TO:	Council
FROM:	Director of Finance and IT
DATE:	1st October 2015

TITLE OF BRIEFING PAPER: Treasury management annual report 2014-15 and mid-year review for 2015-16

1. PURPOSE

1.1 To advise Members of Treasury Management performance for 2014-15, and update Members with regard to the position to date in 2015-16.

2. RECOMMENDATIONS

2.1 The Council is recommended to

(a) note the Outturn position for 2014-15

(b) agree the continuation of the existing Treasury Management Strategy, and Treasury and Prudential Indicators for 2015-16, as set at Finance Council In March

3. BACKGROUND

3.1 In March 2012 the Council adopted CIPFA's 2011 *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, and an updated Treasury Management Policy Statement.

3.2 In March 2015 the Council agreed a Treasury Management Strategy and MRP Policy for 2015-16.

4. RATIONALE

4.1 The CIPFA Treasury Management Code requires the Council to approve a Treasury Management Strategy (including various Treasury Management indicators) before the start of each financial year, and to consider both the outturn after each year end, and the mid-year position in each current year. The Council has determined to combine the outturn and mid-year review into a single report.

5. KEY ISSUES

5.1 Treasury priorities

5.1.1 The Council has operated within CIPFA and statutory guidance and requirements in respect of Treasury Management practice. The approved

Treasury Management Policy Statement, more detailed Treasury Management Practices and each year’s Annual Strategy have all emphasised the importance of security and liquidity over yield.

5.2 <u>Outturn 2014-15</u>

5.2.1 Original Strategy for 2014-15

5.2.1.1 The Treasury Management Strategy for 2014-15 was approved by Council on 3rd March 2014. The main aspects of the strategy are outlined below.

5.2.1.2 With short-term interest rates expected to continue to be lower than long-term rates it was acknowledged, for another year, that it may continue to be more cost effective not to borrow and instead reduce the level of investments. However it was recognised that long-term interest rates were expected to rise in the future so the short-term savings would need to be balanced against potential longer term costs.

5.2.1.3 Long-term borrowing would be taken if it became apparent that there was a risk of significantly increased interest rates or if it was required to maintain cash flow balances.

5.2.1.4 Any balances over and above that required to maintain basic liquidity could be invested either in the medium term (out to a year) or the longer term (over a year). Priority was given to security of funds and liquidity (accessibility) over yield (or return).

5.2.1.5 The limits to investment by reference to amount, duration and credit rating were largely unchanged from those applying in previous years, with the addition of a widening of the scope for investments away from just bank and building society deposits, to potentially allow investments to be made with any public or private sector organisation with satisfactory credit rating criteria.

5.2.2 Economic review 2014-15

5.2.2.1 Over the year, economic growth continued – with around a 3% increase in GDP - though growth was slowing down by the end of the year. The services sector was buoyant, and consumer confidence improved markedly. Unemployment rates fell and employee pay levels increased.

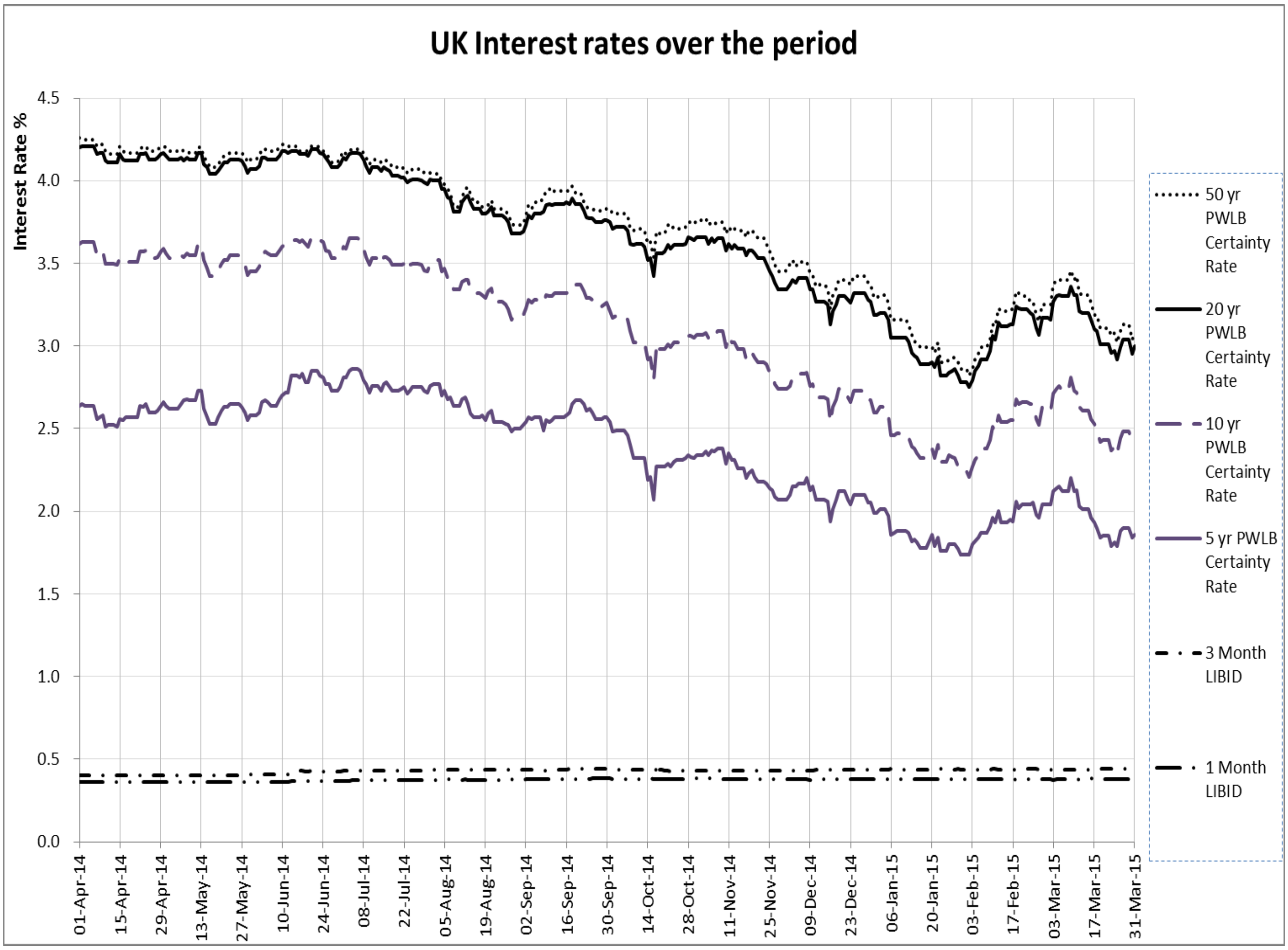
Annual CPI inflation fell to zero for the year to March 2015, down from 1.6% a year earlier, mainly prompted by steep falls in energy prices. Bank of England Governor Mark Carney wrote an open letter to the Chancellor in February, explaining that the Bank expected CPI to temporarily turn negative but rebound around the end of 2015.

UK Monetary Policy remained steady, and the bank rate remained at 0.5%.

In the Eurozone, benchmark interest rates fell further and it was announced that the European Central Bank would intervene in an attempt to fend off deflationary pressures and deliver an economic stimulus. The risks of

Greek debt default and possible exit from the Eurozone were looming large by the end of the year.

The United States' continued economic recovery prompted an easing of the Federal Reserve Bank's market interventions, and expectations were that a US rate rise would follow at some point in 2015.



UK Government borrowing costs – 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. Gilt yields fell to their lows in January before ending the year higher. The Public Works Loans Board (PWLB) rates in the above chart mirrored UK Government borrowing costs.

Nominal investment rates, measured through the London Inter-Bank Bid Rate (LIBID), also shown above, remained largely flat across the year

5.2.3 Treasury management performance 2014-15

5.2.3.1 The following table summarises debt and investment positions at the start and end of the year:

	31 Mar 2014 Principal (£ M)	Rate / Return	Avg Life (Yrs)	31 Mar 2015 Principal (£ M)	Rate / Return	Avg Life (Yrs)
Fixed rate funding:						
PWLB	119.4	4.53%	23.2	116.7	4.51%	22.8
Market Debt (Long Term)	10.4	4.47%	40.7	10.3	4.47%	39.7
Market Debt (Short Term)	0.0			5.0	0.35%	
	129.8			**132.0**		
Variable rate funding:						
PWLB	0.0			0.0		
Market	13.5	6.28%	17.2	13.5	6.28%	16.2
	13.5			**13.5**		
Loans taken by BwDBC	**143.3**	**4.69%**	**23.9**	**145.5**	**4.69%**	**23.4**
Debt from PFI arrangements	73.0			71.5		
Other long term liabilities – debt managed by LCC	18.1	2.5%		17.4	2.1%	
Total debt	**234.4**			**234.4**		
Total investments	**28.4**	**0.38%**		**7.5**	**0.40%**	

5.2.3.2 No new long term borrowing was taken in 2014-15. The key changes to the Council's overall debt position across the year were:

a) Principal repayments of PWLB debt: £1.6M on EIP (Equal Instalment of Principal) loans and one £1.1M Maturity loan repaid.

b) Repayments of part of the outstanding debt recognised on the balance sheet for the PFI debt for Building Schools for the Future, and for debt managed by LCC.

The recognition of PFI assets and liabilities on the balance sheet is designed to show our effective long term control over the assets concerned, and the parallel "indebtedness" arising from financing the cost of them, but do not add to the "bottom line" met by the Council Tax payer.

5.2.3.3 The premium charges for early repayment of PWLB debt were expensive for the Council's loan portfolio, and therefore unattractive for debt rescheduling activity. No rescheduling was undertaken as a consequence.

5.2.3.4 The Council's Capital Financing Requirement (outstanding indebtedness arising from the Capital Programme) grew across the year, while its long term borrowing fell [see table below]:

Movements in CFR and Long Term Borrowing	2013/14	2014/15
(excluding PFI/LCC debt)	£M	£M
BwD Capital Financing Requirement B/Fwd	169.9	182.3
BwD Spend Financed From Borrowing in Year	19.1	24.0
BwD Debt MRP made in Year	-6.7	-7.3
BwD Capital Financing Requirement C/Fwd	182.3	198.9
Long Term Borrowing B/Fwd	140.7	143.3
Net Long Term Borrowing in Year	2.6	-2.8
Long Term Borrowing C/Fwd	143.3	140.5
Amount by which CFR under-funded by long term borrowing (at Year End)	39.0	58.4

The gap between the Council's CFR and its long term borrowing – which is effectively covered by short term borrowing and the use of the Council's balances - widened to around £58M. Investment balances were, therefore, significantly lower than they would otherwise have been. Together with the still low interest rates available and the operation of a cautious and short-term approach to investment, this reduced the amount of interest earned on balances, but delivered large savings on the cost of long term borrowing.

5.2.3.5 In summary, the outturn position in respect of interest costs and income is as follows:

Outturn 2013-14 £'000		**Original Budget 2014-15** £'000	**Outturn 2014-15** £'000
7,062	Interest paid on borrowing	8,013	7,372
6,760	PFI interest paid	6,484	6,484
(274)	Interest receipts	(186)	(297)
7,399	Provision for debt repayment – non-PFI	8,493	8,064
1,497	Provision for debt repayment – PFI	1,495	1,495

5.2.3.6 Interest paid on borrowing in 2014-15 was around £0.6M less than the Original Estimate, which had allowed for higher levels of borrowing. As already noted, there was no new long term borrowing taken in the year. For the first time for several years, short-term borrowing was taken to ensure sufficient cash balances, at an interest cost of around £16,000.

As with the required balance sheet adjustments, PFI interest charges did not add to the "bottom line" faced by the Council Taxpayer, as grants covered their cost.

5.2.3.7 The daily average investment balance across the year was lower, at around £37M (£50M in 2013-14). Balances fell to their lowest point, below £8M, by the end of the year. Overall interest earned was up slightly, to £0.29M in 2014-15 (£0.27M in 2013-14), but this was mainly because of additional income from returns on investment in the Local Education Partnership (which delivered the Building Schools for the Future Programme). Total interest earned on cash balances fell again, earning an average rate of 0.40% (compared to 0.38% in 2013-14).

5.2.3.8 Interest rates have been low for several years, and the rates available from the limited range of institutions used by the Council remained low across 2014-15. Funds have continued to be invested for short periods, and sometimes with the government's Debt Management Office, to manage risk – this also contributed to the low returns.

5.2.3.9 The position with regard to performance against Treasury and Prudential Indicators is summarised in Appendix 1. There were no breaches of the Borrowing Limits and the main element to highlight is that the outturn capital spend was £63M, and lower than the £89.7M forecast. This in turn meant that the outturn total Capital Financing Requirement was £287.8M, lower than the original forecast at the start of the year of £311.6M.

5.2.4 Treasury management consultancy

5.2.4.1 The Council is contracted up to 31st March 2016 to receive treasury management support from Arlingclose Limited. They provide advice and information on the Council's investment and borrowing activities, although responsibility for final decision making remains with the Council and its officers. The process of determining who will act as advisers from April 2016 will take place over the next few months.

5.2.4.2 Over the duration of their support to the Council, Arlingclose have reviewed the Council's Treasury management procedures and activities. They have provided member training; ongoing officer training; support for and review of treasury decisions, reports and strategies; feedback on accounting for treasury activities; benchmarking with other authorities; guidance on borrowing and investment opportunities; forecasts of interest rates; and regular updates on credit ratings and other information on credit quality. The quality of the support provided has been of a high standard.

5.2.5 Local Capital Finance Company

5.2.5.1 The Council, towards the end of 2014/15, invested £50,000 in the Local Capital Finance Company (LCFC), to support the creation of a municipal bond agency, which could act as an alternative source of borrowing for local authorities. This was with a view to reducing borrowing costs for local authorities, which are currently largely driven by the Public Works Loans Board (PWLB). The new municipal agency may take some time to establish, and any benefits some time to be realised.

5.2.6 Support for Failing Banks - Implications for Future Investment Credit Risk

5.2.6.1 The European Parliament, in April 2014, approved the EU Bank Recovery and Resolution Directive (BRRD), establishing rules for future support to be given to failing banks. Following this, the Bank of England published its approach, giving 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 corporate bodies and financial institutions.

5.2.6.2 Both the Bank of England and the European Central Bank (ECB) ran stress tests on financial institutions during the year. The only banks on the Council's lending lists which were reported by the Bank of England as being at risk in the event of a severe economic downturn were Lloyds /Bank of Scotland and RBS /NatWest, both of which have since taken measures to improve their balance sheets. None of the banks failing the ECB tests were on our lending lists.

5.2.6.3 Arlingclose issued guidance in October and February advising reductions in some investment durations in response to market conditions. The Council's day to day investment policy meant that there were no implications for us.

5.3 <u>Strategy review 2015-16</u>

5.3.1 Original strategy for 2015-16

5.3.1.1 The Treasury Management Strategy for 2015-16 was approved by Council on 2nd March 2015. The Council adopted the latest (2011) edition of the CIPFA *Code of Practice on Treasury Management* in March 2012.

5.3.1.2 The broad strategy set at the start of 2015-16 was very much the same as for 2014-15, with the recognition that there was still significant capital expenditure to take place on a number of major projects, and a large degree of under-borrowing still outstanding against the Council's accumulated Capital Financing Requirement. The uncertainty over timing of still anticipated future increases in borrowing costs, and short run strong cash positions, meant that it was still possible that the Council would be able to continue to defer long-term borrowing and generate further net interest savings, as it has over a number of years.

5.3.1.3 The uncertainty over the timing of the take up of borrowing also prompted a continuing cautious approach to investing surplus cash balances, with the emphasis still being placed on prioritising security and liquidity over yield.

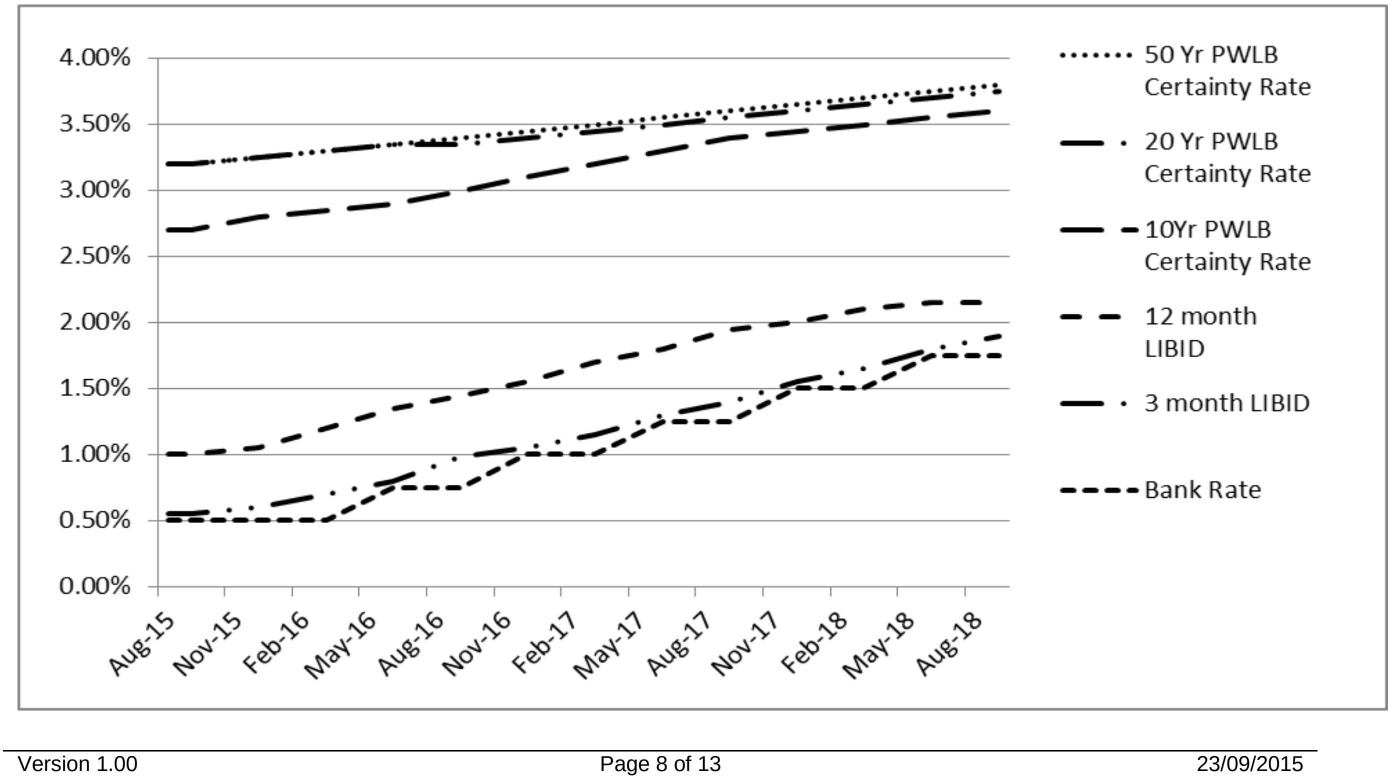
5.3.1.4 Reflecting changes in the likely degree of support underpinning banks in future, the limits to investment by reference to amount, duration and credit rating were re-defined, to distinguish between Unsecured Deposits, which would be subject to greater risk of credit loss, and Secured Deposits, where there was significantly less risk. Otherwise, the limits set were largely comparable to those applying in previous years. The medium term intention was to allow a greater diversity of investments to be used, again with a view to managing risk. Appendix 2 summarises the investment criteria set for 2015-16.

5.3.2 Economic Review 2015-16

5.3.2.1 In the early part of the year, economic data was largely overshadowed by events in Greece, and the risk of a disorderly exit from the Euro. Though an agreement was reached between Greece and its creditors – as represented by the IMF, European Commission and European Central Bank - a great deal of uncertainty remains as to how Greece can effectively address its debts. Along with the UK election and other Eurozone uncertainties, this caused UK borrowing rates to fluctuate at times. However there was a general trend upwards in the first half of the year, easing off in August.

UK economic growth continued, though on a slightly more subdued level than before, and the previous improvements in the labour market also slowed. CPI inflation has been around zero for six months, but the Bank of England has remained sanguine that this will not damage the economy. There are strong signals that the Bank of England will increase its bank rate soon, but also strong expectations that the pace of future rate increases will be gradual and the extent of rises limited.

The Council's current projections for interest rates, based on the latest central forecast from our advisors Arlingclose is below:



5.3.2 Treasury performance to date

5.3.3.1 Thus far, cash balances have recovered from their low at the start of the year, typically averaging between £15M and £25M. These levels were supported, particularly more recently, by some short term borrowing (at low rates). No long term borrowing has yet been taken, and £2M of LOBO debt (see below) was repaid at maturity.

Analysis of debt outstanding

	Start of Apr 2015		End of August 2015	
	£' 000	£ ' 000	£' 000	£ ' 000
TEMPORARY DEBT				
Less than 3 months	5,000		5,000	
Greater than 3 months	0		5,000	
		5,000		10,000
LONG TERM DEBT				
Bonds	23,503		21,503	
Mortgages	17		17	
PWLB	116,694		116,694	
Stock & Annuities	270		258	
		140,484		138,472
Lancs County Council transferred debt		17,352		17,179
Recognition of Debt re PFI Arrangements		71,536		70,936
TOTAL DEBT		234,372		236,587
Less: Temporary Lending		(7,460)		(19,150)
		226,912		217,437

5.3.2.2 Investments have continued to be made with a limited range of banks, building societies and Money Market Funds, along with the Government's Debt Management Office, earning interest at low levels (an average of a little over 0.4%).

5.3.2.3 Savings of around £0.3M on the £7.5M Original Estimate for external interest payments have already been reported through Corporate Monitoring, reflecting lower borrowing last year, and this year to date. Investment returns remain low, as initially projected (Original Estimate was around £0.1M). Further interest savings may arise depending upon market conditions and the resilience of the Council's cash flow.

Latest budget projections anticipate that around £30M long term borrowing will be undertaken later in this year, as revenue cash balances will reduce and there is a risk of increases to longer term interest rates. Though other borrowing options are under consideration – including taking increased short term borrowing - it is likely that most of any long term borrowing will be from the PWLB.

5.3.3 Investment and borrowing strategy for the rest of the year

5.3.3.1 It is proposed that the originally approved **Investment Strategy and Criteria** - and the **Treasury and Prudential Limits and Indicators** - remain unchanged.

Though the Council's Investment Criteria were previously amended to allow investment in other organisations and structures, the priority given to maintaining liquidity, and limited opportunities for straightforward trading in Secured Deposits, have meant that simple, tried and tested, and short dated options have been used. Therefore, actual investments have continued to be made in - fixed term deposits and instant access accounts with banks and building societies; instant access Money Market Funds; and fixed term deposits with local authorities and the UK Government's Debt Management Office (DMO).

It is likely, particularly if material levels of borrowing are taken in future, that at least some investments will be made in a wider range of high grade instruments, such as Treasury bills. The Council's professional treasury advisers, Arlingclose, consider that widening the range of the Council's investment instruments is both appropriate and prudent.

5.3.3.2 It is proposed that the Borrowing Strategy also remain unchanged, with the Council looking to take new borrowing as determined by cash flow requirements and by reference to movements in long term interest rates.

In the short run, the Council will again be able to take advantage of the Public Works Loan Board (PWLB) Certainty Rate, which is set 0.2 percentage points below standard PWLB rates (currently 1.0% above the UK government bond yield). The Government has declared that it will abolish the PWLB, but has confirmed that its lending function will continue unaffected and local authorities will retain access to borrowing rates which offer good value for money. The authority intends to use the PWLB's replacement as a potential source of borrowing if required.

The Council will seek to take borrowing across the remainder of the financial year, looking to balance the short term benefits of lower interest costs against the longer term risks of PWLB rates continuing to move upwards. Most of any material levels of borrowing will be from the PWLB (or its successor). It is not currently anticipated that the Council will seek to take funds via the Local Capital Finance Company this year, but it may take funds from other local authorities.

5.4 <u>Risk management</u>

5.4.1 The Council's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds before seeking the best rate of return. The majority of its surplus cash is therefore held as short-term investments with the UK Government, highly rated banks and pooled funds. In addition, the Council holds some investments that entail a slightly higher level of risk, including callable deposits (where there is a risk that changing interest rates may mean that the loan does not run to full term) and unrated building society deposits (where risks have been mitigated by limiting the amount and duration of exposure).

5.4.2 The Council's primary objective for the management of its debt is to ensure its long-term affordability. The majority of its loans (£117M) have been borrowed from the Public Works Loan Board at long-term fixed rates of interest.

5.4.3 The other significant element of the Council's debt is £21.5M of "lenders option, borrower's option" (LOBO) loans with initially fixed (and initially low) rates of interest. Under these instruments the Lender can, at certain times, exercise an option to increase the rate payable on the debt, and the Borrower has the choice then either to accept the proposed increase or repay the whole loan (which would mean, effectively, having to live with whatever the market conditions for interest rates were at that point). This exposes the Council to some risk of rising long-term interest rates, but that is mitigated by the fact that £10M of this debt (forming a large part of the lowest interest rate elements) can only be "called" once in every five years. Recent estimates based on the current projected future interest rates, suggest LOBOs are unlikely to be called in the next 5 years (assuming no extraneous influences).

5.4.4 The combination of short duration investments and long duration debt exposes the Council to the risk of falling investment income during periods of low interest rates. Both longer-term investments and any variable rate instruments would hedge against that risk, though the Council currently holds neither of these. However this risk is viewed as of lower priority compared to the requirements of optimising the security and liquidity of investments.

5.5 <u>Minimum Revenue Provision (MRP) Policy</u>

5.5.1 The Council's MRP (Minimum Revenue Provision) is the minimum amount which must be charged to revenue each year as a provision for the repayment of debt. The Council, within regulatory guidance, sets its own policy to ensure that the MRP it makes each year is prudent. The charge includes elements relating to "historic debt", acquired before the Prudential Borrowing regime, together with elements relating to more recent "Prudential Borrowing debt".

5.5.2 The Council's MRP Policy Statement at the start of 2015-16 proposed

(a) for existing capital expenditure financed from debt up to 2007-08 and all new Government-supported borrowing arising in 2007-08 and thereafter, to use the Regulatory Method to determine MRP.

(b) for capital expenditure financed from debt arising in 2007-08 and thereafter that is self-financed (i.e. not supported by the Government), to use the Asset Life Method to determine MRP,

This means in practice,

(a) for the older and Government-supported debt, that 4% of the outstanding balance is charged. The 4% sinking basis reflected the historic basis on which local authorities were expected to finance debt, and was factored into the revenue support received from the Government for borrowing approvals.

(b) for more recent, self-financed debt, that the MRP is charged evenly over the asset lives of the acquisitions acquired under Prudential Borrowing.

5.5.3 This Council has not had any Government-supported debt allocations since 2010-11, as the Government has chosen to cease supporting capital programmes in this way. For the majority of the last parliament, the “needs” based formula for allocating resources through the annual local government finance settlement has been frozen. There have also been significant reductions in central government support through revenue support grant. This has broken the direct link between paying for “supported borrowing” MRP on the 4% sinking basis and associated funding provided through the local government funding settlement, so that any link is limited to how historic levels of Government support influence damping elements in the settlement formulas. It is therefore reasonable to consider spreading the cost of standing taking a more even approach to standing the cost of older, and “Government-supported” debt – the existing policy front-loads the cost into earlier years.

The Council is currently reviewing its MRP Policy and will report further in due course.

6. POLICY IMPLICATIONS

6.1 None.

7. FINANCIAL IMPLICATIONS

7.1 The financial implications arising from the 2014-15 Treasury Outturn and latest position for 2015-16 have been, or will be incorporated into Corporate Budget Monitoring Reports.

8. LEGAL IMPLICATIONS

8.1 Under the Local Government Act 2003, local authorities determine locally their levels of capital investment and associated borrowing. The Prudential Code has been developed to support local authorities in taking these decisions, and the Council is required by Regulation to have regard to the Code when carrying out its duties under Part 1 of the Local Government Act 2003.

8.2 The Department for Communities and Local Government has issued Guidance on Local Government Investments, under the Local Government Act 2003, effective from 1st April 2010. Under this, authorities should manage their investments within an approved strategy, setting out what categories of investment they will use and how they assess and manage the risk of loss of investments.

9. RESOURCE IMPLICATIONS

9.1 None.

10. EQUALITY IMPLICATIONS

10.1 None.

11. CONSULTATIONS

11.1 None.

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Date:	7th September 2015
Background papers:	Treasury Management strategies for 2014-15 and 2015-16 approved at Council 3rd March 2014 and 2nd March 2015 respectively.