Essential Reference Paper 'B'

East Herts District Council

Annual Treasury Management Review

2016/17

ABBREVIATIONS USED IN THIS REPORT

CAS Capita Asset Services, Treasury solutions – the Council's treasury management advisers

CE Capital Economics - is the economics consultancy that provides Capita Asset Services, Treasury solutions, with independent economic forecasts, briefings and research

CFR Capital Financing Requirement - the Council's annual underlying borrowing need to finance capital expenditure and a measure of the Council's total outstanding indebtedness

CIPFA Chartered Institute of Public Finance and Accountancy – the professional accounting body that oversees and sets standards in local authority finance and treasury management

CLG The Department for Communities and Local Government - the Government department that directs local authorities in England

CPI Consumer Price Inflation – the official measure of inflation adopted as a common standard by countries in the EU. It is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

ECB European Central Bank - the central bank for the eurozone

EU European Union

EZ eurozone - those countries in the EU which use the euro as their currency

Fed The Federal Reserve, often referred to simply as "the Fed," is the central bank of the United States. It was created by the Congress to provide the nation with a stable monetary and financial system.

FOMC the Federal Open Market Committee – this is the branch of the Federal Reserve Board which determines monetary policy in the USA by setting interest rates and determining quantitative easing policy. It is composed of 12 members - seven members of the Board of Governors and five of the 12 Reserve Bank presidents.

GDP Gross Domestic Product – a measure of the growth and total size of the economy

G7 The group of seven countries that form an informal bloc of industrialised democracies--the United States, Canada, France, Germany, Italy, Japan, and the United Kingdom--that meets annually to discuss issues such as global economic governance, international security, and energy policy.

Gilts Gilts are bonds issued by the UK Government to borrow money on the financial markets. Interest paid by the Government on gilts is called a yield and is at a rate that is fixed for the duration until maturity of the gilt (unless a gilt is index linked to inflation); yields therefore change inversely to the price of gilts i.e. a rise in the price of a gilt will mean that its yield will fall.

IMF International Monetary Fund - the lender of last resort for national governments which get into financial difficulties

LIBID The London Interbank Bid Rate is a bid rate; the rate bid by banks on deposits i.e., the rate at which a bank is willing to borrow from other banks. It is the "other end" of the LIBOR (an offered, hence "ask" rate, the rate at which a bank will lend).

MPC The Monetary Policy Committee is a committee of the Bank of England, which meets for one and a half days, eight times a year, to determine monetary policy by setting the official interest rate in the United Kingdom, (the Bank of England Base Rate, commonly called Bank Rate), and by making decisions on quantitative easing.

MRP Minimum Revenue Provision - a statutory annual minimum revenue charge to reduce the total outstanding CFR (the total indebtedness of a local authority)

PWLB Public Works Loan Board – this is the part of H.M. Treasury which provides loans to local authorities to finance capital expenditure

QE Quantitative Easing – is an unconventional form of monetary policy where a central bank creates new money electronically to buy financial assets, like government bonds (but may also include corporate bonds). This process aims to stimulate economic growth through increased private sector spending in the economy and also aims to return inflation up to target. These purchases increase the supply of liquidity to the economy; this policy is employed when lowering interest rates has failed to stimulate economic growth to an acceptable level and to lift inflation up to target.
Once QE has achieved its objectives of stimulating growth and inflation, QE will be reversed by selling the bonds the central bank had previously purchased, or by not replacing debt that it held which matures. The aim of this reversal is to ensure that inflation does not exceed its target once the economy recovers from a sustained period of depressed growth and inflation, and economic growth, and increases in inflation, are threatening to gather too much momentum if action is not taken to 'cool' the economy.

RPI The Retail Price Index is a measure of inflation that measures the change in the cost of a representative sample of retail goods and services. It was the UK standard for measurement of inflation until the UK changed to using the EU standard measure of inflation – CPI. The main difference between RPI and CPI is in the way that housing costs are treated. RPI is often higher than CPI.

TMSS the annual Treasury Management Strategy Statement report that all local authorities are required to submit for approval by the full council before the start of each financial year

Annual Treasury Management Review 2016/17

1. Introduction

This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2016/17. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

During 2016/17 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 17/02/2016)
- a mid-year (minimum) treasury update report (Council 14/12/2016)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

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 Council's policies previously approved by members.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit and Governance Committee before they were reported to the full Council. Member training on treasury management issues was undertaken during the year on 16/05/2017 in order to support members' scrutiny role.

2. The Economy and Interest Rates

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.

3. Overall Treasury Position as at 31 March 2017

At the beginning and the end of 2016/17 the Council's treasury (excluding borrowing by finance leases) position was as follows:

TABLE 1	31 March 2016 Principal	Rate/ Return	Average Life Years	31 March 2017 Principal		Rate/ Return	Average Life Years
Total debt	*£7.5m*	*8.83%*	*21.5*		*£7.5m*	*8.83%*	*19*
CFR	*(£23.1m)*				*(£23.1m)*		
Over / (under) borrowing	*£7.5m*				*£7.5m*		
Investments over 1yr	*£30.0m*	*3.97%*			*£20.0m*	*3.60%*	
Investments under 1yr	*£24.1m*	*0.58%*			*£41.8m*	*0.66%*	
Total investments	*£54.1m*	*1.51%*			*£61.8m*	*1.61%*	
Net debt	£46.6m				£54.3m		

4. The Strategy for 2016/17

The expectation for interest rates for 2016/17 anticipated low but rising Bank Rate, starting in quarter 1 of 2017 with gradual rises in medium and longer term fixed borrowing rates during 2016/17. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

During 2016/17 there was major volatility in Public Works Loan Board (PWLB) rates with rates falling during quarters 1 and 2 to historically low levels in July and August. The PWLB rates then rose significantly during quarter 3, before partially easing back towards the end of the year.

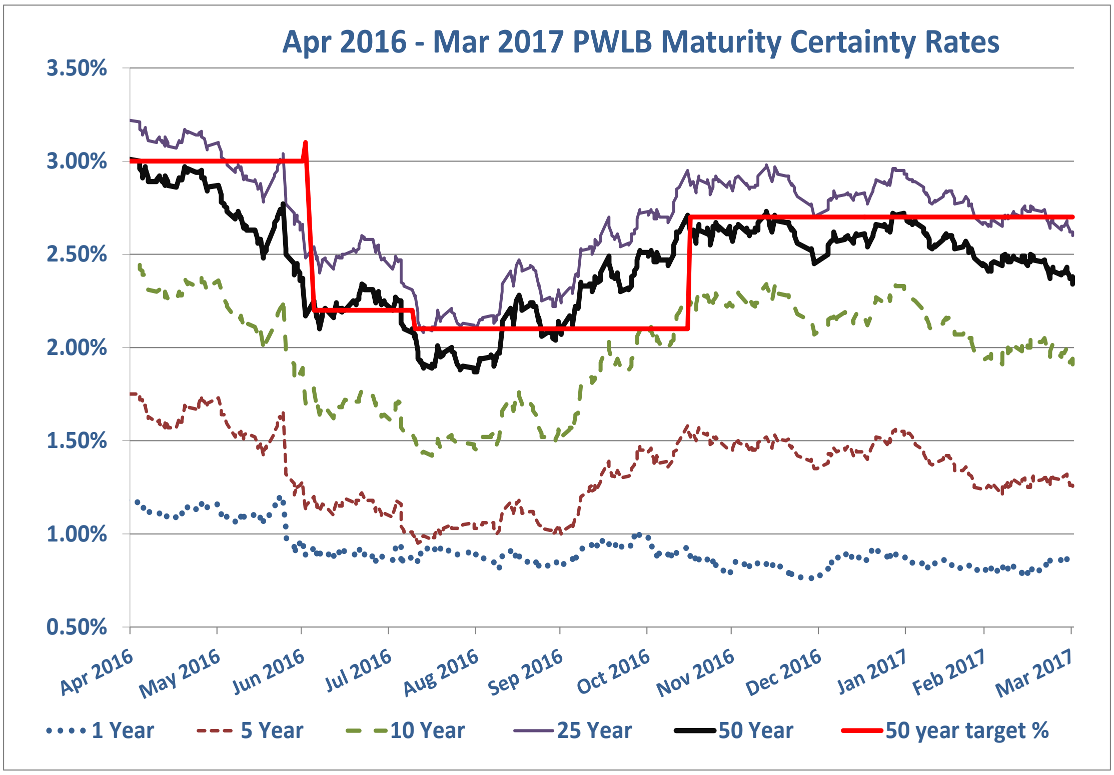
5. The Borrowing Requirement and Debt

The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

	31 March 2016 Actual	31 March 2017 Budget	31 March 2017 Actual
Total CFR (£m)	£23,079	£20,443	£23,079

6. Borrowing Rates in 2016/17

PWLB certainty maturity borrowing rates - the graph below shows how PWLB certainty rates have fallen to historically very low levels during the financial year.



7. Borrowing Outturn for 2016/17

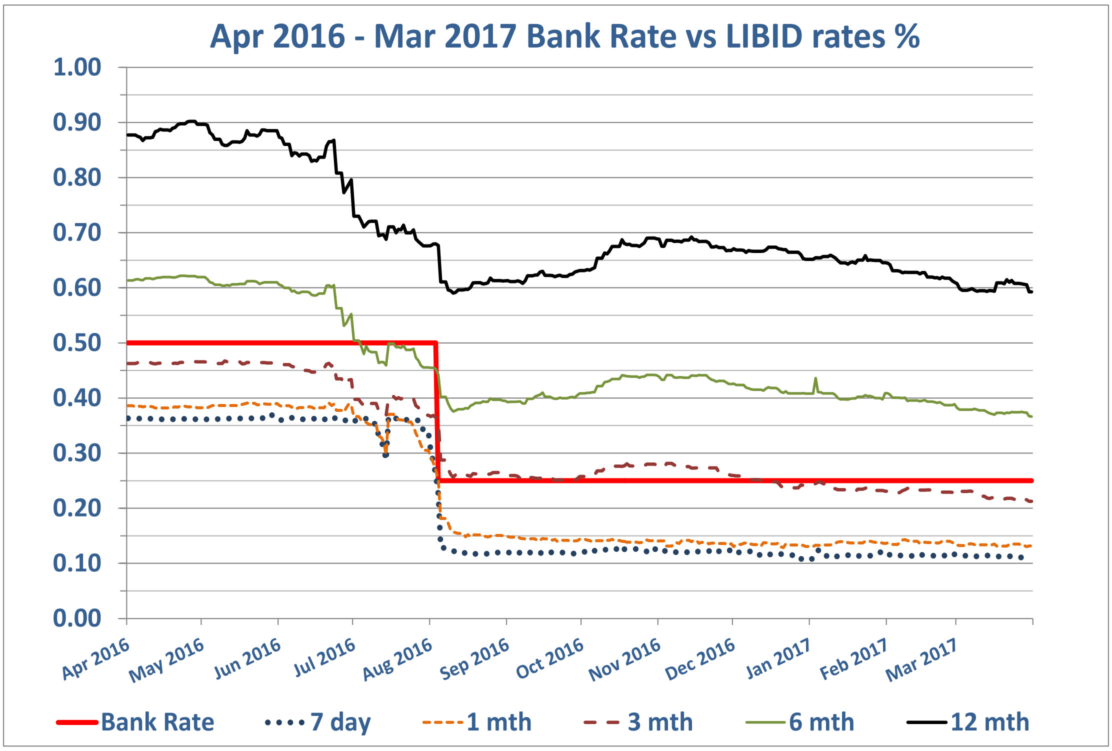
Borrowing
No borrowing was undertaken during the year.

Rescheduling
No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Repayments
No repayments were made by the Council during the year.

8. Investment Rates in 2016/17

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, falling even further after the 4 August MPC meeting resulting 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. Investment Outturn for 2016/17

Investment Policy – the Council's investment policy is governed by CLG guidance, which has been implemented in the annual investment strategy approved by the Council on 17/02/2016. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Investments held by the Council - the Council maintained an average balance of £45.8m of internally managed funds. The internally managed funds earned an average rate of return of 0.67%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.20%.

Investments held by Property Funds – the Council approved the use of property funds up to a value of £20m, at the time of investment. Working with our advisors at Capita Asset Services, two funds were chosen, Lothbury Property Trust and Hermes Property Unit Trust. Both funds had waiting lists to invest. The invitation to invest in the Lothbury fund arose in June 2015 and the Hermes fund in December 2015. The performances of these funds for 2016/17 are detailed below:

Property Fund	Investments Held	Average Return
Lothbury Property Trust	£10m	3.37%
Hermes Property Unit Trust	£10m	3.84%

Budget – The total interest earned on investments for 2016/17 was £1.203m which exceeded the budget of £902k by £301k.

Appendix 1: Prudential and Treasury Indicators

During 2016/17, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Actual prudential and treasury indicators	2015/16 Actual £000	2016/17 Original £000	2016/17 Actual £000
Capital expenditure	22,446*	4,608	2,813
Capital Financing Requirement	23,079	20,433	23,079
Gross borrowing	0	0	0
External debt	7,500	7,500	7,500
Investments	54,085	60,000	61,806
Net borrowing	(46,585)	(52,500)	(54,306)

**Note: The significant capital expenditure variance in 2015/16 was due to the purchase of Old River Lane, which was not in the original budget.*

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2016/17) plus the estimates of any additional capital financing requirement for the current (2017/18) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2016/17.

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, 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.

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 obligation costs net of investment income) against the net revenue stream.

	2016/17
Authorised limit	£13m
Maximum gross borrowing position	£7.5m
Operational boundary	£10m
Average gross borrowing position	£7.5m
Financing costs as a proportion of net revenue stream	X.XX%

TABLE 1	31 March 2016 Principal	Rate/ Return	Average Life Yrs		31 March 2017 Principal	Rate/ Return	Average Life Yrs
Fixed rate funding:							
-PWLB	£1.5m	8.875%	39		£1.5m	8.875%	38
-Market	£6m	8.785%	4		£6m	8.785%	3
Variable rate funding:	N/A						
Total debt	***£7.5m***				***£Xxm***		
CFR	***(£23.1m)***				***(£23.1m)***		
Over/ (under) borrowing	***£7.5m***				***£7.5m***		
Total investments	***£54.1m***				***£61.8m***		
Net debt	**£46.6m**				**£54.3m**		

The maturity structure of the debt portfolio was as follows:

	31 March 2016 actual	2016/17 original limits	31 March 2017 actual
Under 12 months	£0m	£0m	£0m
12 months and within 24 months	£0m	£0m	£0m
24 months and within 5 years	£6m	£6m	£6m
5 years and within 10 years	£0m	£0m	£0m
10 years and within 20 years	£0m	£0m	£0m
20 years and within 30 years	£0m	£0m	£0m
30 years and within 40 years	£1.5m	£1.5m	£1.5m
40 years and within 50 years	£0m	£0m	£0m

The maturity structure of the investment portfolio was as follows:

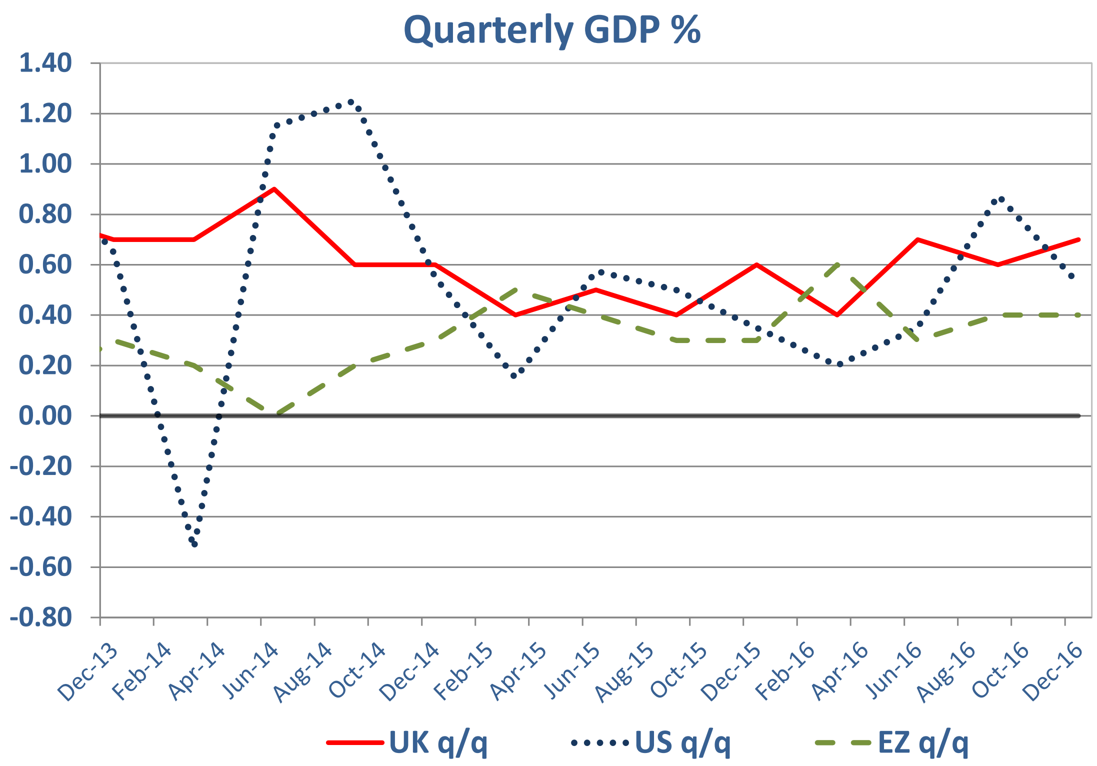
	2015/16 Actual £000	2016/17 Original £000	2016/17 Actual £000
Investments Longer than 1 year Under 1 year	 30,000 20,085	 20,000 40,000	 20,000 41,806
Total	50,085	60,000	61,806

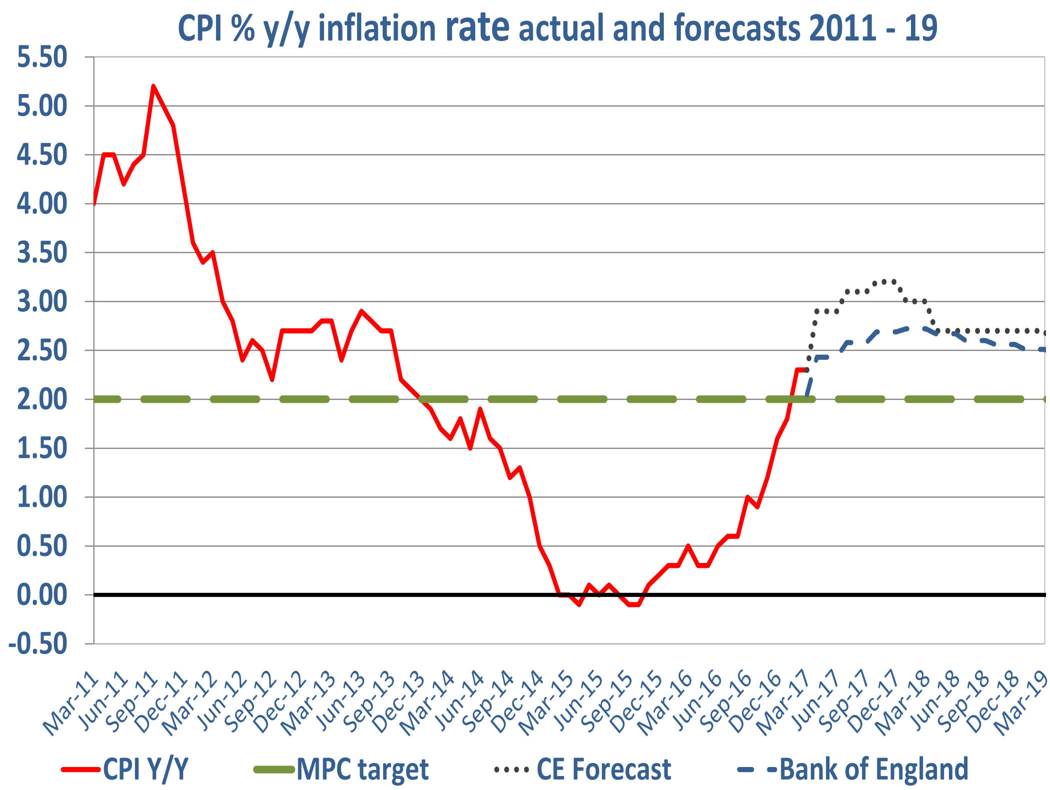
The exposure to fixed and variable rates was as follows:

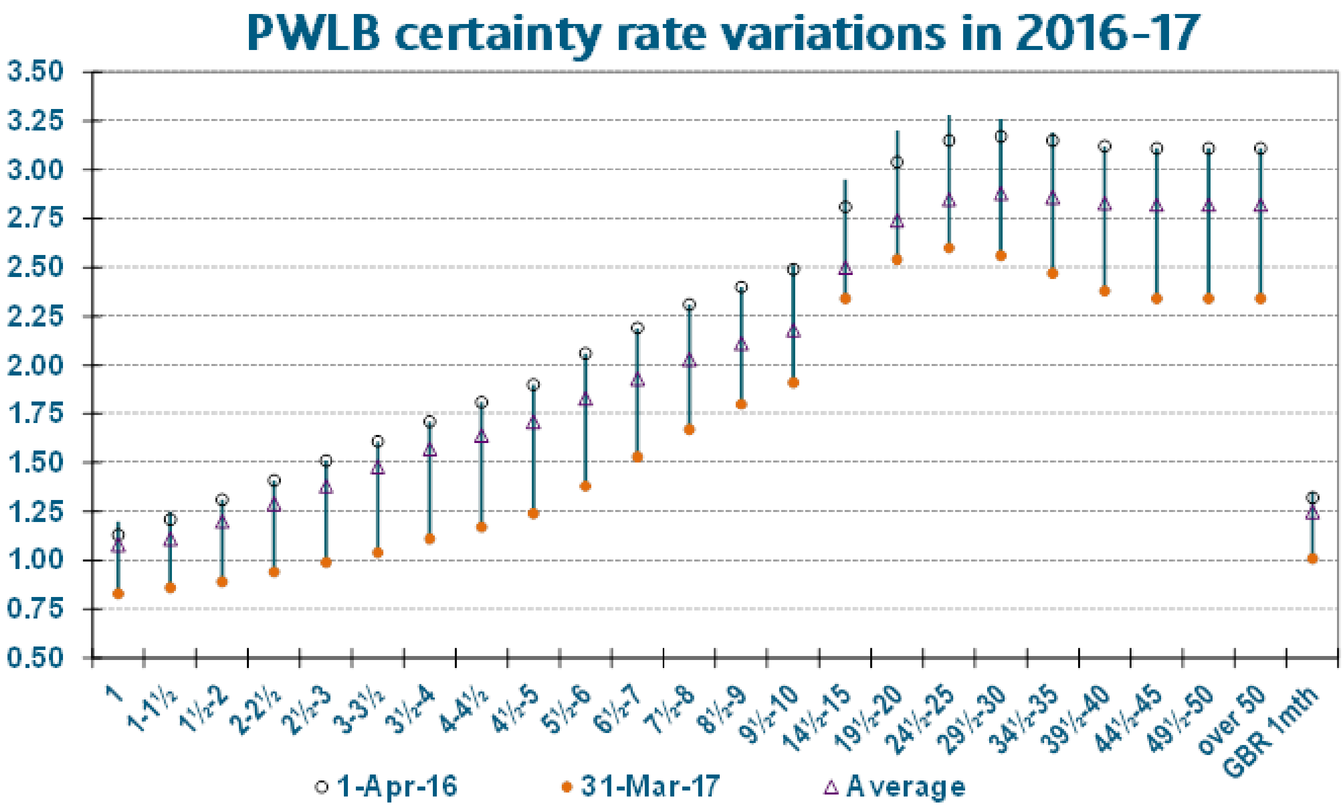
	31 March 2016 Actual £000	2016/17 Original Limits £000	31 March 2017 Actual £000
Limits on fixed interest rates based on net debt:			
• Debt only	100%	100%	100%
• Investments only	27%	100%	50%
Limits on variable interest rates:			
• Debt only	0%	50%	0%
• Investments only	73%	50%	50%

Appendix 2: Graphs

Please find below graphs which clients may wish to use.







	1	1-1.5	2.5-3	3.5-4	4.5-5	9.5-10	24.5-25	49.5-50	1 month variable
1/4/16	1.130%	1.160%	1.330%	1.470%	1.620%	2.310%	3.140%	2.950%	1.310%
31/3/17	0.830%	0.860%	0.990%	1.110%	1.240%	1.910%	2.600%	2.340%	1.010%
High	1.200%	1.250%	1.460%	1.630%	1.800%	2.510%	3.280%	3.080%	1.350%
Low	0.760%	0.800%	0.840%	0.880%	0.950%	1.420%	2.080%	1.870%	1.040%
Average	0.928%	0.961%	1.104%	1.226%	1.361%	2.007%	2.724%	2.494%	1.150%
Spread	0.440%	0.450%	0.620%	0.750%	0.850%	1.090%	1.200%	1.210%	0.310%
High date	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016	20/05/2016
Low date	20/12/2016	15/03/2017	10/08/2016	10/08/2016	10/08/2016	10/08/2016	12/08/2016	30/08/2016	30/11/2016

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/16	1.13%	1.62%	2.31%	3.14%	2.95%
31/3/17	0.83%	1.24%	1.91%	2.60%	2.34%
Low	0.76%	0.95%	1.42%	2.08%	1.87%
Date	20/12/2016	10/08/2016	10/08/2016	12/08/2016	30/08/2016
High	1.20%	1.80%	2.51%	3.28%	3.08%
Date	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016
Average	0.93%	1.36%	2.01%	2.72%	2.49%

Money market investment rates 2016/17

	7 day	1 month	3 month	6 month	1 year
1/4/16	0.363	0.386	0.463	0.614	0.877
31/3/17	0.111	0.132	0.212	0.366	0.593
High	0.369	0.391	0.467	0.622	0.902
Low	0.107	0.129	0.212	0.366	0.590
Average	0.200	0.220	0.315	0.462	0.702
Spread	0.262	0.262	0.255	0.256	0.312
High date	27/5/16	21/6/16	10/5/16	22/4/16	26/4/16
Low date	28/12/16	21/12/16	30/3/17	31/3/17	10/8/16