MEETING:	**AUDIT COMMITTEE**
DATE:	**24 SEPTEMBER 2015**
TITLE:	**TREASURY MANAGEMENT 2015/16 – MID YEAR REVIEW**
PURPOSE:	**CIPFA's Code of Practice recommends that a report on the Council's actual Treasury Management during the current financial year is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
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EXECUTIVE SUMMARY

During the five month period between 1 April and 31 August 2015, the Council's borrowing remained well within the limits originally set. There were no new defaults by banks in which the Council deposited money.

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1. INTRODUCTION

The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that Authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end). This report provides an additional quarterly update.

The Council's Treasury Management Strategy for 2015/16 was approved by full Council on 5 March 2015 which can be accessed on
https://www.gwynedd.gov.uk/en/Council/Councillors-and-committees/Meetings,-minutes-and-agendas/Meetings,-minutes-and-agendas.aspx?pwyllgor=/2014-15/Cyngor Llawn_Full Council/2015-03-05

The Council 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. This report covers treasury activity and the associated monitoring and control of risk.

2. EXTERNAL CONTEXT

As the year began, economic data was largely overshadowed by events in Greece. Markets' attention centered on the never-ending Greek issue stumbled from turmoil to crisis, running the serious risk of a disorderly exit from the Euro. The country's politicians and the representatives of the 'Troika' of its creditors - the European Commission (EC), the European Central Bank (ECB) and the International Monetary

Fund (IMF) – barely saw eye to eye. Greece failed to make a scheduled repayment to the IMF on 30th June, in itself not a default until the IMF's Managing Director declares it so. Prime Minister Tsipras blindsided Greece's creditors by calling a referendum on 5th July on reform proposals which by then were off the table anyway. The European Central Bank froze liquidity assistance provided to Greek banks and capital controls within the country severely restricted individuals' and corporates' access to cash.

On 12th July, following a weekend European Union Summit, it was announced that the terms for a third bailout of Greece had been reached. The deal amounting to €86 billion was agreed under the terms that Greece would see tax increases, pension reforms and privatisations; the very reforms Tsipras had vowed to resist. On 27th August, Alexis Tsipras resigned from his post as Prime Minster of Greece after just eight months in office by calling a snap election, to be held on 20th September. Presumably aiming to solidify his government's position of power, opinion polls in Greece suggest this may have backfired, with the centre-right New Democracy party gaining support and running neck-and-neck with Syriza. Political uncertainty continues.

The summer also saw attention shift towards China as the Shanghai composite index (representing China's main stock market), which had risen a staggering 50%+ since the beginning of 2015, dropped by 43% in less than three months with a reported $3.2 trillion loss to investors, on the back of concerns over growth and after regulators clamped down on margin lending activity in an effort to stop investors borrowing to invest and feeding the stock market bubble. Chinese authorities intensified their intervention in the markets by halting trading in many stocks in an attempt to maintain market confidence. They surprised global markets in August as the People's Bank of China changed the way the yuan is fixed each day against the US dollar and allowed an aggressive devaluation of the currency. This sent jitters through Asian, European and US markets impacting currencies, equities, commodities, oil and metals. On 24th August, Chinese stocks suffered their steepest one-day fall on record, driving down other equity markets around the world and soon becoming known as another 'Black Monday'.

UK Economy: The economy has remained resilient over the last six months. Although economic growth slowed in Q1 2015 to 0.4%, year/year growth to March 2015 was a relatively healthy 2.9%. Q2 2015 GDP growth bounced back and was confirmed at 0.7%, with year/year growth showing slight signs of slowing, decreasing to 2.6%. GDP has now increased for ten consecutive quarters, breaking a pattern of slow and erratic growth from 2009. The annual rate for consumer price inflation (CPI) briefly turned negative in April, falling to 0.1%, before returning to 0.1%, 0.0% and 0.1% in May, June and July respectively. In the August Quarterly Inflation Report, the Bank of England projected that GDP growth will continue around its average rate since 2013. The Bank of England's projections for inflation remained largely unchanged from the May report with them expecting inflation to gradually increase to around 2% over the next 18 months and then remain there in the near future. Further improvement in the labour market saw the ILO unemployment rate for the three months to April fall to 5.5%, although this ticked back up to 5.6% in subsequent months. In the August report, average earnings excluding bonuses for the three months to June rose 2.8% year/year.

The outcome of the UK general election, largely fought over the parties' approach to dealing with the consequences of the structural deficit and the pace of its removal, saw some very big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics.

The US economy slowed to 0.6% in Q1 2015 due to bad weather, spending cuts by energy firms and the effects of a strong dollar. However, Q2 GDP showed a large improvement at a revised 3.7% (annualised). This was largely due to a broad recovery in corporate investment alongside a stronger performance from consumer and government spending and exports. With the Fed's decision on US interest rate dependent upon data, GDP is clearly supportive. However it is not as simple as that and the Fed are keen to see inflation rise alongside its headline economic growth and also its labour markets. Markets remained split between predicting a rate rise in September or December.

Market reaction: Equity markets initially reacted positively to the pickup in the expectations of global economic conditions, but were tempered by the breakdown of creditor negotiations in Greece. China led stock market turmoil around the globe in August, with the FTSE 100 falling by around 8% overnight on 'Black Monday'. Indices have not recovered to their previous levels but some improvement has been seen. Government bond markets were quite volatile with yields rising (i.e. prices falling) initially as the risks of deflation seemingly abated. Thereafter yields fell on the outcome of the UK general election and assisted by reappraisal of deflationary factors, before rising again. Concerns around China saw yields dropping again through August. Bond markets were distorted by the size of the European Central Bank's QE programme, so large that it created illiquidity in the very markets in which it needed to acquire these bonds, notably German government bonds (bunds) where yields were in negative territory

Local Context

At 31/3/2015 the Council'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 £72.2m.

At 31/3/2015, the Council had £113.7m of borrowing and £56.5m of investments. The Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

Borrowing Strategy

At 31/8/2015 the Council held £113.5m of loans, (a decrease of £0.2m on 31/3/2015), as part of its strategy for funding previous years' capital programmes.

The Council does not expect to borrow in 2015/16.

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, the Council 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 Council with this 'cost of carry' and breakeven analysis.

Borrowing Activity in 2015/16

	Balance on 01/04/15 £m	**Maturing Debt £m**	**New Borrowing £m**	**Balance on 31/08/15 £m**	**Avg Rate % and Avg Life (yrs)**
CFR	174,889				
Short Term Borrowing[1]	214	(106)		108	0
Long Term Borrowing	111,107	-	-	111,107	5.78
TOTAL BORROWING	**111,321**	**(106)**	**-**	**111,215**	**5.77**
Other Long Term Liabilities	2,372	(48)	-	2,324	6.17
TOTAL EXTERNAL DEBT	**113,693**	**(154)**	**-**	**113,539**	**5.78**
Increase/ (Decrease) in Borrowing £m				(154)	

PWLB Certainty Rate and Project Rate Update: The Council qualified for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 01/11/2014. In September the Council submitted its application to the Treasury to access this reduced rate for a further 12 month period from 01/11/2015.

LOBOs: The Council holds a £16.2m LOBO (Lender's Option Borrower's Option) loan where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. The next option is in 2018/19.

Debt Rescheduling:

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.

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

[1] Loans with maturities less than 1 year.

Investment Activity

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held.

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

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.

Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the Council's aim to diversify into more secure and/or higher yielding asset classes during 2015/16. The majority of the Council's surplus cash has been invested in short-term unsecured bank deposits, certificates of deposit and money market funds. Diversification into securities with underlying collateral and investments with organisations which are not subject to bail-in will represent develop going forward.

Investment Activity in 2015/16

Investments	Balance on 01/04/15 £'000	Investments Made £'000	Maturities/ Investments Sold £'000	Balance on 31/08/15 £'000	Average Rate %
Unsecured Investments with financial institutions rated A- or higher					
- call accounts	18,420	56,470	(69,765)	5,125	0.42
- deposits and CDs	37,002	42,000	(46,002)	33,000	0.70
Secured Investments with financial institutions - covered bonds	1,121	1,102	0	2,223	1.75
Investments with Corporates - corporate bonds issued by companies	0	2,018	0	2,018	0.87
Money Market Funds	0	81,945	(69,945)	12,000	0.46
TOTAL INVESTMENTS	56,543	183,535	(185,712)	54,366	
Decrease in Investments				(2,177)	

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.

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is 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.

Given the increasing risk and continued low returns from short-term unsecured bank investments, the Council diversified into more secure and higher yielding asset classes such as covered bonds which are secured on the financial institutions' assets.

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
31/03/15	5.24	A+	3.62	AA-
30/06/15	4.94	A+	2.95	AA

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

Investments were made with banks and building societies and included call accounts, fixed-rate term deposits and certificates of deposit, Money Market Funds, covered bonds and a corporate bond.

Counterparty Update

All three credit ratings agencies have reviewed their ratings in the last quarter to reflect the loss of government support for most financial institutions and the potential for varying loss given defaults as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions have seen upgrades due to an improvement in their underlying strength and an assessment that that the level of loss given default is low.

Fitch reviewed the credit ratings of multiple institutions in May. Most UK banks had their support rating revised from 1 (denoting an extremely high probability of support) to 5 (denoting external support cannot be relied upon). This resulted in the downgrade of the long-term ratings of Royal Bank of Scotland (RBS) to BBB+ from A, Deutsche Bank to A from A+, Bank Nederlandse Gemeeten to AA+ from AAA and ING to A from A+. JP Morgan Chase and the Lloyds Banking Group however both received one notch upgrades.

Moody's concluded its review in June and upgraded the long-term ratings of Close Brothers, Standard Chartered Bank, ING Bank, Goldman Sachs International, HSBC, RBS, Coventry Building Society, Leeds Building Society, Nationwide Building Society, Svenska Handelsbanken and Landesbank Hessen-Thueringen.

S&P reviewed UK and German banks in June downgrading Barclays' long-term rating to A- from A, RBS to BBB+ from A- and Deutsche Bank to BBB+ from A. As a result of this the Council has made the decision to temporarily suspend Deutsche Bank as a counterparty for new unsecured investments. S&P has also revised the outlook of the UK as a whole to negative from stable, citing concerns around a planned referendum on EU membership and its affect on the economy.

National Australia Bank (NAB) announced its plans to divest Clydesdale Bank, its UK subsidiary. NAB is looking to list Clydesdale on the London Stock Exchange and transfer ownership to NAB's current shareholders. Fitch placed the long- and short-term ratings of the bank on rating watch negative which the agency is expected to resolve once the transaction has been completed. S&P has also placed the long-term rating of Clydesdale Bank on CreditWatch negative following the announcement.

Budgeted Income and Outturn

The average cash balances were £57.3m during the five months. 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 0.70%. Investments in Money Market Funds generated an average rate of 0.46%.

The Council's budgeted investment income for the year is estimated at £0.40m. The Council anticipates an investment outturn of 0.53% for the whole year.

Update on Investments with Icelandic Banks

The Council has now received repayment of 98% of the investment in Heritable Bank. The outstanding amount is now £80,376. It is likely that a further distribution will be received although the administrator has not yet made an official estimate of the final recovery.

Compliance with Prudential Indicators

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

Treasury Management Indicators

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

Interest Rate Exposures: 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 proportion of net principal borrowed will be:

	2015/16	2016/17	2017/18
Upper limit on fixed interest rate exposure	100%	100%	100%
Actual	100%		
Upper limit on variable interest rate exposure	50%	50%	50%
Actual	0%		

Maturity Structure of Borrowing: 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%	1.74%
12 months and within 24 months	25%	0%	2.25%
24 months and within 5 years	50%	0%	16.24%
5 years and within 10 years	75%	0%	10.06%
10 years and within 20 years	100%	0%	32.00%
20 years and within 30 years	100%	0%	13.62%
30 years and within 40 years	100%	0%	1.56%
40 years and within 50 years	100%	0%	22.53%

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.

Principal Sums Invested for Periods Longer than 364 days: 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	£40m	£30m	£25m
Actual	£3.22m	£2.22m	£2.22m

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average [credit rating] or [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	2.95

Investment Training

During the period officers have attended investment training with Arlingclose and CIPFA relevant to their roles.

Outlook for Q3 and Q4 2015/16

Arlingclose's expectation for the first rise in the Bank Rate (base rate) remains the second calendar quarter of 2016. The pace of interest rate rises will be gradual and the extent of rises limited. The appropriate level for Bank Rate for the post-crisis UK economy is likely to be lower than the previous norm. We would suggest this is between 2.0% and 3.0%. There is also sufficient momentum in the US economy for the Federal Reserve to raise interest rates in 2015, although risks of issues from China could possibly push this back.

The weak global environment and resulting low inflation expectations are likely to dampen long term interest rates. We project gilt yields will follow a shallow upward path in the medium term, with continuing concerns about the Eurozone, and other geo-political events, weighing on risk appetite, while inflation expectations remain subdued. The uncertainties surrounding the timing of UK and US interest rate rises, and the Chinese stock market-led turmoil, are likely to prompt short term volatility in gilt yields.

	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Average
Official Bank Rate														
Upside risk			0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.32
Arlingclose Central Case	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	1.75	1.08
Downside risk				-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-1.00	-1.00	-1.00	-1.00	-0.70

Appendix 1

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.

Capital Expenditure and Financing	2014/15 Actual £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate* £m
General Fund Expenditure	**32.4**	**41.3**	**16.9**	**8.6**
Capital Receipts	1.9	1.5	0.0	0
Government Grants	15.5	13.2	4.3	2.9
Reserves	6.4	8.1	1.2	2.9
Revenue	4.1	4.5	6.6	0
Borrowing	4.5	14.0	4.8	2.8
Total Financing	**32.4**	**41.3**	**16.9**	**8.6**

* The estimate for 2017/18 does not include new schemes as they have not yet been approved.

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 Actual £m	31/03/16 Estimate £m	31/03/17 Estimate £m	31/03/18 Estimate £m
General Fund	**174.9**	**179.0**	**182.9**	**179.5**

The CFR is forecast to rise by £4.6m over the next three 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	31/03/15 Actual £m	31/08/15 Actual £m	31/03/16 Estimate £m	31/03/17 Estimate £m	31/03/18 Estimate £m
Borrowing	112.4	111.3	111.1	109.1	106.6
Finance leases	2.5	2.5	2.3	2.2	2.1
Total Debt	**114.9**	**113.8**	**113.4**	**111.4**	**108.7**

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	2014/15 £m	2015/16 £m	2016/17 £m	2017/18 £m
Borrowing	175	175	175	175
Other long-term liabilities	0	0	0	0
Total Debt	**175**	**175**	**175**	**175**

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 £m	2015/16 £m	2016/17 £m	2017/18 £m
Borrowing	195	195	195	195
Other long-term liabilities	0	0	0	0
Total Debt	**195**	**195**	**195**	**195**

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 Actual %	2015/16 Estimate %	2016/17 Estimate %	2017/18 Estimate %
General Fund	5.08	5.68	5.81	5.73

Incremental Impact of Capital Investment Decisions: This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme proposed.

Incremental Impact of Capital Investment Decisions	**2015/16 Estimate £**	**2016/17 Estimate £**	**2017/18 Estimate £**
General Fund - increase in annual Band D Council Tax	0	0	0

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 March 2011.