Treasury Management Performance to September 2016

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Purpose of Report

1. To review the treasury management activity and the performance against the Prudential Indicators for the six months ended 30th September 2016.

Recommendations

2. The Audit Committee are asked to:
   - Note the Treasury Management Activity for the six-month period ended 30th September 2016.
   - Note the position of the individual prudential indicators for the six-month period ended 30th September 2016.
   - Carry out the Mid-year review of the Treasury Management Strategy and recommend it to Council. (Strategy attached with amendments highlighted)

The Investment Strategy for 2016/17

3. 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. The Council reports six monthly to Full Council against the strategy approved for the year. The scrutiny of treasury management policy, strategy and activity is delegated to the Audit Committee.

4. Treasury management in this context is defined as:
   > "The management of the local authority's cash flows, its borrowings and its investments, the management of the associated risks, and the pursuit of the optimum performance or return consistent with those risks".

5. The Authority has 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. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

6. Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

7. The transposition of European Union directives into UK legislation places the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors through potential bail-in of unsecured bank deposits.

8. Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the Authority's aim to further diversify into more secure and/or higher

yielding asset classes. The Authority invested in covered bonds, and non-financial corporate bonds. The Authority is also invested in bond and property funds which provide diversification of investment risk. This represents a continuation of the strategy adopted in 2015/16.

Interest Rates 2016/17

9. Base rate began the financial year at 0.5% but this was reduced to 0.25% in August.

10. Following the UK's vote to leave the European Union, the economic outlook for the UK has immeasurably altered. It will to a large extent be dependent on the nature of the future relationship negotiated with the EU, particularly in relationship to trade. The negotiations crucially hinge on domestic politics which, at the end of the June quarter, were unsettled themselves.

11. The domestic outlook is uncertain, but likely to be substantially weaker in the short term than previously forecast. Arlingclose has changed its central case for the path of Bank Rate over the next three years. Arlingclose believes any currency-driven inflationary pressure will be looked through by Bank of England policymakers. The central case is for Bank Rate to remain at 0.25%, but there is a 40% possibility of a drop to close to zero, with a small chance of a reduction below zero.

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.12
Arlingclose Central Case	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.40

12. In addition, Arlingclose believes that the Government and the Bank of England have both the tools and the willingness to use them to prevent any immediate market-wide problems leading to bank insolvencies. The cautious approach to credit advice means that the banks currently on the Authority's counterparty list have sufficient equity buffers to deal with any localised problems in the short term.

Counterparty Update

13. Various indicators of credit risk reacted negatively to the result of the referendum on the UK's membership of the European Union. UK bank credit default swaps saw a modest rise but bank share prices fell sharply, on average by 20%, with UK-focused banks experiencing the largest falls. Non-UK bank share prices were not immune although the fall in their share prices was less pronounced.

14. Fitch downgraded the UK's sovereign rating by one notch to AA from AA+, and Standard & Poor's downgraded its corresponding rating by two notches to AA from AAA. Fitch, S&P and Moody's have a negative outlook on the UK. S&P took similar actions on rail company bonds guaranteed by the UK Government.

15. Moody's affirmed the ratings of nine UK banks and building societies and revised the outlook to negative for those banks and building societies that it perceived to be exposed to a more challenging operating environment arising from the 'leave' outcome.

16. There was no immediate change to Arlingclose's credit advice on UK banks and building societies as a result of the referendum result. Our advisor believes there is a risk that the uncertainty over the UK's future trading prospects will bring forward the

timing of the next UK recession. In the coming weeks and months Arlingclose will therefore review all UK based institutions, and it is likely that, over time, will advise shortening durations on those institutions considered to be most affected.

Investment Portfolio

17. The table below shows the Council's overall investments as at 30th September 2016:

	Value of Investments at 01.04.16	Value of Investments at 30.09.16	Fixed/ Variable Rate
Investments advised by Arlingclose	**£**	**£**	
Money Market Fund (Variable Net Asset Value)	997,565	997,565	Variable
Property Fund	4,494,168	4,352,187	Variable
Total	**5,491,733**	**5,349,752**	
Internal Investments			
Certificates of Deposit	5,513,212	8,007,050	Fixed
Corporate Bonds	6,706,395	5,927,913	Fixed
Floating Rate Notes (FRNs)	10,025,398	11,009,471	Variable
Short Term Deposits (Banks)	9,000,000	15,500,000	Variable
Short Term Deposits (Other LAs)	11,000,000	10,000,000	Variable
Money Market Funds (Constant Net Asset Value) & Business Reserve Accounts	1,490,000	2,650,000	Variable
Total	**43,735,005**	**53,094,434**	
TOTAL INVESTMENTS	**49,226,738**	**58,444,186**	

Returns for 2016/17

18. The returns to 30th September 2016 are shown in the table below:

	Actual Income £'000	% Rate of Return
Investments advised by Arlingclose		
Payden Money Market Fund (VNAV)	4	
Property Fund (CCLA)	105	
Total	**109**	**4.37**
Internal Investments		
Certificates of Deposit (CD's)	26	
Corporate Bonds	45	
Floating Rate Notes (FRNs)	34	
Fixed Term Deposits	78	
Money Market Funds (CNAV) & Business Reserve Accounts	16	
Total	**199**	**0.72**
Other Interest		
Miscellaneous Loans	8	
Total	**8**	
TOTAL INCOME TO 30TH SEPTEMBER 2016	**316**	
PROFILED BUDGETED INCOME	**248**	

19. The table above shows investment income for the year to date compared to the profiled budget. The annual budget is set at £496,020. We currently estimate that the position at the end of the financial year will be an overall favourable variance in the order of £68,590. This is assuming SSDC receive a dividend of 3p per unit each quarter for its investment in the property fund.

20. We currently hold £4m nominal value in the CCLA fund, this converts to 1,558,527 units and £1m in Payden which converts to 98,990.299 shares.

21. The outturn position is affected by both the amount of cash we have available to invest and the interest base rate set by the Bank of England. Balances are affected by the timing of capital expenditure and the collection of council tax and business rates.

Investments

22. Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2014/15. New investments can be made with the following institutions:
    - Other Local Authorities;
    - AAA-rated Money Market Funds;
    - Certificates of Deposit (CDs) and Term Deposits with UK Banks and Building Societies systemically important to the UK banking system and deposits with select non-UK Banks (Australian, Canadian and American);
    - T-Bills and DMADF (Debt Management Office);
    - Bonds issued by Multilateral Development Banks, such as the European Investment Bank;
    - Commercial Paper
    - Other Money Market Funds and Collective Investment Schemes meeting the criteria in SI 2004 No 534, SI 2007 No 573 and subsequent amendments.

23. The graph shown in Appendix A shows the performance of the in-house Treasury team in respect of all investments for the quarter ending 30th September 2016 in comparison to all other clients of Arlingclose.

24. The graph shows that SSDC is in a satisfactory position in terms of the risk taken against the return on investments.

Borrowing

25. An actual overall borrowing requirement (CFR) of £9.7 million was identified at the beginning of 2016/17. As interest rates on borrowing exceed those on investments the Council has used its capital receipts to fund capital expenditure. As at 30th September 2016 the Council had no external borrowing.

Breakdown of investments as at 30th September 2016

Date Lent	Counterparty	Principal Amount	Rate	Maturity Date
9 Mar 16	United Overseas Bank Ltd	2,000,000	0.82	8 Mar 17
21 Mar 16	Bank of Scotland	1,000,000	1.05	20 Mar 17
17 Feb 16	Rabobank International	1,000,000	0.75	17 Feb 17
30 Aug 16	Bank of Scotland	1,000,000	0.65	28 Feb 17
19 Sep 16	Nationwide Building Society	1,000,000	0.36	17 Feb 17
29 Jun 16	Eastleigh Borough Council	2,000,000	0.52	20-Feb-17
15 Oct 15	Lancashire County Council	1,000,000	0.60	6 Oct 16
15 Dec 15	North Tyneside Council	2,000,000	0.65	13 Dec 16
31 Mar 16	Greater London Authority	2,000,000	0.60	30 Mar 17
7 Sep 16	Telford & Wrekin Council	1,000,000	0.25	6 Jan 17
9 May 16	Bank of Scotland	1,000,000	0.93	24 Mar 17
16 May 16	Nationwide Building Society	1,000,000	0.71	16 Nov 16
2 Jun 16	North Wales Fire Authority	2,000,000	0.56	20 Mar 17
10 Jun 16	DBS Bank Ltd	2,000,000	0.68	6 Mar 17
28 Jul 16	Commonwealth Bank of Australia	2,000,000	0.52	28 Feb 17
1 Aug 16	Leeds Building Society	1,500,000	0.40	9 Nov 16
8 Aug 16	IPA SCB TD Incoming (Santander)	1,000,000	0.45	8 Feb 17
13 Sep 16	Nationwide Building Society	1,000,000	0.38	24 Feb 17
	Corporate Bonds/Eurobonds			
17 Jan 14	Places for People Capital Markets	568,000	2.67	27 Dec 16
17 Jan 14	Places for People Capital Markets	432,000	2.67	27 Dec 16
4 Aug 14	Leeds Building Society (Covered)	500,000	2.13	17 Dec 18
22 Oct 14	Yorkshire Building Society (Covered)	1,500,000	1.56	12 Apr 18
4 Feb 16	Daimler AG	331,000	1.15	2 Dec 16
31 Mar 16	European Investment Bank	1,000,000	0.65	7 Dec 16
18 Aug 16	Svenska Handelsbanken	1,000,000	0.60	29 Aug 17
22 Sep 16	Daimler AG	399,000	0.46	2 Dec 16
	Certificates of Deposit (CDs)			
29 Jan 16	Toronto Dominion	1,000,000	0.90	27 Jan 17
19 Feb 16	Nordea AB	500,000	0.69	21 Nov 16
3 May 16	Bank of Montreal	500,000	0.83	2 May 17
4 May 16	Toronto Dominion	1,000,000	0.91	4 May 17
11 May 16	Nordea AB	1,000,000	0.63	11 Nov 16
16 Jun 16	Rabobank	1,000,000	0.65	16 Mar 17
23 Jun 16	Svenska Handelsbanken	500,000	0.64	23 Dec 16
5 Jul 16	Svenska Handelsbanken	500,000	0.47	5 Oct 16
22 Jul 16	Rabobank	1,000,000	0.47	3 Feb 17
16 Aug 16	Toronto Dominion	1,000,000	0.55	16 May 17
	Floating Rate Notes (FRNs)			
22 Oct 14	Abbey National Treasury Services *Covered*	1,000,000	0.72	5 Apr 17
21 Nov 14	Barclays Bank Plc *Covered*	1,000,000	0.68	15 Sep 17
27 Mar 15	Lloyds Bank Plc *Covered*	2,000,000	0.65	16 Jan 17
29 Apr 15	Toronto Dominion *Covered*	1,000,000	0.66	20 Nov 17
26 Jun 15	Nationwide Building Society *Covered*	1,000,000	0.68	17 Jul 17
7 Mar 16	Commonwealth Bank of Australia *Covered*	1,000,000	0.87	24 Jan 18
16 May 16	Bank of Nova Scotia	1,000,000	0.82	2 Nov 17
5 Sep 16	National Australia Bank Ltd	1,000,000	0.32	14 Nov 16
23 Sep 16	Barclays Bank Plc *Covered*	2,000,000	0.47	15 Sep 17

	Pooled Finds & Money Market Funds			
	Payden Fund VNAV	1,000,000	0.82	
	CCLA Property Fund	4,000,000	5.26	
	Blackrock	850,000	0.46	
	Federated	500,000	0.48	
	Invesco Aim	500,000	0.47	
	Ignis	800,000	0.44	
	TOTAL	**57,880,000**		

Note: Money Market Funds are instant access accounts so the rate displayed is a daily rate

Prudential Indicators – Quarter 2 monitoring

Background:

26. In February 2016, Full Council approved the indicators for 2016/17, as required by the Prudential Code for Capital Finance in Local Authorities. The Local Government Act 2003 allowed local authorities to determine their own borrowing limits provided they are affordable and that every local authority complies with the code.

Prudential Indicator 1 - Capital Expenditure:

27. The revised estimates of capital expenditure to be incurred for the current year compared to the original estimates are:

	2016/17 Original Estimate £'000	Expected Outturn £'000	2016/17 Variance £'000	Reason for Variance
Approved capital schemes	7,382	7,343	(39)	The variance against the original estimate is due to the reduction in loan to the SWP of £203k, additional spend added to the Capital programme for Transformation £329k in March 2016 and re-profiling of spend within the rest of the programme.
Reserves	2,298	126	(2,172)	This has reduced in the current year due to re-profiling of spend to future years.
Total Expenditure	**9,680**	**7,469**	**(2,211)**	

28. The above table shows that the overall estimate for capital expenditure in the current year has reduced.

Prudential Indicator 2 - Ratio of Financing Costs to Net Revenue Stream:

29. A comparison needs to be made of financing capital costs compared to the revenue income stream to support these costs. This shows how much of the revenue budget is committed to the servicing of finance.

Portfolio	2016/17 Original Estimate £'000	Expected Outturn £'000	2016/17 Variance £'000	Reason for Variance
Financing Costs*	(489)	(471)	18	The reduction in income is due to the cut in base rate in August 16 and the effect on our investments

Net Revenue Stream	16,904	17,559	655	The original estimate was picked up from an early report of the MTFS which was subsequently changed. The actual budget approved at Full Council was £17,291. The increase is due to carry forwards
%*	**(2.9)**	**(2.7)**		

*figures in brackets denote income through receipts and reserves

30. The financing costs include interest payable, notional amounts set aside to repay debt, less, interest on investment income. The figure in brackets is due to investment income outweighing financing costs significantly for SSDC but is nevertheless relevant since it shows the extent to which the Council is dependent on investment income.

Prudential Indicator 3 - Capital Financing Requirement:

31. The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose. Estimates of the year-end capital financing requirement for the authority are:

	2016/17 Original Estimate £'000	**Expected Outturn £'000**	**2016/17 Variance £'000**	**Reason for Variance**
Opening CFR	9,299	9,342	43	
Capital Expenditure	8,067	10,747	2,680	See explanation for Prudential Indicator 1 above
Capital Receipts*	(7,382)	(7,343)	39	
Grants/Contributions*	(685)	(3,404)	(2,719)	
Minimum Revenue Position (MRP)	(87)	(94)	(7)	Estimated figures were taken prior to being finalised at 2015/16 year end which has shown an amendment to the expected outturn
Closing CFR	**9,212**	**9,248**	**36**	

*Figures in brackets denote income through receipts or reserves.

Prudential Indicator 4 – Gross Debt and the Capital Financing Requirement:

32. The Council is also required to ensure that any medium term borrowing is only used to finance capital and therefore it has to demonstrate that the gross external borrowing does not, except in the short term exceed the total of capital financing requirements over a three year period. This is a key indicator of prudence.

	2016/17 Original Estimate £'000	2016/17 Qtr 2 Actual £'000	2016/17 Variance £'000	Reason for Variance
Borrowing	0	0	0	
Finance Leases	99	136	37	Additional finance leases taken out on vehicles
Total Debt	**99**	**136**	**37**	

33. Total debt is expected to remain below the CFR.

Prudential Indicator 5 - Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure:

34. The Council must set three years of upper limits to its exposure to the effects of changes in interest rates. As a safeguard, it must ensure that its limit would allow it to have up to 100% invested in variable rate investments to cover against market fluctuations. For this purpose, term deposits of less than 365 days are deemed to be variable rate deposits. Fixed rate deposits are investments in Eurobonds, Corporate Bonds and term deposits exceeding 365 days.

	2016/17 % Limit	2016/17 Qtr 2 Actual %	2016/17 Variance %	Reason for Variance
Fixed	80	3.46	(76.54)	Within limit
Variable	100	96.54	(3.46)	Within limit

35. The Council must also set limits to reflect any borrowing we may undertake.

	2016/17 % Limit	2016/17 Qtr 2 Actual %	2016/17 Variance %	Reason for Variance
Fixed	100	0	100	SSDC currently has no borrowing
Variable	100	0	100	SSDC currently has no borrowing

36. The indicator has been set at 100% to maximise opportunities for future debt as they arise.

Prudential Indicator 6 - Upper Limit for total principal sums invested over 364 days:

37. SSDC must also set upper limits for any investments of longer than 364 days. The purpose of this indicator is to ensure that SSDC, at any time, has sufficient liquidity to meet all of its financial commitments.

Upper Limit for total principal sums invested over 364 days	2016/17 Maximum Limit £'000	2016/17 Qtr 2 Actual (Principal amount) £'000	Reason for Variance
Between 1-2 years	25,000	4,500	Within limit
Between 2-3 years	20,000	500	Within limit
Between 3-4 years	10,000	0	Within limit
Between 4-5 years	10,000	0	Within limit
Over 5 years	5,000	0	Within limit

38. The table above shows that the Council adopts a policy of safeguarding its investments by minimising investments that are redeemable more than five years ahead.

Prudential Indicator 7 – Credit Risk:

39. The Council considers security, liquidity and yield, in that order, when making investment decisions.

    Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Council's assessment of counterparty credit risk.

    The Council also considers alternative assessments of credit strength, and information on corporate developments of and market sentiment towards counterparties. The following key tools are used to assess credit risk:

- Published credit ratings of the financial institution and its sovereign
- Sovereign support mechanisms
- Credit default swaps (where quoted)
- Share prices (where available)
- Economic Fundamentals, such as a country's net debt as a percentage of its GDP
- Corporate developments, news articles, markets sentiment and momentum
- Subjective overlay

The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

Prudential Indicator 8 - Actual External Debt:

40. This indicator is obtained directly from the Council's balance sheet. It is the closing balance for actual gross borrowing plus other long-term liabilities (this represents our finance leases). This Indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

Actual External Debt as at 31/03/2016	£'000
Borrowing	0
Liabilities arising from finance leases	230
Total	**230**

Prudential Indicator 9 - Authorised Limit for External Debt:

41. The Council has an integrated treasury management strategy and manages its treasury position in accordance with its approved strategy. Borrowing will arise as a consequence of all the financial transactions of the Council not just arising from capital spending.

42. This limit represents the maximum amount that SSDC may borrow at any point in time during the year. If this limit is exceeded the Council will have acted ultra vires. It also gives the Council the responsibility for limiting spend over and above the agreed capital programme. A ceiling of £12 million was set to allow flexibility to support new capital projects over and above the identified borrowing requirement.

	2016/17 Estimate £'000	**2016/17 Qtr 2 Actual £'000**	**2016/17 Variance £'000**	**Reason for Variance**
Borrowing	11,000	0	(11,000)	SSDC currently has no external borrowing
Other Long-term Liabilities (Finance Leases)	1,000	136	(864)	Within limit
Total	**12,000**	**136**	**(11,864)**	

Prudential Indicator 10 – Operational Boundary for External Debt:

43. The operational boundary sets the limit for short term borrowing requirements for cash flow and has to be lower than the previous indicator, the authorised limit for external debt. A ceiling of £10 million was set.

	2016/17 Estimate £'000	**2016/17 Qtr 2 Actual £'000**	**2016/17 Variance £'000**	**Reason for Variance**
Borrowing	9,200	0	(9,200)	SSDC currently has no external borrowing
Other Long-term Liabilities (Finance Leases)	800	136	(664)	Within limit
Total	**10,000**	**136**	**(9,864)**	

Prudential Indicator 11 - Maturity Structure of Fixed Rate borrowing:

44. This indicator is relevant to highlight the existence of any large concentrations of fixed rated debt needing to be replaced at times of uncertainty over interest rates and is designed to protect against excessive exposures to interest changes in any one period. When we borrow we can take a portfolio approach to borrowing in order to reduce interest rate risk. This indicator is shown as the Council has set limits in anticipation of future borrowing.

Maturity structure of fixed rate borrowing	**2015/16 Actual %**	**2016/17 Qtr 2 Actual %**	**Lower Limit %**	**Upper Limit %**
Under 12 months	0	0	0	100
12 months and within 24 months	0	0	0	100
24 months and within 5 years	0	0	0	100
5 years and within 10 years	0	0	0	100
10 years and within 20 years	0	0	0	100
20 years and within 30 years	0	0	0	100
30 years and within 40 years	0	0	0	100
40 years and within 50 years	0	0	0	100
50 years and above	0	0	0	100

As the council doesn't have any fixed rate external borrowing at present the above upper and lower limits have been set to allow flexibility.

Prudential Indicator 12 - Incremental Impact of Capital Investment Decisions:

45. SSDC must show the effect of its annual capital decisions for new capital schemes on the council taxpayer. Capital spend at SSDC is financed from additional receipts so the figure below actually shows the possible decreases in council tax if all capital receipts were invested rather than used for capital expenditure.

Incremental Impact of Capital Investment Decisions	**2016/17 Estimate £**	**2017/18 Estimate £**	**2018/19 Estimate £**
Decrease in Band D Council Tax	0.12	0.22	0.16

Prudential Indicator 13 - Adoption of the CIPFA Treasury Management Code:

46. This indicator demonstrates that the Council has adopted the principles of best practice.

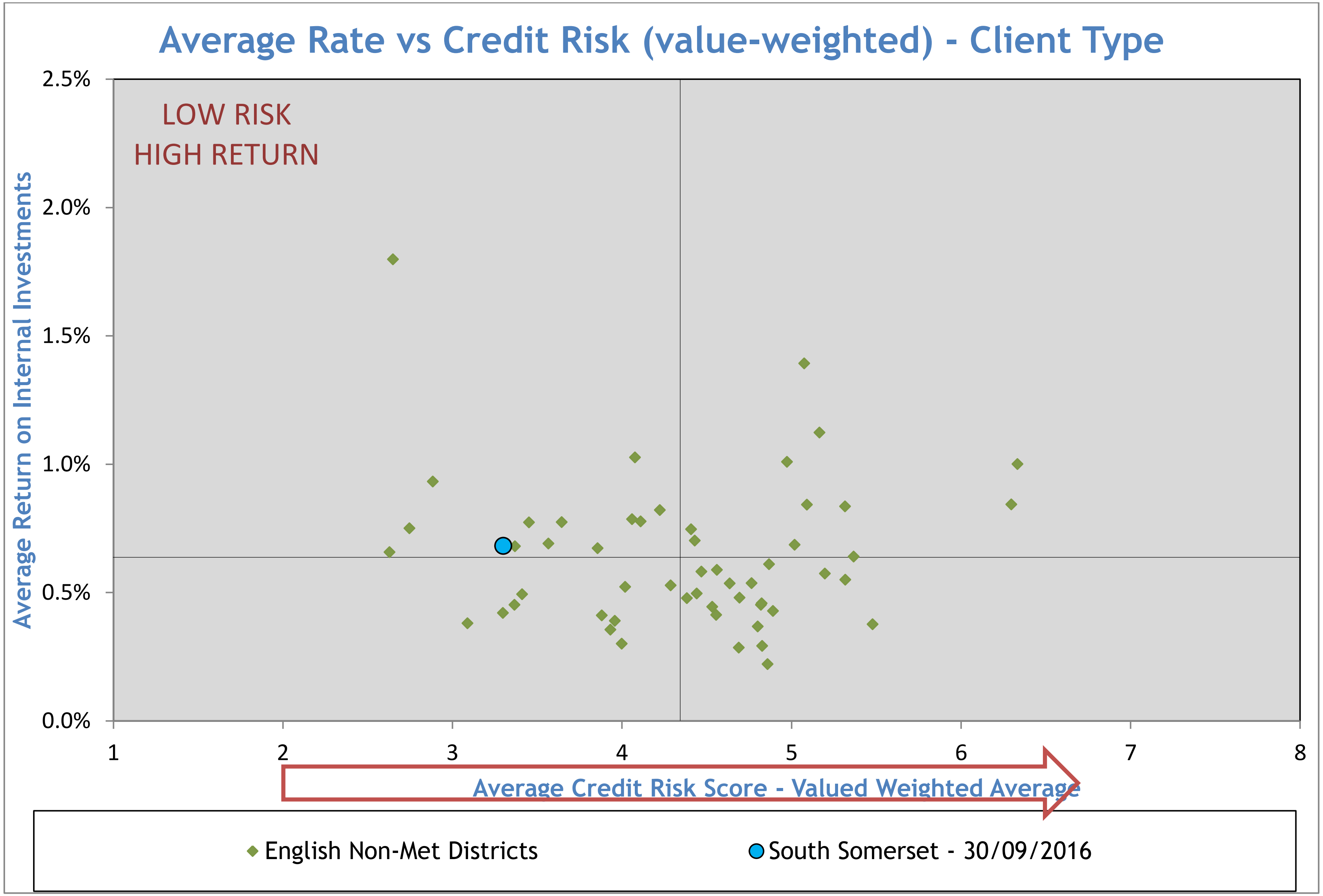
Adoption of the CIPFA Code of Practice in Treasury Management
The Council approved the adoption of the CIPFA Treasury Management Code at its Council meeting on 18th April 2002.

Conclusion

47. The council is currently within all of the Prudential Indicators and is not forecast to exceed them.

Background Papers: Prudential Indicators Working Paper, Treasury Management Strategy Statement 2016/17, Quarter 2 2016/17 Capital Programme.

Appendix A



Average Rate vs Credit Risk (value-weighted) - Client Type
LOW RISK
HIGH RETURN
Average Return on Internal Investments
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
1
2
3
4
5
6
7
8
Average Credit Risk Score - Valued Weighted Average
English Non-Met Districts
South Somerset - 30/09/2016