

## ANNUAL TREASURY REPORT 2015 / 16

**1. Background**

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 a year (mid-year and at year end).

The Council's Treasury Management Strategy for 2015/16 was approved by full Council on 26 March 2015 (Minute 824 refers).

The Council has 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. Economic Background provided by Arlingclose**

**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

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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 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 significant volatility 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 31/03/2016 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was zero, while usable reserves and working capital which are the underlying resources available for investment were £11m.

At 31/03/2016, the Council had no borrowing and £11m of investments. The Council may however have to borrow to pre fund future years requirements or unexpected capital expenditure that occurs in the year providing this does not exceed the authorised limit for borrowing of £10m.

The Council is currently debt free and its capital expenditure plans do not currently imply any need to borrow over the forecast period. Investments are forecast to fall to £7.5m as capital receipts are used to finance capital expenditure and reserves are used to finance the revenue budget over the next three years.

**Investment Activity**

The Council has held significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2015/16 the Council's investment balances have ranged between £12.5 and £21.5 million.

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

Annual Treasury Outturn Report 2015/16Investment Activity in 2015/16

Investments	Balance on 01/04/2015 £'000	Investments Made £'000	Maturities/ Investments Sold £'000	Balance on 31/03/2016 £'000
Short term fixed Investments **	4,500	4,000	5,500	3,000
Cash Accounts	5,005	2,000	6,000	1,005
Money Market Funds	0	54,950	54,950	0
Certificates of Deposit	3,000	9,000	8,000	4,000
LAMIT Property Fund	0	3,000	0	3,000
<b>TOTAL INVESTMENTS</b>	<b>12,505</b>	<b>72,950</b>	<b>74,450</b>	<b>11,005</b>
Increase/ (Decrease) in Investments £m				(1,500)

\*\* The Short Term fixed Investments outstanding at 31 March 2016 were as follows

Borrower	Amount £'000	Maturity Date
Barclays	1,000	7 April 2016
Lloyds	2,000	10 August 2016
<b>Total</b>	<b>3,000</b>	

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 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 the level of loss given default is low.

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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 Council 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.

In January 2016, Arlingclose supplemented its existing investment advice with a counterparty list of high quality bond issuers, including recommended cash and duration limits. As part of this, Bank Nederlandse Gemeeten was moved to the list of bond issuers from the unsecured bank lending list and assigned an increased recommended duration limit of 5 years. Interest rates are likely to stay low for longer, making long-term bonds an increasingly attractive option. The Council did not make use of these long-term investment options during 2015/16.

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.

The end of bank 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 continues to be elevated relative to other investment options. The Council therefore increasingly favoured secured investment options or diversified alternatives such as pooled funds over unsecured bank and building society deposits.

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### Budgeted Income and Outturn

The UK Bank Rate has been maintained at 0.5% since March 2009. Short-term money market rates have remained at relatively low levels. The average 3 month LIBID (London Interbank Bid Rate) during 2015/16 was 0.54%, the 6 month LBID averaged 0.76% and the 1 year LIBID rate averaged 0.99%. The low rates of return on the Council's short dated money market investments reflect prevailing market conditions and the Council's objective of optimising returns commensurate with the principles of security and yield.

The Council's budgeted investment income for the year was £166,000. The Council's investment outturn for the year £188,317.

The actual rate of return achieved on short dated money market investments was 0.61% compared with a benchmark of 0.45% (7 day LIBID) an out performance of 0.16%.

The actual rate of return achieved on the LAMIT property fund in which £3m was invested on 29 October 2015 was 4.52%

### Compliance with Prudential Indicators

The Council confirms compliance with its Prudential Indicators for 2015/16, which were set on 10 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 interest payable, should borrowing become necessary, would be:

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

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

**Maturity Structure of Borrowing:** 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, should borrowing become necessary, would be:

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	Upper	Lower	Actual
Under 12 months	100%	0%	0%
12 months and within 24 months	100%	0%	0%
24 months and within 5 years	100%	0%	0%
5 years and within 10 years	100%	0%	0%
10 years and above	100%	0%	0%

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	£1m	£1m	£1m

2015/16 had no investments made beyond 364 days

**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	3.82

**Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	Target	Actual
Total cash available within 3 months	£3m	£7m

Investment Training

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

During 2015/16 staff attended training courses, seminars and conferences provided by Arlingclose. Training was also provided to Members by Arlingclose at the Council offices in January 2016.