

AUDIT COMMITTEE

28 June 2016

TREASURY MANAGEMENT OUTTURN REPORT FOR 2015/16

REPORT OF HEAD OF FINANCE

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RECENT REFERENCES:

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

AUD119: Treasury Management Practices, 22 June 2015

AUD137: Treasury Management Mid-Year Review 2015/16, 3 December 2015

CAB2766: Treasury Management Strategy 2016-17, 18 February 2016

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 2015/16.

RECOMMENDATIONS:

That the Audit Committee:

- 1 Approves the Annual Treasury Outturn Report 2015/16 and the actual Prudential Indicators provided at pages 10 to 12 of the Report.

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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 2015/16, 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 2015/16, 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 pages 10 to 12.

3 External Context

- 3.1 The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions were made in 2015/16.

Growth, Inflation, Employment:

- 3.2 The UK economy slowed in 2015 with GDP growth falling to 2.3% from a robust 3.0% the year before. CPI inflation hovered around 0.0% through 2015 with deflationary spells in April, September and October. The prolonged spell of low inflation was attributed to the continued collapse in the price of oil from \$67 a barrel in May 2015 to just under \$28 a barrel in January 2016, the appreciation of sterling since 2013 pushing down import prices and weaker than anticipated wage growth resulting in subdued unit labour costs. CPI picked up to 0.3% year on year in February, but this was still well below the Bank of England's 2% inflation target. The labour market continued to improve through 2015 and in Quarter 1 of 2016, the latest figures (January 2016) showing the employment rate at 74.1% (the highest rate since comparable records began in 1971) and the unemployment rate at a 12 year low of 5.1%. Wage growth has however remained modest at around 2.2% excluding bonuses, but after a long period of negative real wage growth (i.e. after inflation) real earnings were positive and growing at their fastest rate in eight years, boosting consumers' spending power.

UK Monetary Policy

- 3.3 The Bank of England's MPC (Monetary Policy Committee) made no change to policy, maintaining the Bank Rate at 0.5% (in March it entered its eighth year at 0.5%) and asset purchases (Quantitative Easing) at £375bn. In its Inflation Reports and monthly monetary policy meeting minutes, the Bank was at pains to stress and reiterate that when interest rates do begin to rise they were expected to do so more gradually and to a lower level than in recent cycles.

4 Local Context

- 4.1 At 31/03/2016 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £162.8m, while usable reserves and working capital which are the underlying resources available for investment were £44.9m (principal invested plus gains on investments with a variable net asset value).
- 4.2 At 31/03/2016, the Council had £156.7m of borrowing and £44.1m 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 are expected to gradually reduce over the same period. This may require the Council to take out new borrowing towards the end of the forecast period.

5 Borrowing Strategy

- 5.1 At 31/03/2016 the Council held £156.7m of loans as part of its strategy for funding previous years' capital 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 2015/16. 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 2015/16

| | Balance on 01/04/2015 £m | Net New Borrowing £m | Balance on 31/03/2016 £m |
|---|--------------------------------|----------------------------|--------------------------------|
| (CFR) | 162.7 | | 162.8 |
| Long Term Borrowing | 156.7 | - | 156.7 |
| TOTAL BORROWING | 156.7 | - | 156.7 |
| Other Long Term Liabilities | 1.5 | (0.3) | 1.2 |
| TOTAL EXTERNAL DEBT | 158.2 | (0.3) | 157.9 |
| Increase/ (Decrease) in Borrowing £m | | | - |

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.

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 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 other than local authorities, means that the risks of making unsecured deposits rose relative to other investment options. The Council therefore increasingly favoured secured investment options or diversified alternatives such as covered bonds, non-bank investments and pooled funds over unsecured bank and building society investments.
- 6.3 The Council has held invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2015/16 the Council's investment balances have ranged between £37.6 and £64.7 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 2015/16

| Investments | Balance on 01/04/15 £m | Balance on 31/03/16 £m | Average Rate/Yield on 31/03/16 % | Average Life on 31/03/16 Years |
|---|---------------------------------|---------------------------------|---|---|
| Short term Investments | | | | |
| - Banks and Building Societies: | | | | |
| - Unsecured | 20.2 | 10.8 | 0.85 | 0.12 |
| - Secured | 3.0 | 4.0 | 0.81 | 0.75 |
| - Money Market Funds | 6.6 | 7.3 | 0.51 | 0.00 |
| - Local Authorities | - | 11.0 | 0.60 | 0.56 |
| - Corporate Bonds | 3.9 | - | - | - |
| Long term Investments | | | | |
| - Banks and Building Societies: | | | | |
| - Secured | - | 7.0 | 0.91 | 1.71 |
| - Local Authorities | 2.0 | 2.0 | 1.48 | 1.42 |
| - Pooled Funds | 2.0 | 2.0 | 2.64 ¹ | N/A |
| TOTAL INVESTMENTS | 37.7 | 44.1 | 0.85 | 0.57 |
| Increase/ (Decrease) in Investments £m | | 6.4 | | |

- 6.5 During 2014/15 the Council diversified its range of investments in order to reduce the risk of loss of funds. This process has continued in 2015/16. Over the year the Council reduced its exposure to unsecured bank and building society investments by increasing its exposure to secured bank and building society investments and other local authorities.
- 6.6 The property fund investment allows the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. The fund, which is operated on a variable net asset value (VNAV) basis, offers diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short term. The Council's pooled fund investment is in the fund's distributing share class which pays out the income generated.
- 6.7 Although money can be redeemed from the pooled fund at short notice, the Council's intention is to hold this for the medium term. Its performance and suitability in meeting the Council's investment objectives are monitored regularly and discussed with Arlingclose.
- 6.8 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 2015/16.

¹ Income return at 31/03/16

- 6.9 Counterparty credit quality was assessed and monitored with reference to credit ratings, for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.
- 6.10 The Council will also consider the use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.
- 6.11 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 objectivity 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.
- 6.12 The Council's average cash balances were £53.1m during the year and interest earned for the year was £605,000, giving a yield of 1.14%.
- 6.13 The Council is currently reviewing the make up of its investment portfolio and considering opportunities to invest some balances on a longer term basis to increase overall yields whilst maintaining sufficient liquidity and reducing its exposure to bail-in risk.

7 Update on Investments with Icelandic Banks

- 7.1 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 15 distributions amounting to £0.98m equating to a return of 98 pence to 100 in the pound. The Council received the latest distribution of £39,964.03 during August 2015. A progress report, received in March 2016, stated that the administrators are not in a position to make any further distributions. A further update will be issued in mid 2016.

8 Compliance with Prudential Indicators

- 8.1 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 and amended in January 2016 as part of the Council's Treasury Management Mid-Year Review 2015/16.

9 Treasury Management Indicators

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

Interest Rate Exposures

- 9.2 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 invested will be:

| | 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 | £80.0m | £61.9m | Yes |

- 9.3 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

- 9.4 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:

| | Upper | Lower | Actual |
|--------------------------------|--------------|--------------|---------------|
| Under 12 months | 25% | 0% | 0% |
| 12 months and within 24 months | 25% | 0% | 0% |
| 24 months and within 5 years | 25% | 0% | 0% |
| 5 years and within 10 years | 25% | 0% | 13% |
| 10 years and within 20 years | 50% | 0% | 38% |
| 20 years and within 30 years | 50% | 0% | 13% |
| 30 years and within 40 years | 75% | 0% | 13% |
| 40 years and within 50 years | 100% | 0% | 23% |

Principal Sums Invested for Periods Longer than 364 days

- 9.5 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:

| | 2015/16 | 2016/17 | 2017/18 |
|---|----------------|----------------|----------------|
| Limit on principal invested beyond year end | £16m | £15m | £15m |
| Actual | £11m | | |

PRUDENTIAL INDICATORS 2015/16

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.

Estimates of Capital Expenditure

The Council's planned capital expenditure and financing may be summarised as follows. Further detail is provided in the capital programme.

| Capital Expenditure and Financing | 2015/16 Approved £m | 2015/16 Revised £m | 2015/16 Actual £m | 2016/17 Estimate £m | 2017/18 Estimate £m |
|--|------------------------------------|-----------------------------------|----------------------------------|------------------------------------|------------------------------------|
| General Fund | 17.3 | 5.7 | 4.3 | 19.2 | 26.1 |
| Housing Revenue Account | 23.1 | 15.7 | 14.2 | 31.3 | 16.7 |
| Total Expenditure | 40.4 | 21.4 | 18.5 | 50.5 | 42.8 |
| Capital Receipts | 6.9 | 1.8 | 1.5 | 7.0 | 13.0 |
| Grants and Contributions | 2.9 | 3.9 | 3.4 | 3.7 | 4.6 |
| Reserves | 13.2 | 9.3 | 9.2 | 8.1 | 8.5 |
| Revenue | 10.4 | 5.4 | 3.8 | 9.9 | 7.2 |
| Borrowing | 7.0 | 1.0 | 0.6 | 21.8 | 9.5 |
| Total Financing | 40.4 | 21.4 | 18.5 | 50.5 | 42.8 |

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 | 31.03.16 Approved £m | 31.03.16 Revised £m | 31.03.16 Actual £m | 31.03.17 Estimate £m | 31.03.18 Estimate £m |
|--------------------------------------|-------------------------------------|------------------------------------|-----------------------------------|-------------------------------------|-------------------------------------|
| General Fund | 16.2 | 5.8 | 5.4 | 16.8 | 25.6 |
| Housing Revenue Account | 160.9 | 157.4 | 157.4 | 167.6 | 166.7 |
| Total CFR | 177.1 | 163.2 | 162.8 | 184.4 | 192.3 |

The CFR is forecast to rise by £20.2m over the next two years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

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 | 31.03.16 Approved £m | 31.03.16 Revised £m | 31.03.16 Actual £m | 31.03.17 Estimate £m | 31.03.18 Estimate £m |
|-------------------|-------------------------------------|------------------------------------|-----------------------------------|-------------------------------------|-------------------------------------|
| Borrowing | 156.7 | 156.7 | 156.7 | 156.7 | 156.7 |
| New borrowing | - | - | - | - | 4.7 |
| Finance leases | 1.2 | 1.2 | 1.2 | 0.8 | 0.5 |
| Total Debt | 157.9 | 157.9 | 157.9 | 157.5 | 161.9 |

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.

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 | 2015/16 Approved £m | 2015/16 Revised £m | 2015/16 Actual £m | 2016/17 Estimate £m | 2017/18 Estimate £m |
|-----------------------------|------------------------------------|-----------------------------------|----------------------------------|------------------------------------|------------------------------------|
| Borrowing | 180.4 | 172.8 | 156.7 | 193.4 | 200.8 |
| Other long-term liabilities | 1.2 | 1.2 | 1.2 | 0.8 | 0.5 |
| Total Debt | 181.6 | 174.0 | 157.9 | 194.2 | 201.3 |

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 | 2015/16 Approved £m | 2015/16 Revised £m | 2015/16 Actual £m | 2016/17 Estimate £m | 2017/18 Estimate £m |
|-----------------------------|------------------------------------|-----------------------------------|----------------------------------|------------------------------------|------------------------------------|
| Borrowing | 181.2 | 179.9 | 156.7 | 200.7 | 208.3 |
| Other long-term liabilities | 1.5 | 1.5 | 1.2 | 1.0 | 0.6 |
| Total Debt | 182.7 | 181.4 | 157.9 | 201.7 | 208.9 |

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 | 2015/16 Approved % | 2015/16 Revised % | 2015/16 Actual % | 2016/17 Estimate % | 2017/18 Estimate % |
|---|-----------------------------------|----------------------------------|---------------------------------|-----------------------------------|-----------------------------------|
| General Fund | 2.03 | 0.69 | 0.38 | 0.92 | 3.06 |
| Housing Revenue Account | 18.89 | 17.67 | 17.52 | 17.71 | 18.66 |

Adoption of the CIPFA Treasury Management Code

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

OTHER CONSIDERATIONS:

BACKGROUND DOCUMENTS: None

APPENDICES: None