Hackney

TITLE OF REPORT TREASURY MANAGEMENT UPDATE	
AUDIT COMMITTEE MEETING DATE 2017/2018 **26 June 2017**	**CLASSIFICATION:** **Open** **If exempt, the reason will be listed in the main body of this report.**
WARD(S) AFFECTED **All Wards**	
GROUP DIRECTOR **Ian Williams, Group Director Finance and Corporate Resources**	

1. INTRODUCTION AND PURPOSE

1.1 This report, at Appendix 1, introduces the treasury management outturn report and the actual prudential indicators for 2016/17 for the Audit Committee setting out the background for treasury management activity over the year and confirming compliance with treasury limits and prudential indicators.

1.2 It goes on in Appendix 2 to provide an update on treasury management activity for the first 2 months of 2017/18.

2. RECOMMENDATION(S)

The Audit Committee is recommended to:

- Note the report

3. BACKGROUND

3.1 Policy Context

Treasury management and ensuring that the function is governed effectively means that it is essential for those charged with governance to review the operations of treasury management on a regular basis. This report sets out the prior year's outturn and forms part of the regular reporting cycle for Audit Committee along with the first of the in-year quarterly updates for the current financial year

3.2 Equality Impact Assessment

There are no equality impact issues arising from this report.

3.3 Sustainability

There are no sustainability issues arising from this report.

3.4 Consultations

No consultations are required in respect of this report.

3.5 Risk Assessment

There are no risks arising from this report as it reports on past events. Clearly though the treasury management function is a significant area of potential risk for the Council if the function were not properly carried out and monitored by those charged with responsibility for oversight. Regular reporting on treasury management ensures that the Committee is kept informed.

4. COMMENTS OF THE GROUP DIRECTOR OF FINANCE AND CORPORATE RESOURCES

There are no direct financial consequences arising from this report as it reflects past performance through 2016/17 and the first two months of 2017/18. The information contained in this report will also assist Members of this Committee in monitoring the treasury management activities and enable better understanding of such operations.

5. COMMENTS OF THE DIRECTOR OF LEGAL

5.1 The Accounts and Audit Regulations 2015 place obligations on the Council to ensure that its financial management is adequate and effective and that it has a sound system of internal control which includes arrangements for management of risk. In addition, the Council within its Annual Treasury Management Strategy has agreed to comply with the CIPFA Code of Practice on Treasury Management. This report demonstrates that Treasury Management is meeting these requirements and adapting to changes as they arise.

5.2 There are no immediate legal implications arising from the report.

6. BACKGROUND PAPERS

6.1 The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that authorities report on the performance of the treasury management function at least twice a year (mid-year and at year end).

6.2 The Authority's Treasury Management Strategy for 2016/17 was approved by full Council on 2nd March 2016 which can be accessed on the Council website:
http://mginternet.hackney.gov.uk/documents/s47820/Appendix%204%20TMS%20201617%20to%20201819%2029022016%20Cabinet.pdf

6.3 The Authority's Treasury Management Strategy for 2017/18 was approved by full Council on 1st March 2017 which can be accessed on the Council website:
http://mginternet.hackney.gov.uk/documents/s53578/Appendix4201718%2027022017%20Cabinet.pdf

Report Author	Pradeep Waddon, ☎020-8356 2757
Comments of the Group Director of Finance and Corporate Resources	Michael Honeysett, ☎020-8356 3332

Comments of the Head of Legal	Patricia Narebor ☎020-8356 2029

APPENDIX 1: Annual Treasury Management Outturn Report 2016/17

1. External Context

1.1 **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 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%.

1.2 **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.

1.3 **Credit background:** 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.

2 The Borrowing Requirement and Debt Management

21 The Council currently had one £3.6m LEEF (London Energy Efficient Fund) loan from the European Investment Bank to fund housing regeneration. This loan is below market rate and was taken out in July 2014.

2.2 The LEEF loan is an EIP (Equal Instalment of Principle) loan where each payment includes an equal amount in respect of loan principle throughout the duration of the loan. Therefore the interest due with each payment reduces as the principle is eroded, and so the total amount reduces with each instalment. Consequently, part of the loan is short term in duration, the amount which will be paid via instalments within one year with the remainder of loan maturing beyond 1 year (long term).

2.3 In addition, the Council borrowed £85m as short term borrowing from local authorities to fund the Hackney Walk Deal and this will be repaid within first six months of 2017-18.

Table 1: Capital Financing Requirement (CFR) & Total External Debt

	Balance as at 31/03/16 £'000	**New Borrowing £'000**	**Debt Maturing £'000**	**Debt Repaid £'000**	**Balance as at 31/03/17 £'000**	**Average Rate %**
CFR	227,688				328,968	
Short Term Borrowing*	5,400	85,000	400	5,000	85,000	0.49%
Long Term Borrowing	3,600	-	-	-	3,600	1.9%
TOTAL BORROWING	**9,000**	**85,000**	**400**	**5,000**	**88,600**	
Other Long Term Liabilities	16,850	-	-	-	15,080	
TOTAL EXTERNAL DEBT	25,850	-	-	0	103,680	

2.4 The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31/03/2017 was £328.968m.

2.5 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 use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding capital expenditure where other resources are not available. This has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. Whilst this net position is expected to continue in 2017/18, it is not likely to be sustainable over the medium to longer term as demands on the capital programme continues to grow.

3. Investment Activity

3.1 CLG's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield.

3.2 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

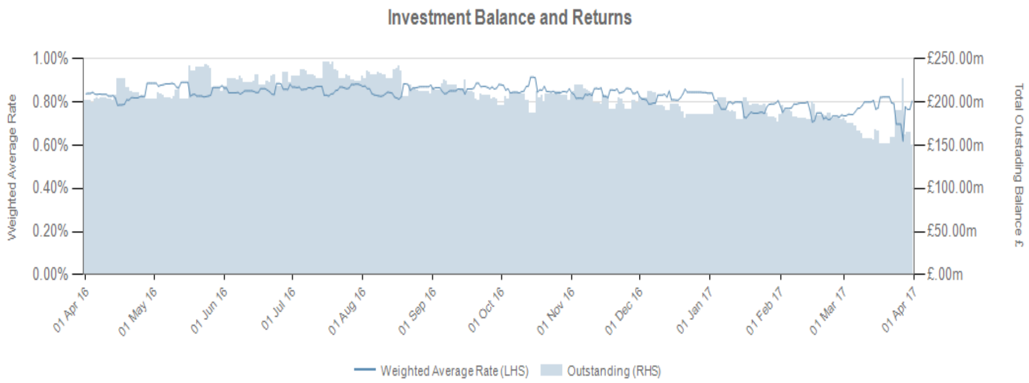
Treasury Management Strategy Statement for 2016/17 Investments during the year included:

- Deposits with other Local Authorities
- Investments in AAA-rated Constant Net Asset Value Money Market Funds
- Investments in AAA-rated Variable Net Asset Value Cash Enhanced Money Market Funds
- Call accounts, deposits, Certificate of Deposits and Covered Bonds with Banks and Building Societies systemically important to each country's banking system (UK, Australia, Canada, Finland, France, Germany, Netherlands, Singapore, Switzerland and the US).
- High quality Bank, Corporate and Covered bonds

Table 2: Investment Balances

Investments	**Balance as at 31/03/16 £'000**	**Average Rate %**	**Balance as at 31/03/17 £'000**	**Average Rate %**
Short Term Investments	136,554		43,104	
Long Term Investments	28,000		31,500	
Covered Bonds	8,822		7,874	
Corporate Bonds	10,121		12,125	
Housing Associations	-		15,000	
Investments in VNAV MMF's (Money Market Funds)	8,000		3,000	
Investments in CNAV MMF's (Money Market Funds)	10,625		36,660	
TOTAL INVESTMENTS	**202,122**	**0.83**	**149,263**	**0.81**

3.3 The Council's investment balance reduced by £52m to £149,263m at the end of the financial year with weighted average rate (investment return) of 0.81%. The Council is forecasting a further downward trend in cash balances as the Council progresses a number of major capital schemes requiring forward funding. The movement of cash balances (thick grey block) and yield (thin blue line) throughout the year is represented in the graph below:



3.4 Credit Risk- Counterparty credit quality was assessed and monitored 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; any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for the 2016/17 treasury strategy was BBB-across rating agencies Fitch, S&P and Moody's.

Table 3: Credit Score Analysis

Scoring: - Aim = AA- or higher credit rating, with a score of 4 or lower, to reflect current investment

Date	Value Weighted Average Credit Risk Score	Value Weighted Average Credit Rating	Time Weighted Average Credit Risk Score	Time Weighted Average Credit Rating
31/03/2016	3.43	AA	3.08	AA
30/06/2016	3.21	AA	3.87	AA
30/09/2016	3.37	AA	3.83	AA
31/12/2016	3.17	AA	3.64	AA
31/03/2017	4.05	AA-	3.64	AA-

approach with main focus on security
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 15

3.5 Liquidity - In keeping with the CLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds/overnight deposits/call accounts.

3.6 Yield - The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.25% through the year.

4. Compliance

4.1 The Council can confirm that it has complied with its Prudential Indicators for 2016/17, which were approved on 2nd March 2016 as part of the Council's Treasury Management Strategy Statement

4.2 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.

4.3 The Authority can confirm that during 2016/17 it complied with its Treasury Management Policy Statement and Treasury Management Practices.

5. Prudential Indicators

5.1 Capital Financing Requirement (CFR)

Estimates of the Council's cumulative maximum external borrowing requirement for 2015/16 to 2017/18 are shown in the table below:

	31/03/16 Approved £'000	31/03/16 Actual £'000	31/03/17 Actual £'000	31/03/18 Estimate £'000
Gross CFR	217,608	227,688	328,968	428,968
Less: Other Long Term Liabilities	19,482	16,850	14,822	14,112
Borrowing CFR	**198,126**	**210,838**	**314,146**	**414,856**
Less: Existing Profile of Borrowing	4,000	9,000	88,600	3,200
Gross Borrowing Requirement/Internal Borrowing	**194,126**	**201,838**	**225,546**	**411,656**
Usable Reserves	209,000	180,000	100,000	100,000
Net Borrowing Requirement/(Investment Capacity)	**(14,874)**	**21,838**	**115,546**	**311,656**

In the Prudential Code Amendment (November 2012), it states that the Chief Finance Officer should make arrangements for monitoring with respect to gross debt and the capital financing requirement such that any deviation is reported to him/her, since any such deviation may be significant and should lead to further investigation and action as appropriate.

	2015/16 Approved £'000	2015/16 Actual £'000	2016/17 Actual £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Gross Debt	23,482	25,850	103,422	117,712	167,712
CFR	217,608	227,688	328,968	428,968	478,968
Borrowed in excess of CFR? (Y/N)	N	N	N	N	N

5.2 Prudential Indicator Compliance

(a) Authorised Limit and Operational Boundary for External Debt

- The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached.
- The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit.

- The Group Director of Finance and Corporate Resources confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year.

	Operational Boundary (Approved) as at 31/03/17 £'000	**Authorised Limit (Approved) as at 31/03/17 £'000**	**Actual External Debt as at 31/03/17 £'000**
Borrowing	337,319	365,319	88,600
Other Long-term Liabilities	18,000	19,000	14,822
Total	**355,319**	**384,319**	**103,422**

(b) Capital Expenditure

This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits, and, in particular, to consider the impact on Council tax and in the case of the HRA, housing rent levels.

	2016/17 Actual £000	**2017/18 Estimate £000**	**2018/19 Estimate £000**	**2019/20 Estimate £000**	**2020/21 Estimate £000**
Capital Expenditure					
Housing	107,990	185,990	247,341	275,517	112,320
Non-Housing	160,009	212,060	115,754	58,314	75,193
Total spend	**267,999**	**398,050**	**363,095**	**333,831**	**187,513**

Capital expenditure has been and will be financed or funded as follows:

Capital Financing	**2016/17 Actual £000**	**2017/18 Estimate £000**	**2018/19 Estimate £000**	**2019/20 Estimate £000**	**2020/21 Estimate £000**
Prudential Borrowing	107,518	141,078	85,649	9,008	0
S106	3,620	2,508	0	0	0
Capital receipts	80,212	110,291	206,281	248,588	126,513
Grants	25,388	30,667	7,043	16,985	6,000
Reserves	15,415	60,792	15,422	8,250	5,000
RCCO	35,846	52,714	48,700	51,000	50,000
Total Financing	**267,999**	**398,050**	**363,095**	**333,831**	**187,513**

The table shows that the capital expenditure plans of the Authority could not be funded entirely from sources other than borrowing.

(c) Ratio of Financing Costs to Net Revenue Stream

- This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs.
- The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2016/17 Approved	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Non-HRA	2.51%	1.74%	3.65%	5.21%	5.55%
HRA	2.99%	2.34%	1.96%	2.31%	1.75%

(d) **Adoption of the CIPFA Treasury Management Code**

This indicator demonstrates that the Authority adopted the principles of best practice via approval of the CIPFA Treasury Management Code

(e) **HRA Limit on Indebtedness**

HRA Limit on Indebtedness	2016/17 Approved £m	2016/17 Actual £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m
HRA CFR	106.118	100.080	159.600	184.674	193,682
HRA Debt Cap (as prescribed by CLG)	178.353	178.353	178.353	178.353	178.353
Difference - Additional Borrowing Capacity for the HRA	72.235	78.273	18.753	(6.321)	(15,239)

The Group Director, Finance and Corporate Resources confirms that the Council's HRA Capital Financing Requirement did not exceed the HRA Debt Cap in 2016/17 and measures will be taken to ensure that the projected breach in 2018/19 and 2019/20 set out in the table above are rectified through financing decisions or a restriction on the overall HRA related capital program.

Appendix 2 – Quarterly Treasury Management Update Report

Treasury Management Activities from April to May 2017

1. Economic Highlights

1.1 **Growth:** The second estimate of Q1 GDP released in May by the ONS confirmed the UK economy expanded by 0.2% over the quarter and 2.0% year-on-year. Both the quarter estimate and year-on-year figure were revised downwards by 0.1 percentage points.

1.2 **Inflation:** The Office for National Statistics' new main measure of inflation, the Consumer Price Index including owner occupiers housing costs (CPIH), rose by 2.6% in the year to April 2017, up from 2.3% in March 2017. This figure met market expectations and continues to represent the highest CPIH rate since June 2013.

1.3 **Labour Market:** The latest statistics released by the ONS for the three months to March 2017 show that the number of people in work increased and both the number of unemployed and economically inactive people fell. The unemployment rate fell to 4.6% and the employment rate increased to a new high of 74.8%, the highest since records began in 1971. Nominal wages increased by 2.4% including bonuses and by 2.1% excluding bonuses but with CPI increasing to 2.7% real wage growth has fallen to a negative of -0.3%.

2. Borrowing & Debt Activity

2.1 The Authority currently has £88.6m in external borrowing. This is made up as a single LEEF loan from the European Investment Bank to fund housing regeneration £3.6m and £85m short-term borrowing from Local Authorities to fund the recent Hackney Walk deal.

3. Investment Policy and Activity

3.1 The Council held average cash balances of £179 million during the reported period, compared to an average £213 million for the same period last financial year.

Movement in Investment Balances 01/04/17 to 31/05/17

	Balance as at 01/04/2017 £'000	**Average Rate of Interest %**	**Balance as at 31/05/2017 £'000**	**Average Rate of Interest %**

Short Term Investments	43,104	-	43,158	-
Long Term Investments	31,500	-	24,500	-
Covered Bonds	7,874	-	7,703	-
Corporate Bonds	12,125	-	11,935	-
Housing Associations	15,000	-	15,000	-
Investments in VNAV MMF's (Money Market Funds)	3,000	-	3,000	-
Investments in CNAV MMF's (Money Market Funds)	36,660	-	77,990	-
	149,263	**0.81**	**183,286**	**0.66**

3.2 Due to the volatility of available creditworthy counterparties, longer term investments have been placed in highly rated UK Government institutions, thus ensuring creditworthiness of investments.

4. Counterparty Update

4.1 Arlingclose, the Council's Treasury Advisors, currently hold a fairly neutral stance on the credit quality of our recommended counterparties. In March the UK Banks had all released their annual results which showed that most of the banks have marginally improved their capital adequacy and seen improving profit levels since 2015. Once again, RBS' full year profits were disappointing as significantly deeper losses than 2015 were experienced. The RBS Group continues to face costs associated with restructuring and charges for ongoing litigation and conduct issues.

4.2 In May Arlingclose reduced their recommended duration of Bank of Scotland, HSBC Bank and Lloyds Banks from 13 months to 6 months. This was due to the uncertainty on which part of the new ring fenced banks LA deposits would sit. Ring-fencing requires the larger UK banks to separate their core retail banking activity from the rest of their business. The deadline for ring-fencing is 1st January 2019 but we expect the majority of the new 'retail' banks to hold higher credit ratings and to be less exposed to bail-in than their 'investment' bank counterparts when the changes eventually come into play.

4.3 Last week's General Election resulted in a hung parliament with no individual party commanding a majority in the House of Commons. The political situation clearly involves an enhanced level of uncertainty with a fluid position subject to change. We and our advisors will continue to monitor events and adjust our activities accordingly as required.

4.4 Whilst the ongoing investment strategy remained cautious counterparty credit quality remains relatively strong, as can be demonstrated by the Credit Score Analysis summarised below:

5. Credit Score Analysis

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating Score	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating Score
30/04/2017	4.1	AA-	3.6	AA-
31/05/2017	4.2	AA-	3.6	AA-

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 27
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

5.1 The Council continues to utilise AAAmmf/Aaa/AAAm rated Money Market Funds for its very short, liquidity-related surplus balances. This type of investment vehicle has continued to provide very good security and liquidity, although yield suffers as a result.

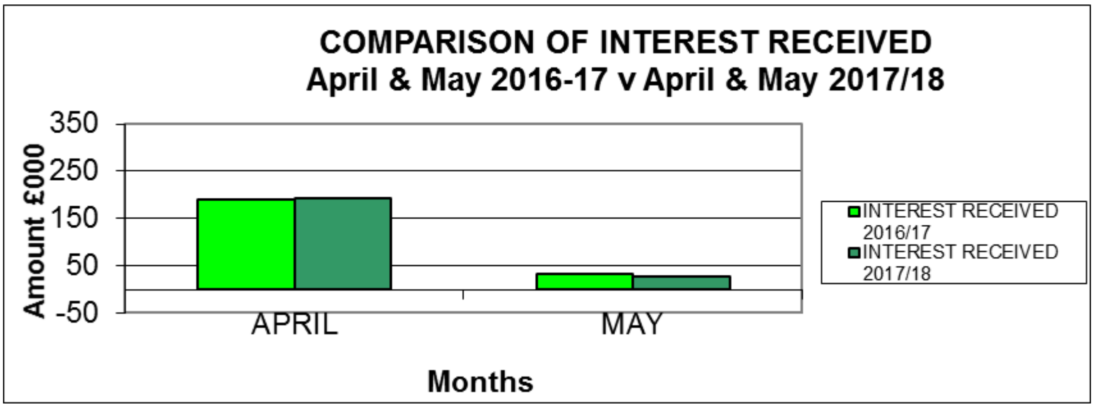
5.2 In light of legislative changes and bail-in risk for unsecured bank deposits, as set out in previous monitoring reports, the Council continues to invest in high quality corporate bonds. This investment vehicle offers good level of security and increases diversification for the Council's portfolio whilst achieving a reasonable yield.

6. Comparison of Interest Earnings

6.1 The Council continues to adopt a fairly cautious strategy in terms of investment counterparties and periods. Due to the volatility of available creditworthy counterparties, longer term investments have been placed in highly rated UK Government institutions or Covered (secured) Bonds, thus ensuring creditworthiness whilst increasing yield's through the duration of the deposits.

6.2 The graph below provides a comparison of interest earnings for April 17 and May 17 against the same period for 2016/17. The graph highlights that the Council's longer term investment approach is paying dividends with high levels on interest received when taking into account the investment market environment.

6.3 Average interest received for the period April to May 2017 was £111k compared to £112k for the same period last financial year.



7. Movement in Investment Portfolio

7.1 Investment levels have decreased to £183 million at the end of May in comparison to the end of May last year of £218 million. The decrease in the investment balance year on year is the result of the continued approach of maintaining borrowing and investments below their underlying levels i.e. use of internal borrowing to finance the Council's capital programme.