MEETING:	**AUDIT COMMITTEE**
DATE:	**14 JULY 2016**
TITLE:	**TREASURY MANAGEMENT 2015/16**
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 2015/16 the Council's borrowing remained well within the limits originally set, total interest received on deposits was £370,040 which was below the budgeted level of £503,230. 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 2015/16 against the strategy which was set out in February 2015 for the financial year which was approved by the full Council at its meeting on 3 March 2015 and can be accessed at
https://democracy.cyngor.gwynedd.gov.uk/documents/s2903/Treasury%20Management.pdf

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, Inflation, Employment: 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/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 Q1 2016, the latest figures (Jan 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.

Global influences: The slowdown in the Chinese economy became the largest threat to the South East Asian region, particularly on economies with a large trade dependency on China and also to prospects for global growth as a whole. The effect of the Chinese authorities' intervention in their currency and equity markets was temporary and led to high market volatility as a consequence. There were falls in prices of equities and risky assets and a widening in corporate credit spreads. As the global economy entered 2016 there was high uncertainty about growth, the outcome of the US presidential election and the consequences of June's referendum on whether the UK is to remain in the EU. Between February and March 2016 sterling had depreciated by around 3%, a significant proportion of the decline reflecting the uncertainty surrounding the referendum result.

UK Monetary Policy: 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.

Improvement in household spending, business fixed investment, a strong housing sector and solid employment gains in the US allowed the Federal Reserve to raise rates in December 2015 for the first time in nine years to take the new Federal funds range to 0.25%-0.50%. Despite signalling four further rate hikes in 2016, the Fed chose not to increase rates further in Q1 and markets pared back expectations to no more than two further hikes this year.

However central bankers in the Eurozone, Switzerland, Sweden and Japan were forced to take policy rates into negative territory. The European Central Bank also announced a range of measures to inject sustained economic recovery and boost domestic inflation which included an increase in asset purchases (Quantitative Easing).

Market reaction: From June 2015 gilt yields were driven lower by the a weakening in Chinese growth, the knock-on effects of the fall in its stock market, the continuing fall in the price of oil and commodities and acceptance of diminishing effectiveness of central bankers' unconventional policy actions. Added to this was the heightened uncertainty surrounding the outcome of the UK referendum on its continued membership of the EU as well as the US presidential elections which culminated in a significant volatility and in equities and corporate bond yields.

10-year gilt yields moved from 1.58% on 31/03/2015 to a high of 2.19% in June before falling back and ending the financial year at 1.42%. The pattern for 20-year gilts was similar, the yield rose from 2.15% in March 2015 to a high of 2.71% in June before falling back to 2.14% in March 2016. The FTSE All Share Index fell 7.3% from 3664 to 3395 and the MSCI World Index fell 5.3% from 1741 to 1648 over the 12 months to 31 March 2016.

Local Context

At 31 March 2016 the Authority's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £173.5m, while usable reserves and working capital which are the underlying resources available for investment were £124m.

At 31 March 2016, the Authority had £114.9m of loans and leases, and £52.3m of investments. The Authority's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

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 2016 the Authority held £112.7m of loans, (an increase of £1.4m from 31 March 2015) 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 2015/16

	Balance on 01/04/2015 £'000	New Borrowing £'000	Maturing Debt £'000	Transfer to short term £'000	Balance on 31/03/2016 £'000	Average Rate %
CFR	174,889				173,512	
Short Term Borrowing	214	0	(214)	2,060	2,060	0.00
Long Term Borrowing	111,107	1,629	0	(2,060)	110,676	5.38
TOTAL BORROWING	**111,321**	**1,629**	**(214)**	**0**	**112,736**	**5.38**
Other Long Term Liabilities	2,372	0	(245)	0	2,127	6.17
TOTAL EXTERNAL DEBT	**113,693**	**106**	**(459)**	**0**	**114,863**	**5.47**
Increase/ (Decrease) in Borrowing £m					(1,170)	

LOBOs: At 31 March 2016 the Authority held £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.

The level of borrowing has increased slightly during the year due to receipt of a service based loan from Welsh Government. The historic strategic borrowing from the PWLB remained at the same level as no repayments were scheduled for 2015/16.

4. Investment Activity

The Authority has held significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2015/16 the Authority's investment balances have ranged between £50.7 and £81.9 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 01/04/15 £'000	Investments Made £'000	Maturities/ Investments Sold £'000	Revalue to Fair Value £'000	Balance on 31/03/16 £'000	Average Rate %
Call Accounts with Banks with ratings of A- or higher - short term	18,420	146,604	(150,892)	0	14,132	0.43
Investments with Banks and Building Societies with ratings of A- or higher - short term	37,002	114,018	(101,020)	0	50,000	0.65
Building Society Covered Bonds – long term	1,121	1,082	0	70	2,273	1.59
Money Market Funds	0	247,300	(247,300)	0	0	0.47
TOTAL INVESTMENTS	**56,543**	**509,004**	**(499,212)**	**70**	**66,405**	**0.63**
Increase/ (Decrease) in Investments £m					9,862	

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 2015/16.

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)
31/03/15	5.24	A+	3.62	AA-	64
30/06/15	4.18	A+	2.95	AA	102
30/09/15	4.94	A+	3.44	AA	104
31/12/15	4.62	A+	3.29	AA	91
31/03/16	4.34	AA-	3.57	AA-	96

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 transposition of two European Union directives into UK legislation placed the burden of rescuing failing EU banks disproportionately onto unsecured institutional investors which include local authorities and pension funds. During the year, all three credit ratings agencies reviewed their ratings to reflect the loss of government support for most financial institutions and the potential for loss given default as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions saw 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), Deutsche Bank, Bank Nederlandse Gemeeten and ING. 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-Thuringen.

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

At the end of July 2015, Arlingclose advised an extension of recommended durations for unsecured investments in certain UK and European institutions following improvements in the global economic situation and the receding threat of another Eurozone crisis. A similar extension was advised for some non-European banks in September, with the Danish Danske

Bank being added as a new recommended counterparty and certain non-rated UK building societies also being extended.

In December the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies which showed that the Royal Bank of Scotland and Standard Chartered Bank were the weakest performers. However, the regulator did not require either bank to submit revised capital plans, since both firms had already improved their ratios over the year.

The first quarter of 2016 was characterised by financial market volatility and a weakening outlook for global economic growth. In March 2016, following the publication of many banks' 2015 full-year results, Arlingclose advised the suspension of Deutsche Bank and Standard Chartered Bank from the counterparty list for unsecured investments. Both banks recorded large losses and despite improving capital adequacy this will call 2016 performance into question, especially if market volatility continues. Standard Chartered had seen various rating actions taken against it by the rating agencies and a rising CDS level throughout the year. Arlingclose will continue to monitor both banks.

Budgeted Income and Outturn

The average cash balances were £58.7m 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 0.63%. Investments in Money Market Funds generated an average rate of 0.47%.

The Authority's budgeted investment income for the year was £0.50m. The Authority's investment income outturn for the year was £0.33m.

Update on Investment with Heritable Bank

The authority has now recovered 98% 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.

5. Compliance with Prudential Indicators

The Authority confirms that it has complied with its **Prudential Indicators** for 2015/16, which were set on 3 March 2015 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:

	2015/16	2016/17	2017/18
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 31/03/16 £'000	Percentage Fixed Rate Borrowing at 31/03/16 %	Compliance with Set Limits?
under 12 months	25%	0%	**2,061**	1.9	Yes
12 months and within 24 months	25%	0%	**2,680**	2.4	Yes
24 months and within 5 years	50%	0%	**20,262**	18.0	Yes
5 years and within 10 years	75%	0%	**14,604**	12.9	Yes
10 years and within 20 years	100%	0%	**30,313**	26.8	Yes
20 years and within 30 years	100%	0%	**15,464**	13.7	Yes
30 years and within 40 years	100%	0%	**1,768**	1.6	Yes
40 years and above	100%	0%	**25,585**	22.7	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 31/03/16 £m	Revised 31/03/16 £m	Actual 31/03/16 £m	Estimate 31/03/17 £m	Estimate 31/03/18 £m
Total	**40.0**	**40.0**	**2.1**	**30.0**	**25.0**

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	**7.0**	**3.57**

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 2015/16. 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 2015/16 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 and additionally when the responsibilities of individual members of staff change.

During 2015/16 staff attended training courses, seminars and conferences provided by Arlingclose and CIPFA.

Appendix 1

Prudential Indicators 2015/16

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 and Financing	Approved 31/03/16 £m	Revised 31/03/16 £m	Actual 31/03/16 £m	Estimate 31/03/17 £m	Estimate 31/03/18 £m
General Fund Expenditure	**35.2**	**42.0**	**35.5**	**35.4**	**20.7**
Capital receipts	1.5	1.6	1.6	0.4	0.8
Government Grants	10.2	15.8	17.6	11.7	4.2
Revenue contributions	11.0	11.7	10.2	9.2	5.2
Supported borrowing	6.6	6.6	4.1	6.7	6.4
Prudential borrowing	5.9	6.5	1.9	7.3	4.1
Total Financing	**35.2**	**42.0**	**35.5**	**35.3**	**20.7**

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 31/03/16 £m	Revised 31/03/16 £m	Actual 31/03/16 £m	Estimate 31/03/17 £m	Estimate 31/03/18 £m
General Fund	179.0	178.4	173.5	182.2	180.4

The CFR is forecast to rise by £6.9m 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 31/03/16 £m	Actual 31/03/16 £m	Estimate 31/03/17 £m	Estimate 31/03/18 £m
Borrowing	195.0	113.4	111.3	110.7
Finance leases	0.0	2.3	2.1	1.9
Total Debt	**195.0**	**115.7**	**113.4**	**112.6**
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	2015/16 £'000	2016/17 £'000	2017/18 £'000
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	2015/16 £'000	2016/17 £'000	2017/18 £'000
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 31/03/16 %	Revised 31/03/16 %	Actual 31/03/16 %	Estimate 31/03/17 %	Estimate 31/03/18 %
Total	**5.68**	**5.88**	**5.07**	**5.91**	**5.60**

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.

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.