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Date: Tuesday, 23 May 2017

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Dear Member

AUDIT COMMITTEE - WEDNESDAY, 31 MAY 2017

I am now able to enclose, for consideration at the Wednesday, 31 May 2017 meeting of the Audit Committee, the following reports that were unavailable when the agenda was printed.

Agenda No	Item	Page
9.	**Treasury Management Outturn Report**	(Pages 40 - 55)

Yours sincerely

Lisa Antrobus
Clerk

Meeting: **Audit Committee**
Council

Date: **31st May 2017**
22nd June 2017

Wards Affected: All Wards in Torbay

Report Title: Treasury Management Outturn 2016/17

Is the decision a key decision? No
When does the decision need to be implemented?

Executive Lead Contact Details: Mayor Gordon Oliver, 01803 207001, gordon.oliver@torbay.gov.uk

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1. Proposal and Introduction

1.1 This report informs Members of the performance of the Treasury Management function in supporting the provision of Council services in 2016/17 through management of cash flow, debt and investment operations and the effective control of the associated risks.

1.2 The headline points of the report are:

- New borrowing of £15 million taken to fund the Capital Investment
- The Council has moved to an under borrowed position (against the Capital Financing Requirement) at the end of the year
- Annual investment rate achieved exceeded the market and peer benchmark levels
- Termination of the external investment management arrangement with Aberdeen Asset Management Ltd by mutual agreement
- New Investment in the CCLA Local Authorities Property Fund
- Treasury Management activities were underspent by £800k against the approved budget target

2. Reason for Proposal

2.1 The Council is required through regulations issued under the Local Government Act 2003 to produce an annual outturn report reviewing treasury management activities and the actual prudential and treasury indicators for 2015/16.

3.2 This report also meets the requirements of the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

3. Recommendation(s) / Proposed Decision

3.1 That the Treasury Management decisions made during 2016/17, as detailed in the submitted report be noted; and

3.2 That the performance against the approved Prudential and Treasury Indicators as set out in Appendix 1 to this report be noted.

4. Background Information

4.1 Treasury management is defined by the Code of practice as:

"The management of the authority's investments and cash flows, it's 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".

4.2 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 (Council 3rd February 2016)
- A mid-year review report (Council 21st September 2016)
- An annual report following the year describing the activity compared to the strategy (this report)

4.3 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is therefore important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the policies previously approved by Members.

4.4 The Council confirms that it has complied with the requirement under the Code to give prior scrutiny to the above strategy and mid-year treasury management reports by the Audit Committee before they were reported to full Council. Member training on treasury management issues was undertaken in July 2015 in order to support members' scrutiny role.

4.6 Treasury Management strategies were planned and implemented in conjunction with the Council's appointed advisors, Capita Asset Services although the Council officers were the final arbiters of the recommended approach.

4.6 This report covers:

- The Economy and Interest rates
- Treasury Position at year end;
- The Strategy for 2016/17;
- Borrowing Outturn for 2016/17;
- Investment Outturn for 2016/17;
- Revenue Budget Performance;
- Reporting Arrangements and Management Evaluation
- Loans to Organisations
- Prudential and Treasury Indicators (Appendix1)

5. The Economy and Interest Rates

5.1 A commentary provided by Capita Asset Services is presented at Appendix 2 to the report.

6. Overall Treasury Position as at 31 March 2017

6.1 At the beginning and the end of 2016/17 the Council's treasury position was as follows:

TABLE 1	31 March 2016 Principal	Rate/ Return	Average Life yrs	31 March 2017 Principal	Rate/ Return	Average Life yrs
Borrowing	*£138.1m*	*4.39%*	*26.5 years*	*£153.1m*	*4.17%*	*26.3 years*
Other long term liabilities	*£20.2m*	*5.26%*	*11.5 years*	*£19.6m*	*5.14%*	*18.9years*
Total debt	***£158.3m***	***4.44%***	***25.7 years***	***£172.7m***	***4.25%***	***25.5years***
CFR	***£151.1m***			***£174.3m***		
Over/(under) borrowing	*£7.2m*			*£(1.6)m*		
Total investments	***£54.6m***	***0.91%***		***£41.7m***	***0.91%***	
Net debt	£103.7m	3.48%		£131.0m	3.24%	

7. The Strategy for 2016/17

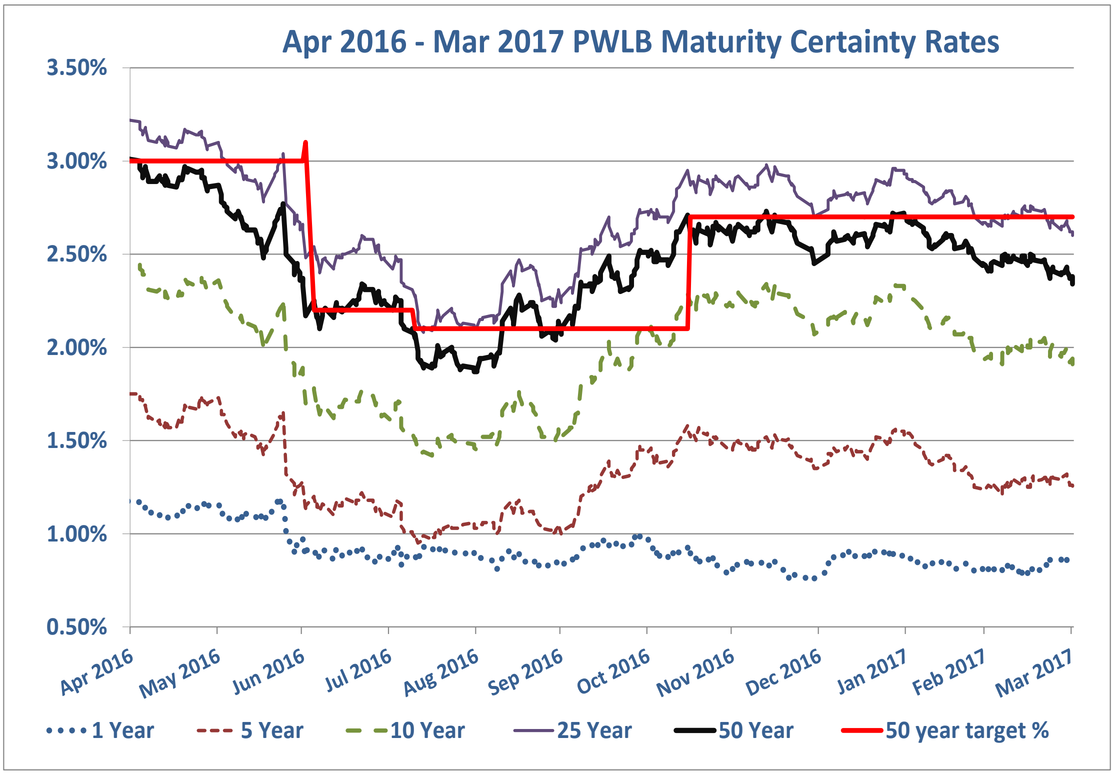
7.1 The 2016/17 approved strategy anticipated the need to fund new capital schemes with £10 million of new borrowing required to restrict the level of internal borrowing and maintain sufficient cash to back core funds.

7.2 The perceived risk to Bank Rate and the affect on investment rates were to the downside (rates expected to fall) and the Annual Investment Strategy approved the continued use of longer term deposits for available cash to lock into higher rates and provide a guarantee of return.

7.3 The decision by Council in September 2016 to expand the Capital Investment Fund from £10million to £50million required a substantial re-evaluation of the Treasury Management Strategy. The effect on the Capital Financing Requirement (CFR) has resulted in a shift in the Council's overall position to being under-borrowed as opposed to over-borrowed in previous years. Going forward the strategy will need to focus on managing the risks of the increased borrowing requirement and this is covered further in paragraphs 8.7 to 8.12 of this report.

8. Borrowing Outturn 2016/17

8.1 The graph below shows how PWLB certainty rates (new loan rates) have again fallen to historically very low levels during the year.



8.2 The Capital Financing Requirement (the Council's underlying need to borrow increased significantly from the original budget position following additional approvals to the Capital Plan.

8.3 The anticipated new borrowing was held off until the end of the year until resources were required to finance the Investment Fund purchase of Wren Park. On exchange of contracts Officers were able to take advantage of a fall in rates to a six month low to take loans of 44 years (£5M) and 10 years (£5M) at 2.54% and 1.42% respectively. A further loan over 45 years (£5M) was taken at 2.48% following a further drop in the market prior to completion.

8.4 The 10 year loan was made on an EIP basis (equal instalment of principal) to balance some risk arising from the decision to not make an MRP provision on the value of the asset.

8.5 As a result of the new loans the borrowing portfolio (excluding other long term liabilities) has increased to £153.1million and the average rate of interest paid on all loans in 2016/17 was 4.37%.

8.6 Some concern has been expressed over the increase in planned borrowing, particularly in regards to the Investment Fund and other major schemes that could involve borrowing and the long term effect of that higher level of borrowing on the Council's financial position.

8.7 Concern over the total value of a Council's borrowing and the resultant ongoing revenue costs are a valid concern. Since 2003 the controls over the level of a Council's borrowing is in effect self regulatory under the Local Government Act 2003 having regard to the CIPFA Treasury Management Code of Practice. I.e. borrowing is based on "principles rather than prescription". The intention of the prudential borrowing system was to encourage councils that need capital expenditure, and can afford to, to do so.

8.8 Torbay's overall borrowing has arisen from three sources. First in 1998 Torbay inherited a tax base share of Devon County Council's debt which was over £30m. Secondly until recently central government's preferred method of financing capital expenditure for primarily schools and transport was to allow councils to borrow, and then central government would fund the ongoing revenue costs within the councils overall grant funding. The value of this borrowing since 1998 would have been approx £100m.

8.9 The final source of borrowing is where the Council has approved schemes to be funded from borrowing where the ongoing costs of the borrowing would be an increased cost to the Council, (where the scheme has no direct income such as Rock Walk or South Devon Highway), or the increased costs would be offset by an income stream or saving such as LED street lights or investment property.

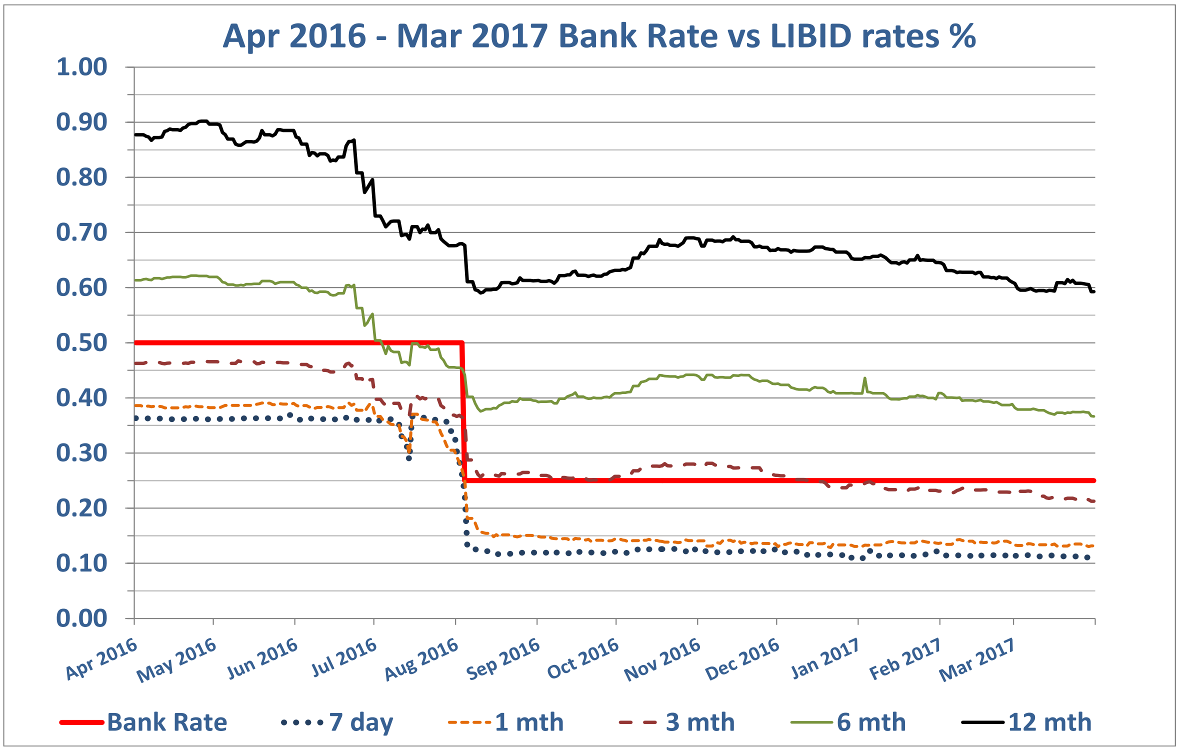
8.10 The Councils' debt, (excluding) PFI commitments, was £153m which will incur over £6m of interest costs per annum and £3m of MRP costs each year. This £9m cost is a significant proportion of the Council's net expenditure. As the Council increases it's borrowing the interest and MRP costs will increase. As a guide, for each £1m of new borrowing, annual costs are currently approx 6% or £60k per annum.

8.11 If the Council uses the borrowing to invest in assets then initially the impact on the Council's net equity will be nil as the asset should, at least, match borrowing.

8.12 As a self regulatory position councils have a legal duty to "determine and keep under review the maximum amount which it can afford to allocate to capital expenditure". This is reflected in the annual setting of an authorised (maximum) limit for borrowing within a year linked to its Treasury Management Strategy and its Revenue budget. As the Council will typically borrow from PWLB at fixed interest rates the risk relates to two key areas; the risk of any loss in the value of the asset or the expected income levels to cover the higher borrowing costs are not achieved. It is these two risks that need to be closely considered when a proposal is presented to Council for approval.

9. Investment Outturn 2016/17

9.1 The movement in key market investment rates during 2016/17 are illustrated in the table below.



9.2 After the EU referendum, Bank Rate was cut from 0.5% to 0.25% on 4 August and remained at that level for the rest of the year. Market expectations as to the timing of the start of monetary tightening started the year at quarter 3 2018, but then moved back to around the end of 2019 in early August before finishing the year back at quarter 3 2018. Deposit rates continued into the start of 2016/17 at previous depressed levels but then fell during the first two quarters and fell even further after the 4 August MPC meeting resulted in a large tranche of cheap financing being made available to the banking sector by the Bank of England. Rates made a weak recovery towards the end of 2016 but then fell to fresh lows in March 2017.

9.3 In view of the pessimistic outlook for investment rates the Council had, prior to the start of 2016/17, locked out £12million of deposits longer term to other Local Authorities at an average rate of 1.00%.

9.4 Strategic investments during the year were predominantly limited to six months duration to adhere to counterparty limits while maximising available returns. In expectation of the Bank Rate cut in August £13 million was locked out for one year duration with Nat West to protect returns.

9.5 Exposure in peer-to-peer lending was increased during the year following the success of the initial experimental period. Lending through the Funding Circle reached £230,000 by the end of the year and the performance of the holding at 31st March 2017 is summarised below:

Funding Circle (peer to peer lending) 2017/18		
Total Invested		**£230,000**
No. of loan parts		503
Interest earned		£17,741
Average principal		£206,233
Gross yield		8.60%
Return net of fees and bad debts		**5.58%**
Bad debts written off		£4,293
Bad debts as a proportion of principal invested		1.84%
Expected bad debt rate of portfolio		0.90%
<u>Risk Analysis</u>		
Proportion of secured/unsecured loans		
	- Secured	61%
	- Unsecured	39%
Proportion of loans by credit rating		
	- A+	71%
	- A	22%
	- B	7%

9.6 During 2016/17 the Chief Finance Officer implemented a restriction on Funding Circle operations to only loans where the Council held a first charge on borrower assets.

9.7 Unrelated to this, Funding Circle has recently advised that they are changing their business plan to focus on loans to small businesses loans and will scale down new property development loans. As property development loans provide the first charge criteria, this effectively means that the policy restriction in 9.6 will result in the Funding Circle investment being unwound as loans mature.

9.8 Officers continue to review other peer-to-peer providers but as yet none have been found that satisfy the two major criteria; (a) a credit rating policy and (b) a first charge on borrower assets in the event of default.

9.9 ***Externally Managed Investments*** – The external management agreement with Aberdeen Asset Management Ltd (AAM) was terminated by mutual consent in February 2017. Due to market conditions, management of the Council's holding had become confined to transacting in AAM's short term liquidity fund and the Council will continue to deal directly in this Fund.

9.10 Also in February 2017, the Chief Finance Officer elected to enact a standing Council approval and invest in the CCLA Local Authorities Property Fund. A sum of £3 million was paid into the Fund as a long term investment. Entry fees paid have been taken to a specific Reserve in the Council's balance sheet to be offset by expected fund growth in future years.

9.11 ***Performance Analysis*** - Detailed below is the result of the investment strategy undertaken by the Council. Despite the continuing difficult operating environment the Council's investment returns remain well in excess of the benchmark.

	Average Investment Principal	Rate of Return (gross of fees)	Rate of Return (net of fees)	Capita Benchmarking Club		Market Benchmark/ Target Return
				Peer LA Comparison	English Unitaries	
Internally Managed	£42.1M	0.95%	na	0.77%	0.86%	0.20%
Aberdeen Short Liquidity Fund*	£15.6M	1.12%	0.98%			0.20%
CCLA Property Fund	£0.3M	4.82%	4.22%			
Combined	£58.0M	1.01%	0.96%			0.20%

* Reported as an externally managed investment including the period following termination of the Agreement

9.12 In interest terms, the in-house treasury function contributed an additional £440,000 (after fees) to the General Fund over and above what would have been attained from the benchmark return.

9.13 A list of those institutions with which the in-house team invested funds during the year is provided at Appendix 3. No institutions with which investments were made showed any difficulty in repaying investments and interest in full during the year.

10 Revenue Budget Performance

10.1 The effect of the decisions outlined in this report on the approved revenue budget is outlined in the table below.

	Revised Budget 2016/17	Actual 2016/17	Variation
	£M	**£M**	**£M**
Investment Income	(0.9)	(0.6)	0.3
Interest Paid on Borrowing	6.1	6.1	0.0
Net Position (Interest)	**5.2**	**5.5**	**0.3**
Minimum Revenue Provision (MRP)	3.8	2.7	(1.1)
MRP re: PFI	0.5	0.5	0
PFI Grant re: MRP	(0.5)	(0.5)	0
Net Position (Other)	**3.8**	**2.7**	**(1.1)**
Net Position Overall	**9.0**	**8.2**	**(0.8)**

10.2 The position was regularly reported to OSB and Council throughout the year as part of the budget monitoring reports to Members

11 Reporting Arrangements and Management Evaluation

11.1 The management and evaluation arrangements identified in the annual strategy and followed for 2016/17 were as follows:

- Monthly monitoring report to Executive Lead for Finance, Chief Finance Officer and Group Leaders
- Regular meeting of the Treasury Manager and Finance Manager to review previous months performance and plan following months activities
- Regular meetings with the Council’s treasury advisors
- Regular meetings with the Council’s appointed Fund Manager
- Membership and participation in Capita Treasury Services Investment Benchmarking Club

12 Loans to Organisations

12.1 The Council has provided loans or loan facilities to the following organisations. These are policy decisions and not part of the treasury management strategy except for identifying any impact on cash balances:

Organisation	Value of loan at 31/03/17	Full Term of Loan	Rate
Torbay Economic Development Company*	£575,000	25 years	Linked to Council borrowing Rate
Torbay Economic Development Company	£1,463,773	25 years	Linked to Council borrowing Rate
Academy Schools	£66,686	3 to 7 years	Linked to Council borrowing Rate
Babbacombe Cliff Railway	£7,000	10 years	Linked to Council Borrowing Rate
Sports Clubs	£31,544	10 - 20 years	Linked to Council Borrowing Rate
Suttons Seeds Ltd **	£1,500,000**	3 years	Market rate
Torbay Coast & Countryside Trust	£895,000	45 years	Linked to Bank Base Rate
Torbay Coast & Countryside Trust – Green Heart Project	50,000 (37,500)	4 years	Linked to Bank Base Rate

*Not fully drawn down as at 31st December 2016
**Original advance repaid and no further drawdowns on the facility to date (expires 2017)

The current overall rate of interest on these loans is around 4%.

Appendices

Appendix 1: Prudential and Treasury Indicators 2016/17
Appendix 2: The Economy and Interest Rates
Appendix 3: Counterparties with which funds have been deposited in 2016/17

Background Documents

Appendix 1

Prudential and Treasury Indicators 2016/17

Capital Expenditure and Financing 2016/17

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need (though the timing of borrowing may be delayed through the application of cash balances held by the Council).

The actual capital expenditure forms one of the required prudential indicators and is shown in the table below.

	2015/16 Actual £m	2016/17 Revised Budget £m	2016/17 Actual £m
Total capital expenditure	23	42	37

*

Capital Financing Requirement

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's net debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2016/17 unfinanced capital expenditure and prior years' net or unfinanced capital expenditure which has not yet been financed by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively the reserving of funds for repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. The Council's 2016/17 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2016/17 on 3rd February 2016 and amended on 22nd September 2016.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

The Council's CFR for the year represents a key prudential indicator analysed below. This includes PFI schemes on the balance sheet, which increase the Council's long term liabilities. No borrowing is actually required against these schemes as a borrowing facility is included in the contract (if applicable).

CFR (£m)	31 March 2016 Actual	31 March 2017 Revised Indicator	31 March 2017 Actual
CFR at Year End	151.1	174.8	174.3

The borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit presented at Appendix 1 to this report.

Net borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2016/17 plus the expected changes to the CFR over 2017/18 and 2018/19. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

CFR (£m)	31 March 2016 Actual	31 March 2017 Actual
Opening balance	135.3	151.1
Capital expenditure in year funded from borrowing	7.7	26.6
EFW PFI Liability	12.4	-
Minimum Revenue Provision	(4.3)	(3.4)
CFR at Year End	151.1	174.3
Net borrowing position	**103.7**	**131.0**

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2016/17 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached. Borrowing levels were maintained well below the operational boundary throughout the year.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term liabilities net of investment income) against the net revenue stream.

	2016/17
Authorised limit	£234m
Maximum gross borrowing position	£173.3m
Operational boundary	£207m
Average gross borrowing position	£165.5m
Financing costs as a proportion of net revenue stream	8.1%

Treasury Indicators:

Maturity Structure of the fixed rate borrowing portfolio - This indicator assists Authorities avoid large concentrations of fixed rate debt that has the same maturity structure and would therefore need to be replaced at the same time.

	31 March 2017 Actual	31 March 2016 Proportion	2016/17 Original Limits Upper-Lower
Up to 10 years	£24M	16%	5% - 50%
10 to 20 years	£26M	17%	5% - 50%
20 to 30 years	£38M	25%	10% - 60%
30 to 40 years	£37M	24%	10% - 50%
Over 40 years	£28M	18%	0% - 50%

Principal sums invested for over 364 days - The purpose of this indicator is to contain the Council's exposure to the possibility of losses that might arise as a result of it having to seek early repayment or redemption of principal sums invested. The Actual figure reflects deposits and the recent £3M investment in the CCLA Property Fund

	2015/16 Actual	2016/17 Limit	2016/17 Actual
Investments of 1 year and over	£22M	£28m	£15m

Exposure to Fixed and Variable Rates - The Prudential Code requires the Council to set upper limits on its exposure to the effects of changes on interest rates. The exposure to fixed and variable rates was as follows:

	31 March 2016 Actual %	2016/17 Upper Limits %	31 March 2017 Actual %
Limits on fixed interest rates: • Debt only • Investments only	100 52	100 80	100 53
Limits on variable interest rates • Debt only • Investments only	0 47	30 70	0 47

Appendix 2

The Economy and Interest Rates

By Capita Asset Services May 2017

The two major landmark events that had a significant influence on financial markets in the 2016-17 financial year were the UK EU referendum on 23 June and the election of President Trump in the USA on 9 November. The first event had an immediate impact in terms of market expectations of when the first increase in Bank Rate would happen, pushing it back from quarter 3 2018 to quarter 4 2019. At its 4 August meeting, the Monetary Policy Committee (MPC) cut Bank Rate from 0.5% to 0.25% and the Bank of England's Inflation Report produced forecasts warning of a major shock to economic activity in the UK, which would cause economic growth to fall almost to zero in the second half of 2016. The MPC also warned that it would be considering cutting Bank Rate again towards the end of 2016 in order to support growth. In addition, it restarted quantitative easing with purchases of £60bn of gilts and £10bn of corporate bonds, and also introduced the Term Funding Scheme whereby potentially £100bn of cheap financing was made available to banks.

In the second half of 2016, the UK economy confounded the Bank's pessimistic forecasts of August. After a disappointing quarter 1 of only +0.2% GDP growth, the three subsequent quarters of 2016 came in at +0.6%, +0.5% and +0.7% to produce an annual growth for 2016 overall, compared to 2015, of no less than 1.8%, which was very nearly the fastest rate of growth of any of the G7 countries. Needless to say, this meant that the MPC did not cut Bank Rate again after August but, since then, inflation has risen rapidly due to the effects of the sharp devaluation of sterling after the referendum.

Appendix 3

Counterparties with which funds were deposited (April 2016 – March 2017)

Banks and Building Societies

Bank of Scotland
Goldman Sachs International Bank
Lloyds Bank
Royal Bank of Scotland/National Westminster
Santander UK
Svenska Handelsbanken

Local Authorities

Lancashire County Council
Nottinghamshire Police and Crime Commissioner
Newcastle City Council

Other Approved Institutions

Public Sector Deposit Fund
Goldman Sachs Sterling Fund
Aberdeen Asset Management Ltd
Funding Circle
CCLA Local Authorities Property Fund