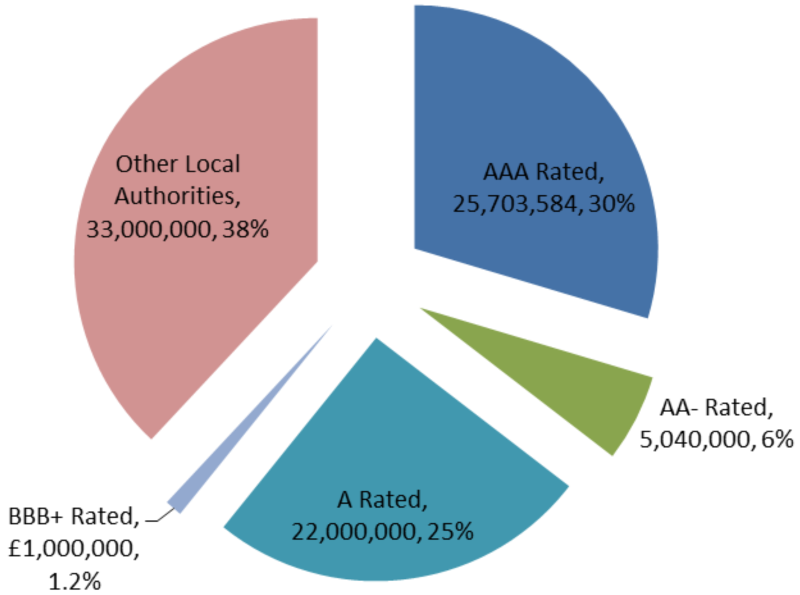
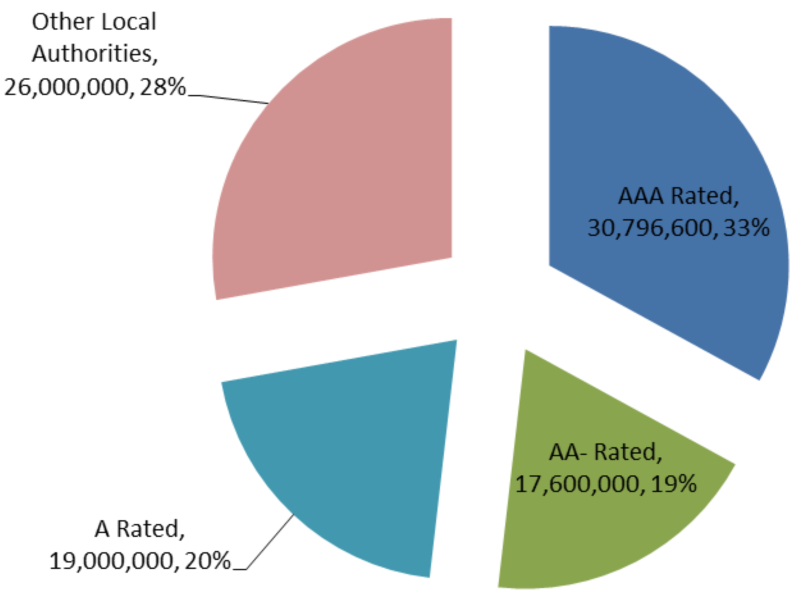


Chart 4: Council Investments per lowest equivalent Long Term credit rating (£93.4m) 30th June 2016



APPENDIX 3

Average rate of return on investments for 2016/17

	April %	May %	June %	July %	Aug %	Sept %	Average for Period
Average rate of interest earned	0.45	0.52	0.52	0.52	0.51	0.48	**0.50%**
Benchmark = Average 7 Day LIBID rate +0.05% (source: Arlingclose)	0.41	0.42	0.41	0.41	0.36	0.33	**0.39%**
Performance against Benchmark %	+0.04	+0.10	+0.11	+0.11	+0.15	+0.15	**+0.11%**

APPENDIX 4

Councils External Borrowing at 30th September 2016

LONG TERM	Amount	Start Date	Maturity Date	Interest Rate
PWLB	10,000,000	15/10/04	15/10/35	4.75%
PWLB	5,000,000	12/05/10	15/08/35	4.55%
PWLB	5,000,000	12/05/10	15/08/60	4.53%
PWLB	5,000,000	05/08/11	15/02/31	4.86%
PWLB	10,000,000	05/08/11	15/08/29	4.80%
PWLB	15,000,000	05/08/11	15/02/61	4.96%
PWLB	5,300,000	29/01/15	15/08/29	2.62%
PWLB	5,000,000	29/01/15	15/02/61	2.92%
PWLB	20,000,000	20/06/16	200641	2.36%
KBC Bank N.V*	5,000,000	08/10/04	08/10/54	4.50%
KBC Bank N.V*	5,000,000	08/10/04	08/10/54	4.50%
Eurohypo Bank*	10,000,000	27/04/05	27/04/55	4.50%
West Midland Police Authority	5,000,000	08/10/14	10/10/16	1.10%
Portsmouth City Council	3,000,000	15/10/14	17/10/16	1.08%
Gloucestershire County Council	5,000,000	25/11/14	25/11/19	2.05%
Gloucestershire County Council	5,000,000	19/12/14	19/12/19	2.05%
London Borough of Ealing	5,000,000	21/10/15	19/10/16	0.60%
West Midland Police Authority	5,000,000	27/11/15	25/11/16	0.62%
TOTAL	**128,300,000**			
TEMPORARY	**Nil**			
TOTAL	**128,300,000**			**3.43%**

*All LOBO's (Lender Option / Borrower Option) have reached the end of their fixed interest period and have reverted to the variable rate of 4.50%. The lender has the option to change the interest rate at 6 monthly intervals. Should the lender use the option to change the rate, then at this point the borrower has the option to repay the loan without penalty.

APPENDIX 5

Economic and market review for July to September 2016 (provided by Arlingclose)

The preliminary estimate of Q2 2016 GDP showed reasonably strong growth as the economy grew 0.7% quarter-on-quarter, as compared to 0.4% in Q1 and year/year growth running at a healthy pace of 2.2%. However the UK economic outlook changed significantly on 23rd June 2016. The surprise result of the referendum on EU membership prompted forecasters to rip up previous projections and dust off worst-case scenarios. Growth forecasts had already been downgraded as 2016 progressed, as the very existence of the referendum dampened business investment, but the crystallisation of the risks and the subsequent political turmoil prompted a sharp decline in household, business and investor sentiment.

The repercussions of this plunge in sentiment on economic growth were judged by the Bank of England to be severe, prompting the Monetary Policy Committee to initiate substantial monetary policy easing at its August meeting to mitigate the worst of the downside risks. This included a cut in Bank Rate to 0.25%, further gilt and corporate bond purchases (QE) and cheap funding for banks (Term Funding Scheme) to maintain the supply of credit to the economy. The minutes of the August meeting also suggested that many members of the Committee supported a further cut in Bank Rate to near-zero levels (the Bank, however, does not appear keen to follow peers into negative rate territory) and more QE should the economic outlook worsen.

In response to the Bank of England's policy announcement, money market rates and bond yields declined to new record lows. Since the onset of the financial crisis over eight years ago, Arlingclose's rate outlook has progressed from 'lower for longer' to 'even lower for even longer' to, now, 'even lower for the indeterminable future'.

The new members of the UK government, particularly the Prime Minister and Chancellor, are likely to follow the example set by the Bank of England. After six years of fiscal consolidation, the Autumn Statement on 23rd November is likely to witness fiscal initiatives to support economic activity and confidence, most likely infrastructure investment. Tax cuts or something similar cannot be ruled out.

Whilst the economic growth consequences of BREXIT remain speculative, there is uniformity in expectations that uncertainty over the UK's future trade relations with the EU and the rest of the world will weigh on economic activity and business investment, dampen investment intentions and tighten credit availability, prompting lower activity levels and potentially a rise in unemployment. These effects will dampen economic growth through the second half of 2016 and in 2017.

Meanwhile, inflation is expected to pick up due to a rise in import prices, dampening real wage growth and real investment returns. The August Quarterly *Inflation Report* from the

Bank of England forecasts a rise in CPI to 0.9% by the end of calendar 2016 and thereafter a rise closer to the Bank's 2% target over the coming year, as previous rises in commodity prices and the sharp depreciation in sterling begin to drive up imported material costs for companies.

The rise in inflation is highly unlikely to prompt monetary tightening by the Bank of England, with policymakers looking through import-led CPI spikes, concentrating instead on the negative effects of Brexit on economic activity and, ultimately, inflation.

Market reaction: Following the referendum result gilt yields fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. The yield on the 10-year gilt fell from 1.37% on 23rd June to a low of 0.52% in August, a quarter of what it was at the start of 2016. The 10-year gilt yield has since risen to 0.69% at the end of September. The yield on 2- and 3-year gilts briefly dipped into negative territory intra-day on 10th August to -0.1% as prices were driven higher by the Bank of England's bond repurchase programme. However both yields have since recovered to 0.07% and 0.08% respectively. The fall in gilt yields was reflected in the fall in PWLB borrowing rates.

On the other hand, after an initial sharp drop, equity markets appeared to have shrugged off the result of the referendum and bounced back despite warnings from the IMF on the impact on growth from 'Brexit' as investors counted on QE-generated liquidity to drive risk assets.

The most noticeable fall in money market rates was for very short-dated periods (overnight to 1 month) where rates fell to between 0.1% and 0.2%

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. S&P also downgraded the long-term ratings of the local authorities to which it assigns ratings as well as the long-term rating of the EU from AA+ to AA, the latter on the agency's view that it lowers the union's fiscal flexibility and weakens its political cohesion.

Moody's affirmed the ratings of nine UK banks and building societies but revised the outlook to negative for those 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.

The European Banking Authority released the results of its 2016 round of stress tests on the single market's 51 largest banks after markets closed on Friday 29th July. The stress tests gave a rather limited insight into how large banks might fare under a particular economic scenario. When the tests were designed earlier this year, a 1.7% fall in GDP over three years must have seemed like an outside risk. Their base case of 5.4% growth now looks exceptionally optimistic and the stressed case could be closer to reality. No bank was said to have failed the tests. The Royal Bank of Scotland made headline news as one of the worst performers as its ratios fell by some of the largest amounts, but from a relatively high base. Barclays Bank and Deutsche Bank ended the test with Common Equity Tier 1 (CET1) ratios below the 8% threshold, and would be required to raise more capital should the stressed scenario be realised. The tests support our cautious approach on these banks.

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.

APPENDIX 6

Interest & Capital Financing Costs – Budget Monitoring 2016/17 (July to September)

April to June 2016	**YEAR END FORECAST** **Budgeted Spend or (Income) £'000**	**Forecast Spend or (Income) £'000**	**Forecast over or (under) spend £'000**	**ADV/FAV**
Interest & Capital Financing				
- Debt Costs	5,403	5103	(300)	FAV
- Internal Repayment of Loan Charges	-10,671	-10,671	0	
- Ex Avon Debt Costs	1,240	1,240	0	
- Minimum Revenue Provision (MRP)	7,115	6865	(260)	FAV
- Interest on Balances	-79	-79	0	
Sub Total - Capital Financing	**3,008**	**2,488**	**(560)**	**FAV**

APPENDIX 7

Summary Guide to Credit Ratings

Rating	**Details**
AAA	Highest credit quality – lowest expectation of default, which is unlikely to be adversely affected by foreseeable events.
AA	Very high credit quality - expectation of very low default risk, which is not likely to be significantly vulnerable to foreseeable events.
A	High credit quality - expectations of low default risk which may be more vulnerable to adverse business or economic conditions than is the case for higher ratings.
BBB	Good credit quality - expectations of default risk are currently low but adverse business or economic conditions are more likely to impair this capacity.
BB	Speculative - indicates an elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions over time.
B	Highly speculative - indicates that material default risk is present, but a limited margin of safety remains. Capacity for continued payment is vulnerable to deterioration in the business and economic environment.
CCC	Substantial credit risk - default is a real possibility.
CC	Very high levels of credit risk - default of some kind appears probable.
C	Exceptionally high levels of credit risk - default is imminent or inevitable.
RD	Restricted default - indicates an issuer that has experienced payment default on a bond, loan or other material financial obligation but which has not entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, and which has not otherwise ceased operating.
D	Default - indicate san issuer that has entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, or which has otherwise ceased business.