APPENDIX A

Treasury Management Performance Report 2016/17

Introduction

In February 2011 the Isle of Wight Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) which requires the Council to approve a treasury management annual report after the end of each financial year.

This report fulfils the council's legal obligation to have regard to the CIPFA Code.

The council's treasury management strategy for 2016/17 was approved at the full council meeting of Isle of Wight Council on 24 February 2016, as part of the overall budget and council tax setting. The Isle of Wight Council has borrowed and 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 council's treasury management strategy.

External Context

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 29 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%.

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 prereferendum 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 7,342 and 3,996 respectively on 31 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.

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 Isle of Wight Council'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 31 December 2015, 11 months out of date for most. As part of its creditworthiness research and advice, the council'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.

Local Context

On 31 March 2017, the council had net borrowing of £127.3m arising from its revenue and capital income and expenditure, a decrease on 2016 of £5.8m. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors and the year-on-year change are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.16 Actual £m	2016/17 Movement £m	31.3.17 Actual £m
General Fund CFR	275.3	25.2	300.5
Less: Other debt liabilities *	(86.7)	(11.2)	(97.9)
Borrowing CFR	**188.6**	**14.0**	**202.6**
Less: Usable reserves	(70.9)	(20.0)	(90.9)
Less: Working capital	15.4	0.2	15.6
Net borrowing	**133.1**	**(5.8)**	**127.3**

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt

Net borrowing has decreased due to an increase in the useable reserves following a recalculation of the minimum revenue provision.

The council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 31 March 2017 and the year-on-year change in show in table 2 below.

Table 2: Treasury Management Summary

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %
Long-term borrowing	117.9	19.4	**137.3**	4.35%
Short-term borrowing	40.5	(18.0)	**22.5**	0.52%
Total borrowing	**158.4**	**1.4**	**159.8**	**3.59%**
Short-term investments	25.3	7.2	**32.5**	0.27%
Total investments	**25.3**	**7.2**	**32.5**	**0.27%**
Net borrowing	**133.1**	**(5.8)**	**127.3**	**4.95%**

Note: the figures in the table are from the balance sheet in the council's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments

Due to the reduced cost of borrowing from PWLB it was decided to increase the long-term borrowing levels and reduce the short term borrowing. Due to timing differences some of the additional borrowing undertaken this year has been invested on a short-term basis.

Borrowing Activity

At 31 March 2017, the council held £159.8m of loans, a slight increase of £1.4m on the previous year, as part of its strategy for funding previous years' capital programmes. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %	31.3.17 WAM* years
Public Works Loan Board	107.9	24.4	132.3	4.51%	9.5
Banks (LOBO)	5.0	-	5.0	4.27%	17.7
Banks (fixed-term)	-	-	-	-	-
Local authorities (long-term)	-	-	-	-	-
Local authorities (short-term)	45.5	(23.0)	22.5	0.52%	0.8
Total borrowing	**158.4**	**1.4**	**159.8**	**3.97%**	**8.6**

*Weighted average maturity

The council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the council's long-term plans change being a secondary objective.

In furtherance of these objectives, new borrowings were taken out mainly to replace existing loans as they fell due during 2016/17. This strategy enabled the council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

The "cost of carry" analysis performed by the council's treasury management advisor Arlingclose did not indicate any value in borrowing in advance for future years' planned expenditure and therefore none was taken.

However, to enable certainty of cost to be achieved without suffering a cost of carry in the intervening period, the council arranged £10m of forward starting loans during 2016/17 with fixed interest rates of 0.65% for the delivery of cash in 1 years' time.

The council continues to holds £5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during 2016/17.

Other Debt Activity

Although not classed as borrowing, the council also raised £20m of capital finance for Highway Improvements via Private Finance Initiative during the 2016/17 financial year. Total debt other than borrowing stood at £97.8m on 31 March 2017, taking total debt to £257.6m.

Investment Activity

The council holds invested funds, representing income received in advance of expenditure plus balances and reserves held and money borrowed in advance of need. During 2016/17, the council's investment balance ranged between £22.0 and £63.1 million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change in show in table 4 below.

Table 4: Investment Position

	31.3.16 Balance £m	2016/17 Movement £m	31.3.17 Balance £m	31.3.17 Rate %	31.3.17 WAM* days
Banks & building societies (unsecured)	18.8	(14.8)	4	0.55%	1
Covered bonds (secured)	-	-	-	-	-
Government (incl. local authorities)	6.5	10	16.5	0.38%	146
Corporate bonds and loans	-	-	-	-	-
Money Market Funds	-	12	12	0.22%	1
Other Pooled Funds	-	-	-	-	-
Total investments	**25.3**	**7.2**	**32.5**	**0.34%**	**75**

*Weighted average maturity

Both the CIPFA Code and government guidance require the council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the council increased the value of investments with other local authorities. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 5 below.

Table 5: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2016	5.17	A+	74%	145	0.70%
30.06.2016	4.25	AA-	55%	54	0.56%
30.09.2016	4.52	A+	62%	111	0.49%
31.12.2016	3.85	AA-	42%	63	0.42%
31.03.2017	3.93	AA-	49%	75	0.34%
Similar LAs	**4.77**	**A+**	**65%**	**119**	**0.67%**
All LAs	**4.30**	**AA-**	**60%**	**47**	**0.61%**

*Weighted average maturity

Performance Report

The council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to forecast interest rates for new investments and borrowing, as shown in table 6 below.

Table 6: Performance

	Actual £m	Budget £m	Over/ under	Actual interest %	Forecast interest %	Over/ under
Total investment income	0.4	0.2	0.2	0.39%	0.25%	0.14%
Total cost of borrowing	(6.4)	(7.9)	1.5	2.11%	0.60%	(1.51%)
GRAND TOTAL	(6.0)	(7.7)	1.7	n/a	n/a	n/a

The council undertook new borrowing with PWLB to take advantage of lower long term interest rates. The amount borrowed was included in the strategy for 2016/17, but it was projected to be additional short term borrowing, at a much lower rate. Due to lower than anticipated borrowing overall, the increased cost of borrowing through PWLB did not negatively impact on the council's revenue budget.

Compliance Report

The Director of Finance & S151 Officer is pleased to report that all treasury management activities undertaken during 2016/17 complied fully with the CIPFA Code of Practice and the council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	2016/17 Maximum £m	31.3.17 Actual £m	2016/17 Limit £m	Complied
Any single organisation, except UK Government	4.0	4.0	4.0	✓
Any group of funds under the same management	4.0	4.0	4.0	✓
Investments held in a broker's nominee account	-	-	20.0	✓
Foreign countries	-	-	4.0	✓
Registered Providers	-	-	4.0	✓
Unsecured investments with Building Societies	4.0	4.0	4.0	✓
Loans to unrated corporates	-	-	4.0	✓
Money Market Funds	12.0	5.9	12.0	✓
Non-specified investments	**-**	-	**45.0**	✓

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 8: Debt Limits

	2016/17 Maximum £m	31.3.17 Actual £m	2016/17 Operational Boundary £m	2016/17 Authorised Limit £m	Complied
Borrowing	180.4	159.8	190	252	✓
PFI & finance leases	85.1	85.1	102	102	✓
Total debt	**265.5**	**244.9**	**292**	**354**	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Treasury Management Indicators

The council measures and manages its exposures to treasury management risks using the following indicators.

Security: The council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.3.17 Actual	2016/17 Limit	Complied
Portfolio average credit score	3.93	6.0	✓

Liquidity: The council addresses liquidity issues by restricting a significant proportion of its investment opportunities to short term and instant access deposits..

Interest Rate Exposures: This indicator is set to control the council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed was:

	31.3.17 Actual £m	2016/17 Limit £m	Complied
Upper limit on fixed interest rate exposure	143.9	226.0	✓
Upper limit on variable interest rate exposure	7.3	24.1	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

Maturity Structure of Borrowing: This indicator is set to control the council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

	31.3.17 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	19%	30%	0%	✓
12 months and within 24 months	3%	10%	0%	✓
24 months and within 5 years	11%	20%	0%	✓
5 years and within 10 years	22%	50%	0%	✓
10 years and above	45%	95%	0%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2016/17	2017/18	2018/19
Actual principal invested beyond year end	-	-	-
Limit on principal invested beyond year end	£35m	£41m	£38m
Complied	✓	✓	✓