MEETING:	**AUDIT COMMITTEE**
DATE:	**16 JULY 2015**
TITLE:	**TREASURY MANAGEMENT 2014/15**
PURPOSE:	**CIPFA's Code of Practice requires that a report on the results of the Council's actual treasury management is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
AUTHOR:	**CAROLINE ROBERTS, INVESTMENT MANAGER**

Executive Summary

During 2014/15 the Council's borrowing remained well within the limits originally set, total interest received on deposits was £411,020 which was above the budgeted level of £319,860. There were no new defaults by banks in which the Council deposited money.

1. Introduction and Background

CIPFA's revised Code of Practice on Treasury Management was adopted by the Council on 1st March 2011 and the Council fully complies with its requirements. The Code requires that I report on the results of the Council's actual treasury management in the previous financial year against that which was expected. It is considered that the Audit Committee is the appropriate body to consider this report.

This report compares our actual performance for 2014/15 against the strategy which was set out in February 2014 for the financial year which was approved by the full Council at its meeting on 6 March 2014 and can be accessed at - https://www.gwynedd.gov.uk/en/Council/Councillors-and-committees/Meetings,-minutes-and-agendas/Meetings,-minutes-and-agendas.aspx?pwyllgor=/2013-14/Cyngor Llawn_Full Council/2014-03-06

The report looks at:

- the economic background;
- the borrowing requirement and debt management;
- investment activity;
- compliance with Prudential Indicators.

This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the Welsh Government's Investment Guidance.

The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

2. External Context

Growth and Inflation: 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.

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 the oil price (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: 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: The Bank of England's MPC maintained interest rates at 0.5% and asset purchases (QE) 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 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.

Political uncertainty had a large bearing on market confidence this year. The possibility of Scottish independence was of concern to the financial markets, however this dissipated following the outcome of September's referendum. The risk of upheaval (the pledge to devolve extensive new powers to the Scottish parliament; English MPs in turn demanding separate laws for England) lingers on. The highly politicised March Budget heralded the start of a closely contested general election campaign and markets braced for yet another hung parliament.

On the continent, the European Central Bank lowered its official benchmark interest rate from 0.15% to 0.05% in September and the rate paid on commercial bank balances held with it was from -0.10% to -0.20%. The much-anticipated quantitative easing, which will expand the ECB's balance sheet by €1.1 trillion was finally announced by the central bank at its January meeting in an effort to steer the euro area away from deflation and invigorate its moribund economies. The size was at the high end of market expectations and it will involve buying €60bn of sovereign bonds, asset-backed securities and covered bonds a month commencing March 2015 through to September 2016. The possibility of a Greek exit from the Eurozone refused to subside given the clear frustrations that remained between its new government and its creditors.

The US economy rebounded strongly in 2014, employment growth was robust and there were early signs of wage pressures building, albeit from a low level. The Federal Reserve made no change to US policy rates. The central bank however continued with ‘tapering’, i.e. a reduction in asset purchases by $10 billion per month, and ended them altogether in October 2014. With the US economy resilient enough the weather the weakness of key trading partners and a strong US dollar, in March 2015 the Fed removed the word “patient” from its statement accompanying its rates decisions, effectively leaving the door open for a rise in rates later in the year.

Market reaction: From July, 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. 5-, 10- and 20-year gilt yields fell to their lows in January (0.88%, 1.33% and 1.86% respectively) before ending the year higher at 1.19%, 1.57% and 2.14% respectively.

Local Context

At 31/03/2015 the Authority’s underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £174.9m, while usable reserves and working capital which are the underlying resources available for investment were £119m.

At 31/03/2015, the Authority had £113.7m of loans and leases, and £38.4m of investments. The Authority’s current strategy is to maintain borrowing and investments below their underlying levels.

The Authority has an increasing CFR over the next 2 years due to the capital programme, and a significant level of investments and therefore is not planning to borrow over the forecast period.

Borrowing Strategy

At 31 March 2015 the Authority held £111.3m of loans, (a decrease of £1.1m from 31 March 2014) as part of its strategy for funding previous years’ capital programmes.

The Authority’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 Authority’s long-term plans change being a secondary objective.

Affordability and the “cost of carry” remained important influences on the Authority’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 at least over the forthcoming two years, lower than long-term rates, the Authority determined it was more cost effective in the short-term to use internal resources instead.

The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Authority with this 'cost of carry' and breakeven analysis.

3. Borrowing Activity in 2014/15

	Balance on 01/04/2014 £'000	New Borrowing £'000	Maturing Debt £'000	Transfer to short term £'000	Balance on 31/03/2015 £'000	Average Rate %
CFR	173,309				174,889	
Short Term Borrowing[1]	1,193	0	(1,193)	214	214	5.74
Long Term Borrowing	111,215	106	0	(214)	111,107	5.73
TOTAL BORROWING	**112,408**	**106**	**(1,193)**	**0**	**111,321**	**5.73**
Other Long Term Liabilities	2,484	0	(112)	0	2,372	6.17
TOTAL EXTERNAL DEBT	**114,892**	**106**	**(1,305)**	**0**	**113,693**	**5.74**
Increase/ (Decrease) in Borrowing £m					(1,199)	

LOBOs: The Authority holds £16.2m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost.

Debt Rescheduling:
The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Authority's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

Changes in the debt portfolio over the year have achieved a reduction in the level of borrowing as well as a reduction in credit risk by repaying loans from investment balances.

Abolition of the PWLB: 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 Public Works Loans Board. 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 authority intends to use the PWLB's replacement as a potential source of borrowing if required.

[1] Loans with maturities less than 1 year.

4. Investment Activity

The Authority has held significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2014/15 the Authority's investment balances have ranged between £45.3 and £77.6 million.

The Welsh Government's Investment Guidance gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

Investments	**Balance on 01/04/14 £'000**	**Investments Made £'000**	**Maturities/ Investments Sold £'000**	**Revalue to Fair Value £'000**	**Balance on 31/03/15 £'000**	**Average Rate %**
Call Accounts with Banks with ratings of A- or higher - short term	20,825	157,650	(160,055)	0	18,420	0.47
Investments with Banks and Building Societies with ratings of A- or higher - short term	27,000	52,597	(42,595)	0	37,002	0.78
Building Society Covered Bond – long term	0	1,088	0	33	1,121	0.45
Money Market Funds	0	89,796	(89,796)	0	0	2.09
TOTAL INVESTMENTS	**47,825**	**301,131**	**(292,446)**	**33**	**56,543**	
Increase/ (Decrease) in Investments £m					8,718	

Security of capital has remained the Authority's main investment objective. This was maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement for 2014/15.

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Authority's minimum long-term counterparty rating was A- 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.

Credit Risk

Counterparty credit quality as measured by credit ratings is summarised below:

Date	Value Weighted Average Credit Risk Score	Value Weighted Average Credit Rating	Time Weighted Average Credit Risk Score	Time Weighted Average Credit Rating	Average Life (days)
31/03/2014	5.69	A	5.80	A	102
30/06/2014	5.19	A+	5.12	A+	139
30/09/2014	5.01	A+	3.21	AA	118
31/12/2014	5.39	A+	3.49	AA	148
31/03/2015	5.24	A+	3.62	AA-	64

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 26
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Counterparty Update

The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on April 15, 2014. Taking the view that potential extraordinary government support available to banks' senior unsecured bondholders will likely diminish, over 2014-15 Moody’s revised the Outlook of several UK and EU banks from Stable to Negative (note, this is not the same as a rating review negative) and S&P placed the ratings of UK and German banks on Credit Watch with negative implications, following these countries’ early adoption of the bail-in regime in the BRRD.

S&P also revised the Outlook for major Canadian banks to negative following the government’s announcement of a potential bail-in policy framework.

The Bank of England published its approach to bank resolution which gave 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 corporates and financial institutions. Other EU countries, and eventually all other developed countries, are expected to adopt similar approaches in due course.

In December the Bank’s Prudential Regulation Authority (PRA) stress tested eight UK financial institutions to assess their resilience to a very severe housing market shock and to a sharp rise in interest rates and address the risks to the UK’s financial stability. Institutions which ‘passed’ the tests but would be at risk in the event of a ‘severe economic downturn’ were Lloyds Banking Group and Royal Bank of Scotland. Lloyds Banking Group, [whose constituent banks are on the Authority’s lending list], is taking measures to augment capital and the PRA does not require the group to submit a revised capital plan. RBS, which is not on the Authority’s lending list for investments, has updated plans to issue additional Tier 1 capital. The Co-operative Bank failed the test.

The European Central Bank also published the results of the Asset Quality Review (AQR) and stress tests, based on December 2013 data. 25 European banks failed the test, falling short of the required threshold capital by approximately €25bn (£20bn) in total – none of the failed banks featured on the Authority's lending list.

In October following sharp movements in market signals driven by deteriorating global growth prospects, especially in the Eurozone, Arlingclose advised a reduction in investment duration limits for unsecured bank and building society investments to counter the risk of another full-blown Eurozone crisis. Duration for new unsecured investments with some UK institutions was further reduced to 100 days in February 2015.

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 Authority therefore has started to use secured investment options or diversified alternatives such as covered bonds, in addition to unsecured bank and building society deposits. Deposits were generally made over short periods in order to reduce the risk. Use of secured options including non-bank investments and pooled funds as well as covered bonds is likely to increase in order to reduce the risk of default.

Budgeted Income and Outturn

The average cash balances were £63.5m during the year. The UK Bank Rate has been maintained at 0.5% since March 2009. Short-term money market rates have remained at relatively low levels. New deposits were made at an average rate of 0.78%. Investments in Money Market Funds generated an average rate of 0.45%.

The Authority's budgeted investment income for the year was £0.32m. The Authority's investment income outturn for the year was £0.41m.

Update on Investment with Heritable Bank

The authority has now recovered 94% of its investment in Heritable Bank. It is likely that further distributions will be received and that the full amount should be recovered. The timing of future distributions is unclear and depends on settlement of the ongoing court case. Notice that a dividend will be paid in August 2015 has been received but the amount is not yet known.

5. Compliance with Prudential Indicators

The Authority confirms that it has complied with its **Prudential Indicators** for 2014/15, which were set on 6 March 2014 as part of the Authority's Treasury Management Strategy Statement.

Treasury Management Indicators

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

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

	2014/15	2015/16	2016/17
Upper Limit for Fixed Rate Exposure	100%	100%	100%
Maximum during the year			
Compliance with Limits:	Yes	Yes	Yes
Upper Limit for Variable Rate Exposure	50%	50%	50%
Maximum during the year			
Compliance with Limits:	Yes	Yes	Yes

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

Maturity Structure of Fixed Rate Borrowing	Upper Limit %	Lower Limit %	Actual Fixed Rate Borrowing at 31/03/15 £'000	Percentage Fixed Rate Borrowing at 31/03/15 %	Compliance with Set Limits?
under 12 months	25%	0%	**214**	0.2	Yes
12 months and within 24 months	25%	0%	**1,981**	1.8	Yes
24 months and within 5 years	50%	0%	**20,857**	18.7	Yes
5 years and within 10 years	75%	0%	**11,450**	10.3	Yes
10 years and within 20 years	100%	0%	**34,003**	30.5	Yes
20 years and within 30 years	100%	0%	**15,464**	13.9	Yes
30 years and within 40 years	100%	0%	**0**	0.0	Yes
40 years and above	100%	0%	**27,352**	24.6	Yes

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment. The Council's LOBO loan is included in the '24 months and within 5 years' category above.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Authority'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:

	Approved 31/03/15 £m	**Revised 31/03/15 £m**	**Actual 31/03/15 £m**	**Estimate 31/03/16 £m**	**Estimate 31/03/17 £m**
Total	**30.0**	**30.0**	**1.1**	**20.0**	**10.0**

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the time-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target	**Actual**
Portfolio average credit score	6.0	5.24

In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2014/15. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

The Authority also confirms that during 2014/15 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.

6. Investment Training

The needs of the Authority's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

During 2014/15 staff attended training courses, seminars and conferences provided by Arlingclose and CIPFA.

APPENDIX 1

Prudential Indicators 2014/15

The Local Government Act 2003 requires the Authority 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 Authority 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 Authority's planned capital expenditure and financing may be summarised as follows.

Capital Expenditure	Approved 31/03/15 £m	Revised 31/03/15 £m	Actual 31/03/15 £m	Estimate 31/03/16 £m	Estimate 31/03/17 £m
General Fund	**35.6**	**41.3**	**32.4**	**38.4**	**16.9**

Capital Expenditure and Financing	Approved 31/03/15 £m	Revised 31/03/15 £m	Actual 31/03/15 £m	Estimate 31/03/16 £m	Estimate 31/03/17 £m
Capital receipts	1.2	1.9	1.9	1.5	0.0
Government Grants	12.8	21.3	15.5	12.9	4.3
Revenue contributions	9.5	7.5	6.4	11.2	1.2
Supported borrowing	4.1	4.1	4.1	6.6	6.6
Prudential borrowing	8.0	6.5	4.5	6.2	4.8
Total Financing	**35.6**	**41.3**	**32.4**	**38.4**	**16.9**

Estimates of the Capital Financing Requirement

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

Capital Financing Requirement	Approved 31/03/15 £m	Revised 31/03/15 £m	Actual 31/03/15 £m	Estimate 31/03/16 £m	Estimate 31/03/17 £m
General Fund	173.7	175.2	174.9	179.5	185.1

The CFR is forecast to rise by £10.2m over the next two years as capital expenditure financed by debt is higher than the 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 Authority 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	**Approved 31/03/15 £m**	**Actual 31/03/15 £m**	**Estimate 31/03/16 £m**	**Estimate 31/03/17 £m**
Borrowing	195.0	111.3	111.1	109.1
Finance leases	0.0	2.4	2.3	2.1
Total Debt	**195.0**	**113.7**	**113.4**	**111.2**
Borrowing in excess of CFR?	No	No	No	No

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 Authority's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

Operational Boundary	**2014/15 £m**	**2015/16 £m**	**2016/17 £m**
Borrowing	**175,000**	**175,000**	**175,000**
Other long-term liabilities	**0**	**0**	**0**
Total Debt	**175,000**	**175,000**	**175,000**

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 Authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	**2014/15 £m**	**2015/16 £m**	**2016/17 £m**
Borrowing	**195,000**	**195,000**	**195,000**
Other long-term liabilities	**0**	**0**	**0**
Total Debt	**195,000**	**195,000**	**195,000**

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	Approved 31/03/15 %	Revised 31/03/15 %	Actual 31/03/15 %	Estimate 31/03/16 %	Estimate 31/03/17 %
Total	**5.34**	**5.34**	**5.08**	**5.68**	**5.81**

Adoption of the CIPFA Treasury Management Code

This indicator demonstrates that the Authority adopted the principles of best practice.

The Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* on 3rd March 2011.

APPENDIX 2

Credit Score Analysis

Scoring:

Long-Term Credit Rating	Score
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
BBB+	8
BBB	9
BBB-	10

The value weighted average reflects the credit quality of investments according to the size of the deposit. The time weighted average reflects the credit quality of investments according to the maturity of the deposit.

The Authority aimed to achieve a score of 7 or lower, to reflect the Authority's overriding priority of security of monies invested and the minimum credit rating threshold of A- for investment counterparties.