Appendix 1

1. Introduction

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

The Council's Treasury Management Strategy for 2014/15 was approved by Full Council on 27th February 2014 which can be accessed on the Council's intranet.

The 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. This report covers treasury activity and the associated monitoring and control of risk.

2. External Context

Growth and Inflation: The robust pace of GDP growth of 3% in 2014 was underpinned by a buoyant services sector, supplemented by positive contributions from the production and construction sectors. Resurgent house prices, improved consumer confidence and healthy retail sales added to the positive outlook for the UK economy given the important role of the consumer in economic activity.

Annual CPI inflation fell to zero for the year to March 2015, down from 1.6% a year earlier. The key driver was the fall in the oil price and a steep drop in wholesale energy prices. The Bank of England expect CPI to temporarily turn negative but rebound around the end of 2015 as the lower prices dropped out of the annual rate calculation.

Labour Market: The UK labour market continued to improve and remains resilient across a broad base of measures including real rates of wage growth. January 2015 showed a headline employment rate of 73.3%, while the rate of unemployment fell to 5.7% from 7.2% a year earlier. Comparing the three months to January 2015 with a year earlier, employee pay increased by 1.8% including bonuses and by 1.6% excluding bonuses.

UK Monetary Policy: The Bank of England's MPC maintained interest rates at 0.5% and asset purchases (QE) at £375bn. The minutes of the MPC meetings reiterated the Committee's stance that the economic headwinds for the UK economy and the legacy of the financial crisis meant that increases in the Bank Rate would be gradual and limited, and below average historical levels.

Market reaction: From July, gilt yields were driven lower by a combination of factors: geo-political risks emanating from the Middle East and Ukraine, the slide towards deflation within the Eurozone and the big slide in the price of oil and its transmission though into lower prices globally. 5-, 10- and 20-year gilt yields fell to their lows in January (0.88%, 1.33% and 1.86% respectively) before ending the year higher at 1.19%, 1.57% and 2.14% respectively.

3. Local Context

At 31/03/2015 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £549.4m, while usable reserves and working capital which are the underlying resources available for investment were £257.3m.

At 31/03/2015, the Council had £342.3m of borrowing, being loans of £294.1 million and leases / PFI borrowings of £48.2 million. In addition there were £35.2 million of investments. The Council's current strategy is to maximise the use of internal borrowing and minimise investment balances, subject to ensuring sufficient liquidity to meet the Council's obligations, thereby reducing the need to borrow. Where borrowing is required, there is a preference for short term local Council sourced debt to minimise the cost.

The Council has an increasing CFR over the next 3 years due to the capital programme, but currently has limited investments and therefore is projected to be required to borrow up to £111 million (including refinancing maturing debt) over the forecast period.

4. Borrowing Strategy

At 31/03/2015 the Council held £294.1 million of loans, (a decrease of £13.1 million on 31/03/2014) as part of its strategy for funding previous years' capital programmes from internal borrowing.

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.

Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained, and are likely to remain at least over the forthcoming two years, lower than long-term rates, the Council determined it was more cost effective in the short-term to both to use internal resources and to borrow short-term loans instead. During 2014-15 there was no requirement to fund short term even for liquidity purposes.

The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with this 'cost of carry' and breakeven analysis. Although long term rates have modestly increased from their all time lows, there is insufficient clarity over the scale and timing of capital expenditure to justify additional borrowing at present.

Borrowing Activity in 2014/15

	Balance on 01/04/2014 £'000	Maturing Debt £'000	Debt Prematurely Repaid £'000	New Borrowing £'000	Balance on 31/03/2015 £'000	Avg Rate % and Avg Life (yrs)
CFR	543,849				549,387	
Short Term Borrowing[1]	0	0	0	0	0	
Long Term Borrowing	307,159	13,094	0	0	294,065	5.34% / 30.1yrs
TOTAL BORROWING	307,159	13,094	0	0	294,065	5.34% / 30.1yrs
Other Long Term Liabilities	54,414	6,196	0	0	48,218	n/a
TOTAL EXTERNAL DEBT	361,573	19,290	0	0	342,283	n/a
Increase/ (Decrease) in Borrowing £m					(19,290)	

LOBOs: The Council holds £125 million 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 Council 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. The rate of interest on these loans of 4.70% greatly exceeds current PWLB rates making it unlikely that there will be call in the immediate future.

5. Debt Rescheduling:

1 Loans with maturities less than 1 year.

The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

6. Abolition of the PWLB

In January 2015 the Department of Communities and Local Government confirmed that HM Treasury (HMT) would be taking the necessary steps to abolish the Public Works Loans Board (PWLB). HMT has confirmed however that its lending function will continue unaffected and local authorities will retain access to borrowing rates which offer good value for money. The Council intends to use the PWLB's replacement as a potential source of borrowing if required.

7. Investment Activity

The Council has held significant invested funds, representing income received in advance of expenditure plus working capital balances and revenue / capital reserves (prior year income not spent). During 2014/15 the Council's investment balances have ranged between £9.6 million and £86.5 million.

The Guidance on Local Government Investments gives priority to security and liquidity and the aim is to achieve a yield commensurate with these principles.

Investment Activity in 2014/15 (excluding Icelandic Deposits)

Investments	Balance on 01/04/2014 £'000	Investments Made £'000	Maturities/ Investments Sold £'000	Balance on 30/03/2015 £'000	Avg Rate/Yield (%)
Short term Investments (call accounts, deposits) - Banks & Building Societies with ratings of A- or higher	9,570	104,688	107,418	6,840	0.50
UK Government: - Deposits at Debt Management Office	0	572,390	560,190	12,200	0.25
Money Market Funds	0	255,390	239,200	16,190	0.38
TOTAL INVESTMENTS	9,570	932,468	906,808	35,230	0.36
Increase/ (Decrease) in Investments £m				25,660	

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.

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

8. Credit Risk

Throughout 2014-15 credit risk scores have been reported to Committee based on a methodology devised by Arlingclose. The scores show credit risk on a scale of 0 to 10 on both a value weighted and a time weighted basis and the table below demonstrates how to interpret the scores:

Above target	AAA to AA+	Score under 3
Target score	AA to A+	Score 3-5
Below target	Below A+	Score over 5

The scores during 2014-15 are shown below:

	June 2014	September 2014	December 2014	March 2015
Value weighted	4.42	3.73	4.68	3.57
Time weighted	4.92	4.23	4.33	2.70

The year end scores (March 2015) are in line or marginally better that the target credit ratings due to the concentration on investments with the Government rated DMO and also highly diversified money market funds.

9. Counterparty Update

The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on April 15, 2014. Taking the view that potential extraordinary government support available to banks' senior unsecured bondholders will likely diminish, over 2014-15 Moody's revised the Outlook of several UK and EU banks from Stable to Negative (note, this is not the same as a rating review negative) and S&P placed the ratings of UK and German banks on Credit Watch with negative implications, following these countries' early adoption of the bail-in regime in the BRRD.

S&P also revised the Outlook for major Canadian banks to negative following the government's announcement of a potential bail-in policy framework.

The Bank of England published its approach to bank resolution which gave an indication of how the reduction of a failing bank's liabilities might work in practice. The Bank of England will act if, in its opinion, a bank is failing, or is likely to fail, and there is not likely to be a successful private sector solution such as a takeover or share issue; a bank does not need to be technically insolvent (with liabilities exceeding assets) before regulatory intervention such as a bail-in takes place.

The combined effect of the BRRD and the UK's Deposit Guarantee Scheme Directive (DGSD) is to promote deposits of individuals and SMEs above those of public authorities, large corporates and financial institutions. Other EU countries, and eventually all other developed countries, are expected to adopt similar approaches in due course.

In December the Bank's Prudential Regulation Council (PRA) stress tested eight UK financial institutions to assess their resilience to a very severe housing market shock and to a sharp rise in interest rates and address the risks to the UK's financial stability. Institutions which 'passed' the tests but would be at risk in the event of a 'severe economic downturn' were Lloyds Banking Group and Royal Bank of Scotland. Lloyds Banking Group, whose constituent banks (Lloyds and Bank of Scotland) are on the Council's lending list, is taking measures to augment capital and the PRA does not require the group to submit a revised capital plan. RBS, which is not on the Council's lending list for investments, has updated plans to issue additional Tier 1 capital. The Co-operative Bank failed the test.

In October following sharp movements in market signals driven by deteriorating global growth prospects, Arlingclose advised a reduction in investment duration limits for unsecured bank and building society investments to counter the risk of another full-blown Eurozone crisis. Duration for new unsecured investments with some UK institutions was further reduced to 100 days in February 2015.

The outlawing of bail-outs, the introduction of bail-ins, and the preference being given to large numbers of depositors other than local authorities means that the risks of making unsecured deposits rose relative to other investment options. As a consequence the Council's 2015-16 strategy incorporated selected high quality overseas banks and additional UK names that meet the minimum credit quality. Further attention is also being given to diversified pooled funds that would not be significantly impacted by the failure of a single counterparty.

There was one significant change in credit rating during the year impacting on RBS whose long term rating dropped below the minimum of A-. RBS / NatWest have been removed from the counterparty list. The Council moved its banking arrangement from RBS to Barclays from September 2013.

10. Budgeted Income and Outturn

The average cash balances in 2014-15 were £44.5 million. The UK Bank Rate has been maintained at 0.5% since March 2009. Short-term money market rates have remained at relatively low levels. New deposits were made at an average rate of 0.36%. The Council's budgeted investment income for the year was £140,000. The Council's investment outturn for the year was £168,000.

At the end of the financial year the average interest payable on the borrowing portfolio payable had fallen marginally to 5.33% from 5.45% as at 1 April 2014. The loans maturing in the year carried an average interest rate of 9.5%. The interest paid in 2014-15 of £16.3 million is £1.6 million lower than the previous year. Looking forward, there is £44 million of debt with a coupon of 9-11% maturing by 2022 that offers further scope for savings.

11. Update on Investments with Icelandic Banks

To date distributions from the failed Icelandic Banks amount to £34.8 million compared with the original deposits of £36.9 million. Future recoveries are estimated at £1.2 million. A distribution from Heritable Bank of £0.8 million payable August 2015 has recently been announced.

12. Treasury Management Indicators

Adoption of the CIPFA Treasury Management Code of Practice is one of the Prudential Indicators. The Council originally adopted the Code of Practice in May 2002. Revisions to the Code in 2009 and 2011 have been reflected in updated versions of all policies and procedures. The Council measures and manages its exposures to treasury management risks using the indicators set out in Annex 1.

13. Prudential Indicators 2014/15

The Local Government Act 2003 requires the Council to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the indicators that must be set and monitored each year.

The Council has complied with its Prudential Indicators for 2014/15, which were set in February 2014 as part of the Council's approved Treasury Management Strategy

Statement. These are detailed within Annex 2. Borrowing is well within the operational and authorised limits and has steadily decreased throughout the year in line with the policy of using internal cash balances to fund the capital programme.

14. Investment Training

Members of the Corporate Committee and the Overview and Scrutiny Committee undertook training during January 2015 in advance of approving the 2015-16 treasury management strategy.

Annex 1: Summary of Treasury Management Activity and Performance

1. Treasury Portfolio

	Position March 2015 £000	Position December 2014 £000	Position September 2014 £000	Position June 2014 £000
Long Term Borrowing PWLB	169,065	169,065	181,675	181,675
Long Term Borrowing Market	125,000	125,000	125,000	125,000
Total Borrowing	294,065	294,065	306,675	306,675
Investments: Council	35,230	9,590	35,280	66,370
Investments: Icelandic deposits in default	2,177	2,177	2,177	2,177
Total Investments	37,407	11,767	37,457	68,547
Net Borrowing position	256,658	282,268	269,218	238,128

2. Security measure

	Quarter 4 2014/15 (march 15)	Quarter 3 2014/15	Quarter 2 2014/15	Quarter 1 2014/15
Credit score – Value weighted	3.57	4.68	3.73	4.42
Credit score – Time weighted	2.70	4.33	4.23	4.92

3. Liquidity measure

	Quarter 4 2014/15	Quarter 3 2014/15	Quarter 2 2014/15	Quarter 1 2014/15
Weighted average maturity: deposits (days)	1.9	1.0	5.7	2.5
Weighted average maturity: borrowing (years)	30.1	30.1	29.1	29.7

4. Yield measure

	Quarter 4 2014/15	Quarter 3 2014/15	Quarter 2 2014/15	Quarter 1 2014/15
Interest rate earned	0.36	0.34	0.34	0.33
Interest rate payable	5.33	5.39	5.41	5.34

Annex 2: Prudential Indicators

The Prudential indicators are designed to demonstrate the affordability of current and forecast borrowing. There is no ‘correct’ value in each table and the trend is at least as important as the absolute numbers. Debt is used to finance the capital programme and each decision to incur capital expenditure will consider how it is to be funded.

	Prudential Indicator	2014/15 Original Indicator	Position/Actual at 31/3/2015
CAPITAL INDICATORS			
1	Capital Expenditure	£’000	£’000
	General Fund	46,563	64,049
	HRA	63,310	40,997
	TOTAL	109,873	105,046

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 tax and housing rent levels. Capital expenditure is lower than projected, which helps explain the decrease in borrowing.

2	Ratio of financing costs to net revenue stream	2014/15 Original Indicator	Actual as at 31 March 2015
	General Fund	2.16%	1.89%
	HRA	11.13%	10.01%

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, net of investment income.

The indicators show that interest costs have used a marginally lower proportion of council income than initially projected.

3	Capital Financing Requirement	2014/15 Original Indicator (£'000)	Actual as at 31 March 2015 (£'000)
	General Fund	281,727	278,291
	HRA	271,096	271,096
	TOTAL	552,823	549,387

The above is the maximum external borrowing requirement representing the remaining cost of capital expenditure. The out-turn is in line with the start of year projections.

4	**Incremental impact of capital investment decisions**	**2014/15 Original Indicator (£)**	**Actual as at 31 March 2015 (£)**
	Band D Council Tax	17.19	16.02
	Weekly Housing rents	0.17	0.09

This is an indicator of affordability and shows the impact of capital investment decisions on Council tax and housing rent levels. Both indicators are a little better than originally projected due to lower capital expenditure and more of what was spent being funded from grants, thereby reducing the need for borrowing.

	Prudential Indicator	2014/15 Original Indicator		2014/15 Position/Actual at 31/3/2015
TREASURY MANAGEMENT LIMITS				
5	Borrowing Limits	£'000		£'000
	Authorised Limit	561,079		342.283
	Operational Boundary	425,844		342,283
Actual borrowing is considerably lower than the limit set for the year.				
6	HRA Debt Cap	£'000		£'000
	Headroom	55,824		56,442
The capacity of HRA to incur additional borrowing is in line with projections.				
7	Gross debt compared to CFR	£'000		£'000
	Gross Debt	392,588		342,283
	CFR	552,823		549,387
		72%		62%
Gross debt is less than previous projections due to use of internal balances to finance capital expenditure.				
8	Upper limit – fixed rate exposure	100%		98%
	Upper limit – variable rate exposure	40%		2%
With no new borrowing in the year, the vast majority of debt remains fixed rate.				
9	Maturity structure of borrowing (U: upper, L: lower)	L	U	**As at 31 March 2015**
	under 12 months	0%	40%	3.7%
	12 months & within 2 years	0%	35%	4.3%
	2 years & within 5 years	0%	35%	11.4%
	5 years & within 10 years	0%	35%	13.1%
	10 yrs & within 20 yrs	0%	35%	0.0%
	20 yrs & within 30 yrs	0%	35%	7.5%
	30 yrs & within 40 yrs	0%	35%	21.8%
	40 yrs & within 50 yrs	0%	50%	12.7%
	50 yrs & above	0%	50%	25.5%
The maturity profile of debt is shown above. The ranges set have been complied with and there is a spread of maturities.				

	Prudential Indicator	2014/15	2014/15

		Original Indicator	Position/Actual at 31/3/2015
10	Sums invested for more than 364 days	£0	£0
11	Adoption of CIPFA Treasury Management Code of Practice	√	√

12 LOBO Adjusted Maturity Structure for Debt			
Maturity structure of borrowing (U: upper, L: lower)	L	U	**As at 31st March 2015**
under 12 months	0%	55%	46.2%
12 months & within 2 years	0%	40%	4.3%
2 years & within 5 years	0%	40%	11.4%
5 years & within 10 years	0%	35%	13.1%
10 yrs & within 20 yrs	0%	35%	0.0%
20 yrs & within 30 yrs	0%	35%	4.1%
30 yrs & within 40 yrs	0%	35%	8.2%
40 yrs & within 50 yrs	0%	50%	12.7%
50 yrs & above	0%	50%	0%

The above table restates table 9 showing the earliest data on which the interest rate on LOBO loans (see 14.3) can change as the maturity date. The impact is to restate 40% of debt previously classified as between 20 years and 50+ years to less than one year. As discussed on page 3, the interest rate on LOBO loans is higher than current rates for new borrowing and as a consequence should the lender try to change the rate, the Council can repay with no penalty and refinance at a considerable interest saving.