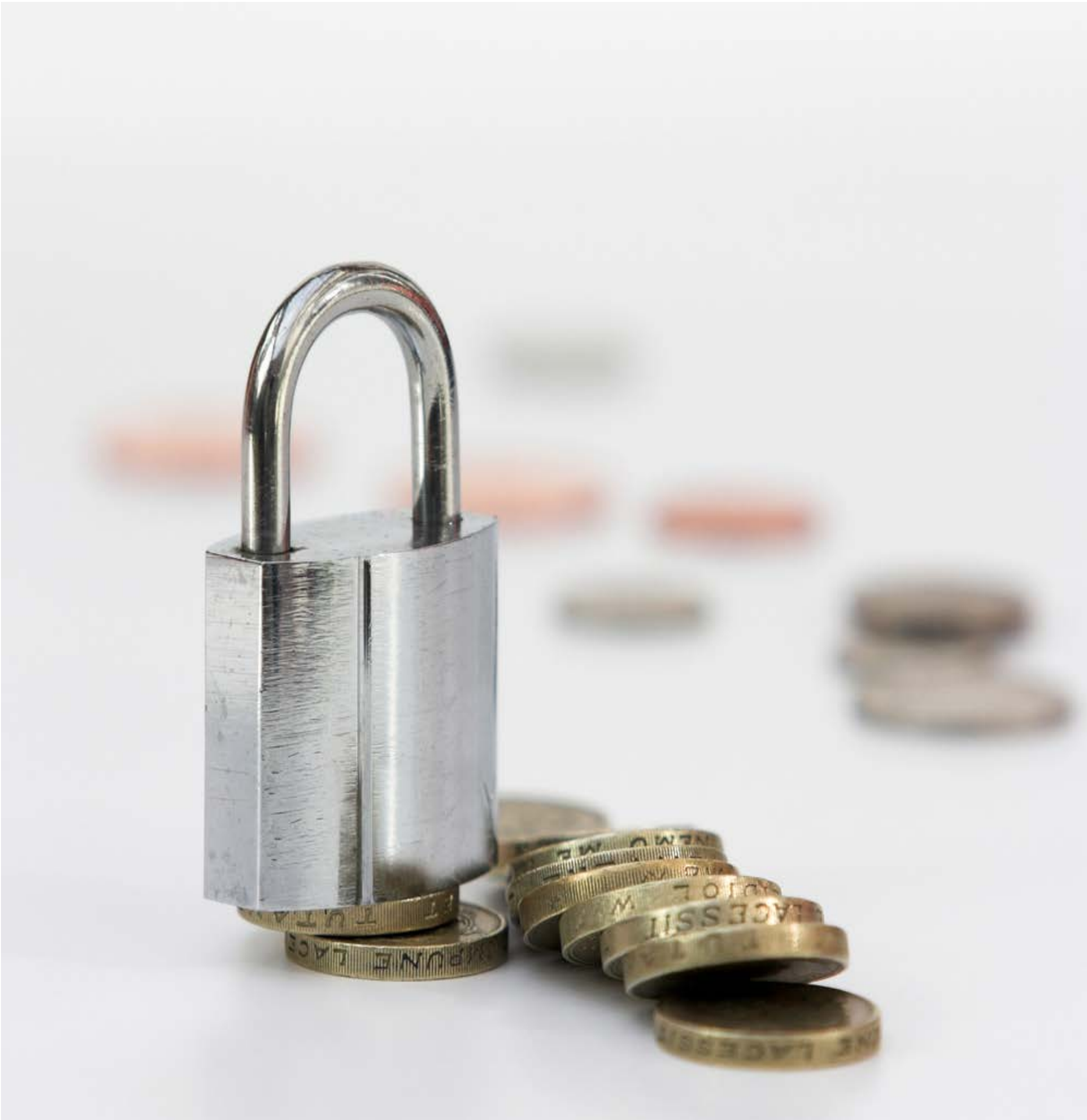
APPENDIX 1

Annexes B & C to this Appendix are not for publication as they contain exempt information of the description in Paragraphs 14 and 21 of Schedule 12A of the Local Government Act 1972.

The County Council of the City and County of Cardiff

Treasury Management Annual Report 2016/17



Introduction

1. Treasury management activities are the management of an organisation'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.

2. The Council carries out its treasury management activities in accordance with a code developed for public services in 2011 by the Chartered Institute of Public Finance and Accountancy (CIPFA).

3. On 25th February 2010, Council approved policies and adopted the four clauses of the treasury management code which are replicated in **Annexe A** for information. Council received a report in February 2016 on the Council's Treasury Management Strategy for 2016/17 and a mid year review in November 2016.

4. This report provides members with an annual report for the Council's Treasury Management activities for 2016/17. It covers:-

   - the economic background to treasury activities
   - investment strategy and outturn for 2016/17
   - borrowing strategy and outturn for 2016/17
   - debt rescheduling
   - compliance with treasury limits and prudential indicators
   - treasury management issues for 2017/18

5. Council requires the scrutiny of the accounting, audit and commercial issues of its Treasury Management Strategy and practices to be undertaken by the Council's Audit Committee. A number of reports were submitted to the Committee to note and review during the year, with each committee receiving a report on the position and performance of treasury investments and borrowing. Member training has also been undertaken to support Members' scrutiny role.

Economic Background

6. The UK EU referendum on 23 June pushed back market expectations of a rate rise with the Monetary Policy Committee (MPC) actually reducing bank rate from 0.5% to 0.25% in August 2016. Quantitative easing and was re-introduced and further funding was made available to banks, reducing interest rates available on investments. UK Growth has remained strong and inflation has risen rapidly due to the effects of price increases following the fall in the sterling exchange rate. This has meant further base rate reductions were unnecessary. During 2016/17 there was major volatility in PWLB rates with rates falling during quarters 1 and 2 to reach historically very low levels in July and August, before rising during quarter 3. The long term forecast is for borrowing rates to rise.

Investments and Outturn

7. The management of the day-to-day cash requirements of the Council is undertaken in-house with credit advice from Capita Asset Services, the Council's Treasury

Management Advisors. This may involve temporary borrowing pending receipt of income/long-term funds or the temporary lending of surplus funds. These temporary surplus funds fluctuate daily and arise from a number of sources including differences in timing of revenue and capital cash flows, reserves, provisions and other balances held for future use.

8. The Council invests with institutions listed on the Council's approved lending list and in accordance with investment guidelines established by the Welsh Government as reflected in the Council's investment strategy. Lending to these institutions is subject to the time and size limits laid down on that list. The categories, names, periods and size limits on this list can be extended, varied or restricted at any time by the Section 151 Officer under delegated powers and are monitored closely in conjunction with the Council's treasury advisors.

9. An extract from the investment strategy approved by Council in February 2016 is shown below.

Given the likelihood of internal borrowing and the interest rate forecasts identified above, longer-term investments above one year will be unlikely. The Debt Management Agency Deposit Facility will be used only as a last resort.

10. At 31 March 2017, investments stood at £68.6 million, with a short term investment strategy employed for most of the year. The Council's choice of investments maintained an approach of security where the amount invested is that repayable. **Annexe B** shows with whom these investments were held.

11. A selection of performance indicators and benchmarking charts in relation to investments is included in **Annexe C.** The main areas to highlight at 31 March 2017 are as follows:-

- Counterparty exposure against the maximum allowed directly with an organisation. This shows that at 31 March 2017 no exposure limits set were breached. This was also the case during the course of the year.
- Investments held with different institutions as a percentage of the total shows that investments are diversified over a number of organisations and this was a strategy applied where possible during the course of the year.
- The geographic spread of investments as determined by the country of origin of relevant organisations. All investments are in sterling and countries are rated AA and above as per our approved criteria.

12. Using historic data adjusted for current financial market conditions and based on the level of counterparty exposure at 31 March 2017, the probability of any default is low at circa 0.013% of the investments outstanding, £8,912.

13. All investments held at 31 March 2017 are deemed recoverable. Accordingly, no impairment losses are reflected in the Council's 2016/17 Statement of Accounts arising from the Council's treasury management activities.

14. The overall level of interest receivable from treasury investments totalled £0.6 million in 2016/17. The returns achieved compared to industry benchmarks are shown in the table below.

	Return on Investment 2015/16		Return on Investment 2016/17	
	Benchmark 7day / 3month (%)	**Achieved (%)**	**Benchmark 7day / 3month (%)**	**Achieved (%)**
In-house	0.36/ 0.46	0.70	0.20/ 0.32	0.62

15. The benchmarks are the average of the 7 day London Interbank Bid Rate (LIBID) and 3 month LIBID respectively. These represent the average rate during the course of the year for investments for those periods. Performance exceeded benchmarks, due to availability of notice accounts offering higher deposit rates and undertaking longer term deposits where appropriate.

<u>Borrowing and Outturn</u>

16. Long term borrowing is undertaken to finance the Council's capital programme. The main sources of borrowing are currently the Public Works Loan Board (PWLB) and the Money Markets.

17. At 31 March 2017, the Council had £674 million of external borrowing. This was predominantly fixed interest rate borrowing payable on maturity.

31 March 2016			31 March 2017	
£m	**Rate (%)**		**£m**	**Rate (%)**
612.8		Public Works Loan Board (PWLB)	617.2	
52.0		Market	51.0	
0.5		Welsh Government	3.0	
0.8		Other	2.8	
666.1	**4.84**	**Total External Debt**	**674.0**	**4.74**

18. Total interest payable on external debt during 2016/17 was £32.3 million of which £12.5 million was payable by the Housing Revenue Account (HRA). In total £32.7 million was set aside from General Fund and HRA revenue budgets in line with the Councils approved policy on provision for debt repayment.

19. Extracts from the borrowing strategy approved by Council in February 2017 are shown below.

The Council will aim to manage its debt portfolio on a long-term basis with a high regard to the effects on current and future Council Tax and Rent Payers.
The Council's Borrowing Strategy for 2016/17 and the capital financing revenue budgets included in the MTFP will consider all options to meet the long-term aims of: • *Promoting revenue cost stability to aid financial planning and avoid a stop-start approach to service delivery, although it is recognised that this may have a financial impact.* • *Pooling borrowing and investments to ensure the whole Council shares the risks and rewards of treasury activities.* • *Reduction over time in the average rate of interest on overall Council borrowing* • *Ensuring any refinancing risk is manageable each financial year, using opportunities to re-profile borrowing where cost effective to do so both in the short and long term.* • *Ensuring borrowing plans are aligned to known capital expenditure spending plans, the useful life of assets created, financial reserve levels and consistent with the prudent provision for the repayment of any such expenditure paid for by borrowing.*
<u>External verses internal borrowing</u> *Whilst interest rates for borrowing are greater than interest rates the Council receives for investments (the cost of carry), it makes financial sense to use any internal cash balances held in the short-term to pay for capital expenditure and minimise costs (Internal Borrowing), rather than undertake external borrowing. However, there is a risk that the Council may have to borrow at higher rates when it does actually need to borrow in future and so this position is kept under continuous review.* *A high level balance sheet review undertaken at a point in time suggests that a maximum level of internal borrowing is circa £70 million. However this is dependent on cash flows, the timing of use of General and Earmarked Reserves and provisions and longer term pressures in the MTFP.*
The forecast level of internal borrowing at 31 March 2016 in relation to the CFR is deemed manageable. However, based on the current forecasts of future capital expenditure plans and high level analysis of the sustainability of internal borrowing from the Council's balance sheet position for future years, external borrowing will be required to be undertaken in the medium term. *Whilst investment rates remain lower than long term borrowing rates internal borrowing will be used to minimise short-term costs where possible.*

20. During 2016/17 borrowing of £14.6 million was undertaken. £10 million from PWLB at 2.53% and a further £4.6 million of interest free borrowing from Welsh Government and Salix for specific capital schemes. Together with the natural maturity of £6.8m of primarily PWLB loans, the overall effect of new borrowing during the year was to reduce the average rate on the Council's borrowing to 4.74% at the 31 March 2017.

21. As part of its loan portfolio, the Council has 6 Lender Option Borrower Option (LOBO) loans totalling £51 million. These are where the lender can request a change in the rate

of interest payable by the Council on pre-determined dates. The Council at this point has the option to repay the loan. Apart from the option to increase rates these loans are comparable to PWLB and have no other complications such as variation in interest rates or complex terms.

22. Interest rates on the LOBO's held range between 3.81% and 4.35% which are not unreasonable and are below the Council's average rate of interest payable. Details of the loans are shown in the table below.

23. None of the LOBO's had to be repaid during 2016/17. However £24 million of the LOBO's are subject to the lender potentially requesting a change in the rate of interest payable every six months which could trigger early repayment. A further £5 million and £22 million have call options in January 2018 and November 2020 respectively and every five years thereafter. This is a manageable refinancing risk as LOBO's form a relatively low proportion of the Council's overall borrowing at 7.57%.

£m	Rate	Potential Repayment Date	Option Frequency	Full Term Maturity
6	4.28%	21/05/2017	6 months	21/11/2041
6	4.35%	21/05/2017	6 months	21/11/2041
6	4.06%	21/05/2017	6 months	23/05/2067
6	4.08%	01/09/2017	6 months	23/05/2067
5	4.10%	15/01/2018	5 years	17/01/2078
22	3.81%	21/11/2020	5 years	23/11/2065

24. In accordance with the strategy, the Council has been undertaking internal borrowing which is when it uses temporary cash balances it holds in the short term instead of undertaking external borrowing. This is confirmed by a comparison of the Council's external level of debt and Capital Financing Requirement at 31 March 2017 as shown later in this report.

Debt Rescheduling

25. No debt rescheduling or early repayment of debt was undertaken during 2016/17. The main obstacle remains the level of premium (penalty) that would be chargeable on early repayment by the PWLB. The premium payable on the balance of PWLB loans at 31 March 2017, which are eligible for early repayment (£424 million) is £305 million. This premium is payable primarily because:-

- Interest rates on loans of equivalent maturities compared to those held are currently lower
- A penalty rate or lower early repayment rate was introduced by HM Treasury in November 2007, which increased the cost of premiums and reduced flexibility of Local Authorities to make savings. This has been a significant thorn in the ability of local authorities to manage debt more effectively.

26. Whilst the cost of Premiums can be spread over future years, options for restructuring that have been considered previously, but result in an adverse Net Present Value (NPV). Whilst there may have been short terms savings, these were outweighed by potentially longer term costs and not deemed cost effective.

Compliance with treasury limits and prudential indicators

27. During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the annual Treasury Management Strategy. The actual outturn for 2016/17 Prudential Indicators is shown in the following paragraphs and compared to the original estimates contained in the 2016/17 Budget Report. Future year's figures are taken from the Budget Report for 2017/18 and will be updated in the Budget Report for 2018/19.

Capital Expenditure

28. The "Prudential Code" requires the Council to estimate the capital expenditure that it plans to incur over the Medium Term. The actual capital expenditure incurred in 2016/17 and reported in the Outturn Report to Cabinet in June 2017 and estimates of capital expenditure for the current and future years as set out in the Budget Report of February 2017 are as follows:-

Capital Expenditure	**2016/17 Actual £m**	**2016/17 Original Estimate £m**	**2017/18 Estimate Month 4 £m**	**2018/19 Estimate £m**	**2019/20 Estimate £m**
General Fund	84	89	117	81	18
HRA	24	25	33	31	24
Total	**108**	**114**	**150**	**112**	**42**

Capital Financing Requirement (CFR) – The Borrowing Requirement (Excluding Landfill Provision)

29. Where capital expenditure has been incurred without a resource to pay for it immediately e.g. via capital receipts, grants or other contributions, this will increase what is termed the Council's Capital Financing Requirement (CFR) or its need to undertake borrowing. The Council is required to make an annual prudent provision for the repayment of historic capital expenditure from its revenue budget. This reduces the CFR. Calculation of the CFR is summarised in the following table.

	Opening Capital Financing Requirement (CFR)
+	Capital expenditure incurred in year
-	Grants, contributions, reserves and receipts received to pay for capital expenditure
-	Prudent Minimum Revenue Provision & Voluntary Repayment
=	Closing Capital Financing Requirement (CFR)

30. It is the CFR that results in the need to borrow and it is important to note that any financial deficit and liabilities of the HRA are ultimately liabilities of the Council. It should be noted that the CFR figures quoted below exclude non cash backed provisions in relation to Landfill after care provision. This relates to future expenditure obligations over a 60 year period.

31. The CFR as at 01 April 2016 was £709 million. The actual CFR as at 31 March 2017, estimates for current and future years (estimated in the February 2017 budget) are shown in the table below:-

Capital Financing Requirement (Excludes landfill provision)

	31.03.2017 Actual £m	31.03.2017 Original Estimate £m	31.03.2018 Estimate £m	31.03.2019 Estimate £m	31.03.2020 Estimate £m
General Fund	450	459	476	472	462
HRA	274	279	282	291	292
Total CFR	**724**	**738**	**758**	**763**	**754**
External Debt	**674**				
Over / (Under) Borrowing	**(50)**				

32. By comparing the CFR at 31 March 2017 (£724 million) and the level of external debt at the same point in time (£674 million), it can be seen that the Council is temporarily using circa £50 million of internal cash balances to finance the Capital Programme at 31 March 2017 (£43 million at 31 March 2016).

33. As set out in the February 2017 Budget Report, the CFR for the General Fund is forecast to increase over the next three years due to increasing investment in the current Capital Programme which includes increasing levels of additional borrowing for invest to save schemes. These forecasts will be updated in the 2018/19 Budget Report.

34. The Housing Revenue Account CFR at 31 March 2017 is £274 million. As part of the Housing Finance Reform voluntary agreement with WG and HM Treasury, a debt cap (limit of indebtedness) was set for this figure to be no higher than £316 million. The Council remained within the HRA debt cap at 31 March 2017.

Actual External Debt

35. The Code requires the Council to indicate its actual external debt at 31 March 2017 for information purposes. This was £674 million as shown in the earlier paragraphs.

Affordable Borrowing Limit

36. The Council has a statutory duty under section 3 of the Local Government Act 2003 and supporting regulations to determine and keep under review how much it can afford to borrow and to enter into credit arrangements (the “Affordable Borrowing Limit”). This

cannot be breached without Council approval. Council must have regard to the Prudential Code when setting this limit which is intended to ensure that total capital investment remains within sustainable limits and that the impact upon future council tax/rent levels is affordable.

37. During 2016/17 the Council remained within the authorised limit of £780 million set for that year.

Operational Boundary

38. The operational boundary is the estimated level of external borrowing and is subject to the timing of borrowing decisions. The boundary was originally estimated at £738 million to match the forecast for the CFR when setting the 2016/17 budget, but the actual level of external debt equalled £674 million reflecting the strategy to utilise internal borrowing in the short term.

Maturity Structure of Fixed Rate Borrowing

39. The maturity structure remains within the limits below approved as part of the 2016/17 strategy below. These limits are set to avoid having large amounts of debt maturing in a short space of time, thus being exposed to significant liquidity risk and interest rate risk.

	31-Mar-16			31-Mar-17			
			Upper limit	Loans to Maturity		Loans if LOBO's Paid Early	
	%	£m	%	%	£m	%	£m
Under 12 months	1.0	6.7	10.0	0.9	6.0	5.2	35.0
12 months and within 24 months	0.8	5.6	10.0	0.6	4.0	0.6	4.0
24 months and within 5 years	0.9	5.7	15.0	1.5	9.9	4.7	31.9
5 years and within 10 years	3.1	20.3	20.0	3.6	24.2	3.6	24.2
10 years and within 20 years	21.6	144.2	30.0	22.6	152.2	22.6	152.2
20 years and within 30 years	24.6	164.0	35.0	24.5	165.0	22.7	153.0
30 years and within 40 years	26.8	178.7	35.0	30.9	208.7	31.0	208.7
40 years and within 50 years	18.6	123.9	35.0	12.9	87.0	9.6	65.0
50 years and within 60 years	1.8	12.0	15.0	1.8	12.0	0.0	0.0
60 years and within 70 years	0.8	5.0	5.0	0.7	5.0	0.0	0.0

40. The maturity profile of the Council's borrowing as at 31 March 2017 is also shown in a chart in **Annexe D**. Unless the Council's LOBO loans are repaid early, very little debt matures within the next 10 years. In the medium to long term, efforts will be made to restructure loans maturing in 2056/57 and to review LOBO maturities in order to reduce refinancing risk.

Ratio of financing costs to net revenue stream

41. This indicator is an indicator of the affordability of historic and future capital investment plans and shows the proportion of the Council's net revenue stream that is subsumed

each year in servicing debt financing costs. Financing costs include, interest payable and receivable on treasury management activities, prudent revenue budget provision for repayment of capital expenditure paid for by borrowing and re-imbursement of borrowing costs from directorates in respect of Invest to Save schemes.

42. For the General Fund, net revenue stream is the sum of non-specific WG Grants and Council Tax, whilst for the HRA it is the amount to be met from rent payers.

Ratio of Capital Financing Costs to Net Revenue Stream

	2016/17	**2016/17**	**2017/18**	**2018/19**	**2019/20**
	Original Estimate	Actual	Estimate	Estimate	Estimate
	%	%	%	%	%
General Fund	6.08	6.00	5.77	5.80	5.92
HRA	31.17	30.46	30.53	30.89	30.97

43. Whilst the indicator above is required by the Prudential Code, it has a number of limitations:

- it does not take into account the fact that some of the Council's budget is outside of its direct control
- it is impacted by transfers in and out of the settlement.
- it includes investment income which is unpredictable, particularly in future years.
- it does not reflect gross capital financing costs for schemes where additional borrowing is undertaken to be repaid from within directorate budgets.

44. Although there may be short term implications, approved invest to save schemes are intended to be net neutral on the capital financing budget. However there are risks that the level of income, savings or capital receipts anticipated from such schemes will not materialise and would have a detrimental long term consequence on the Revenue budget. This requires careful monitoring when considering future levels of additional borrowing.

45. Accordingly additional local indicators were developed and are shown in the table below for the period up to 2021/22. These indicators, which will be updated in the budget proposals report for 2018/19, show capital financing costs of the Council as a percentage of its controllable budget and excludes treasury investment income on temporary cash balances:-

Capital Financing Costs as percentage of Controllable Budget

	2011/12	2016/17	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	Difference 11/12-21/22
	Actual	Original Estimate	Actual	Estimate	Estimate	Estimate	Estimate	Estimate	%
	%	%	%	%	%	%	%	%	
Net	13.47	15.79	15.10	14.77	15.29	15.78	17.11	18.32	36.01
Gross	15.17	19.94	18.95	19.44	20.13	20.51	22.00	23.19	52.87

46. Whilst the method on which the above indicator is based continues to be refined, it is a useful measure of risk to affordability. An increasing ratio indicates that a greater percentage of the budget that is controllable is required for capital financing costs which are committed in the long term. The requirement to meet these additional costs can only come from future savings or from increases in Council Tax. Careful monitoring of these indicators will be required over the life of the Capital Programme and the Medium Term Financial Plan.

Principal Invested for over 364 days

47. An upper limit for principal invested over 364 days was set at £60 million and this was not breached during the year, primarily due to the strategy adopted of minimising the period for which investments were made during 2016/17.

Treasury Management issues for 2017/18

48. Whilst this report is primarily in relation to Treasury Activities for 2016/17, some key issues for 2017/18 are :-

- Implementation of Markets in Financial Instruments Directive II (MiFID II) from January 2018 to ensure financial institutions undertake more extensive checks on their client's suitability for investment products. Whilst there is likely to be additional administrative costs to the Council, as highlighted in the approved February 2017 Treasury Management Strategy, the Council will aim to secure professional status with each organisation it invests with. Not doing so may limit the products and interest rates offered by financial institutions for what may be similar risk.
- CIPFA consultation on updates to the Prudential Code and Treasury Management Code of Practice.

49. In accordance with the Council's Treasury Management Policy, Council will a further update on Treasury Management issues as part of the 2017/18 Mid-Year Treasury Management report in November 2017.

Christine Salter
Corporate Director Resources
13 September 2017

The following Annexes are attached:-
Annexe A – Treasury Management Policy and Four Clauses of Treasury Management
Annexe B – Investments at 31 March 2017
Annexe C – Investment charts at 31 March 2017
Annexe D – Maturity analysis of debt as at 31 March 2017