TREASURY MANAGEMENT ANNUAL REPORT 2015/16

Cabinet – 15 September 2016

Report of the:	Chief Finance Officer
Status:	For recommendation to Cabinet
Also considered by:	Finance Advisory Committee – 6 September 2016
Key Decision:	No

Executive Summary: This report provides the customary review of investment activity during 2015/16 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 Treasury Management Annual Report for 2015/16.

Recommendation to Cabinet: That the Treasury Management Annual Report for 2015/16 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 2015/16. 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 2015/16 the minimum reporting requirements were that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 17/2/2015)
- a mid year (minimum) treasury update report (Finance Advisory Committee 17/11/2015, Cabinet 3/12/2015)
- 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 Finance 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 2015/16;

(c) the economy and interest rates in 2015/16;

(d) compliance with treasury limits and prudential indicators;

(e) investment rates in 2015/16;

(f) investment outturn for 2015/16 and performance; and

(g) an update on the 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 2015/16

9 The expectation for interest rates within the treasury management strategy for 2015/16 anticipated low but rising Bank Rate, (starting in quarter 1 of 2016), and gradual rises in medium and longer term fixed borrowing rates during 2016/17. 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 sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back.

12 The strategy adopted in the original Treasury Management Strategy Report for 2015/16, approved by the Council on 17 February 2015, was subject to a minor revision during the year as a consequence of expanding the Property Investment Strategy. Three of the prudential indicators relating to borrowing were reviewed by Cabinet on 16 July 2015 and approved by Council on 21 July 2015. The indicators relating to the Operational Boundary and the Authorised Limit For External Debt were amended, whilst the indicator relating to Treasury Management Limits On Activity was left unchanged for the time being. Other indicators relating to the Council's borrowing need (the Capital Financing Requirement or 'CFR') and the Council's minimum revenue provision (MRP) strategy were highlighted for potential changes once a requirement to borrow had been identified.

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 2015/16

14 Market expectations for the first increase in Bank Rate moved considerably during 2015/16, starting at quarter 3 2015 but soon moving back to quarter 1

2016. However, by the end of the year, market expectations had moved back radically to quarter 2 2018 due to many fears including concerns that China's economic growth could be heading towards a hard landing; the potential destabilisation of some emerging market countries particularly exposed to the Chinese economic slowdown; and the continuation of the collapse in oil prices during 2015 together with continuing Eurozone growth uncertainties.

15 These concerns have caused sharp market volatility in equity prices during the year with corresponding impacts on bond prices and bond yields due to safe haven flows. Bank Rate, therefore, remained unchanged at 0.5% for the seventh successive year. Economic growth (GDP) in 2015/16 has been disappointing with growth falling steadily from an annual rate of 2.9% in quarter 1 2015 to 2.1% in quarter 4.

16 The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back. In addition, a notable trend in the year was that several central banks introduced negative interest rates as a measure to stimulate the creation of credit and hence economic growth.

17 The European Central Bank (ECB) commenced a full blown quantitative easing (QE) programme of purchases of Eurozone government and other bonds starting in March at €60bn per month. This put downward pressure on Eurozone bond yields. There was a further increase in this programme of QE in December 2015.

18 As for America, the economy has continued to grow healthily on the back of resilient consumer demand. The first increase in the central rate occurred in December 2015 since when there has been a return to caution as to the speed of further increases due to concerns around the risks to world growth.

19 The UK elected a majority Conservative Government in May 2015, removing one potential concern but introducing another due to the promise of a referendum on the UK remaining part of the EU. The government maintained its tight fiscal policy stance but the more recent downturn in expectations for economic growth has made it more difficult to return the public sector net borrowing to a balanced annual position within the period of this parliament.

Compliance with treasury limits and prudential indicators

20 During 2015/16, 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:

	2014/15 Actual (£000)	2015/16 Original (£000)	2015/16 Actual (£000)
Capital expenditure	4,263	13,467	8,248
Total Capital Financing Requirement:			
• Non-HRA	-	-	-
• HRA	-	-	-
• Total	-	-	-
Net borrowing	-	-	-
External debt	-	-	-
Investments:			
• Longer than 1 year	-		3,000
• Under 1 year	37,801		31,420
• Total	37,801		34,420

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

22 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 (as amended in July 2015) with two exceptions:-

a) On 8 May 2015, £5.3m was held in the Barclays Business Premium Account, which, together with £2.0m held in a Flexible Interest Bearing Current Account, exceeded the limit for Barclays by £0.3m. This was due to staff being absent on elections duties and the position was corrected the following working day.

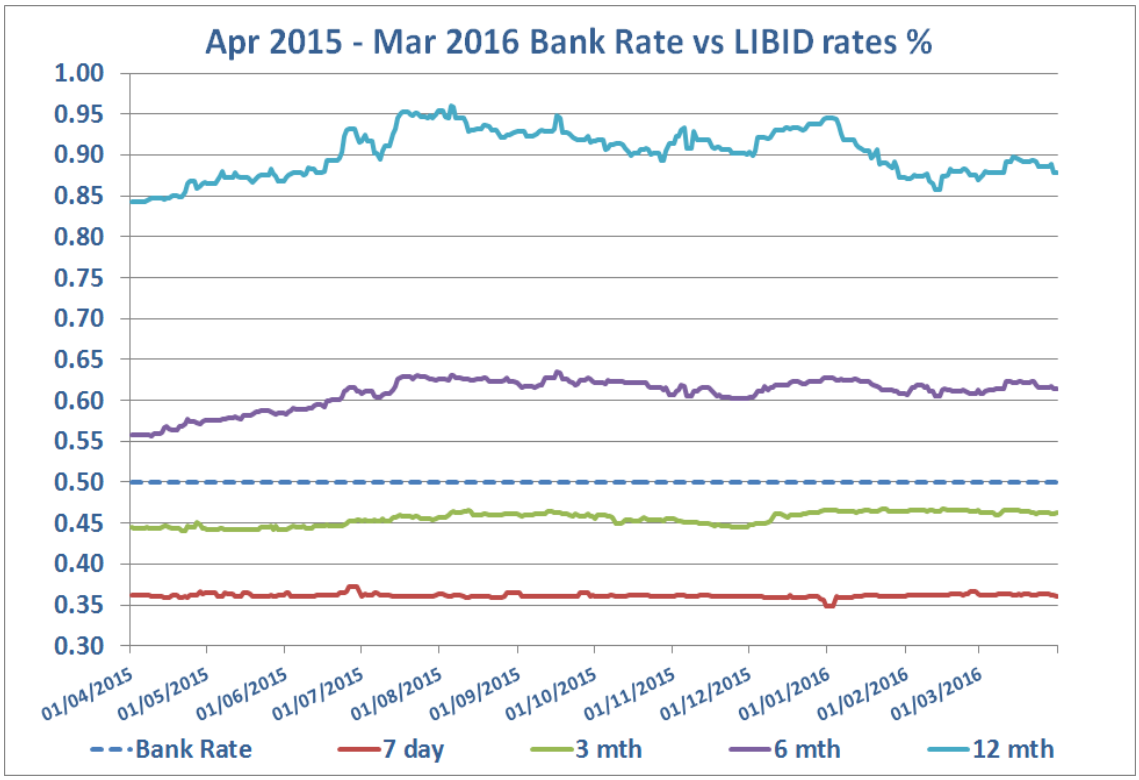
b) On 15 September 2015, £6.1m was held in the Barclays Business Premium Account, which, together with a treasury deposit of £3.0m, exceeded the limit for Barclays by £2.1m. This was due to treasury staff being absent on a training course and the position was corrected the following working day.

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

24 No institutions in which investments were made during 2015/16 had any difficulty in repaying investments and interest in full during the year.

Investment rates in 2015/16

25 Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for seven years. Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 2016 but then moved back to around quarter 2 2018 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 and due to the continuing weak expectations as to when Bank Rate would start rising.



Investment outturn for 2015/16 and performance

26 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 17 February 2015. 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).

27 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.

28 Appendix C shows the performance of the fund during 2015/16 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.

29 The graph shows actual monthly receipts for 2013/14, 2014/15 and 2015/16 plus budgeted monthly receipts for 2015/16. The monthly interest budget has been profiled in line with the previous year's monthly weighted average principal.

30 Over the course of the year interest receipts amounted to £284,600 compared with a budget of £328,000.

31 In 2015/16 the average return on the Council's investments was roughly in line with that of our neighbouring authorities. Our overall rate of return was 0.65% compared with 0.75% for Tonbridge & Malling Borough Council and 0.69% for Gravesham Borough Council. Dartford Borough Council's rate of return is not in the public domain, so I am unable to provide a comparison. It should be noted 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).

32 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 0.361%
- 3-month LIBID uncompounded 0.456%

Update on the Municipal Bonds Agency

33 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 (MBA). 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 Public Works Loan Board (PWLB).

34 The Agency has now converted to a PLC and is seeking a first bond issue in the autumn of 2016, although pricing and duration of the initial bond issue are unknown at present. It has been confirmed that pricing would be advantageous to the 57 shareholders, the latest of which to join are Surrey County Council and East Sussex County Council.

35 The MBA has stressed that success or failure will depend on local authority take up of loans. To date, eight local authorities have signed off the "framework agreement" allowing them to borrow from the MBA, but the major sticking point has been the implementation of a joint and several liability clause in the event that a borrowing local authority defaults on its loan. In these circumstances, the other borrowing authorities would be liable to make up the shortfall.

36 The objective of the MBA is to provide borrowing at lower rates than the PWLB Certainty Rates (i.e. gilts + 80 basis points). A credit rating has been issued by both Fitch & Moodys and the MBA is content with the outcome. No further information on this will be released ahead of the first bond issue.

37 It is also the intention of the MBA to develop a platform for inter-authority borrowing between councils. They are looking to provide a platform that is more controlled, more transparent and cheaper than the PWLB.

38 The MBA is keen for all of its shareholders to sign up to the framework agreement mentioned above. This would paint a more positive picture to those investors looking to purchase the bonds.

39 Although there are no immediate plans to borrow from the MBA, for the reasons given above, it is my intention to bring the draft agreement before the next meeting of this Committee for approval. It will need to be checked by our legal team, particularly the part covering joint and several liability as this has been of major concern to other authorities.

Key Implications

Financial

40 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

41 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.

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

43 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.

44 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

45 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

46 The overall return on the Council's investments was below budget in 2015/16 by approximately £43,400.

47 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 2015/16

Background Papers: Treasury Management Strategy for 2015/16 - Council 17 February 2015

Adrian Rowbotham
Chief Finance Officer