

CABINET

7 JULY 2015

TREASURY MANAGEMENT OUTTURN ANNUAL REPORT

Portfolio Holder: Councillor Alan Jarrett, Leader

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Summary

This report gives an overview of treasury management activity during 2014/15.

1 Budget and Policy Framework

- 1.1 The council's treasury management strategy and policy are approved by Full Council following consideration by Cabinet and Audit Committee. In addition, Full Council approved that reporting of the Treasury Management Annual Outturn is to Cabinet followed by Audit Committee

2 Background

- 2.1 This Council is required by regulations issued under the Local Government Act 2003 to produce an annual review of treasury management activities and the actual prudential and treasury indicators for 2014/15. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).
- 2.2 During 2014/15 the minimum reporting requirements were that the full Council should receive the following reports:
- An annual treasury strategy in advance of the year (Council 20 February 2014)
 - A mid-year treasury update report (Council 26 February 2015)
 - An annual report following the year describing the activity compared to the strategy (this report).
- 2.3 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

2.4 This Council also promotes prior scrutiny of the Treasury Strategy and mid-year review by submission to Audit Committee before reporting to Cabinet and Full Council.

2.5 This annual treasury outturn report covers:

- The Council's treasury position as at 31 March 2015;
- Borrowing activity 2014/15
- Performance measurement
- The strategy for 2014/15
- The economy and interest rates in 2014/15
- Borrowing rates in 2014/15
- The borrowing outturn for 2014/15
- Debt rescheduling;
- Compliance with treasury limits and Prudential Indicators;
- Investment rates in 2014/15
- Investment outturn for 2014/15

3 The Economy and Interest Rates

3.1 The original market expectation at the beginning of 2014/15 was for the first increase in Bank Rate to occur in quarter 1 2015 as the unemployment rate had fallen much faster than expected through the Bank of England's initial forward guidance target of 7%. In May, however, the Bank revised its forward guidance. A combination of very weak pay rises and inflation above the rate of pay rises meant that consumer disposable income was still being eroded and in August the Bank halved its forecast for pay inflation in 2014 from 2.5% to 1.25%. Expectations for the first increase in Bank Rate therefore started to recede as growth was still heavily dependent on buoyant consumer demand. During the second half of 2014 financial markets were caught out by a halving of the oil price and the collapse of the peg between the Swiss franc and the euro. Fears also increased considerably that the ECB was going to do too little too late to ward off the threat of deflation and recession in the Eurozone. In mid-October, financial markets had a major panic for about a week. By the end of 2014, it was clear that inflation in the UK was going to head towards zero in 2015 and possibly even turn negative. In turn, this made it clear that the MPC would have great difficulty in starting to raise Bank Rate in 2015 while inflation was around zero and so market expectations for the first increase receded back to around quarter 3 of 2016.

3.2 Gilt yields were on a falling trend for much of the last eight months of 2014/15 but were then pulled in different directions by increasing fears after the anti-austerity parties won power in Greece in January; developments since then have increased fears that Greece could be heading for an exit from the euro. While the direct effects of this would be manageable by the EU and ECB, it is very hard to quantify quite what the potential knock on effects would be on other countries in the Eurozone once the perceived impossibility of a country leaving the EZ had been disproved. Another downward pressure on gilt yields was the announcement in January that the ECB would start a major programme of quantitative easing, purchasing EZ government and other debt in March. On the other hand, strong growth in the US caused an increase in confidence that the US was well on the way to making a full recovery from the

financial crash and would be the first country to start increasing its central rate, probably by the end of 2015. The UK would be closely following it due to strong growth over both 2013 and 2014 and good prospects for a continuation into 2015 and beyond. However, there was also an increase in concerns around political risk from the general election due in May 2015.

- 3.3 The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in money market investment rates falling drastically in the second half of that year and continuing throughout 2014/15
- 3.4 The UK coalition Government maintained its tight fiscal policy stance but recent strong economic growth and falling gilt yields led to a reduction in the forecasts for total borrowing in the March budget.
- 3.5 The EU sovereign debt crisis had subsided since 2012 until the Greek election in January 2015 sparked a resurgence of fears. While the UK and its banking system has little direct exposure to Greece, it is much more difficult to quantify quite what effects there would be if contagion from a Greek exit from the euro were to severely impact other major countries in the EZ and cause major damage to their banks.

4 Overall Treasury Position as at 31 March 2015

- 4.1 The Council's debt and investment position at the beginning and end of the year was as follows.

Table 1 – borrowing and investment levels

	31/03/14 £m	Rate	31/03/15 £m	Rate
Gross borrowing	162.3	4.20%	166.0	4.22%
Plus other long term liabilities*	2.0		0.8	
Total Debt	164.3		166.8	
Capital Financing Requirement (CFR)	248.4		247.8	
(Under)/Over Borrowing	(84.1)		(81.0)	
Less investments	39.3	0.675%	31.9	1.51%
Net borrowing	125.0		134.9	

*Embedded Leases (on balance sheet)

- 4.2 The costs of the treasury management function in 2013/14 were £142,100 which exceeded the average of the 50 other authorities participating in the CIPFA Treasury Management Benchmarking Club. Since then Medway had stopped using external fund manager Investec to manage core investments, saving some £30,100 (based on 13/14 costs) and has deleted a senior manager post from its own treasury management structure. Although Medway no longer subscribes to the CIPFA Benchmarking Club these costs reductions mean that Medway is likely to bear favourable comparison with costs incurred by other authorities.

5 The Strategy for 2014/15

- 5.1 The expectation for interest rates within the strategy for 2014/15 anticipated low but rising Bank Rate (starting in quarter 1 of 2015), and gradual rises in medium and longer term fixed borrowing rates during 2014/15. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.
- 5.2 In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.
- 5.3 The actual movement in gilt yields meant that PWLB rates saw little overall change during the first four months of the year but there was then a downward trend for the rest of the year with a partial reversal during February.

6 The Borrowing Requirement and Debt

- 6.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2014/15 unfinanced capital expenditure, and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

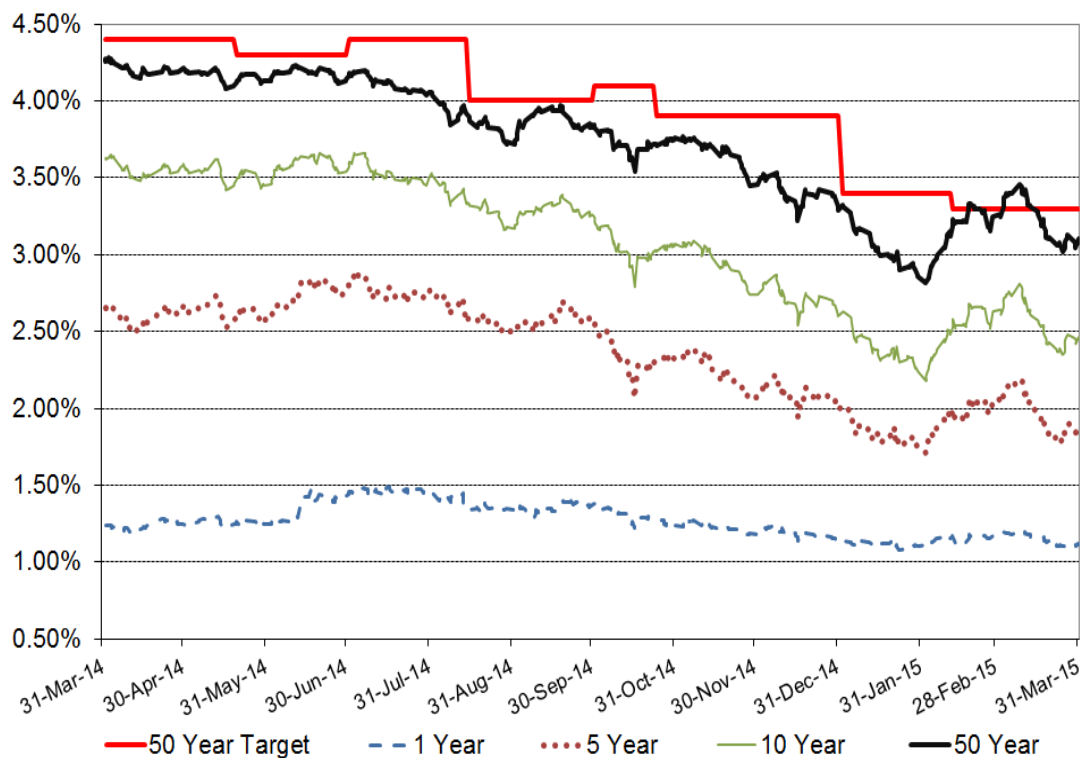
Table 2 Capital Financing Requirement

	31 March 2014 Actual £m	31 March 2015 Budget £m	31 March 2015 Actual £m
CFR General Fund (£m)	209,021	203,124	207,296
CFR HRA (£m)	39,516	42,524	40,542
Total CFR	248,537	245.648	247,838

7 Borrowing rates in 2014/15

- 7.1 PWLB borrowing rates - the graph below shows how PWLB rates remained at historically very low levels during the year.

Graph 1 PWLB certainty maturity borrowing rates.



8 Borrowing Outturn for 2014/15

- 8.1 The borrowing strategy for the council confirmed the holding of £101.8 million in Lenders Options, Borrowers Options (LOBO) debt. These are debts that are subject to immediate repayment or variation of interest chargeable and the option to repay, on request from the lender on the review dates. However, the lender can only apply this clause once within the lifetime of the LOBO. This type of borrowing has therefore been classed as fixed rate.
- 8.2 No new loans were taken out and no repayments made except for annuity repayments.
- 8.3 The approach during the year was to use cash balances to finance new capital expenditure so as to run down cash balances and minimise counterparty risk incurred on investments. This also maximised treasury management budget savings, as investment rates were much lower than most new borrowing rates.

9 Debt Rescheduling

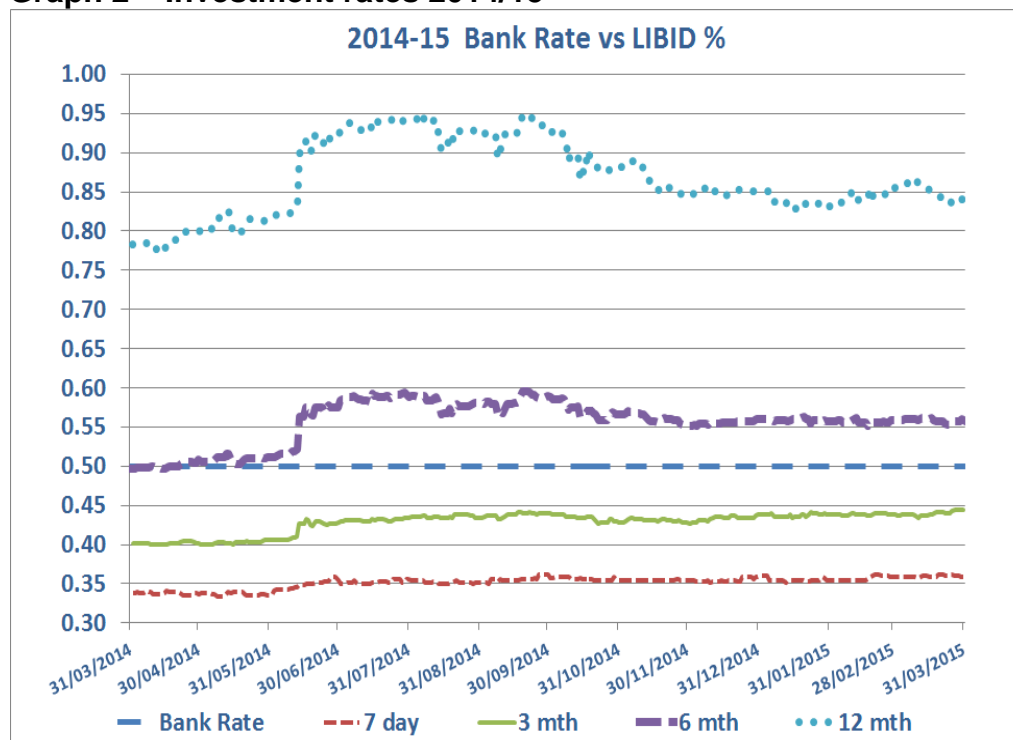
- 9.1 No debt restructuring was undertaken during 2014/15 and it is not envisaged that there will be any opportunities where the debt restructuring would be economically viable in 2015/16.

10 Investment Rates in 2014/15

- 10.1 Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for six years. Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 2015 but then moved back to around quarter 3 2016 by the end of the year. Deposit rates remained

depressed during the whole of the year, primarily due to the effects of the Funding for Lending Scheme.

Graph 2 – Investment rates 2014/15



11 Investment Outturn for 2014/2015

11.1 **Investment Policy** – the Council’s investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council on 20 February 2015. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

11.2 **Internally Managed Investments** – The Council manages its investments in-house using the institutions listed in the Council’s approved lending list. These funds are identified as ‘core funds’ where the investment can be for an extended time period and usually fixed prepayment date, or ‘cash flow’ where the investment is required to be available for immediate liquidity. The council can invest for a range of periods from overnight to 5 years dependent on forecast of the Council’s cash flows, the duration and counterparty limits set out in the approved investment strategy, its interest rate view and the interest rates on offer. During the year all investments were made in full compliance with the Council’s treasury management policies and practices. The Annual Investment Strategy, outlines the Council’s investment priorities as:

- (1) Security of capital and liquidity; and
- (2) The achievement of optimum return (yield) on investments.

11.3 **Externally Managed Investments** – The Council no longer uses an external investment manager.

11.4 **Investment performance for 2014/15** – Detailed below is the result of the investment strategy undertaken by the Council.

Table 3 Investment Performance 2014/15

	Average Investment	Rate of Return (gross of fees)
Internally Managed – Core Funds	£12,417,466	2.07%
Internally Managed – Cash Flow Funds	£42,204,290	0.53%
Overall Internally Managed Funds	£54,621,755	0.92%

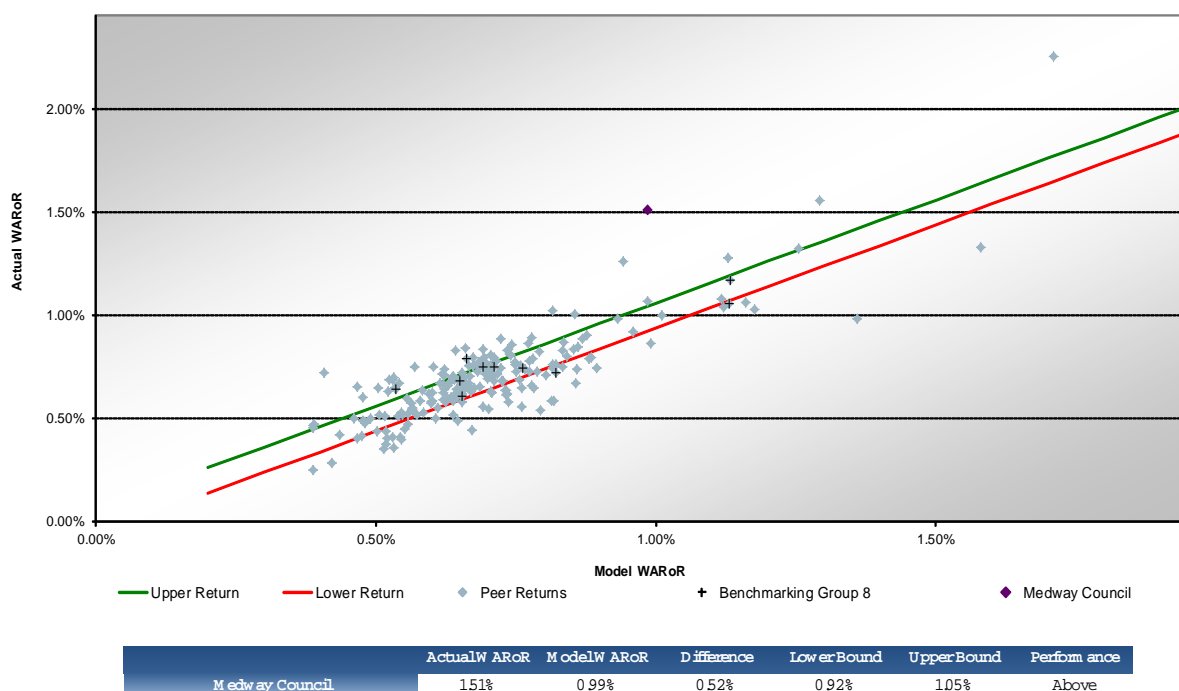
11.5 No institutions in which investments were made during 2014/2015 had any difficulty in repaying investments and interest in full during the year.

11.6 The Graph below is produced by Capita Asset Services (our external adviser) in its own benchmarking exercises which are built to compare return vs risk.

11.8 The “x” axis of the graph shows the “Model Weighted Average Rate of Return” (WARoR), this is the level of return we should expect for the level of risk that we are taking with our investment portfolio. This is then plotted against the “Actual Weighted Average Rate of Return” on the “y” scale. Running diagonally upwards across the graph are two parallel lines, if a Council performance falls between these lines then they are deemed to be receiving a return as would be expected for their level of risk, below these two lines and performance is considered below that expected and above indicates that the return being received is above expectation. As can be seen Medway’s return is “above” that expected for our level of risk.

11.9 The Capita benchmarking is run as a snap shot as at 31 March 2015 and not the performance for the whole of 2014-15 financial year.

Graph 3 Actual Returns against Model Returns



- 11.10 In 2014/15 Medway commenced lending to other Local Authorities for periods of up to 5 years (see table below). This increased the yield whilst not increasing the risk inherent within portfolio.

Authority	£m	Maturity Date	Rate%
City of Newcastle Upon Tyne	5.00	31/7/19	2.35
Lancashire County	5.00	1/8/18	2.00
Doncaster Metropolitan Borough	5.00	8/8/19	2.35
Newcastle City	4.75	10/7/17	1.50
	19.75		

12 Compliance with Treasury Limits

- 12.1 Treasury management Practice 1.1.2 sets guidance that the amount held in the Council's main bank accounts at the end of each day should not exceed £300,000 in credit or overdrawn. On 2 December 2014 a delay in processing a transfer of £400,000 to one of the authority's interest bearing deposits resulted in this balance being exceeded and consequently the council lost £8.22 interest which it would have earned. Processing timescales have now been tightened and additional supervision procedures introduced to minimise the risk of re-occurrence. The outturn for the Prudential Indicators is shown in Appendix 1.

13 Risk Management

- 13.1 As stated within the Treasury Strategy, a key driver for the review of the CIPFA code has been the exposure to risk evidenced by the Icelandic investments and more generally by the financial crisis. Risk and the management thereof is a key feature throughout the strategy and in detail within the treasury management practices (TMP1) within the Treasury Strategy.

14 Financial and Legal Implications

- 14.1 Overall the Interest and Financing budget made a surplus over its targeted budget of £0.998m. In light of the continued historically low bank rate which continued at 0.5% throughout 2014/15, the overall rate achieved on investments averaged 0.92%.
- 14.2 A breakdown of the Interest and Financing budget is shown below

Table 4 Interest and Finance Budget against spend

	Budget 2014/15 £000's	Actual 2014/15 £'000s	(Under)/ Overspend £'000s
Treasury Expenses	170	164	(6)
Interest Earned	(3,071)	(2,939)	132
Interest Paid	9,104	8,820	(284)
KCC Principal	1,669	1,808	139
MRP	6,993	5,879	(1,114)
Invest to Save recharges	(622)	(487)	135
Total	14,243	13,245	(998)

- 14.3 The body of the report and the appendices outline the significant financial implications. Any transactions undertaken on either investments or borrowings are governed by the London Code of Conduct, the council's treasury policy statement, and the CIPFA Code of Practice on Treasury Management in Local Authorities.
- 14.4 Legal implications – For the financial year 2014/15 our investments were managed in compliance with the Codes of Practices, guidance and regulations made under the Local Government Act 2003

15 Recommendations

- 15.1 In accordance with the CIPFA Code of Practice, Cabinet is asked to note the content and recommend this report to the Audit Committee.

16 Suggested Reasons for Decision

- 16.1 In line with CIPFA's Code of Treasury Management Practice an annual report must be taken to Cabinet detailing the council's treasury management outturn within six months of the close of each financial year.

Appendices

Appendix 1 Prudential Indicators

Background papers

Capita Asset Services Template Report.

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PRUDENTIAL AND TREASURY INDICATORS

	2013/14	2014/15	2014/15
	£'000	£'000	£'000
	Actual	Estimate	Actual
Capital Expenditure			
Non - HRA	40,015	24,399	35,675
HRA	5,214	8,577	5,437
TOTAL	45,229	32,976	41,112
Ratio of financing costs to net revenue stream			
Non - HRA	4.41%	2.82%	4.52%
HRA	23.14%	17.54%	22.73%
Gross borrowing requirement			
brought forward 1 April	175,881	162,324	166,132
carried forward 31 March	166,132	162,324	166,006
in year borrowing requirement	-9,949	0	-126
Actual External Debt	168,087	162,416	166,835
Capital Financing Requirement as at 31 March			
Non – HRA	209,021	203,124	207,296
HRA	39,516	42,524	40,542
TOTAL	248,537	245,648	247,838
HRA Limit on Indebtedness	45,846	45,846	45,846
Annual change in Cap. Financing Requirement			
Non – HRA	-3,143	-6,233	-1,725
HRA	-807	3,008	1,026
TOTAL	-3,950	-3,225	-699

	2013/14 Limit £'000	2014/15 Limit £'000	2013/14 Breach?
Authorised Limit for external debt -			
borrowing	431,515	424,282	No Breach
other long term liabilities	4,400	4,400	No Breach
TOTAL	435,915	428,682	No Breach
Operational Boundary for external debt -			
borrowing	392,286	385,711	No Breach
other long term liabilities	4,000	4,000	No Breach
TOTAL	396,286	389,711	No Breach
HRA Limit on Debt	45,846	45,846	No Breach
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	100%	100%	No Breach
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments	40%	40%	No Breach
Upper limit for total principal sums invested for over 364 days (per maturity date)	£150,000	£150,000	No Breach

Maturity structure of fixed rate borrowing during 2014/15	upper limit	lower limit	Breach ?
under 12 months	75%	0%	No Breach
12 months and within 24 months	50%	0%	No Breach
24 months and within 5 years	50%	0%	No Breach
5 years and within 10 years	50%	0%	No Breach
10 years and above	100%	0%	No Breach