

# Appendix 1

## DENBIGHSHIRE COUNTY COUNCIL

### ***ANNUAL TREASURY MANAGEMENT REPORT 2016/17***

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## **1. Background**

- 1.1 The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year. Reports are made twice a year to the Corporate Governance Committee which is the committee with responsibility for the scrutiny of the Council's treasury policy, strategy and activity, as well as the annual report made to cabinet and the report to full council for approval of the annual treasury strategy.
- 1.2 Treasury management is defined as: "The management of the local authority'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."
- 1.3 The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk.

## **2. Economic Background**

- 2.1 Politically, 2016/17 was an extraordinary twelve month period which defied expectations when the UK voted to leave the European Union and Donald Trump was elected the 45<sup>th</sup> President of the USA. Uncertainty over the outcome of the US presidential election, the UK's future relationship with the EU and the slowdown witnessed in the Chinese economy in early 2016 all resulted in significant market volatility during the year. Article 50 of the Lisbon Treaty, which sets in motion the 2-year exit period from the EU, was triggered on 29<sup>th</sup> March 2017.
- 2.2 UK inflation had 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/year in April 2016 to 2.3% year/year in March 2017.
- 2.3 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 (MPC) to cut the Bank Rate to 0.25% in August and embark on further gilt and corporate bond purchases as well as provide cheap funding for banks via the Term Funding Scheme to maintain the supply of credit to the economy. 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 the labour market also proved resilient.

### **3. Borrowing Activity**

3.1 The table below shows the level of the Council's borrowing from the Public Works Loan Board (PWLB) at the start and the end of the year.

	Balance at 01/04/2016 £000	Maturing loans £000	Premature repayments £000	New Borrowing £000	Balance at 31/03/2017 £000
Fixed rate loans – Public Works Loan Board (PWLB)	190,165	5,439	0	0	184,726
<b>Total borrowing</b>	<b>190,165</b>	<b>5,439</b>	<b>0</b>	<b>0</b>	<b>184,726</b>

3.2 The Council's strategy in 2016/17 was to internally borrow to fund its borrowing requirement.

3.3 The Council has also been accessing temporary borrowing from other local authorities at very low rates to cover short-term cash flow requirements.

3.4 As a result of maturities during the year, the average rate on the Council's debt decreased from 4.95% at 1 April 2016 to 4.94% at 31 March 2017.

3.5 Annex A shows how interest rates for borrowing have moved over the course of the year.

### **Abolition of the PWLB**

3.6 In January 2015 the Department of Communities and Local Government (CLG) confirmed that HM Treasury (HMT) would be taking the necessary steps to abolish the PWLB. HMT confirmed however that its lending function will continue unaffected and local authorities will retain access to borrowing rates which offer good value for money. There is a consultation due but HMT hasn't released further details on this matter.

### **4. Investment Activity**

4.1 The Council held cash balances of £1.2m at the end of 2016/17. These represent the Council's Balances and Reserves (after internal borrowing and working cash balances are accounted for) and also where money has been borrowed before capital expenditure is incurred.

4.2 The Welsh Government's Investment Guidance requires local authorities to focus on security (keeping the money safe) and liquidity (making sure the Council never runs out of cash) as the primary objectives of a prudent investment policy. The Council's aim was to achieve a return on investments in line with these principles. The return is important but is a secondary consideration and the priority is the security of the sums invested.

4.3 The table below shows the level of the Council's investments at the start and the end of the year.

	Balance at 01/04/2016 £000	Investments Raised £000	Investments Repaid £000	Balance at 31/03/2017 £000
<b>Investments</b>	<b>12,000</b>	<b>275,500</b>	<b>286,300</b>	<b>1,200</b>

4.4 The Council's investment income for the year was £0.032m compared to £0.108m in 2015/16 which meant that the low interest rates available in the market continued to have a significant impact on the investment return earned by the Council.

4.5 Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2016/17 which defined "high credit quality" organisations as those having a long-term credit rating of A- or higher if domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher.

#### **Unsecured Bank Deposits**

4.6 Conventional bank deposits became riskier during 2016/17 because of a lower likelihood that the UK and other governments would support failing banks. As the Banking Reform Act 2014 was implemented in the UK from January 2015, banks were no longer able to rely on government bail-outs if they got into difficulty. They would be required instead to bail themselves out by taking a proportion of investors' deposits to build up their capital. This new risk has been termed 'bail-in' risk and is potentially a greater risk to investors than the 'bail-out' risk of the past.

4.7 As a result of the increased risks, the Council has been placing a far greater emphasis on investing with the UK Government's Debt Management Office and other local authorities in order to minimise these risks.

#### **Secured Investment Options**

4.8 The Council also included secured investment options within its investment strategy such as those described below with a view to using them during 2016/17.

### **Reverse Repurchase Agreements (REPOs)**

- 4.9 These involve the purchase of a security (usually bonds, gilts or other government securities) tied to an agreement to sell it back later at a pre-determined date and price. REPOs provide protection through the ownership of collateral in the form of securities which is significantly more secure than investing in unsecured bank deposits. These are therefore secured investments with banks which are exempt from bail-in risk so they offer a safer alternative at similar rates to unsecured bank deposits.

### **Covered Bonds**

- 4.10 These are also secured investments with banks which are exempt from bail-in risk and they offer a secure option for long term investments.

(The glossary in Annex C provides definitions of the various treasury terms used)

### **Credit Risk Management**

- 4.11 Counterparty credit quality was assessed and monitored with reference to the following:
- credit ratings (minimum long-term counterparty rating of A- across rating agencies Fitch / S&P / Moody's);
  - analysis of funding structure and susceptibility to bail-in;
  - credit default swap prices;
  - financial statements;
  - information on potential government support;
  - share prices.

### **Liquidity Management**

- 4.12 In keeping with the WG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of overnight deposits and instant access call accounts. The Authority uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed.

### **Yield**

- 4.13 The Council sought to achieve the best return balanced against its objectives of security and liquidity. The UK Bank Rate was reduced from 0.5% to 0.25% on 4 August 2016. Short term money market rates also remained at very low levels which had a significant impact on investment income.

- 4.14 All investments made during the year complied with the Council's agreed Treasury Management Strategy, Prudential Indicators, Treasury Management Practices and prescribed limits. Maturing investments were repaid to the Council in full and in a timely manner.

## **5. Compliance with Prudential Indicators**

- 5.1 The Council can confirm that it has complied with its Prudential Indicators for 2016/17, which were set in February 2016 as part of the Council's Treasury Management Strategy Statement. Details can be found in Annex B.
- 5.2 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2016/17. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

## **6. Money Laundering Update**

- 6.1 The Council is alert to the possibility that it may become the subject of an attempt to involve it in a transaction involving the laundering of money. Accordingly, it maintains procedures for verifying and recording the identity of counterparties and reporting suspicions, and will ensure that relevant staff are properly trained.
- 6.2 The Head of Finance has been appointed as the Money Laundering Reporting Officer. There haven't been any cases of money laundering reported since the start of Denbighshire to date and the risk to the Council is considered to be minimal.

**Interest Rates 2016/17**

Public Works Loan Board (PWLB) borrowing rates and UK Money Market rates during the year were:

Example PWLB Borrowing rates (The rate at which the Council could borrow money from the Government)

<b>Start Date</b>	<b>Length of Loan</b>		
	<b>1yr %</b>	<b>19½-20 yrs %</b>	<b>49½-50 yrs %</b>
01-Apr-16	1.32	3.23	3.14
30-Sep-16	1.03	2.38	2.30
31-Mar-17	1.03	2.74	2.54

Example Bank Rate, Money Market rates (The rate at which the Council could invest with banks)

<b>Date</b>	<b>Bank Rate %</b>	<b>7-day Investment Rates %</b>	<b>1-month Investment Rates %</b>	<b>6-month Investment Rates %</b>
01-Apr-16	0.50	0.36	0.39	0.61
30-Sep-16	0.25	0.12	0.14	0.41
31-Mar-17	0.25	0.11	0.13	0.37



**Compliance with Prudential Indicators 2015/16**

**1 Estimated and Actual Capital Expenditure**

1.1 This indicator is set to ensure that the level of proposed investment in capital assets remains within sustainable limits and, in particular, to consider the impact on the Council Tax and in the case of the HRA, housing rent levels.

<b>Capital Expenditure</b>	<b>2016/17 Estimated February 2016 £000</b>	<b>2016/17 Revised February 2017 £000</b>	<b>2016/17 Outturn March 2017 £000</b>
Non-HRA	9,860	24,375	16,610
Corporate Plan	29,933	20,045	18,373
HRA	11,768	11,184	7,981
<b>Total</b>	<b>51,561</b>	<b>55,604</b>	<b>42,964</b>

NB The figures for the February estimate were produced early in January but due to the nature of capital expenditure, some of the major schemes have slipped and this expenditure will now be incurred in 2017/18.

**2 Estimated and Actual Ratio of Financing Costs to Net Revenue Stream**

2.1 This is an indicator of affordability and demonstrates the revenue implications of capital investment decisions by highlighting the proportion of the revenue budget required to meet the borrowing costs associated with capital spending. The financing costs include existing and proposed capital commitments.

<b>Ratio of Financing Costs to Net Revenue Stream</b>	<b>2016/17 Estimated February 2016 £000</b>	<b>2016/17 Revised February 2017 £000</b>	<b>2016/17 Outturn March 2017 £000</b>
Financing Costs	12,445	13,214	13,214
Net Revenue Stream	185,056	185,062	185,062
<b>Non-HRA Ratio</b>	<b>6.73%</b>	<b>7.14%</b>	<b>7.14%</b>
Financing Costs	6,016	5,982	5,759
Net Revenue Stream	13,620	14,129	14,129
<b>HRA Ratio</b>	<b>44.17%</b>	<b>42.34%</b>	<b>40.76%</b>

**3 Capital Financing Requirement**

3.1 The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose. In order to ensure that over the medium term net borrowing will only be for a capital purpose, the Council ensures that net external borrowing does not, except in the short term, exceed the CFR in the preceding year plus the estimates of any additional

CFR for the current and next two financial years. This is demonstrated in the following table:

<b>Capital Financing Requirement</b>	<b>31/03/2017 Estimated February 2016 £000</b>	<b>31/03/2017 Revised February 2017 £000</b>	<b>31/03/2017 Outturn March 2017 £000</b>
Non-HRA	190,539	176,635	175,867
HRA	71,958	71,279	65,697
<b>Total</b>	<b>262,497</b>	<b>247,914</b>	<b>241,564</b>
<b>Borrowing</b>	<b>201,059</b>	<b>194,725</b>	<b>184,726</b>

NB The outturn figures are taken from the pre-audited Statement of Accounts 2016/17 so they may be subject to change.

#### **4 Authorised Limit and Operational Boundary for External Debt**

##### **Summary Table:**

<b>2016/17</b>	<b>March 2017 £000</b>
<b>External Borrowing</b>	184,726
<b>Internal Borrowing</b>	56,838
<b>Operational Boundary</b>	235,000
<b>Authorised Limit</b>	240,000

- 4.1 **Operational Boundary:** This limit is set to reflect the Council's best view of the most likely prudent (i.e. not worst case) levels of borrowing activity.
- 4.2 **Authorised Limit:** This is the maximum amount of external debt that can be outstanding at one time during the financial year. The limit, which is expressed gross of investments, is consistent with the Council's existing commitments, proposals for capital expenditure and financing and with its approved treasury policy and strategy and also provides headroom over and above for unusual cash movements.
- 4.3 The levels of debt are measured on an ongoing basis during the year for compliance with the Authorised Limit and the Operational Boundary. The Council maintained its total external borrowing and other long-term liabilities within both limits; at its peak this figure was £196.4m. In addition to external borrowing, the Council uses its own reserves and balances to fund capital expenditure and this is known as internal borrowing as shown in the table above.

## 5 Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

- 5.1 These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. The exposures are calculated on a net basis i.e. fixed rate debt net of fixed rate investments. The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on the portfolio of investments.

	<b>2016/17 Estimated %</b>	<b>2016/17 Actual Peak Exposure %</b>
<b>Upper Limit for Fixed Rate Exposure</b>	100	100
<b>Upper Limit for Variable Rate Exposure</b>	40	0

## 6 Maturity Structure of Fixed Rate borrowing

- 6.1 This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates and is designed to protect against excessive exposures to interest rate changes in any one period, in particular in the course of the next ten years.
- 6.2 It is calculated as the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate.

<b>Maturity structure of fixed rate borrowing</b>	<b>Upper limit %</b>	<b>Lower limit %</b>	<b>Actual Borrowing as at 31/03/2017 £000</b>	<b>Percentage of total as at 31/03/2017 %</b>
under 12 months	30	0	4,533	2.45
12 months and within 24 months	30	0	4,390	2.38
24 months and within 5 years	30	0	13,763	7.45
5 years and within 10 years	30	0	13,776	7.46
10 years and above	100	50	148,264	80.26
<b>Total</b>			<b>184,726</b>	<b>100.00</b>

## **7 Total principal sums invested for periods longer than 364 days**

- 7.1 This indicator is set in order to allow the Council to manage the risk inherent in investments longer than 364 days. For 2016/17 this limit was set at £10m. The Council did not have any investments which exceeded 364 days during 2016/17 because the policy was to limit investments to a shorter period than 1 year.

## **8 Adoption of the CIPFA Treasury Management Code**

- 8.1 The Council confirms its adoption of the CIPFA Code of Treasury Management at its Council meeting on 26 March 2002. The Council has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies, procedures and practices.

**GLOSSARY - Useful guide to Treasury Management Terms and Acronyms**

<b>BANK OF ENGLAND</b>	UK's Central Bank
<b>BANK RATE</b>	Bank of England Interest Rate (also known as Base Rate)
<b>CPI</b>	Consumer Price Index – a measure of the increase in prices
<b>RPI</b>	Retail Price Index – a measure of the increase in prices
<b>DMO</b>	Debt Management Office – issuer of gilts on behalf of HM Treasury
<b>FSA</b>	Financial Services Authority - the UK financial watchdog
<b>GDP</b>	Gross Domestic Product – a measure of financial output of the UK
<b>LIBID</b>	London Interbank Bid Rate - International rate that banks lend to other banks
<b>LIBOR</b>	London Interbank Offer Rate – International rate that banks borrow from other banks (the most widely used benchmark or reference for short term interest rates)
<b>PWLB</b>	Public Works Loan Board – a Government department that lends money to Public Sector Organisations
<b>MPC</b>	Monetary Policy Committee - the committee of the Bank of England that sets the Bank Rate
<b>LONG TERM RATES</b>	More than 12 months duration
<b>SHORT TERM RATES</b>	Less than 12 months duration
<b>BOND (GENERAL)</b>	An investment in which an investor loans money to a public or private company that borrows the funds for a defined period of time at a fixed interest rate
<b>GOVERNMENT BOND</b>	A type of bond issued by a national government generally with a promise to pay periodic interest payments and to repay the face value on the maturity date
<b>CORPORATE BOND</b>	A type of bond issued by a corporation to raise money in order to expand its business

**COVERED BOND**

A corporate bond issued by a financial institution but with an extra layer of protection for investors whereby the investor has recourse to a pool of assets that secures or “covers” the bond if the financial institution becomes insolvent

**GILT**

A bond that is issued by the British government which is classed as a low risk investment as the capital investment is guaranteed by the government

**REPO**

A repurchase agreement involving the selling of a security (usually bonds or gilts) with the agreement to buy it back at a higher price at a specific future date  
For the party selling the security (and agreeing to repurchase it in the future) it is a REPO  
For the party on the other end of the transaction e.g. the local authority (buying the security and agreeing to sell in the future) it is a reverse REPO

**FTSE 100**

Financial Times Stock Exchange 100 - An index composed of the 100 largest companies listed on the London Stock Exchange which provides a good indication of the performance of major UK companies