AUD137
FOR DECISION
WARD(S): GENERAL

AUDIT COMMITTEE

3 DECEMBER 2015

TREASURY MANAGEMENT MID-YEAR REVIEW 2015/16

REPORT OF CHIEF FINANCE OFFICER

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RECENT REFERENCES:

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

EXECUTIVE SUMMARY:

The Treasury Management Strategy for 2015/16 (CAB2648) has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

The Code also recommends that members are informed of treasury management activities at least twice a year. This report therefore ensures that the Council is embracing Best Practice in accordance with CIPFA's recommendations.

Treasury management is defined as:

"The management of the local authority'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."

Full Council will need to approve the changes to the Strategy, outlined in recommendation 2 below.

RECOMMENDATIONS:

That the Audit Committee:

1 Approves the Treasury Management Mid-Year Monitoring Report for 2015/16; and

2 Recommends to Council that the change to the 2015/16 Treasury Management Strategy and increase in the upper limit on variable interest rate investment exposure to £80.0m, as detailed in paragraphs 7.2 to 7.6 of the report, be approved.

AUDIT COMMITTEE

3 December 2015

TREASURY MANAGEMENT MID-YEAR REVIEW 2015/16

REPORT OF CHIEF FINANCE OFFICER

DETAIL:

1 Introduction

1.1 The Treasury Management Strategy for 2015/16 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

1.2 The Code also recommends that Members are informed of Treasury Management activities at least twice a year (a mid year and a year end report). This report therefore ensures that Winchester City Council (WCC) are embracing best practice in accordance with CIPFA's recommendations.

1.3 Treasury management is defined as: "the management of investments and cash flows, 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 Economic Background

2.1 The following section outlines the key economic themes currently in the UK against which investment and borrowing decisions have been made in the year to date.

2.2 Growth – positive growth in the UK economy has continued with output growing at a preliminary estimate of 2.3% year-on-year in Q3 2015, which was slightly below the market's expectations. The largest contribution to growth came from services – increasing by 0.7% and contributing 0.6% to overall growth.

2.3 The latest figures released by the Office for National Statistics for September 2015 show the UK labour market improving, with marginal movements in the number of employed (up to 73.7% from 73.4%) and the number of unemployed (down to 5.3% from 5.6%). Wage growth was 2.5% excluding bonuses over the three months to September 2015 year-on-year.

2.4 The Consumer Price Index (CPI) fell to -0.1% in the year to September 2015 from 0.0% in August. This was lower than market expectations of no change.

As set out in the Governor of the Bank of England's letter to the Chancellor, around three quarters of the deviation of inflation from the 2% target reflects unusually low contributions from energy, food and other imported goods prices. The remaining quarter of the deviation of inflation from target reflects the past weakness of domestic cost growth, and unit labour costs in particular.

2.5 UK Monetary Policy: at its meeting ending on 4 November 2015, the monetary Policy Committee (MPC) voted by a majority of 8-1 to maintain Bank Rate at 0.5%. The lone member, for the fourth month in a row, was Ian McCafferty who voted for a 0.25% increase in Bank Rate. The Committee voted unanimously to maintain the stock of purchased assets financed by the issuance of central bank reserves at £375 billion.

2.6 The MPC has previously emphasised that when the Bank Rate does begin to rise, it is expected to do so only gradually and to remain below average historical levels for some time to come. The treasury management advisers to WCC, Arlingclose, now estimate the first rise in interest rates will be in the third quarter of 2016, which is still later than many economic commentators. Arlingclose's expectation is that the appropriate level for Bank Rate for the post-crisis UK economy will be lower than the previous norm, between 2.0 and 3.0%.

2.7 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.

2.8 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.

3 Borrowing Strategy

3.1 At 30/09/2015 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.

3.2 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.

3.3 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. As short-term interest rates have remained, and are likely to remain, lower than long-term rates, WCC determined it was more cost effective in the short-term to use internal resources instead.

3.4 As at 30 September 2015 WCC had a total of £156.7m of long term loans, made up of a number of Public Works Loan Board (PWLB) loans at a weighted average fixed interest rate of 3.30%, and average outstanding term remaining of 25.1 years. This average rate is well below the rate currently being offered for a similar timescale and therefore when viewed against historical interest rates the debt portfolio represents good mitigation against the long-term risk of exposure to interest rate fluctuations, which could increase the cost of borrowing.

3.5 The premia that applies to the premature repayment of PWLB loans is still relatively expensive for the loans in WCC’s portfolio and therefore unattractive for debt rescheduling. As a consequence no rescheduling activity has taken place. However, consideration will continue to be given to any advantageous opportunity for WCC to reduce or restructure its debt portfolio.

4 <u>Investment Activity</u>

4.1 WCC holds invested funds representing income received in advance on expenditure plus balances and reserves held.

4.2 The Guidance on Local Government Investments in England gives priority to security and liquidity and WCC’s aim is to achieve a yield commensurate with these principles.

4.3 The transposition of European Union directives into UK legislation now places the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors through potential bail-in of unsecured bank deposits.

4.4 Given the increasing risk and continued low returns from short-term unsecured bank investments, it is WCC’s aim to further diversify into more secure and/or higher yielding asset classes during 2015/16. The majority of WCC’s surplus cash was previously invested in short-term unsecured bank deposits, certificates of deposit and money market funds. This diversification into securities with underlying collateral and investments with organisations which are not subject to bail-in represents a substantial change in strategy this year.

4.5 WCC has invested £2.0m in a pooled property fund; this investment is aimed for the long-term and provides a regular dividend income, and so far, has proved to be a good investment for WCC to make.

4.6 In order to access additional investments that can attract higher returns than cash and make use of WCC's stable core balances, WCC are considering additional investments of up to a further £4m in longer term investments, including pooled equity funds and a fixed term investment with a housing authority. These investments would be made within the existing Treasury Management Strategy.

4.7 WCC's investment holding was £49.2m at 30 September 2015, which is £12.3m higher than the same time last year, and was placed with the following counterparties:

Table 1: Investment Activity as at 30 September 2015

Duration to maturity	Overnight £m	< 1 year £m	> 1 year £m	Total £m
Subject to bail-in risk				
Bank call accounts	3.0			3.0
Bank notice accounts		3.0		3.0
Bank fixed deposits		1.0		1.0
Bank certificates of deposit*	2.0	14.0		16.0
Money market funds**	5.3	2.0		7.3
Exempt from bail-in risk				
Covered floating rate notes		2.0	2.0	4.0
Covered bonds			2.5	2.5
Corporate bonds		6.4		6.4
Local authorities		2.0	2.0	4.0
Pooled property fund			2.0	2.0
Total	**10.3**	**30.4**	**8.5**	**49.2**

* certificates of deposit have fixed terms but have greater liquidity as they can be sold on the secondary market.

** money market funds are exposed to bail-in risk however their exposure is lower than that of an unsecured bank investment.

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

4.9 Counterparty credit quality was assessed and monitored with reference to credit ratings (WCC's minimum long-term counterparty rating for institutions defined as having 'high credit quality' is BBB+ across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

4.10 The average cash balances were £50.6m during the year to 30 September 2015. The average interest rate earned on WCC's investments at 30 September 2015 was 0.81%, which should be considered within the context of an unchanged UK Base Rate of 0.5% since March 2009 and very low short-term money mark rates.

5 Arlingclose Benchmarking

5.1 According to Arlingclose, WCC's investments are performing well in comparison to two separate indictors, the average of 49 non-metropolitan districts, and the average of 122 local authorities:

Table 2 – Arlingclose benchmarking as at 30 September 2015

	Winchester City Council	46 Non-Met Districts Average	122 Local Authorities Average
Average credit rating	AA-	AA-	AA-
Number of counterparties	26	15	14
Total investments – income return*	1.01%	0.91%	0.87%
Proportion exposed to bail-in	60%	70%	68%

* the Arlingclose total investments – income return figure is greater than the average interest rate earned for the same period, as the average interest rate earned only includes the dividend part of the pooled equity fund, whilst the total investments – income return figure also includes the capital value of the investment.

6 Compliance with Prudential Indicators

6.1 The Council confirms compliance with its Prudential Indicators for 2015/16, which were set in February 2015 as part of the Council's Treasury Management Strategy Statement.

Authorised Limit for External Debt

6.2 CIPFA's Code of Practice requires authorities to set an authorised limit for external debt, defined as the sum of external borrowing and other long-term liabilities. The annual strategy report agreed by Council on 19 February 2015 set an authorised limit for external debt of £182.7m.

6.3 This limit is based on the estimated CFR in order to enable it to be financed entirely from external borrowing should WCC's internal resources be depleted. This limit also includes an allowance for temporary borrowing to cover normal cash flow requirements and unexpected outflows or delays in receiving cash.

6.4 During the period to 30 September 2015 WCC remained well within the authorised limit of £182.7m and no new long term borrowing has been taken out. There has been no temporary borrowing, so the maximum total external debt in the period has remained at £156.7m.

Operational Boundary for External Debt

6.5 WCC has set an operational boundary for external debt reflecting the more likely scenario and consistent with WCC's capital gains and Treasury Management Strategy. Temporary breaches of the 2015/16 operational boundary can take place for cash flow reasons, but any sustained breach will lead to further investigation. The Council approved an operational boundary for 2015/16 of £181.6m.

6.6 As outlined above WCC's maximum total external debt of £156.7m in the period from April to September 2015 was within the operational boundary.

7 Treasury Management Indicators

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

Interest Rate Exposures

7.2 WCC has to set an upper limit on its fixed and variable interest rate exposure for both total investments and total external debt. The Council has approved the following limits, none of which have been exceeded as follows:

Table 3 – Interest Rate Exposures

	Approved Limits for 2015/16	Maximum during 2015/16	Compliance with Limits:
Upper limit on fixed interest rate investment exposure	£16.0m	£5.0m	Yes
Upper limit on variable interest rate investment exposure	£60.0m	£58.9m	Yes
Upper limit on fixed interest rate borrowing exposure	£181.6m	£156.7m	Yes
Upper limit on variable interest rate borrowing exposure	£90.8m	-	Yes

7.3 The limit for borrowing rate exposure has been set to enable maximum policy flexibility for the potential for refinancing e.g. from variable to fixed rate borrowing. WCC's long-term debt portfolio is currently made up of fixed interest loans.

7.4 The upper limit for exposure for investments is intended to be based on an extreme case for the total investment balances, and to allow for all of this to be held at variable rate (investments with a maturity of less than one year) if necessary.

7.5 However during the year to date, the maximum balance has risen close to the upper limit (£58.9m balance compared to a £60.0m limit) – this is due to the fact that at 30 September 2015 cash balances have increased by 33% in comparison to 30 September 2014 (£49.2m compared to £36.9m), and at its highest point this year, cash balances have risen to £62.5m.

7.6 Although it is not planned that all investments would be held at variable rate, it is prudent for the allowance to be made so that this can happen in a worst case scenario. Therefore it would be helpful to make a change to the 2015/16 Treasury Management Strategy and increase the upper limit on variable interest rate investment exposure to £80.0m. If this change to the strategy is acceptable, the proposed interest rate exposures will become as follows:

Table 4 – Proposed Interest Rate Exposures

	Approved Limits for 2015/16
Upper limit on fixed interest rate investment exposure	£16.0m
Upper limit on variable interest rate investment exposure	£80.0m
Upper limit on fixed interest rate borrowing exposure	£181.6m
Upper limit on variable interest rate borrowing exposure	£90.8m

<u>Maturity Structure of Borrowing</u>

7.7 The Code also requires WCC to set upper and lower percentage limits on the maturity structure of its long-term fixed rate borrowing during 2015/16. The following table shows the limits approved by the Council. These have been set in order to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

Table 5 – Maturity Structure of Borrowing

	Upper	Lower	Actual
Under 12 months	25.0%	0.0%	0.0%
12 months and within 24 months	25.0%	0.0%	0.0%
24 months and within 5 years	25.0%	0.0%	0.0%
5 years and within 10 years	25.0%	0.0%	9.5%
10 years and within 20 years	50.0%	0.0%	41.5%
20 years and within 30 years	50.0%	0.0%	12.8%
30 years and within 40 years	75.0%	0.0%	12.8%
40 years and within 50 years	100.0%	0.0%	23.4%

Principal Sums Invested for Periods Longer than 364 days

7.8 For 2015/16 WCC restricted investments for periods of over a year to a maximum of £16.0m. At 30 September 2015 WCC had £8.5m of investments with over 364 days to their maturity.

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

	2015/16	**2016/17**	**2017/18**
Limit on principal invested beyond year end	£16.0m	£15.0m	£15.0m
Actual	£8.5m		

OTHER CONSIDERATIONS:

8 COMMUNITY STRATEGY AND PORTFOLIO PLANS (RELEVANCE TO):

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

9 RESOURCE IMPLICATIONS:

9.1 Investment income is currently expected to amount to £444k in 2015/16 (£430k in 2014/15).

10 RISK MANAGEMENT ISSUES

10.1 These are considered within the report. The Council's Treasury Management Practices provide a detailed consideration of the management of treasury risks.

BACKGROUND DOCUMENTS: None

APPENDICES: None