FLINTSHIRE COUNTY COUNCIL

TREASURY MANAGEMENT

ANNUAL REPORT 2016/17

1.00 INTRODUCTION

1.01 The Council approved the Treasury Management Strategy (Strategy) 2016/17 including key indicators, limits and an annual investment strategy on 16th February 2016.

1.02 The Strategy was produced based on the 2011 edition of the CIPFA Treasury Management in the Public Services: Code of Practice.

1.03 The purpose of this report is to review the outcomes from 2016/17 treasury management operations and compare with the Strategy.

1.04 Treasury management comprises the management of the local authority's 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.

2.00 ECONOMIC & INTEREST RATE REVIEW 2016/17

Provided by Arlingclose Ltd the Council's Treasury Management advisors.

Economic background: Politically, 2016/17 was an extraordinary twelve month period which defied expectations when the UK voted to leave the European Union and Donald Trump was elected the 45th President of the USA. Uncertainty over the outcome of the US presidential election, the UK's future relationship with the EU and the slowdown witnessed in the Chinese economy in early 2016 all resulted in significant market volatility during the year. Article 50 of the Lisbon Treaty, which sets in motion the 2-year exit period from the EU, was triggered on 29th March 2017.

UK inflation had been subdued in the first half of 2016 as a consequence of weak global price pressures, past movements in sterling and restrained domestic price growth. However the sharp fall in the Sterling exchange rate following the referendum had an impact on import prices which, together with rising energy prices, resulted in CPI rising from 0.3% year/year in April 2016 to 2.3% year/year in March 2017.

In addition to the political fallout, the referendum's outcome also prompted a decline in household, business and investor sentiment. The repercussions on economic growth were judged by the Bank of England to be sufficiently severe to prompt its Monetary Policy Committee (MPC) to cut the Bank Rate to 0.25% in August and embark on further gilt and corporate bond purchases as well as provide cheap funding for banks via the Term Funding Scheme to maintain the supply of credit to the economy.

Despite growth forecasts being downgraded, economic activity was fairly buoyant and GDP grew 0.6%, 0.5% and 0.7% in the second, third and fourth calendar quarters of 2016. The labour market also proved resilient, with the International Labour Organisation (ILO) unemployment rate dropping to 4.7% in February, its lowest level in 11 years.

Following a strengthening labour market, in moves that were largely anticipated, the US Federal Reserve increased rates at its meetings in December 2016 and March 2017, taking the target range for official interest rates to between 0.75% and 1.00%.

Financial markets: Following the referendum result, gilt yields fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. After September there was a reversal in longer-dated gilt yields which moved higher, largely due to the MPC revising its earlier forecast that Bank Rate would be dropping to near 0% by the end of 2016. The yield on the 10-year gilt rose from 0.75% at the end of September to 1.24% at the end of December, almost back at pre-referendum levels of 1.37% on 23rd June. 20- and 50-year gilt yields also rose in Q3 2017 to 1.76% and 1.70% respectively, however in Q4 yields remained flat at around 1.62% and 1.58% respectively.

After recovering from an initial sharp drop in Q2, equity markets rallied, although displaying some volatility at the beginning of November following the US presidential election result. The FTSE-100 and FTSE All Share indices closed at 7342 and 3996 respectively on 31st March, both up 18% over the year. Commercial property values fell around 5% after the referendum, but had mostly recovered by the end of March.

Money market rates for overnight and one week periods remained low since Bank Rate was cut in August. 1- and 3-month LIBID rates averaged 0.36% and 0.47% respectively during 2016-17. Rates for 6- and 12-months increased between August and November, only to gradually fall back to August levels in March, they averaged 0.6% and 0.79% respectively during 2016-17.

3.00 BORROWING REQUIREMENTS AND DEBT MANAGEMENT

3.01 PWLB (Public Works Loans Board) Certainty Rate

The Council again qualified for the PWLB Certainty Rate, allowing the authority to borrow at a reduction of 20 basis points on the Standard Rate.

3.02 Borrowing Activity in 2016/17.

The total long term borrowing outstanding, brought forward into 2016/17 totalled £251.3 million. Loans with the Public Works Loans Board were in the form of fixed rate (£222.4m) and variable rate (£10m). The remaining £18.95m was variable in the form of LOBO's (Lender's Option, Borrower's Option). The Council's average borrowing rate throughout the year was 5.02%.

	Balance 01/04/2016 £m	**Debt Maturing £m**	**New Debt £m**	**Balance 31/03/2017 £m**
Capital Financing Requirement	**280.3**	6.2	31.2	**305.3**
Short Term Borrowing	0.00	0.00	10.00	10.00
Long Term Borrowing	251.3	0.00	0.00	251.3
TOTAL BORROWING	251.3	0.00	10.00	261.3
Other Long Term Liabilities	6.5	0.5	0.00	6.0
TOTAL EXTERNAL DEBT	**257.8**	**0.5**	**10.00**	**267.3**
Increase/(Decrease in Borrowing (£m)	-	-	9.5	

3.03 The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31st March 2017 was £305.3m. The Council's total external debt was £267.3m.

3.04 Loans at Variable Rates

The Council has £10m of PWLB variable rate loans, at an average rate of 0.55% which mitigate the impact of changes in variable rates on the Authority's overall treasury portfolio (the Authority's investments are deemed to be variable rate investments due to their short-term nature). This strategic exposure to variable interest rates will be regularly reviewed and, if appropriate, reduced by switching into fixed rate loans.

3.05 Internal Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the strategy followed was to minimise debt interest payments without compromising the longer-term stability of the portfolio. The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant at around 1.92%. The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding £31.2m of capital expenditure incurred during the year for the majority of the financial year. This, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. However, the position was not sustainable for the whole year and the Council had always expected it would need to borrow for capital purposes from 2017/18 onwards.

3.06 Short Term Borrowing

Towards the end of the financial year, short term borrowing was undertaken as necessary in accordance with the 2016/17 borrowing strategy. The total short term (temporary) borrowing as at 31st March 2017 was £10m with an average rate of 0.4%.

3.07 Lender's Option Borrower's Option Loans (LOBOs)

The Authority holds £18.95m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. All of these LOBOS had options during the year, none of which were exercised by the lender.

3.08 Debt Rescheduling

Debt rescheduling opportunities were considered in detail by officers in conjunction with the Council's Treasury Management advisors. A sample of PWLB loans were considered for rescheduling with the results reported to the Audit Committee on 15th March 2017. The results indicated it was not prudent to reschedule any PWLB debt. No rescheduling activity was undertaken as a consequence.

However, The Chief Finance Officer, along with the Council's Treasury Management Advisors, keeps under review any opportunities which may arise for restructuring the Council's debt in order to take advantage of potential savings as interest rates change and to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility).

3.09 Loan to NEW Homes

In May 2016 Cabinet approved a loan to the Council's wholly owned company, NEW Homes Ltd, to build 62 homes on The Walks site in Flint for rent at affordable levels. To enable the funding of this loan, Council approved an increase in the Council's borrowing limit in June 2016.

The first £3.4m of this loan was drawn down on 31st March 2017 and was funded by short term borrowing at 31st March 2017.

The loan to NEW Homes does not meet the definition of an investment and is not therefore included in the Council's investment figures below. It is classed as capital expenditure.

4.00 INVESTMENT ACTIVITY

4.01 The Welsh Government's Investment Guidance gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

4.02 Investment Activity in 2016/17

Summary of investments as at 31st March 2017.

Country	Total	<1 month	1 –12 months	>12 months
	£m	%	£m	£m
UK BANKS				
UK BUILDING SOCIETIES	1.0		1.0	
OVERSEAS				
MMF's				
LOCAL AUTHORITIES				
DMO	7.6	7.6		
TOTAL	**8.6**	**7.6**	**1.0**	**0.0**
% OF PORTFOLIO		88.4%	11.6%	0.0%
TARGET 2016/17		35%	55%	10%

4.03 Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Strategy for 2016/17. Investments during the year included:

- Deposits with the Debt Management Office
- Deposits with other Local Authorities
- Investments in AAA-rated Constant Net Asset Value Money Market Funds
- Call accounts and deposits with Banks and Building Societies
- Certificates of Deposit

4.05 Credit Risk

The Authority assessed and monitored counterparty credit quality with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP and share price. The minimum long-term counterparty credit rating determined by the Authority for the 2016/17 treasury strategy was A-/A-/A3 across rating agencies Fitch, S&P and Moody's.

4.06 Counterparty Update

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.

Fitch and Standard & Poor's downgraded the UK's sovereign rating to AA. Fitch, S&P and Moody's have a negative outlook on the UK. Moody's has a negative outlook on those banks and building societies that it perceives to be exposed to a more challenging operating environment arising from the 'leave' outcome.

None of the banks on the Authority's lending list failed the stress tests conducted by the European Banking Authority in July and by the Bank of England in November, the latter being designed with more challenging stress scenarios, although Royal Bank of Scotland was one of the weaker banks in both tests. The tests were based on banks' financials as at 31st December 2015, 11 months out of date for most. As part of its creditworthiness research and advice, the Authority's treasury advisor Arlingclose regularly undertakes analysis of relevant ratios - "total loss absorbing capacity" (TLAC) or "minimum requirement for eligible liabilities" (MREL) - to determine whether there would be a bail-in of senior investors, such as local authority unsecured investments, in a stressed scenario.

On the advice of Arlingclose, new investments with Deutsche Bank and Standard Chartered Bank were suspended in March 2016 due to the banks' relatively higher credit default swap (CDS) levels and disappointing 2015 financial results. Standard Chartered was reintroduced to the counterparty list in March 2017 following its strengthening financial position, but Deutsche Bank was removed altogether from the list.

In July, following a review of unrated building societies' annual financial statements, Cumberland, Harpenden and Vernon building societies were removed from the Authority's list due to a deterioration in credit indicators. The maximum advised maturity was also lowered for eleven other societies from 6 months to 100 days due to the uncertainty facing the UK housing market following the EU referendum.

4.07 Liquidity

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

4.08 Yield

The UK Bank Rate remained at 0.50% until August when it was reduced to 0.25% where it has since stayed. Short term money market rates also remained at very low levels which continued to have a significant impact on investment income. The low rates of return on the Authority's short-dated money market investments reflect prevailing market conditions and the Authority's objective of optimising returns commensurate with the principles of security and liquidity.

Income earned on £2m of longer-dated investments made in 2015/16 at a rate of 1.05% provided some cushion against the low interest rate environment.

The Authority's budgeted investment income for the year had been estimated at £65k. The average cash balance was £30.9m during the period and interest earned was £133k, at an average interest rate of 0.43%.

5.00 COMPLIANCE

5.01 The Council can confirm that it has complied with its Prudential Indicators for 2016/17. These were approved by Council as part of the Treasury Management Strategy on 16th February 2016, before being revised and approved by Council on 14th June, to allow for the loan to NEW Homes (see 3.08 above).

5.02 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2016/17. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

5.03 The treasury function operated within the limits detailed in the Treasury Management Policy and Strategy Statement 2016/17.

6.00 OTHER ITEMS

6.01 The following were the main treasury activities during 2016/17:

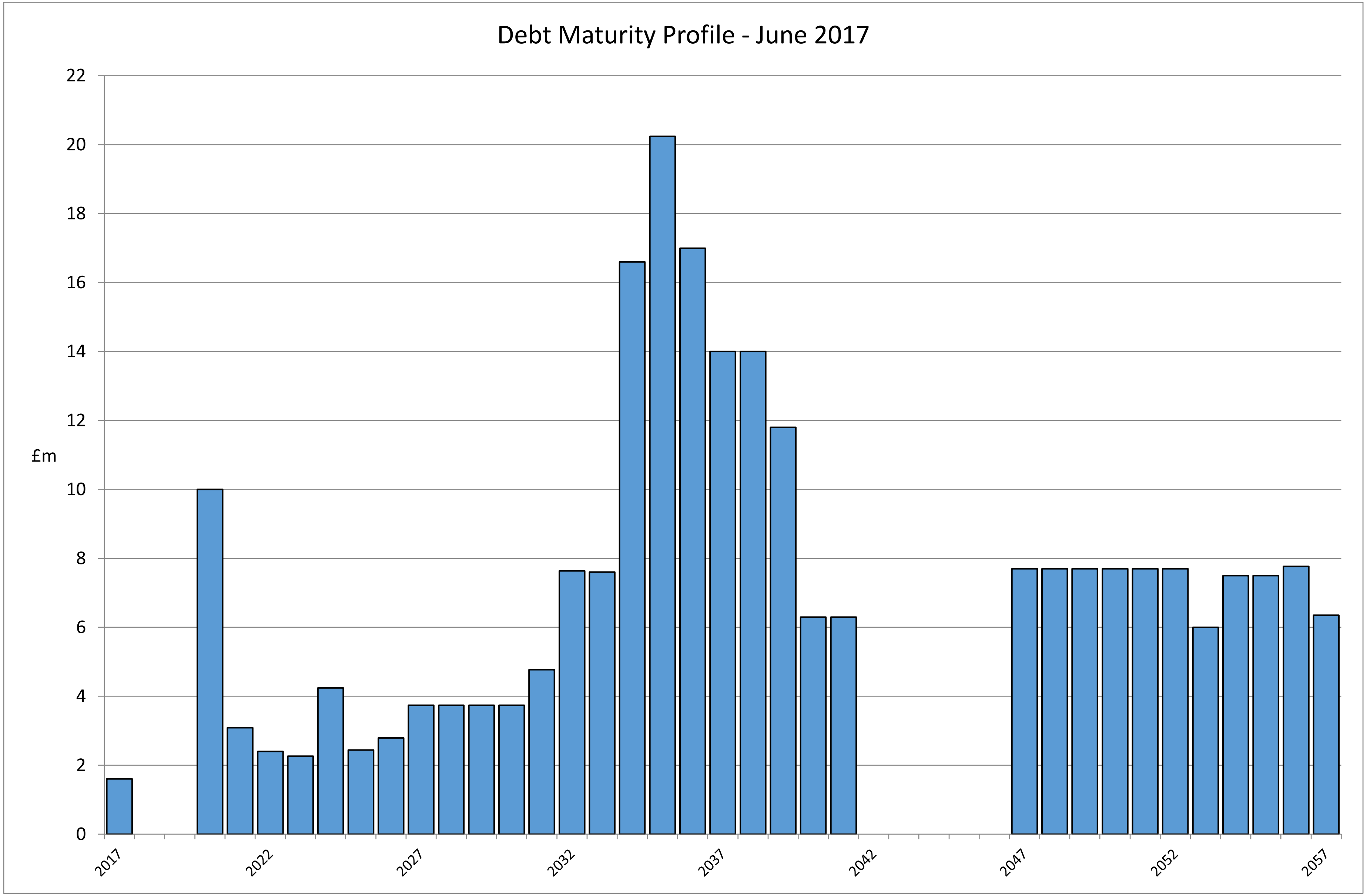
- The Council received a Mid-Year Report on 16th February 2017.
- Quarterly update reports were presented to the Audit Committee.
- The 2017/18 Investment Strategy Statement was approved by Council on 16th February 2017.
- The Council continues to be an active member of the CIPFA Treasury Management Network.

- The Council's cash flow was managed on a daily basis. During the year the Authority acted both as a borrower and as a lender and was a net borrower over the year in question. The maximum investments the Authority had on deposit at any one time was £51.1m and the maximum long-term borrowing at any one time was £251.3m.

7.00 CONCLUSION

7.01 The treasury management function has operated within the statutory and local limits detailed in the 2016/17 Treasury Management Strategy.

7.02 The Policy was implemented in a pro-active manner with security and liquidity as the focus.


Debt Maturity Profile - June 2017
£m
0
2
4
6
8
10
12
14
16
18
20
22
2017
2022
2027
2032
2037
2042
2047
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2057