Appendix 1 to Cabinet Report

Treasury Management Monitoring Report 2015/16

1. Purpose

1.1. The Treasury Management Strategy for 2015/16 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

1.2. The Code also recommends that members are informed of Treasury Management activities at least twice a year (a mid year and a year end report). This report therefore ensures that the County Council is embracing best practice in accordance with CIPFA's recommendations.

1.3. Treasury Management is defined as: "the management of investments and cash flows, banking, money market and capital market transactions; the effective control of the risks associated with those activities, and the pursuit of optimum performance consistent with those risks".

2. Economic Background

2.1. The following sections outlines the key economic themes currently in the UK against which investment and borrowing decisions have been made in the year to date.

2.2. Growth – positive growth in the UK economy has continued with output growing at a preliminary estimate of 2.6% year-on-year in Q2 2015, which was in line with the market's expectations. The largest contribution to growth came from services – increasing by 0.7% and contributing 0.5% to overall growth.

2.3. The latest figures released by the Office for National Statistics for June 2015 show a broadly stable UK labour market, with marginal movements in the number of employed (down to 73.4% from 73.5%) and the number of unemployed (up to 5.8% from 5.7%). Wage growth was 2.8% excluding bonuses over the three months to June 2015 year-on-year.

2.4. The Consumer Prices Index (CPI) rose by 0.1% in the year to July 2015, up from 0.0% in June. This was slightly above market expectations, which had predicted inflation remaining at 0.0%. As set out in the Governor of the Bank of England's letter to the Chancellor, around three quarters of the weakness in headline inflation relative to the 2% target reflects unusually low contributions from energy, food and other imported goods prices. The remaining part of the undershoot is judged to reflect relatively weak domestic cost growth, given a continuing, but declining, drag from spare capacity in the labour market.

2.5. UK Monetary Policy: at its meeting ending on 9 September 2015, the Monetary Policy Committee (MPC) voted by a majority of 8-1 to maintain Bank Rate at 0.5%. This is the second meeting running that the vote to hold rates at 0.5% has not been unanimous, perhaps indicating that the first rise in interest rates is approaching.

2.6. The MPC has previously emphasised that when the Bank Rate does begin to rise, it is expected to do so only gradually and to remain below average historical levels for some time to come. The treasury management advisers to the County Council, Arlingclose, now estimate the first rise in interest rates will be in the second quarter of 2016, which is still later than many economic commentators. Arlingclose's expectation is that the appropriate level for Bank Rate for the post-crisis UK economy will be lower than the previous norm, between 2.0% and 3.0%.

3. Borrowing Strategy

3.1. At 31/08/2015 the County Council held £354m of loans, (a decrease of £7m since 31/03/2015) as part of its strategy for funding previous years' capital programmes.

3.2. Affordability and the "cost of carry" remained important influences on the County 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 at least for the next two years, lower than long-term rates, the County Council determined it was more cost effective in the short-term to use internal resources instead of taking out new borrowing.

3.3. For the County Council the use of internal resources in lieu of borrowing, has therefore continued to be the most effective means of funding capital expenditure. No new long-term borrowing has taken place in the five months to August 2015, or is planned for the remainder of the financial year. This has lowered overall treasury risk by reducing both external debt and temporary investments.

3.4. As at 31 August 2015 the County Council has a total of £354m of long term loans, made up of £281m of Public Works Loan Board (PWLB) loans and £73m of Lenders Option Borrowers Options (LOBO) loans. The PWLB loans are at a weighted averaged fixed interest rate of 4.84%, and average outstanding term remaining of 25.0 years. This average rate compares favourably against historic interest rates and the County Council's debt portfolio represents good mitigation against the long-term risk of exposure to interest rate fluctuations, which could increase the cost of borrowing.

3.5. The premia that applies to the premature repayment of the County Council's PWLB loans is still relatively expensive for the loans in the portfolio and therefore unattractive for debt rescheduling. As a consequence no rescheduling activity has taken place. However, consideration will continue to be given to any advantageous opportunity for the County Council to reduce or restructure its debt portfolio.

3.6. The County Council holds £73m of LOBO loans where the lender has the option to propose an increase in the interest rate at set dates, following which the County Council has the option to either accept the new rate or to repay the loan at no additional cost. None of the LOBO loan options were exercised by the lender in the year to date.

4. Investment Activity

4.1. The County Council holds invested funds representing income received in advance of expenditure plus balances and reserves held. Cashflow forecasts indicate that during 2015/16 the County Council's investment balances will range between £490m and £700m.

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

4.3. 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.

4.4. Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the County Council's aim to further diversify into more secure and/or high yielding asset classes during 2015/16. The majority of the County Council's surplus cash was previously invested in short-term unsecured bank deposits, certificates of deposit and money market funds. This diversification into securities with underlying collateral and investments with organisations which are not subject to bail-in represents a substantial change in strategy this year.

4.5. The County Council's investment holding was £549.9m on 31 August 2015, which is £75m lower than the same time last year, and was placed with the following counterparties:

Table 1: Investment Activity as at 31 August 2015

Duration to maturity	**Overnight £m**	**< 1 year £m**	**> 1 year £m**	**Total £m**
Subject to bail-in risk				
Bank call accounts	2.8			2.8
Bank fixed deposits		10.0		10.0
Bank notice accounts		15.0		15.0
Bank certificates of deposit*		140.0		140.0
Bank bonds*		10.0		10.0
	2.8	175.0	0.0	177.8
Exempt from bail-in risk				
Covered floating rate notes		15.0		15.0
Covered bonds			25.0	25.0
Corporate floating rate notes		1.9	10.0	11.9
Corporate bonds		31.3	10.0	41.3
Money market funds	38.3			38.3
Local authorities		66.5	139.0	205.5
Pooled property funds			35.0	35.0
	38.3	114.7	219.0	372.0
Total	41.1	289.7	219.0	549.8

*certificates of deposit and bonds have fixed terms but have greater liquidity as they can be sold on the secondary market.

4.6. Security of capital has remained the County Council's main investment objective. This has been maintained by following the County Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2015/16.

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

4.8. The average cash balances were £576.8m during the year to 31 August 2015. The average interest rate earned on the County Council's investments at 31 August 2015 was 1.49%, which should be considered within the context of an unchanged UK Base Rate of 0.5% since March 2009 and very low short-term money market rates.

4.9. The Guidance on Local Government Investments in England gives priority to security and liquidity and the County Council's aim is to achieve a yield commensurate with these principles. This has been maintained by following the County Council's counterparty policy as set out in its Treasury Management Strategy for 2015/16.

4.10. As part of its 2014/15 Treasury Management Strategy the County Council approved a limit of £105m that could be made available for investments that would attract a higher income return to contribute to the County Council's overall resources. The limit was set to identify core balances that were available for long-term investment and could therefore be invested in instruments that may suffer from short term fluctuations in capital value.

4.11. So far in 2015/16 the County Council has invested a further £25m into additional pooled property fund investments. This brings the total investments of this type to £65m. Since the County Council made this decision opportunities have been limited by the very low long-term outlook for interest rates, but attempts continue to place these investments in line with the strategy that has been set.

5. Compliance with Prudential Indicators

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

Authorised limit for external debt

5.2. CIPFA's Code of Practice requires authorities to set an authorised limit for external debt, defined as the sum of external borrowing and other long-term liabilities. The annual strategy report agreed by County Council on 19 February 2015 set an authorised limit for external debt of £870.0m

5.3. This limit is based on the estimated CFR in order to enable it to be financed entirely from external borrowing should the County Council's internal resources become depleted. This limit also includes an allowance for temporary borrowing to cover normal cash flow requirements and unexpected outflows or delays in receiving cash.

5.4. During the period to 31 August 2015 the County Council remained well within the authorised limit of £870.0m and no new long term borrowing has been taken out. There has been no temporary borrowing, so the maximum total external debt in the period has remained at £572.6m.

Operational boundary for external debt

5.5. The County Council has set an operational boundary for external debt reflecting the more likely scenario and consistent with the County Council's capital plans and Treasury Management Strategy. Temporary breaches of the 2015/16 operational boundary can take place for cash flow reasons, but a sustained breach will lead to further investigation. The County Council approved an operational boundary for 2015/16 of £810.0m.

5.6. As outlined above the County Council's maximum total external debt of £576.2m in the period from April to August 2015 was within the operational boundary.

6. Treasury Management Indicators

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

Interest Rate Exposures

6.2. The County Council has to set an upper limit on its fixed and variable interest rate exposure for both total investments and total external debt. The County Council has approved the following limits, none of which have been exceeded as follows:

Table 2 – Interest Rate Exposures

	Approved Limits for 2015/16	**Maximum during 2015/16**	**Compliance with Limits:**
Upper limit on fixed interest rate investment exposure	£285m	£179m	Yes
Upper limit on variable interest rate investment exposure	£800m	£465m	Yes
Upper limit on fixed interest rate borrowing exposure	£800m	£458m	Yes
Upper limit on variable interest rate borrowing exposure	£800m	£114m	Yes

6.3. The limit for borrowing rate exposure has been set to enable maximum policy flexibility for the potential for refinancing e.g. from variable to fixed rate borrowing.

6.4. The upper limit for exposure for investments rates is based on an extreme case for the total investment balances, and to allow for all of this to be held at variable rates (investments with a maturity of less than one year) if necessary.

Maturity Structure of Borrowing

6.5. The Code also requires the County Council to set upper and lower percentage limits on the maturity structure of its long-term fixed rate borrowing during 2015/16.3 The following table shows the limits approved by the County Council. These have been set in order to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

Table 3 – Maturity Structure of Borrowing

	Upper	Lower	Actual
Under 12 months	50%	0%	2%
12 months and within 24 months	50%	0%	2%
24 months and within 5 years	50%	0%	8%
5 years and within 10 years	75%	0%	16%
10 years and within 20 years	75%	0%	42%
20 years and within 30 years	75%	0%	26%
30 years and above	100%	0%	4%

Principal Sums Invested for Periods Longer than 364 days

6.6. For 2015/16 the County Council restricted investments for a period of over a year to a maximum of £285.0m. At 31 August 2015 the County Council had £219.0m of investments with over 364 days to their maturity.

7. Recommendations

7.1. That the mid-year review of treasury management activities be noted.

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