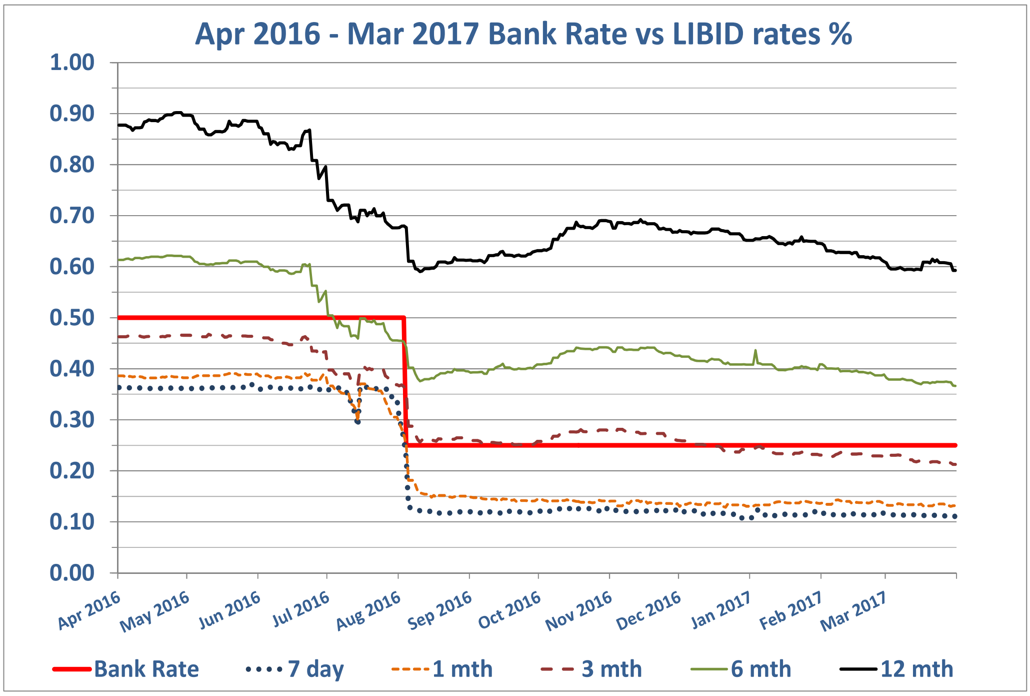
Bank Rate v London Interbank BID (LIBID) investment rates



3. Capital Expenditure and Financing 2016/17

3.1 The Council finances capital expenditure resulting in an increase in long-term assets. These may either be;

- Financed immediately through the application of capital receipts, capital grants or contributions from revenue expenditure, or
- If insufficient financing is available the expenditure will give rise to a borrowing need

3.2 The Council has been debt-free since 1997 but the increase in capital outlay during 2016/17 (for the purchase of assets in Leatherhead and the refurbishment and regeneration of Pippbrook and Meadowbank in Dorking) has reduced the Council's balances to the point where borrowing was, once again, required. The borrowing requirement during 2016/17 was £11m, of which £10m was borrowed from the Public Works Loan Board (PWLB) and the remainder was financed through internal borrowing against earmarked reserves that will need to be replenished in future years.

3.3 The table below shows how capital expenditure was financed over the past two years. Actual expenditure is lower than the estimate. This is mainly related to two projects. Firstly the inclusion of the £48.53m Asset Investment Strategy budget in the estimate: although a number of properties were considered for purchase as part of this strategy during 2016/17, the first one to be successfully purchased was in April 2017. Secondly the budget for the construction of the football ground at Meadowbank, Dorking includes £4.6m of expenditure for works which will not be completed until the following financial year (2017/18). Members approved the carry forward to 2017/18 of £503,000 capital minor works scheme provision at the Executive meeting on 27th June 2017.

	2015/16 Actual £000	2016/17 Estimate £000	2016/17 Actual £000
Total capital expenditure	**6,502**	**73,632**	**17,509**
Resourced by :			
Capital receipts	4,164	5,154	2,767
Capital grants & contributions	2,183	3,647	2,293
Capital reserves	155	1,005	812
Borrowing	0	63,826	11,637
Total Resources Applied	**6,502**	**73,632**	**17,509**

4. Investment Rates in 2016/17

4.1 The market interest rates at the start and end of the year are shown below. As can be seen rates have reduced during the year from historically low levels. The reduction in interest rates, including the effect of the introduction of the Term Funding Scheme by the Government, has had a significant bearing on the interest earnings of the Authority on internal investments and will do so moving forward.

Market Rates (Average):

Notice	2014/15	2015/16	2016/17
	%	%	%
7 Day	0.352	0.361	0.200
1 Month	0.374	0.383	0.220
3 Month	0.429	0.456	0.315
6 Month	0.556	0.609	0.462
1 Year	0.868	0.902	0.702

5. Borrowing Strategy for 2016/17

5.1 The major borrowing requirement objectives to be followed in 2016/17 were;

- To forecast average future interest rates and movements in future interest rates
- To manage the Council's debt ensuring prompt payment of interest and principal on the due dates
- To secure the cheapest cost for financing capital schemes commensurate with future risk

5.2 The Council greatly values revenue budget stability and will therefore borrow the majority of its long-term funding needs at long-term fixed rates of interest. Short-term and variable rate loans will only be borrowed to the extent that they either offset short-term and variable rate investments or can be shown to produce revenue savings.

5.3 It was anticipated that it would become necessary to commence borrowing to fund the capital programme during 2016/17 and beyond. This is reflected in the higher

Operational Boundary and Affordable Limits set out against Performance Indicators 6 and 7 (Appendix A).

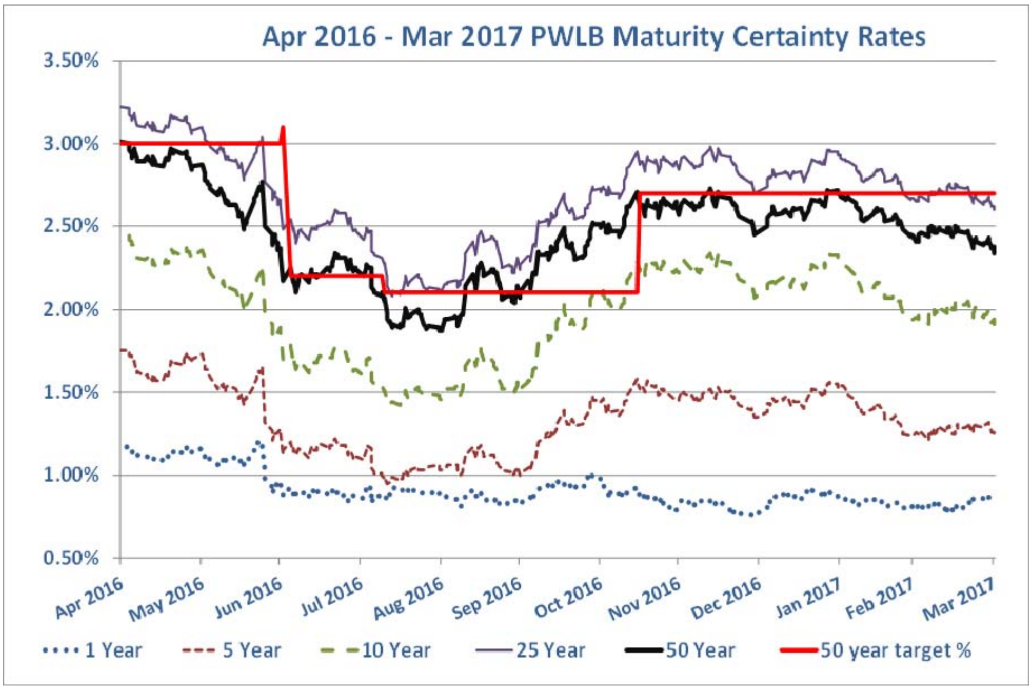
6. Borrowing Outturn for 2016/17

6.1 The Council raised funds during 2016/17 through the Public Works Loans Board (PWLB).

6.2 The following loan was taken out during the year:-

Lender	Principal (£)	Type	Interest Rate %	Maturity
PWLB	10,000,000	Fixed interest rate	2.72	50 years

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



7. Compliance with Prudential and Treasury Management Indicators

7.1 During the financial year the Council operated within the Prudential and Treasury Management Indicators 2016/17 – 2018/19 and Treasury Management Strategy and Plan 2016/17 as agreed by Council on 23rd February 2016. The outturn for the Prudential and Treasury Management Indicators is detailed in Appendix A of this report.

8. Investment Strategy for 2016/17

8.1 The Investment Strategy's primary objectives are safeguarding the re-payment of the principal and interest of its investments on a timely basis first and ensuring adequate liquidity second, with the investment return being the third objective.

8.2 The Council's Medium Term Financial Plan, approved in 2013, set out the need to replace reducing Government Grant by income generated through making the best use of assets. The reduction in grant announced for 2016/17 has accelerated the need to pursue a policy of property investment to generate income in support of services.

8.3 At its meeting on 11th October 2016 the Council approved an Asset Investment Strategy (AIS) and the consequent addition of £48.5m to the capital programme for the purchase of investment assets. To enable this, the Council would need to borrow funds as the Council's reserves are no longer sufficient to support this initiative.

8.4 The 2016/17 Treasury Management Strategy set out the appropriate indicators, authorities and limits within the Prudential Code, to enable the Council to borrow.

8.5 Investing cash balances in policy investments is a departure from previous investment strategies. This type of investment is not required to be reported in treasury management reports as they will be included in regular Asset Investment Strategy reviews. It was felt important to include reference to the AIS here to give Members a comprehensive view of how cash balances are being used and how this will impact on the treasury management function and by implication capital expenditure and treasury Prudential Indicators and Limits moving forward.

8.6 The Council predominantly manages its investments in-house and invests with the institutions listed in the Council's approved lending list. Following the increase in planned capital spend as a consequence of the AIS, the Council now primarily invests for a range of periods less than one year dependent on the Council's cash flows, its interest rate view and the rates of interest on offer.

8.7 The expectation for interest rates within the Strategy for 2016/17 anticipated an increase in the Bank Rate in quarter 4. The Bank Rate actually fell by 0.25% on 4th August 2016. Investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

8.8 No institutions in which investments were made during 2016/17 had any difficulty in repaying principal and interest in full during the year.

9. Investment Outturn for 2016/17

9.1 The Council's Investment Policy is governed by Communities and Local Government (CLG) guidance, which has been implemented in the annual investment strategy approved by the Council on 23rd February 2016. This Policy sets out the approach for selecting 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. Counterparties are selected and limits applied using rating criteria. The application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with the CIPFA Treasury Management Code of Practice. Credit rating information is supplied by our treasury management advisor (Capita Asset Services, Treasury Solutions).

9.2 Detailed below is the result of the investment strategy undertaken by the Council.

Internally Managed Funds

9.3 The Council maintained its investment activities during the year, as agreed by Council on 23rd February 2016.

9.4 During the year all investments were made in full compliance with the Council's treasury management policies and practices and the Council had no liquidity difficulties.

9.5 The limit to be placed, with each counterparty, remained at £7.5 million. The Council also operated a 'group limit', whereby the collective investment exposure to individual banks within the same banking group was restricted to a group total set also at £7.5 million.

9.6 The analysis below shows the activity undertaken on internally managed funds during 2016/17.

	£
Balance outstanding 01/04/16	21,247,000
Investments made during the year	157,999,000
Downward revaluation of CCLA Property Fund investment (at 31/03/17)	(94,000)
	179,152,000
Less: Investments maturing during the year	161,610,000
Balance outstanding 31/03/17	17,542,000

9.7 These investments generated interest of approximately £379,000 in the year (£481,000 in 2015/16), gross of all associated charges against a budget of £448,000. As referred to in paragraph 8.3 agreement was given to increased licence in terms of the scope and range of Council investments. During 2016/17 funds were moved from short-term investments where interest rates were performing at historically low levels. These funds were re-invested in, better performing, property purchases that generated a rental income but meant that there was less to invest in financial instruments. This would help to explain the variation in actual outturn and estimate for investment interest earnings. A proportion of investment income is received from short-term investments (investments that mature in, or are held for, 12 months or less). Also good returns are still being achieved on the investment of £5m that was made in the CCLA Property Fund on 30th June 2013 (refer to paragraph 9.10). During the reporting period the Base Rate was reduced from 0.50% to 0.25% on 4th August 2016.

	Original Estimate 2016/17 £	**Actual Outturn 2016/17 £**	**Variance 2016/17 £**
Internally Managed Funds	448,000	378,614	69,386

9.8 Mole Valley achieved a rate of return of 1.61% on its internally managed funds during the year, this was based on an average fund value of approximately £23,534,000. The formal method used to compare performance is to contrast the rate of return against the average uncompounded 7-day LIBID (London Interbank BID) rate (0.20% for 2016/17). The investment in the CCLA Property Fund, previously alluded to, has significantly enhanced the return on internally managed funds when compared to the benchmark.

9.9 Detailed below is the result of the investment strategy undertaken by the Council.

Funds	Average Fund Value	Rate of Return	Benchmark Return *
Internally / Externally Managed	£23,534,000	1.61%	0.20%

* 7-day LIBID uncompounded 0.20%

The uncompounded rates are for internally managed funds and exclude the roll-up of principal and interest. Upon maturity of the investment, interest is paid over with the original principal sum.

Externally Managed Funds – Churches, Charities and Local Authorities (CCLA)

9.10 On 30th June 2013 the Council invested £5m in the Charities, Churches and Local Authorities (CCLA) Property Fund. To realise the full potential of this investment it should be considered as a medium to long term placement. Income is received quarterly and in the current economic climate very good yields are still being achieved.

9.11 The Fund offers all of the advantages of a professionally managed property portfolio, with broadly diversified exposure to high quality properties in the strongest areas of the market. The Fund is a high quality, well diversified commercial and industrial property portfolio. There is a focus on delivering attractive income returns and the Fund is actively managed to add value.

9.12 CCLA has been appointed by the Local Authorities' Mutual Investment Trust (LAMIT) to manage and administer the Local Authorities' Property Fund. LAMIT was established approximately 30 years ago to provide investment services for local authorities in the UK. It is controlled by Members and Officers appointed by the Associations of Local Authorities in the United Kingdom and by Trust Members representing the Funds' unit holders.

9.13 Excellent returns of 5.31% were achieved from this Fund during the year. With the property market remaining buoyant it is anticipated that these returns will continue during 2017/18.

10. Debt rescheduling

10.1 As short term borrowing rates will be considerably cheaper than longer term fixed

interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

10.2 The reasons for any rescheduling to take place will include:

- the generation of cash savings and/or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

10.3 Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on the current debt.

10.4 All rescheduling will be reported to the Council, at the earliest meeting following its action.

11. Other issues

11.1 The Treasury Management Strategy Report for 2018/19 to 2020/21 will be presented to Audit Committee on 8th February 2018.

12. Financial Implications

The financial implications are covered in the body of this report.

13. Legal Implications

The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity.
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (no restrictions were made in 2016/17).
- The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act.
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities. The Prudential Code required indicators to be set, some of which are limits, for a minimum of the three forthcoming years.
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services.
- Under the Act the DCLG has issued Investment Guidance to structure and regulate the Council's investment activities. Updated guidance became available on 1st April 2010. The emphasis of the Guidance is on the security and liquidity of investments.

The Council has complied with all of the above relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

14. Corporate Implications

Monitoring Officer Commentary

The Monitoring Officer confirms that all relevant legal implications have been taken into account.

S151 Officer commentary

The S151 Officer confirms that all financial implications have been taken into account.

Risk Implications

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

Security – counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swaps, gross domestic product (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 2016/17 was A/A3/A (Fitch/Moody's/Standard and Poors).

Liquidity – the Council maintained a sufficient, though not excessive, level of liquidity during the year using a call account and short-term, fixed-rate, deposits.

Yield – the Council sought to optimise returns commensurate with its objectives of security and liquidity. Short-term money market rates remained at very low levels throughout the year which had a significant impact on investment income.

A high reliance on investment income can place the Council at significant risk of budget variation as interest rates rise and fall, which has an impact upon future Council Tax levels. The Council's Medium Term Financial Strategy addresses this risk and seeks to reduce this reliance over time.

Locking significant investments into long-term fixed-rate deals means the Council has a potential disadvantage in a rising interest market, especially if the interest rate rises above the assumption made when the long-term deal was placed.

To mitigate this, the Council's in-house team predominantly invest up to periods of three months only, hence advantage can be taken of prevailing interest rates upon the investments maturity. This minimises the disadvantage whilst maintaining certainty over the level of future return and stability in planned future Council Tax levels.

The Council will continue to look to diversify its investment portfolio and the 2016/17 Treasury Management Strategy provides for alternative investment funds should the opportunity arise.

Equalities Implications

There are no equalities implications arising as a direct consequence of this report.

Employment Issues

None within the report.

Sustainability Issues

None within the report.

Consultation

A number of meetings and telephone conversations were convened during the year involving Capita Asset Services Treasury Solutions, Members and Officers.

15. Background Papers

CIPFA Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes (2011 edition).

CIPFA Treasury Management in the Public Services – Guidance Notes for Local Authorities including Police Authorities and Fire Authorities (2011 edition).

CIPFA the Prudential Code for Capital Finance in Local Authorities (2013 edition).

Treasury Management Annual Strategy Report 2016-17 and Prudential Indicators 2016-17 to 2018-19.

Performance management information from Capita Asset Services Treasury Solutions.

2016/17 final accounts working papers.

Appendix A

1. PRUDENTIAL AND TREASURY MANAGEMENT INDICATORS AND COMPLIANCE ISSUES

1.1 The treasury management service is an important part of the overall financial management of the Council's affairs. Whilst the Prudential Indicators consider the affordability and impact of capital expenditure decisions, the treasury management service covers the effective funding of these decisions.

1.2 The 2003 Prudential Code for Capital Finance in Local Authorities requires that the actual position at year end for designated prudential indicators is reported after the year-end. The table below summarises the prudential indicator performance for 2016/17 for these indicators only.

1.3 The Council at its meeting on 23rd February 2016 adopted the following prudential indicators for 2016/17 (Estimate). (The full list of Prudential Indicators is set out at Appendix B.)

PRUDENTIAL INDICATORS

2015/16	PRUDENTIAL INDICATOR	2016/17	2016/17
Actual		**Estimate**	**Actual**
	CAPITAL EXPENDITURE / AFFORDABILITY		
	Capital Expenditure Plans– Prudential Indicator 1		
£000's		**£000's**	**£000's**
6,502	Capital Expenditure	30,837	17,509
6,502	**Total**	**30,837**	**17,509**
	Capital Financing Requirement (CFR) – Prudential Indicator 2		
£000's		**£000's**	**£000's**
2,676	Capital Financing Requirement	26,191	14,393
2,676	**Total**	**26,191**	**14,393**
	Ratio of Net Financing Costs to Net Revenue Stream – Prudential Indicator 3		
%		**%**	**%**
4.77	Ratio of Net Financing Costs to Net Revenue Stream	5.50	-3.00
4.77	**Total**	**5.50**	**-3.00**
	Incremental Impact of Capital Investment Decisions on the Band D Council Tax – Prudential Indicator 4		
£p		**£p**	**£p**
0.35	Increase in Council Tax (Band D) per annum	4.41	4.44
	Borrowing and the Capital Financing Requirement (CFR) – Prudential Indicator 5		
£000's		**£000's**	**£000's**
0	External Debt	26,100	10,000

Capital Financing Requirement (CFR)

1.4 The CFR is derived from the Authority's balance sheet and measures its underlying need to borrow for a capital purpose. Where capital expenditure is to be financed in future years by charges to revenue as assets are used by the Authority, the expenditure results in an increase in the Capital Financing Requirement, a measure of the capital expenditure incurred historically by the Authority that has yet to be finalised.

1.5 In accordance with best practice this Authority does not associate borrowing with particular items or types of expenditure, in day-to-day cash management no distinction can be made between capital cash and revenue cash. Any external borrowing would arise as a consequence on all financial transactions whereas this measure reflects the Authority's underlying need to borrow for a capital purpose only.

Net Borrowing and the CFR

1.6 In order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2016/17 plus the expected changes to the CFR over 2017/18 and 2018/19. Prudential Indicator 5 demonstrates the Council's compliance with this.

TREASURY MANAGEMENT INDICATORS

The Operational Boundary – <u>Prudential Indicator 6</u>

1.7 The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Operational Boundary is acceptable subject to the Authorised Limit not being exceeded. The Operational Boundary does not allow for additional headroom as is the case with the Authorised Limit. A limit of £30m was used for the Operational Boundary. The actual outturn was £11.7m of which £10m was for external borrowing and £1.7m for finance lease liabilities. (£2.8m in 2015/16 for finance lease liabilities. There was no external borrowing during 2015/16).

The Authorised Limit – <u>Prudential Indicator 7</u>

1.8 The Authorised Limit is the 'Affordable Borrowing Limit' required by S3 of the Local Government Act 2003 irrespective of the Authority's indebted status. The limit is the maximum amount of external debt that can be outstanding at any one time during the financial year. The Authorised Limit also provides some headroom for unexpected cash movements. The introduction of International Financial Reporting Standards (IFRS) required finance leases to be included under other long-term liabilities on the balance sheet. A limit of £35m was used for the Authorised Limit. The actual outturn was £11.7m of which £10m was for external borrowing and £1.7m for finance lease liabilities. (£2.8m in 2015/16 for finance lease liabilities. There was no external borrowing during 2015/16).

Actual financing costs as a proportion of net revenue stream

1.9 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.

1.10 In December 2016 the Authority borrowed £10m. Interest payable on this loan during 2016/17 was £80k.

Investment Activity

1.11 The purpose of the following indicators is to contain the activity of the treasury management function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates.

1.12 **Maximum principal sums invested > 364 days – <u>Prudential Indicator 8</u>**

Maximum principal sums invested > 364 days			
	2015/16 Actual	**2016/17 Estimate**	**2016/17 Actual**
Principal sums invested > 364 days	£6.0m	£12m	£5.9m

1.13 **Interest rate exposure – <u>Prudential Indicator 9</u>**

Interest rate exposures	**2015/16 Actual**	**2016/17 Estimate**	**2016/17 Actual**
	Upper	**Upper**	**Upper**
Limits on variable interest rates:			
• Debt only	0%	20%	0%
• Investments only	33%	40%	30%
Limits on fixed interest rates:			
• Debt only	0%	100%	100%
• Investments only	67%	100%	70%

1.14 **Maturity structure of fixed interest rate borrowing 2016/17**

– <u>Prudential Indicator 10</u>

	Maturity structure of fixed interest rate borrowing 2016/17			
	2016/17 Estimate		**2016/17 Actual**	
	Lower	**Upper**	**Lower**	**Upper**
Under 12 months	0%	25%	0%	0%
12 months to 2 years	0%	25%	0%	0%
2 years to 5 years	0%	25%	0%	0%
5 years to 10 years	0%	50%	0%	0%
10 years and above	0%	100%	0%	100%

Adoption of the CIPFA Treasury Management Code

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

1.16 The Council approved the adoption of the CIPFA Treasury Management Code at its full Council meeting on 20th January 2004.

1.17 The Council has incorporated the changes from the revised CIPFA Treasury Management Code of Practice into its treasury policies, procedures and practices. Council approved the revised Treasury Management Policy on 17th February 2015.

Appendix B

THE 10 PRUDENTIAL INDICATORS

The Indicators demonstrate overall control of capital expenditure and that the level of expenditure is sustainable and affordable. They are required by legislation to be set and approved before the start of the year, monitored during the year and reported on at year end.

They address:-

1. Plans for capital expenditure – the projected capital expenditure for each of the next three years and the source of funding.
2. Capital Financing Requirement – the anticipated need for borrowing where capital cannot be financed by existing resources.
3. Affordability indicator – the ratio of capital financing costs to the net revenue budget.
4. Affordability Indicator - the impact of capital investment decisions on Council Tax.
5. Comparison of borrowing estimate and capital financing requirement, to confirm that borrowing is intended for capital purposes only.
6. Operational Boundary for external debt – is based on the Authority's estimate of most likely - i.e. prudent, but not worst case scenario for external debt.
7. Authorised Limit for external debt – is the maximum amount of debt that the Authority can legally owe. The Authorised Limit provides headroom over and above the Operational Boundary for unusual cash movements.
8. To preserve liquidity, the maximum value of investments for more than one year.
9. To assess interest rate exposure, the upper limit on variable, as opposed to fixed, interest rate investments.
10. The maturity structure of fixed interest rate borrowing, to regulate the Council's exposure to large repayment requirements.