ANNUAL TREASURY MANAGEMENT REPORT 2014/15

Cabinet – 17 September 2015

Report of the:	Chief Finance Officer
Status:	For recommendation to Cabinet
Also considered by:	Finance Advisory Committee – 1 September 2015
Key Decision:	No

Executive Summary: This report provides the customary review of investment activity during 2014/15 as required by the Council's Financial Procedure Rules. The report outlines the strategy adopted during the year, shows the position of the investment portfolio at the beginning and the end of the year and gives details of how the fund performed in comparison with previous years and against various benchmarks.

This report supports the Key Aim of Effective Management of Council Resources.

Portfolio Holder Cllr. Searles

Contact Officer Roy Parsons, Principal Accountant - Ext 7204

Recommendation to Finance Advisory Committee: That Cabinet be asked to approve the Annual Treasury Management Report for 2014/15.

Recommendation to Cabinet: It be RESOLVED that the Annual Treasury Management Report for 2014/15 be approved.

Reason for recommendation: As required by both the Council's Financial Procedure Rules and the CIPFA Code, an annual report of treasury management activity is to be presented to Members for approval.

Background

1 The Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the actual prudential and treasury indicators for 2014/15. This report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

2 During 2014/15 the minimum reporting requirements were that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 18/2/2014)
- a mid year (minimum) treasury update report (Finance and Resources Advisory Committee 11/11/14, Cabinet 13/11/14)
- an annual report following the year describing the activity compared to the strategy (this report)

3 In addition, regular reports on progress were presented to the predecessor of this Committee, the Finance and Resources Advisory Committee. The Council's treasury management advisers, Capita Asset Services Ltd, also provided monthly reviews of our investment performance which were forwarded to Members.

4 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

5 This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to treasury management reports before they were reported to the full Council. Member training on treasury management issues was undertaken on 27 January 2010 in order to support Members' scrutiny role.

6 Members will be aware of the Property Investment Strategy which commenced in the latter part of 2014/15. The use of surplus cash balances for this type of 'Policy Investment' does not form part of the treasury management strategy and is not required to be included in either the Treasury Management Strategy Statement or the Annual Investment Strategy.

Introduction

7 This **annual treasury report** covers:

(a) The Council's treasury position at the beginning and end of the financial year;

(b) Investment Strategy for 2014/15;

(c) the economy and interest rates in 2014/15;

(d) compliance with treasury limits and prudential indicators;

(e) investment rates in 2014/15;

(f) investment outturn for 2014/15 and performance; and

(g) Icelandic bank defaults and Municipal Bonds Agency

Treasury position at the beginning and end of the financial year

8 The Council's investment portfolio at the beginning and end of the financial year appears at Appendix A, whilst an analysis by maturity and repayment due dates appears at Appendix B.

Investment Strategy for 2014/15

9 The expectation for interest rates within the strategy for 2014/15 anticipated low but rising Bank Rate (starting in quarter 1 of 2015), and gradual rises in medium and longer term fixed borrowing rates during 2014/15. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

10 In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

11 The actual movement in gilt yields meant that Public Works Loan Board (PWLB) rates saw little overall change during the first four months of the year but there was then a downward trend for the rest of the year with a partial reversal during February.

12 The strategy adopted in the original Treasury Management Strategy Report for 2014/15, approved by the Council on 18 February 2014, was subject to a minor revision during the year to allow investment in one non-UK institution, Svenska Handelsbanken AB.

13 Counterparty credit ratings were kept under constant review to ensure that any investment decisions met minimum lending requirements.

The economy and interest rates in 2014/15

14 The original market expectation at the beginning of 2014/15 was for the first increase in Bank Rate to occur in quarter 1 of 2015 as the unemployment rate had fallen much faster than expected through the Bank of England’s initial forward guidance target of 7%. In May, however, the Bank revised its forward guidance. A combination of very weak pay rises and inflation above the rate of pay rises meant that consumer disposable income was still being eroded and in August the Bank halved its forecast for pay inflation in 2014 from 2.5% to 1.25%. Expectations for the first increase in Bank Rate therefore started to recede as growth was still heavily dependent on buoyant consumer demand.

15 During the second half of 2014 financial markets were caught out by a halving of the oil price and the collapse of the peg between the Swiss franc and the Euro. Fears also increased considerably that the European Central Bank (ECB) was going to do too little too late to ward off the threat of deflation and recession in the Eurozone. In mid-October, financial markets had a major panic for about a week. By the end of 2014, it was clear that inflation in the UK was going to head towards zero in 2015 and, possibly, even turn negative. In turn, this made it clear that the Bank of England’s Monetary Policy Committee (MPC) would have great difficulty in starting to raise Bank Rate in 2015 while inflation was around zero and so market expectations for the first increase receded back to around quarter 3 of 2016.

16 Gilt yields were on a falling trend for much of the last eight months of 2014/15 but were then pulled in different directions by increasing fears after the anti-

austerity parties won power in Greece in January; developments since then have increased fears that Greece could be heading for an exit from the euro. While the direct effects of this would be manageable by the EU and ECB, it is very hard to quantify quite what the potential knock on effects would be on other countries in the Eurozone (EZ) once the so called impossibility of a country leaving the EZ had been disproved.

17 Another downward pressure on gilt yields was the announcement in January that the ECB would start a major programme of quantitative easing, purchasing EZ government and other debt in March. On the other hand, strong growth in the US caused an increase in confidence that the US was well on the way to making a full recovery from the financial crash and would be the first country to start increasing its central rate, probably by the end of 2015. The UK would be closely following it due to strong growth over both 2013 and 2014 and good prospects for a continuation into 2015 and beyond. However, there was also an increase in concerns around political risk from the general election due in May 2015.

Compliance with treasury limits and prudential indicators

18 During 2014/15, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

	2013/14 Actual (£000)	2014/15 Original (£000)	2014/15 Actual (£000)
Capital expenditure	2,114	1,207	4,263
Total Capital Financing Requirement:			
• Non-HRA	-	-	-
• HRA	-	-	-
• Total	-	-	-
Net borrowing	-	-	-
External debt	-	-	-
Investments:			
• Longer than 1 year	-		-
• Under 1 year	33,050		37,801
• Total	33,050		37,801

19 The investment figures relate to the time left to maturity, not the length at the commencement date and exclude accrued interest.

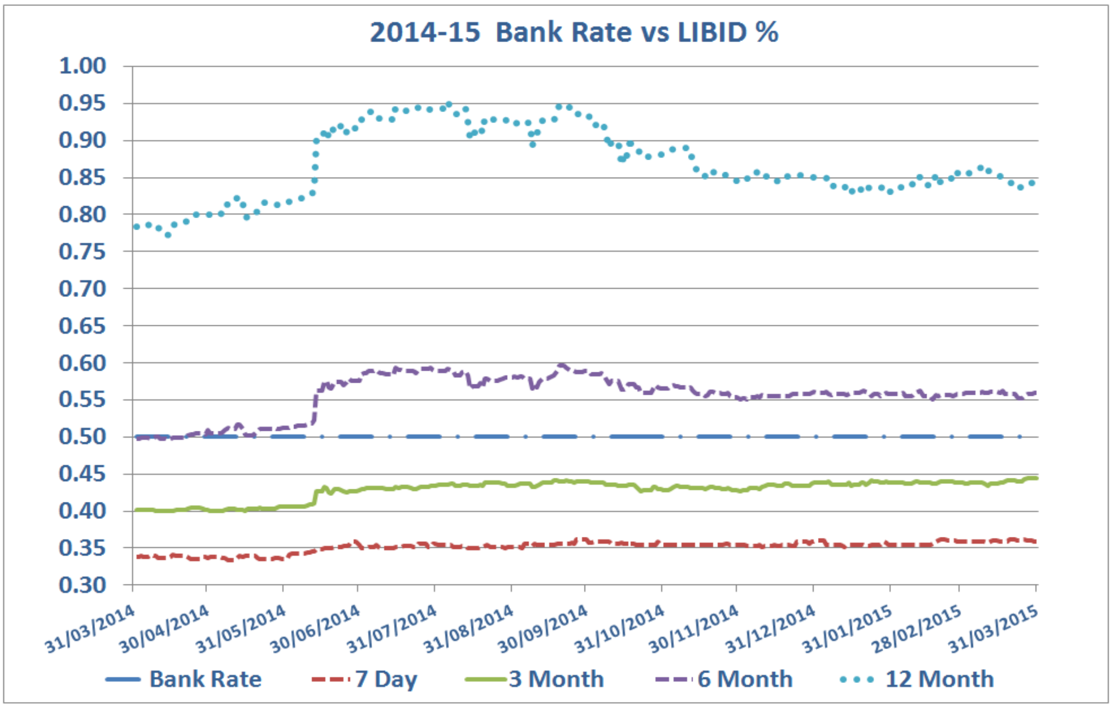
20 During the year the Council operated within the treasury limits and prudential indicators set out in its Treasury Policy Statement and Annual Treasury Strategy Statement.

21 The lending list was kept under constant review throughout the year in response to credit rating changes as and when they arose.

22 No institutions in which investments were made during 2014/15 had any difficulty in repaying investments and interest in full during the year.

Investment rates in 2014/15

23 Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for six years. Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 of 2015 but then moved back to around quarter 3 of 2016 by the end of the year. Deposit rates remained depressed during the whole of the year, primarily due to the effects of the Funding for Lending Scheme.



Investment outturn for 2014/15 and performance

24 The Council's investment policy is governed by Department of Communities and Local Government (CLG) guidance, which has been implemented in the annual investment strategy approved by the Council on 18 February 2014. This policy sets out the approach for choosing 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).

25 The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties, which might have led to the need to borrow.

26 Appendix C shows the performance of the fund during 2014/15 both in table and graphical form. The table shows the average percentage return on the fund, both monthly and for the whole year and compares them with the average 7-day and 3-month London Interbank Bid (LIBID) rates. The average return achieved by each broker is only a very basic measure of performance, because returns will depend on the number and length of each investment he/she is asked to carry out. If a particular broker is only asked to place short term investments, he/she may well not achieve the same overall rate as a broker who predominantly handles longer term investments for us.

27 The graph shows actual monthly receipts for 2012/13, 2013/14 and 2014/15 plus budgeted monthly receipts for 2014/15. The monthly interest budget has been profiled in line with the previous year's monthly weighted average principal.

28 Over the course of the year interest receipts amounted to £0.250m compared with a budget of £0.268m.

29 In 2014/15 the average return on the Council's investments was in line with that of one of our neighbouring authorities. Our overall rate of return was 0.58% compared with 0.68% for Tonbridge & Malling Borough Council. It should be noted, however, that investment returns are notoriously difficult to compare as they have often been compiled on a different basis (for example, whether or not interest has been compounded, whether or not cashflow generated balances have been included, whether or not externally managed funds have been included and whether or not the figures are net of borrowings).

30 Our treasury management advisers recommend the 3-month LIBID figure as a benchmark. This reflects a more realistic neutral investment position for core investments with a medium term horizon and a rate which is more stable with less fluctuation caused by market liquidity. Historically, this rate has been slightly higher than the 7-day rate and therefore more challenging a comparator, but one which does not necessitate a significantly increased level of risk. The figures calculated by our advisers for these two benchmarks are as follows:

- 7-day LIBID uncompounded 0.352%
- 3-month LIBID uncompounded 0.429%

Icelandic bank defaults and Municipal Bonds Agency

31 The Council had an investment of £1m frozen in Landsbanki Islands hf (later renamed as LBI). The investment was placed on 25 June 2007 at 6.32%, to mature on 25 June 2009.

32 The Council has sold its claim against the insolvent estate of LBI. The claim was sold through a sales process brokered by Deutsche Bank. The price at which the claim was sold was based on a reserve price set by the Council on the basis of legal advice received from Bevan Brittan, Solicitors and financial advice procured by the Local Government Association. The proceeds of the sale were paid in cash in Pounds Sterling. The sale means that the Council has recovered 95.9% of the amount that was originally deposited with LBI in 2007. The Council is now no longer a creditor of LBI.

33 After taking into account interest received prior to the insolvency, the full amount of the original investment has now been recovered.

34 In addition, a small repayment in Icelandic Krona remains in an escrow account in Iceland awaiting the lifting of capital controls before it can be repatriated. The GBP equivalent is approximately £7,000. It is attracting interest at a rate of between 3% and 4%.

35 During 2014/15, the Council invested £50,000 to become an equity shareholder in the Local Capital Finance Company, which was set up by the Local Government Association under the name of the Municipal Bonds Agency. Again, this was a 'Policy Investment' and does not form part of the treasury management strategy. The purpose of the Agency is to facilitate borrowing by local authorities at rates that are expected to be more competitive than those of the PWLB. At the time of writing this report, the Agency is in the process of conversion to a PLC and hopes to be issuing its first £250m bond in the Autumn of 2015.

Key Implications

Financial

36 The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority. The security of its capital and liquidity of its investments is of paramount importance.

Legal Implications and Risk Assessment Statement

37 Under Section 151 of the Local Government Act 1972, the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority, including securing effective arrangements for treasury management.

38 This annual review report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009.

39 Treasury management has two main risks :

- Fluctuations in interest rates can result in a reduction in income from investments; and
- A counterparty to which the Council has lent money fails to repay the loan at the required time.

40 Consideration of risk is integral in our approach to treasury management. However, this particular report has no specific risk implications as it is not proposing any new actions, but merely reporting performance over the last year.

Equality Assessment

41 The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act. There is no perceived impact on end users.

Conclusions

42 The overall return on the Council's investments was below budget in 2014/15 by approximately £18,000.

43 The economic situation both globally and within the Eurozone remains volatile, and this will have consequences for the UK economy. Treasury management in the past financial year was conducted against this background and with a cautious investment approach.

Appendices:

Appendix A – Investment portfolio at start and end of financial year

Appendix B – Analysis of investment portfolio by maturity and repayment due dates

Appendix C - Investment performance in 2014/15

Background Papers:

Treasury Management Strategy for 2014/15 - Council 18 February 2014

Adrian Rowbotham
Chief Finance Officer