AUD120
FOR DECISION
WARD(S): GENERAL

AUDIT COMMITTEE

22 JUNE 2015

TREASURY MANAGEMENT OUTTURN REPORT FOR 2014/15

REPORT OF CHIEF FINANCE OFFICER

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RECENT REFERENCES:

CAB2554: Treasury Management Strategy 2014-15, 12 February 2014

AUD084: Treasury Management Practices, 11 March 2014

AUD105: Treasury Management Mid-Year Review 2014/15, 4 December 2014

CAB2648: Treasury Management Strategy 2015-16, 16 February 2015

EXECUTIVE SUMMARY:

In accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, this report provides detail of the performance of the treasury management function, on the effects of the decisions taken and the transactions executed in the past year, and confirmation that there were no instances of non-compliance with the Council's Treasury Management Policy Statement and Treasury Management Practices, for the year 2014/15.

RECOMMENDATIONS:

That the Audit Committee:

1 Approves the Annual Treasury Outturn Report 2014/15 and the actual Prudential Indicators provided at Appendix A.

AUDIT COMMITTEE

22 June 2015

TREASURY MANAGEMENT OUTTURN REPORT FOR 2014/15

REPORT OF CHIEF FINANCE OFFICER

DETAIL:

1 Introduction

1.1 The Council adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes an annual report on the treasury management strategy after the end of each financial year.

2 Summary

2.1 Treasury management in the context of this report is defined as:

2.2 "The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2.3 This annual report sets out the performance of the treasury management function during 2014/15, to include the effects of the decisions taken and the transactions executed in the past year.

2.4 Hampshire County Council's Investments & Borrowing Team has been contracted to manage the Council's treasury management balances since September 2014 but overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

2.5 All treasury activity has complied with the Council's Treasury Management Strategy and Investment Strategy for 2014/15, and all relevant statute, guidance and accounting standards. In addition the Council's treasury advisers, Arlingclose, provide support in undertaking treasury management activities.

2.6 The Council has complied with all of the prudential indicators set in its Treasury Management Strategy; these are detailed fully in Appendix 1.

3 Economic Background

Growth and Inflation

3.1 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.

3.2 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 oil prices (which fell to $44.35 a barrel; a level not seen since March 2009) and a steep drop in wholesale energy prices with extra downward momentum coming from supermarket competition resulting in lower food 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 as the lower prices dropped out of the annual rate calculation.

Labour Market

3.3 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

3.4 The Bank of England's Monetary Policy Committee (MPC) maintained interest rates at 0.5% and asset purchases (quantitative easing) at £375bn. Its members held a wide range of views on the response to zero CPI inflation, but just as the MPC was prepared to look past the temporary spikes in inflation to nearly 5% a few years ago, they felt it appropriate not to get panicked into a response to the current low rate of inflation. 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.

3.5 Arlingclose's expectation for the first rise in official interest rates remains Quarter 2 of 2016. The risks to this forecast remain weighted to the downside; in particular, signs of more widespread deflation or political uncertainty could prompt a further downward revision to the forecast. Arlingclose projects a slow rise in Bank Rate. The pace of interest rate rises will be gradual and the extent of rises limited.

3.6 A continuation of Base Rates being held at record lows has limited the return that can be made for investment balances. Also, despite positive economic indicators there remain risks for investors due to the UK banks ‘bail-in’ legislation. The credit risk associated with making unsecured bank deposits will increase relative to the risk of other investment options available to the Council. Whilst the likelihood of suffering a loss from the default of bank remains relatively unchanged, the ‘bail-in’ regime has significantly increased the impact a default would have in terms of the scale of loss the Council could be exposed to.

4 Local Context

4.1 At 31/03/2015 the Council’s underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £162.7m, while usable reserves and working capital which are the underlying resources available for investment were £37.8m.

4.2 At 31/03/2015, the Council had £156.7m of borrowing and £37.7m of principal invested. The Council’s current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

4.3 The Council has a forecast increasing CFR over the coming years due to the capital programme, and the Council’s reserves will gradually reduce over the same period. This will require the Council to take out new borrowing towards the end of the forecast period.

5 Borrowing Strategy

5.1 At 31/03/2015 the Council held £156.7m of loans, (there has been no change since 31/03/2012) as part of its strategy for funding previous years’ HRA programmes.

5.2 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.

5.3 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.

5.4 The Council’s portfolio of long-term debt is in the form of loans from the Public Works Loan Board (PWLB). A cautious approach has been applied in terms of take-up of new borrowing to minimise debt interest payments without compromising the long-term stability of the portfolio. No new borrowing took place in 2014/15. Internal resources in lieu of external borrowing have been used to lower overall treasury risk by reducing both external debt and temporary investments.

Table 1: Borrowing Activity in 2014/15

	Balance on 31/03/2014 £m	Net new borrowing £m	Balance on 31/03/2015 £m	Average Rate %
CFR	165.7		162.7	
Long Term Borrowing	156.7	-	156.7	3.30%
TOTAL BORROWING	**156.7**	**-**	**156.7**	**3.30%**
Other Liabilities	1.8	0	1.5	2.16%
TOTAL EXTERNAL DEBT	158.5	0	158.2	3.29%
Increase/ (Decrease) in Borrowing £m			(0.3)	

Debt Rescheduling

5.5 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.

Abolition of the PWLB

5.6 In January 2015 the Department of Communities and Local Government (CLG) confirmed that HM Treasury (HMT) would be taking the necessary steps to abolish the 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.

6 Investment Activity

6.1 The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on 15 April 2014. 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.

6.2 The outlawing of bail-outs, the introduction of bail-ins, and the preference being given to large numbers of depositors rather than local authorities, means that the risks of making unsecured deposits rose relative to other investment options. The Council has therefore attempted to diversify through investing in secured covered bonds, local authorities and other non-bank investments.

6.3 The Council has held invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2014/15 the

Council's investment balances have ranged between £26.2 million and £52.7 million.

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

Table 2: Investment Activity in 2014/15

Investments	Balance on 31/03/2014 (£m)	Balance on 31/03/2015 (£m)	Average Rate at 31/03/2015	Average Life at 31/03/2015 (years)
Short term Investments (call accounts, deposits) - Banks & Building Societies - Local Authorities	18.00	23.16	0.87%	0.28
Long term Investments - Banks & Building Societies - Local Authorities	0.00	2.00	1.48%	2.43
Money Market Funds	4.70	6.62	0.52%	0.00
Other Pooled Funds	2.00	2.00	17.35%[1]	n/a
Corporate Bonds (unsecured)	0.00	3.87	0.72%	0.52
TOTAL INVESTMENTS	24.70	37.65	1.68%	0.45
Increase/ (Decrease) in Investments £m		12.95		

6.5 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.

6.6 Counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

7 Investment Outturn

7.1 The Council maintained a sufficient level of liquidity through the use of call accounts and money market funds. The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate has been maintained at 0.5% since March 2009 and short-term money market rates have remained at relatively low levels which continued to have a significant impact on cash investment income.

[1] Rate of return based on 12 months of monthly returns.

7.2 The Council's average cash balances were £40.8m during the year and interest earned for the year was £430,000, giving a yield of 1.05%.

8 Update on Investments with Icelandic Banks

8.1 The collapse of Icelandic banks in October 2008 put at risk £1m of the Council's short term investments. The Council had invested with the Heritable Bank Ltd. which was placed into administration on 7 October 2008. To date the Council has received 14 distributions amounting to £0.94m. There were no receipts in the 2014/15 financial year. However, a notice of intended dividend was received in May 2015 to be paid in August 2015, and the estimated return has been revised up to 98 to 100 pence in the pound. A further progress report is expected in September 2015.

9 Compliance with Prudential Indicators

9.1 The Council confirms compliance with its Prudential Indicators for 2014/15, which were set in February 2014 as part of the Council's Treasury Management Strategy Statement.

10 Treasury Management Indicators

10.1 The Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

10.2 This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed will be:

Table 4 – Interest Rate Exposures

	Approved Limits for 2014/15	**Maximum during 2014/15**	**Compliance with Limits:**
Upper limit on fixed interest rate exposure	100%	80%	Yes
Upper limit on variable interest rate exposure	66%	24%	Yes

10.3 Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing

10.4 This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 5 – Maturity Structure of Borrowing

	Upper	**Actual**
Under 12 months	£20m	-
12 months and within 24 months	£20m	-
24 months and within 5 years	£20m	-
5 years and within 10 years	£30m	15m
10 years and within 30 years	£120m	85m
30 years and within 40 years	£50m	20m
40 years and within 50 years	£50m	37m
50 years and above	£50m	-

Principal Sums Invested for Periods Longer than 364 days

10.5 The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

Table 6 – Principal Sums Invested for Periods Longer than 364 days

	2014/15	**2015/16**	**2016/17**
Limit on principal invested beyond year end	£5m	£16m	£15m
Actual	£4m		

OTHER CONSIDERATIONS:

11 COMMUNITY STRATEGY AND PORTFOLIO PLANS (RELEVANCE TO):

11.1 The Treasury Management Strategy supports all tenets of the Sustainable Community Strategy including the core value of being efficient and ensuring value for money.

12 RESOURCE IMPLICATIONS:

12.1 Investment income amounted to £430k in 2014/15 (£343k in 2013/14).

13 RISK MANAGEMENT ISSUES

13.1 These are considered within the report. The Council's Treasury Management Practices provide a detailed consideration of the management of treasury risks (and are being considered elsewhere on this agenda AUD119).

BACKGROUND DOCUMENTS:

None

APPENDICES:

Appendix A: 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 following indicators that must be set and monitored each year.

1. Estimates of Capital Expenditure

The Council's planned capital expenditure and financing may be summarised as follows.

Capital Expenditure and Financing	**2014/15 Approved £m**	**2014/15 Revised £m**	**2014/15 Actual £m**	**2015/16 Estimate* £m**	**2016/17 Estimate* £m**
General Fund	28.6	8.7	**2.9**	17.3	20.7
HRA	17.1	9.9	**8.9**	23.1	22.6
Total Expenditure	**45.7**	**18.6**	**11.8**	**40.4**	**43.3**
Capital Receipts	2.2	1.9	**1.0**	6.9	11.0
Grants & Contributions	5.4	0.9	**1.4**	2.9	2.3
Reserves	9.9	7.1	**6.3**	132	6.8
Revenue	7.2	3.1	**1.9**	10.4	7.6
Borrowing	21.0	5.6	**1.2**	7.0	15.6
Total Financing	**45.7**	**18.6**	**11.8**	**40.4**	**43.3**

* Treasury Management Strategy 2015/16, February 2015 (CAB2648 (Revised))

2. Estimates of Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	**31.03.15 Approved £m**	**31.03.15 Revised £m**	**31.03.15 Actual £m**	**31.03.16 Estimate* £m**	**31.03.17 Estimate* £m**
General Fund	26.6	10.4	**6.0**	16.2	26.5
HRA	160.4	160.4	**156.7**	160.9	165.6
Total CFR	**187.0**	**170.8**	**162.7**	**177.1**	**192.1**

* Treasury Management Strategy 2015/16, February 2015 (CAB2648 (Revised))

The CFR is forecast to rise by £29m over the next three years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

3. Gross Debt and the Capital Financing Requirement

In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	**31.03.15 Approved £m**	**31.03.15 Revised £m**	**31.03.15 Actual £m**	**31.03.16 Estimate* £m**	**31.03.17 Estimate* £m**
Borrowing	180.7	156.7	**156.7**	156.7	156.7
New borrowing	0.0	0.0	**0.0**	0.0	16.7
Finance leases	1.5	1.5	**1.5**	1.2	0.8
Total Debt	**182.2**	**158.2**	**158.2**	**157.9**	**174.2**

* Treasury Management Strategy 2015/16, February 2015 (CAB2648 (Revised))

Total debt is expected to remain below the CFR during the forecast period.

The actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt, below.

4. Operational Boundary for External Debt

The operational boundary is based on the Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

Operational Boundary	**2014/15 Approved £m**	**2014/15 Revised £m**	**2014/15 Actual £m**	**2015/16 Estimate* £m**	**2016/17 Estimate* £m**
Borrowing	182.0	174.5	**156.7**	180.4	194.8
Other long-term liabilities	4.0	1.5	**1.5**	1.2	0.8
Total Debt	**186.0**	**176.0**	**158.2**	**181.6**	**195.6**

* Treasury Management Strategy 2015/16, February 2015 (CAB2648 (Revised))

5. Authorised Limit for External Debt

The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	**2014/15 Approved £m**	**2014/15 Revised £m**	**2014/15 Actual £m**	**2015/16 Limit £m**	**2016/17 Limit £m**
Borrowing	187.0	175.2	**156.7**	181.2	195.8
Other long-term liabilities	6.0	1.9	**1.5**	1.5	1.0
Total Debt	**193.0**	**177.1**	**158.2**	**182.7**	**196.8**

6. Ratio of Financing Costs to Net Revenue Stream

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.

Ratio of Financing Costs to Net Revenue Stream	**2014/15 Approved %**	**2014/15 Revised %**	**2014/15 Actual %**	**2015/16 Estimate* %**	**2016/17 Estimate* %**
General Fund	(0.40)	1.00	0.89	2.03	2.95
HRA	19.30	19.25	32.52	18.89	18.79

* Treasury Management Strategy 2015/16, February 2015 (CAB2648 (Revised))

7. <u>Adoption of the CIPFA Treasury Management Code</u>

The Authority adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition in February 2012.