Annual Treasury Outturn Report 2015/16

1. Introduction

1.1. 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).

1.2. The Authority's Treasury Management Strategy for 2015/16, which can be accessed on the Council's website, was approved by Full Council on 23 February 2015.

1.3. The Authority 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

2.1. **Growth, Inflation, Employment:** The UK economy slowed in 2015 with GDP growth falling to 2.3% from a robust 3.0% the year before. CPI inflation hovered around 0.0% through 2015 with deflationary spells in April, September and October. The prolonged spell of low inflation was attributed to the continued collapse in the price of oil from $67 a barrel in May 2015 to just under $28 a barrel in January 2016, the appreciation of sterling since 2013 pushing down import prices and weaker than anticipated wage growth resulting in subdued unit labour costs. CPI picked up to 0.3% year on year in February 2016, but this was still well below the Bank of England's 2% inflation target.

2.2. The labour market continued to improve through 2015 and in Q1 2016, the latest figures (Jan 2016) showing the employment rate at 74.1% (the highest rate since comparable records began in 1971) and the unemployment rate at a 12 year low of 5.1%. Wage growth has however remained modest at around 2.2% excluding bonuses, but after a long period of negative real wage growth (i.e. after inflation) real earnings were positive and growing at their fastest rate in eight years, boosting consumers' spending power.

2.3. **Global influences**: The slowdown in the Chinese economy became the largest threat to the South East Asian region, particularly on economies with a large trade dependency on China and also to prospects for global growth as a whole. The effect of the Chinese authorities' intervention in their currency and equity markets was temporary and led to high market volatility as a consequence. There were falls in prices of equities and risky assets and a widening in corporate credit spreads. As the global economy entered 2016 there was high uncertainty about growth, the outcome of the US presidential election and the consequences of June's referendum on whether the UK is to remain in the EU. Between February and March 2016 sterling had depreciated by around 3%, a significant proportion of the decline reflecting the uncertainty surrounding the referendum result.

2.4. **UK Monetary Policy:** The Bank of England's MPC (Monetary Policy Committee) made no change to policy, maintaining the Bank Rate at 0.5% (in March it entered its eighth year at 0.5%) and asset purchases (Quantitative Easing) at £375bn. In its *Inflation Reports* and monthly monetary policy meeting minutes, the Bank was at pains to stress and reiterate that when interest rates do begin to rise they were expected to do so more gradually and to a lower level than in recent cycles.

2.5. Improvement in household spending, business fixed investment, a strong housing sector and solid employment gains in the US allowed the Federal Reserve to raise rates in December 2015 for the first time in nine years to take the new Federal funds range to 0.25%-0.50%. Despite signalling four further rate hikes in 2016, the Fed chose not to increase rates further in Q1 and markets pared back expectations to no more than two further hikes this year.

2.6. However central bankers in the Eurozone, Switzerland, Sweden and Japan were forced to take policy rates into negative territory. The European Central Bank also announced a range of measures to inject sustained economic recovery and boost domestic inflation which included an increase in asset purchases (Quantitative Easing).

2.7. **Market reaction**: From June 2015 gilt yields were driven lower by the a weakening in Chinese growth, the knock-on effects of the fall in its stock market, the continuing fall in the price of oil and commodities and acceptance of diminishing effectiveness of central bankers' unconventional policy actions. Added to this was the heightened uncertainty surrounding the outcome of the UK referendum on its continued membership of the EU as well as the US presidential elections which culminated in a significant volatility and in equities and corporate bond yields.

2.8. 10-year gilt yields moved from 1.58% on 31/03/2015 to a high of 2.19% in June before falling back and ending the financial year at 1.42%. The pattern for 20-year gilts was similar, the yield rose from 2.15% in March 2015 to a high of 2.71% in June before falling back to 2.14% in March 2016. The FTSE All Share Index fell 7.3% from 3664 to 3395 and the MSCI World Index fell 5.3% from 1741 to 1648 over the 12 months to 31 March 2016.

3. Local Context

3.1. At 31/03/2016, the Authority's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £548m, while usable reserves and working capital which are the underlying resources available for investment were £93.10m.

3.2. At 31/03/2016, the Authority had £283.2m of borrowing and £17.6m of investments. The Authority's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

3.3. The Authority has an increasing CFR over the next 3 years as the Council implements its capital strategy. This will require some borrowing hence the reason the CFR is projected to increase over the next 3 years and beyond.

4. Borrowing Strategy

4.1. At 31/03/2016 the Authority held £283.3m of loans, (a decrease of £10.83m on 31/03/2015) as part of its strategy for funding previous years' capital programmes.

4.2. The Authority'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 Authority's long-term plans change being a secondary objective.

4.3. Affordability and the "cost of carry" remained important influences on the Authority'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 Authority determined it was more cost effective in the short-term to use internal resources / borrow short-term loans instead.

4.4. 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 Authority with this 'cost of carry' and breakeven analysis.

4.5. Temporary and short-dated loans borrowed from the markets, predominantly from other local authorities, also remained affordable and attractive. £59.7m of such loans were borrowed at an average rate of 0.50% and an average life of 1 month which includes the replacement of maturing loans.

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Borrowing Activity in 2015/16

	Balance on 01/04/2015 £'000	Maturing Debt £'000	Debt Prematurely Repaid £'000	New Borrowing £'000	Balance on 31/03/2016 £'000	Avg Rate % and Avg Life (yrs)
Capital Financing Requirement (CFR)	549,387				548,015	
Short Term Borrowing[1]	0	30,700	0	59,700	29,000	0.50% - 1 month
Long Term Borrowing	294,065	10,832	0	0	283,233	5.19% / 27.5 yrs
TOTAL BORROWING	294,065	41,532	0	59,700	312,233	5.19% / 27.5 yrs
Other Long Term Liabilities	48,218	3,198	0	0	45,020	n/a
TOTAL EXTERNAL DEBT	342,283	44,730	0	59,700	357,253	n/a
Increase/ (Decrease) in Borrowing £m					14,970	

4.6. **LOBOs:** The Authority holds £125m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. All of these LOBOS loans 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.

4.7. **LGA Bond Agency**: UK Municipal Bonds Agency (MBA) plc was established in 2014 by the Local Government Association as an alternative to the PWLB with plans to issue bonds on the capital markets and lend the proceeds to local authorities. In early 2016 the Agency declared itself open for business, initially only to English local authorities. The Authority has analysed the potential rewards and risks of borrowing from the MBA although is yet to approve and sign the Municipal Bond Agencies framework agreement which sets out the terms upon which local authorities will borrow, including details of the joint and several guarantee.

5. Debt Rescheduling:

5.1. The PWLB continued to operate a spread of approximately 1% between "premature repayment rate" and "new loan" rates so the premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Authority's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

[1] Loans with maturities less than 1 year.

6. Investment Activity

6.1. The Authority has held significant invested funds, representing income received in advance of expenditure plus balances and reserves held. Details of investments held and realised during 2015/16 are set out below.

6.2. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

Investment Activity in 2015/16

Investments	Balance on 01/04/2015 £'000	Investments Made £'000	Maturities/ Investments Sold £'000	Balance on 31/03/2016 £'000	Avg Rate/Yield (%)
Short term Investments (call accounts, deposits) - Banks & Building Societies with ratings of A- or higher	6,840	132,387	129,227	10,000	0.49
UK Government: - Deposits at Debt Management Office	12,200	706,789	718,989	0	0.25
Money Market Funds	16,190	270,595	279,185	7,600	0.44
TOTAL INVESTMENTS	35,230	1,109,771	1,127,401	17,600	0.32
Increase/ (Decrease) in Investments £m				(17,630)	

6.3. Security of capital has remained the Authority's main investment objective. This has been maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement for 2015/16.

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

6.5. The authority will also consider the use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

7. Credit Risk

7.1 Counterparty credit quality as measured by credit ratings is summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/2015	3.57	AA-	2.70	AA
30/06/2015	4.39	AA-	5.30	A+
30/09/2015	4.02	AA-	3.55	AA-
31/12/2015	3.33	AA-	3.22	AA-
31/03/2016	2.61	AA	2.33	AA+

8. Counterparty Update

8.1. The transposition of two European Union directives into UK legislation placed the burden of rescuing failing EU banks disproportionately onto unsecured institutional investors which include local authorities and pension funds. During the year, all three credit ratings agencies reviewed their ratings to reflect the loss of government support for most financial institutions and the potential for loss given default as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions saw upgrades due to an improvement in their underlying strength and an assessment that that the level of loss given default is low.

8.2. Fitch reviewed the credit ratings of multiple institutions in May. Most UK banks had their support rating revised from 1 (denoting an extremely high probability of support) to 5 (denoting external support cannot be relied upon). This resulted in the downgrade of the long-term ratings of Royal Bank of Scotland (RBS), Deutsche Bank, Bank Nederlandse Gemeeten and ING. JP Morgan Chase and the Lloyds Banking Group however both received one notch upgrades.

8.3. Moody's concluded its review in June and upgraded the long-term ratings of Close Brothers, Standard Chartered Bank, ING Bank, Goldman Sachs International, HSBC, RBS, Coventry Building Society, Leeds Building Society, Nationwide Building Society, Svenska Handelsbanken and Landesbank Hessen-Thuringen.

8.4. S&P reviewed UK and German banks in June, downgrading the long-term ratings of Barclays, RBS and Deutsche Bank.

8.5. At the end of July 2015, Arlingclose advised an extension of recommended durations for unsecured investments in certain UK and European institutions following improvements in the global economic situation and the receding threat of another Eurozone crisis. A similar extension was advised for some non-European banks in

September, with the Danish Danske Bank being added as a new recommended counterparty and certain non-rated UK building societies also being extended.

8.6. In December the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies which showed that the Royal Bank of Scotland and Standard Chartered Bank were the weakest performers. However, the regulator did not require either bank to submit revised capital plans, since both firms had already improved their ratios over the year.

8.7. In January 2016, Arlingclose supplemented its existing investment advice with a counterparty list of high quality bond issuers, including recommended cash and duration limits. As part of this, Bank Nederlandse Gemeeten was moved to the list of bond issuers from the unsecured bank lending list and assigned an increased recommended duration limit of 5 years.

8.8. The first quarter of 2016 was characterised by financial market volatility and a weakening outlook for global economic growth. In March 2016, following the publication of many banks' 2015 full-year results, Arlingclose advised the suspension of Deutsche Bank and Standard Chartered Bank from the counterparty list for unsecured investments. Both banks recorded large losses and despite improving capital adequacy this will call 2016 performance into question, especially if market volatility continues. Standard Chartered had seen various rating actions taken against it by the rating agencies and a rising CDS level throughout the year. Arlingclose will continue to monitor both banks.

9. Budgeted Income and Outturn

9.1. The average cash balances were £64m during the year. The UK Bank Base 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%. Investments in Money Market Funds generated an average rate of 0.44%.

9.2. The Authority's budgeted investment income for the year was £0.136m. The Authority's investment outturn for the year was £0.202m (0.36%).

10. Update on Investments with Icelandic Banks

10.1. To date distributions from the failed Icelandic Banks amount to £37.0 million compared with the original deposits of £36.9 million. The government of Iceland have announced a final auction of deposits held in escrow. The Council has given notice that it intends to participate in the auction where the remainder of the Council's money that is held in escrow would likely be returned. The final amount that will be paid to the Council will depend on the level of participation in the auction – the more participants that take part, the more favourable the exchange rate will be. It is estimated that the Council will receive between £0.43m and £0.48m. This should bring to a close the Icelandic bank saga and the Council would have recovered all of the principal invested with some interest.

11. Treasury Management Indicators

11.1 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 Appendix 1.

12. Prudential Indicators 2015/16

12.1. 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.

12.2. Appendix 1 sets out how the Council has performed against all prudential and treasury indicators.

13. Investment Training

13.1. Members of the Corporate Committee and the Overview and Scrutiny Committee undertook training during January 2016 in advance of approving the 2015-16 treasury management strategy.

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Appendix 1

Summary of Treasury Management Activity and Performance

1. Treasury Portfolio

	Position March 2016 £000	Position December 2015 £000	Position September 2015 £000	Position June 2015 £000
Long Term Borrowing PWLB Long Term Borrowing Market	158,233 125,000	163.600 125,000	163,740 125,000	165,010 125,000
Total Borrowing	283,233	288,600	288,740	294,065
Investments: Council Investments: Icelandic deposits in default	17,600 492	30,903 1,385	52,803 1,385	63,883 2,177
Total Investments	18,092	32,288	54,188	66,060
Net Borrowing position	265,141	256,312	234,552	223,950

2. Security measure

	Quarter 4 2015/16	Quarter 3 2015/16	Quarter 2 2015/16	Quarter 1 2015/16
Credit score – Value weighted	2.61	3.33	4.02	4.39
Credit score – Time weighted	2.33	3.22	3.55	5.60

3. Liquidity measure

	Quarter 4 2015/16	Quarter 3 2015/16	Quarter 2 2015/16	Quarter 1 2015/16
Weighted average maturity: deposits (days)	11	16	16.0	12.0
Weighted average maturity: borrowing (years)	31	31	30.2	29.9

4. Yield measure

	Quarter 4 2015/16	Quarter 3 2015/16	Quarter 2 2015/16	Quarter 1 2015/16
Interest rate earned	0.45	0.43	0.46	0.41
Interest rate payable	5.29	5.29	5.29	5.27

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	**2015/16 Original Indicator**	**Position/Actual at 31/3/2016**
CAPITAL INDICATORS			
1	Capital Expenditure	£'000	£'000
	General Fund	54,568	44,571
	HRA	92,074	96,436
	TOTAL	146,642	141,007

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**	**2015/16 Original Indicator**	**Actual as at 31 March 2016**
	General Fund	1.90%	1.85%
	HRA	9.28%	9.02%

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**	**2015/16 Original Indicator (£'000)**	**Actual as at 31 March 2016 (£'000)**
	General Fund	297,121	276,919
	HRA	292,666	271,096
	TOTAL	589,787	548,015

The above is the maximum external borrowing requirement representing the remaining cost of capital expenditure. The outturn is less than projected at the start of the year due to most capital projects being funded from sources other than borrowing.

4	**Incremental impact of capital investment decisions**	**2015/16 Original Indicator (£)**	**Actual as at 31 March 2016 (£)**
	Band D Council Tax	34.03	10.03
	Weekly Housing rents	2.27	0.42

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		2015/16 Original Indicator	2015/16 Position/Actual at 31/3/2015
TREASURY MANAGEMENT LIMITS				
5	Borrowing Limits		£'000	£'000
	Authorised Limit		503,532	503,532
	Operational Boundary		447,867	447,867
Actual borrowing is considerably lower than the limit set for the year.				
6	HRA Debt Cap		£'000	£'000
	Headroom		44,235	65,805
The capacity of HRA to incur additional borrowing has improved due to lack of borrowing to fund capital projects in 2015/16.				
7	Gross debt compared to CFR		£'000	£'000
	Gross Debt		342,283	357,253
	CFR		549,387	548,015
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 2016**
	under 12 months	0%	40%	4.10%
	12 months & within 2 years	0%	35%	4.34%
	2 years & within 5 years	0%	35%	10.20%
	5 years & within 10 years	0%	35%	11.24%
	10 yrs & within 20 yrs	0%	35%	4.27%
	20 yrs & within 30 yrs	0%	35%	0%
	30 yrs & within 40 yrs	0%	35%	29.79%
	40 yrs & within 50 yrs	0%	50%	9.57%
	50 yrs & above	0%	50%	26.48%
The maturity profile of debt is shown above. The ranges set have been complied with and there is a spread of maturities.				
	Prudential Indicator		**2015/16**	**2015/16**

		Original Indicator	Position/Actual at 31/3/2016
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 2016**
under 12 months	0%	55%	48.24%
12 months & within 2 years	0%	40%	4.34%
2 years & within 5 years	0%	40%	10.20%
5 years & within 10 years	0%	35%	11.24%
10 yrs & within 20 yrs	0%	35%	4.27%
20 yrs & within 30 yrs	0%	35%	0%
30 yrs & within 40 yrs	0%	35%	12.14%
40 yrs & within 50 yrs	0%	50%	9.57%
50 yrs & above	0%	50%	0%

The above table restates table 9 showing the earliest date on which the interest rate on LOBO loans can change as well as the maturity date. The impact is to restate approximately 44% of debt previously classified as between 30 years and 50+ years to less than one year. As discussed on , 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.