AUDIT COMMITTEE

Date of Meeting	Wednesday 15th March 2017
Report Subject	Treasury Management Update 2016/17
Report Author	Corporate Finance Manager

EXECUTIVE SUMMARY

The report provides an update on matters relating to the Council's Treasury Management Policy, Strategy and Practices 2016/17 to the end of February 2017.

RECOMMENDATIONS	
1	Members note the Treasury Management 2016/17 quarterly update.

REPORT DETAILS

1.00	EXPLAINING THE QUARTERLY UPDATE
1.01	The Council has nominated the Audit Committee to be responsible for ensuring effective scrutiny of Treasury Management Strategy and Policies. The Audit Committee has previously agreed to include Treasury Management as a standing item on each quarterly agenda to receive an update.
1.02	On 16th February 2016 the Council approved the Treasury Management Policy Statement 2016-2019 and Treasury Management Practices 2016-2019, following the recommendation of the Cabinet and consideration by the Audit Committee.
1.03	On 16th February 2016 the Council also approved the Treasury Management Strategy 2016/17, following the recommendation of the Cabinet and consideration by the Audit Committee.

1.04	A statement setting out the Council's investments as at 28th February 2017 is attached at Appendix 1 and shows that the investment balance at this time was £11.6m, spread across 6 counterparties with an average investment rate of 0.34%.
1.05	Further to questions raised by the Committee at its January meeting attached at Appendix 2 is a graph showing the investment position throughout 2016/17 to date. This demonstrates how cash balances fluctuate throughout each month, with the cash balance at the beginning of the month being £15m to £20m higher than at the end of each month. The graph shows a line of best fit to illustrate the overall trend; the cash balance is gradually declining as the Council moves into a position where borrowing will be required as has been reported previously.
1.06	There have been no changes to the Council's long term borrowing during the quarter. A schedule of outstanding loans as at 28th February is attached as Appendix 3, with total long-term borrowing remaining at £251.3m with a weighted average interest rate of 5.01%.
1.07	A short term loan from another local authority was take out on 18th January. The loan was for £2m, at a rate of 0.25%, and was repaid on 13th February. This was primarily to test systems and processes ahead of an anticipated increase in short term borrowing activity in the near future.
1.08	The borrowing strategy for the remainder of this financial year is to continue to test systems and processes by undertaking further short term borrowing. The borrowing requirement is now expected to materialise early in 2017/18, when short term borrowing will be used to confirm the Council's longer term borrowing requirement.
1.09	**Debt Rescheduling** At the meeting of the Audit Committee on 25th January members asked various questions in relation to debt rescheduling and it was agreed that some worked examples would be prepared to aid understanding of this complex area.
1.10	Debt rescheduling is where existing loans are repaid and funded from either new loans or cash balances. Although in the current economic climate new loans are likely to have significantly lower interest rates than existing loans, the repayment of existing loans will lead to a sizeable 'premium' being payable and any potential savings from reduced interest costs need to be considered against the cost of the premium. In addition, other factors also need to be considered when assessing debt rescheduling opportunities such as the potential loss of investment income, the additional costs of borrowing to fund the premium, and sensitivity to future movements in interest rates.
1.11	As agreed at the January meeting a reflective sample of the council's PWLB loans were reviewed. In each case a substantial premium would be payable; in one case the premium was more than the loan principal itself. Two scenarios were considered, firstly where the loan and the premium were replaced with new PWLB borrowing, and secondly where the loan and

	premium were funded from cash balances (which in the Councils current position would mean additional short term borrowing would need to be undertaken.) To help illustrate this a detailed worked example for one loan has been included in the following paragraphs.
1.12	

Example – Loan Details	
Debt Principal	£3,700,000
Interest Rate	4.5%
Annual Interest	£166,500
Maturity	March 2052
Remaining Life	36 years
Premium payable	£2,525,718
Total Repayment	£6,225,718

1.13 The following table shows the impact of rescheduling the loan, assuming repayment is funded by new PWLB loans. A number of assumptions are made, particularly around interest rates, and the figures presented are 'present value' figures, reflecting the decreasing value of money over time. A positive figure is a cost, and a negative figure represents a saving.

Scenario 1 – Funding debt repayment with new PWLB loans	
	£
5 year cost	43,403
10 year cost	74,771
25 year cost	83,858
Total Life saving	-60,600
Sensitivity to Investment Rates – 10 year present value:	
+1%	249,704
-0.25%	-30,976

The figures show that replacing PWLB debt with new PWLB loans is not worthwhile. By years 5, 10 and 25 the cost of the premium outweighs any savings. There is a saving over the life of the loan, but the present value of the amount at £60,600 is negligible.

As uncertainty increases the further we look into the future, it is more prudent to consider the impact of rescheduling over the short to medium term. The sensitivity analysis shows that if interest rates rise, even by a small amount, the costs increase. The example above shows how a 1%

	increase in interest rates turns a 10 year cost of £74,771 into a much higher cost of £249,704. All loans in the sample showed an overall cost, as opposed to a saving, when looking at a five year time frame.
1.14	The following table shows the same loan, repaid from cash balances

Scenario 2 – Funding debt repayment from cash balances	
	£
5 year saving	-78,317
10 year saving	-45,240
25 year saving	-36,108
Total Life saving	-180,550
Sensitivity to Investment Rates – 10 year present value:	
+1%	402,928
-0.25%	-151,824

The figures show that some savings are available should the Council fund the loan repayment from cash balances, which would mean the Council would need to undertake more short term borrowing than currently planned. However, the sensitivity analysis shows that if interest rates rise, even by a small amount, any saving would quickly turn into a cost in future years. The example above shows how a 1% increase in interest rates turns a 10 year present value saving of £45,240 into a loss of £402,928. Due to the risk involved and the relatively small amount of savings the benefits of rescheduling is questionable.

1.15 A further consideration when reviewing debt rescheduling is the Council's exposure to refinancing risk. The risk being that a large proportion of loans mature at the same time. The aim is to have a portfolio of loans which are evenly spread over short, medium and long term periods. An indicator is included within the Council's Treasury Management Strategy for 'maturity structure of borrowing', which is presented below for information:

	Lower	Upper
Under 12 months	0%	10%
12 months and within 24 months	0%	10%
24 months and within five years	0%	30%
Five years and within 10 years	0%	50%
10 years and above	0%	100%

10% of the current debt balance equates to £25m.

1.16 The Council's primary objective when borrowing money is to strike an

	appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which the funds are required. The Council has been forecasting a borrowing requirement for some time, the borrowing strategy throughout 2016/17 and into 2017/18 has been to monitor capital expenditure plans to confirm the Council's long term borrowing need. This is to ensure that the Council does not commit to long term borrowing too early and borrow unnecessarily which will be costly. The use of short-term borrowing will assist with such. Some short term borrowing will be undertaken over the coming months to take advantage of the lower rates currently available. This must be balanced against exposing the Council to an unacceptable level of risk. This can be achieved by funding the forthcoming borrowing requirement in full or in part by short term borrowing, rather than refinancing existing loans and incurring the significant premium cost. Taking out further short term debt to replace existing loans on top of this would lead to an unacceptably high level of risk and a breach of the maturity structure indicator. It is therefore not considered prudent to reschedule any PWLB debt at this time however this situation will be kept under continual review.
1.17	**Economic update** The outlook for the UK economy is dominated by the negotiations to leave the EU.
1.18	The global environment remains uncertain, with repercussions for financial market volatility and long-term interest rates. Donald Trump's victory in the US general election and Brexit are symptomatic of the popular disaffections with globalisation trends.
1.19	Political uncertainty, specifically the French presidential election, is currently weighing on European risk appetite, despite signs of stronger global growth following significant global fiscal and monetary stimulus.
1.20	The short term outlook for the global economy is brighter than early 2016, although the potential rise in protectionism could dampen growth prospects in the medium term.
1.21	As expected, there are signs that the rise in the UK inflation rate is beginning to dampen economic growth. Household consumption growth, the recent driver of UK GDP growth, has softened, and with employment plateauing and real wage growth declining, a recovery back to the strong growth rates seen in early 2016 is unlikely.
1.22	Meanwhile, economic and political uncertainty continue to depress UK business investment. A recovery appears unlikely given post-EU Referendum uncertainty.
1.23	Given the pressure on household spending and business investment, the rise in inflation is unlikely to prompt monetary tightening by the Bank of England, with policymakers looking through import-led CPI spikes to the negative effects of Brexit on economic activity and, ultimately, inflation.

1.24	Bank of England policymakers have, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods, particularly if this feeds through into wage growth. Given this view and the current inflation outlook, further monetary loosening through a further cut in interest rates or additional Quantitative Easing looks less likely.
1.25	**Interest Rate Forecast** The Arlingclose projection is for Bank Rate to remain at 0.25%, but there is a low possibility of a drop to close to zero. Gilt yields have fallen as expected, any borrowing that the Council undertakes is linked to gilt yields. The Arlingclose projection is for yields to decline or remain stable during 2017.

2.00	**RESOURCE IMPLICATIONS**
2.01	Financial implications set out in the report; no other resource implications directly as a result of this report.

3.00	**CONSULTATIONS REQUIRED / CARRIED OUT**
3.01	Arlingclose Ltd, being the Council's treasury management advisors.

4.00	**RISK MANAGEMENT**
4.01	Risk Management directly addressed within the report.

5.00	**APPENDICES**
5.01	1. Investment Portfolio as at 28th February 2017 2. Graph of 2016/17 Investment balances during 2016/17 3. Borrowing Portfolio as at 28th February 2017

6.00	**LIST OF ACCESSIBLE BACKGROUND DOCUMENTS**
6.01	**Contact Officer:** Liz Thomas – Technical Finance Manager **Telephone:** 01352 702289 **E-mail:** liz.thomas@flintshire.gov.uk

7.00	**GLOSSARY OF TERMS**
7.01	**Bank Rate:** The official interest rate set by the Bank of England's Monetary Policy Committee and what is generally termed at the "base rate". **Basis Point:** A unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100th of a percent). In most cases, it refers to changes in interest rates and bond yields. For example, if interest rates rise by 25 basis points, it means that rates have risen by 0.25% percentage points. **Bond:** A certificate of debt issued by a company, government, or other institution. The bond holder receives interest at a rate stated at the time of issue of the bond. The price of a bond may vary during its life. **Capital Expenditure:** Expenditure on the acquisition, creation or enhancement of capital assets. **Capital Financing Requirement (CFR):** The Council's underlying need to borrow for capital purposes representing the cumulative capital expenditure of the local authority that has not been financed. **Credit Default Swaps:** Similar to an insurance policy against a credit default. **Certificates of Deposits (CD's**): A savings certificate entitling the bearer to receive interest. A CD bears a maturity date, a specified fixed interest rate and can be issued in any denomination. CDs are generally issued by commercial banks. The term of a CD generally ranges from one month to five years. **Cost of Carry:** The "cost of carry" is the difference between what is paid to borrow compared to the interest which could be earned. For example, if one takes out borrowing at 5% and invests the money at 1.5%, there is a cost of carry of 3.5%. **Consumer Price Index (CPI):** The UK's main measure of inflation (along with Retail Price Index or 'RPI') The Monetary Policy Committee of the Bank of England set the Bank Rate in order to try and keep CPI at or close to the target set by the Government. The calculation of CPI includes many items of normal household expenditure but excludes some items such as mortgage interest payments and Council Tax. **Credit Rating**: Formal opinion by a registered rating agency of a counterparty's future ability to meet its financial liabilities; these are opinions only and not guarantees. **Corporate Bonds:** Corporate bonds are bonds issued by companies. The term is often used to cover all bonds other than those issued by governments in their own currencies and includes issues by companies, supranational organisations and government agencies. **Counterparty List:** List of approved financial institutions with which the

Council can place investments.

Debt Management Office (DMO): The DMO is an Executive Agency of Her Majesty's Treasury and provides direct access for local authorities into a government deposit facility known as the Debt Management Account Deposit Facility (DMADF). All deposits are guaranteed by HM Government and therefore have the equivalent of a sovereign credit rating.

Federal Reserve: The US central bank, the equivalent of the Bank of England. (Often referred to as "the Fed").

Financial Instruments: Financial instruments are tradable assets of any kind. They can be cash, evidence of an ownership interest in an entity, or a contractual right to receive or deliver cash or another financial instrument

Gilts: Gilts are bonds issued by the UK Government. They take their name from 'gilt-edged'. They are deemed to be very secure as the investor expects to receive the full face value of the bond to be repaid on maturity.

LIBID: The London Interbank Bid Rate (LIBID) is the rate bid by banks on Eurocurrency deposits (i.e. the rate at which a bank is willing to borrow from other banks).

LIBOR: The London Interbank Offered Rate (LIBOR) is the rate of interest that banks charge to lend money to each other. The British Bankers' Association (BBA) work with a small group of large banks to set the LIBOR rate each day. The wholesale markets allow banks who need money to borrow from those with surplus amounts. The banks with surplus amounts of money are keen to lend so that they can generate interest which it would not otherwise receive.

LOBO: Stands for Lender Option Borrower Option. The underlying loan facility is typically very long-term - for example 40 to 60 years - and the interest rate is fixed. However, in the LOBO facility the lender has the option to call on the facilities at pre-determined future dates. On these call dates, the lender can propose or impose a new fixed rate for the remaining term of the facility and the borrower has the 'option' to either accept the new imposed fixed rate or repay the loan facility.

IFRS: International Financial Reporting Standards.

Maturity: The date when an investment or borrowing is repaid.

Maturity Structure / Profile: A table or graph showing the amount (or percentage) of debt or investments maturing over a time period.

Monetary Policy Committee (MPC): Government Body that sets the Bank Rate. Its primary target is to keep inflation within 1% of a central target of 2%. Its secondary target is to support the Government in maintaining high and stable levels of growth and employment.

Money Market Funds (MMF): Pooled funds which invest in a range of short term assets providing high credit quality and high liquidity.
Minimum Revenue Provision (MRP): An annual provision that the Council

is statutorily required to set aside and charge to the Revenue Account for the repayment of debt associated with expenditure incurred on capital assets.

Non Specified Investment: Investments which fall outside the WG Guidance for Specified investments (below).

Operational Boundary: This linked directly to the Council's estimates of the CFR and estimates of other day to day cash flow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely prudent but not worst case scenario but without the additional headroom included within the Authorised Limit.

Premiums and Discounts: In the context of local authority borrowing,
(a) the premium is the penalty arising when a loan is redeemed prior to its maturity date and
(b) the discount is the gain arising when a loan is redeemed prior to its maturity date.

Prudential Code: Developed by CIPFA and introduced in April 2004 as a professional code of practice to support local authority capital investment planning within a clear, affordable, prudent and sustainable framework and in accordance with good professional practice.

Prudential Indicators: Indicators determined by the local authority to define its capital expenditure and asset management framework. They are designed to support and record local decision making in a manner that is publicly accountable; they are not intended to be comparative performance indicators

Public Works Loans Board (PWLB): The PWLB is a statutory body operating within the United Kingdom Debt Management Office, an Executive Agency of HM Treasury. The PWLB's function is to lend money from the National Loans Fund to local authorities and other prescribed bodies, and to collect the repayments.

Quantitative Easing (QE): QE is a form of monetary policy where a Central Bank creates new money electronically to buy financial assets, like government bonds. This cash injection lowers the cost of borrowing and boosts asset prices to support spending.

Revenue Expenditure: Expenditure to meet the continuing cost of delivery of services including salaries and wages, the purchase of materials and capital financing charges.

Retail Price Index (RPI): A monthly index demonstrating the movement in the cost of living as it tracks the prices of goods and services including mortgage interest and rent.

Term Deposits: Deposits of cash with terms attached relating to maturity and rate of return (Interest).

Specified Investments: Term used in the Welsh Assembly Guidance for Local Authority Investments. Investments that offer high security and high liquidity, in sterling and for no more than one year. UK government, local authorities and bodies that have a high credit rating.

Supported Borrowing: Borrowing for which the costs are supported by the government or third party.

Supranational Bonds: Instruments issued by supranational organisations created by governments through international treaties (often called multilateral development banks). The bonds carry an AAA rating in their own right. Examples of supranational organisations are the European Investment Bank, the International Bank for Reconstruction and Development.

Treasury Bills (T-Bills): Treasury Bills are short term Government debt instruments and, just like temporary loans used by local authorities, are a means to manage cash flow. They are issued by the Debt Management Office and are an eligible sovereign instrument, meaning that they have an AAA-rating.

Treasury Management Code: CIPFA's Code of Practice for Treasury Management in the Public Services, initially brought in 2003, subsequently updated in 2009 and 2011.

Treasury Management Practices (TMP): Treasury Management Practices set out the manner in which the Council will seek to achieve its policies and objectives and prescribe how it will manage and control these activities.

Temporary Borrowing: Borrowing to cover peaks and troughs of cash flow, not to fund capital spending.

Unsupported Borrowing: Borrowing which is self-financed by the local authority. This is also sometimes referred to as Prudential Borrowing.

Yield: The measure of the return on an investment instrument.