

HAMPSHIRE COUNTY COUNCIL**Decision Report**

Decision Maker:	Audit Committee
Date:	23 June 2016
Title:	Annual Treasury Outturn Report 2015/16
Reference:	7464
Report From:	Director of Corporate Resources – Corporate Services

Contact name: Gemma Farley

Tel: 01962 847540 **Email:** gemma.farley@hants.gov.uk

1. Purpose

- 1.1. The County Council adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes an annual report on the treasury management strategy after the end of each financial year.

2. Summary

- 2.1. Treasury management in the context of this report is defined as:
 “The management of the organisation’s investments and cash flows, its 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.”
- 2.2. This annual report sets out the performance of the treasury management function during 2015/16, to include the effects of the decisions taken and the transactions executed in the past year.
- 2.3. Overall responsibility for treasury management remains with the County Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the County Council’s treasury management objectives.
- 2.4. All treasury activity has complied with the County Council’s Treasury Management Strategy and Investment Strategy for 2015/16, and all relevant statute, guidance and accounting standards. In addition the County Council’s treasury advisers, Arlingclose, provide support in undertaking treasury management activities.
- 2.5. The County Council has complied with all of the prudential indicators set in its Treasury Management Strategy; these are detailed fully in Appendix 1.

3. External Context

- 3.1. The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions were made in 2015/16.

Growth, Inflation, Employment

- 3.2. 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 Quarter 1 of 2016, the latest figures (January 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.

UK Monetary Policy

- 3.3. 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.

4. Local Context

- 4.1. At 31/03/2016 the County Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £756m, while usable reserves and working capital which are the underlying resources available for investment were £503m (principal invested plus gains on investments with a variable net asset value).
- 4.2. At 31/03/2016, the County Council had £346m of borrowing and £496m of principal invested. The County Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.
- 4.3. The County Council's CFR is forecast to reduce in 2016/17 and its capital programme do not include any need to borrow externally over the forecast period. Investments are forecast to fall as capital receipts and internal borrowing are used to finance capital expenditure.

5. Borrowing Strategy

- 5.1. At 31/03/2016 the County Council held £346m of loans, (a decrease of £15m on 31/03/2015) as part of its strategy for funding previous years' capital programmes.
- 5.2. The County Council'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 County Council's long-term plans change being a secondary objective.
- 5.3. 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 over the forthcoming 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.
- 5.4. 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 County Council with the monitoring of internal and external borrowing.

Table 1: Borrowing Activity in 2015/16

	Balance on 01/04/2015 £m	Net New Borrowing £m	Balance on 31/03/2016 £m
CFR	761.6		755.7
Short Term Borrowing ¹	11.5	1.0	12.5
Long Term Borrowing	349.8	(16.5)	333.3
TOTAL BORROWING	361.3	(15.5)	345.8
Other Long Term Liabilities	180.2	(4.7)	175.5
TOTAL EXTERNAL DEBT	541.5	(20.2)	521.3
Increase/ (Decrease) in Borrowing £m			(15.5)

- 5.5. During 2015/16 the County Council repaid £11.54m of maturing PWLB debt, and did not replace this borrowing. This will reduce the future cost of interest payments on the County Council's external debt.

¹ Loans with maturities less than 1 year – the increase reflects more loans falling into this category in the last financial year, rather than new borrowing.

LOBOs

- 5.6. The County Council holds £73m 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 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 2015/16.

Debt Rescheduling

- 5.7. The premium charged for early repayment of PWLB debt remained relatively expensive for the loans in the County Council's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence. However, consideration continues to be given to any advantageous opportunity for the County Council to reduce or restructure its debt portfolio.

6. Investment Activity

- 6.1. The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on April 15, 2014. The combined effect of the BRRD and the UK's Deposit Guarantee Scheme Directive is to promote deposits of individuals and SMEs above those of public authorities, large corporates and financial institutions. Other EU countries, and eventually all other developed countries, are expected to adopt similar approaches in due course.
- 6.2. The outlawing of 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 rose relative to other investment options. The County Council therefore increasingly favoured secured investment options or diversified alternatives such as covered bonds, non-bank investments and pooled funds over unsecured bank and building society deposits.
- 6.3. The County Council has held 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 £490 and £633 million.
- 6.4. 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.

Table 2: Investment Activity in 2015/16

Investments	Balance on 01/04/2015 £m	Balance on 31/03/2016 £m	Average Rate/Yield on 31/03/2016 %	Average Life on 31/03/2016 years
Short term Investments				
- Banks and Building Societies:				
- Unsecured	207.1	55.7	0.71	0.09
- Secured	15.0	27.8	0.84	0.73
- Money Market Funds	47.8	66.1	0.49	0.00
- Local Authorities	28.0	92.5	0.78	0.41
- Corporate Bonds	15.9	10.0	0.86	0.85
Long term Investments				
- Banks and Building Societies:				
- Secured	0.0	65.0	1.01	2.20
- Local Authorities	137.5	113.5	2.08	2.44
Long term Investments – high yielding strategy				
- Local Authorities				
- Fixed deposits	20.0	20.0	3.96	17.97
- Fixed bonds	10.0	10.0	3.78	17.77
- Pooled Funds	10.0	35.0	4.90 ²	n/a
TOTAL INVESTMENTS	491.3	495.6	1.55	2.08
Increase/ (Decrease) in Investments £m		4.3		

6.5. During 2014/15 the County Council diversified its range of investments in order to reduce the risk of loss of funds. This process has continued in 2015/16. Over the year the County Council reduced its exposure to unsecured bank and building society investments by increasing its exposures to secured bank and building society investments, money market funds (which have a reduced exposure to bail-in investments), and other local authorities. The County Council has also invested more of the allocation to the high yield strategy through further investing in the pooled property funds.

6.6. As part of the 2014/15 Investment Strategy it was agreed to target £90m for higher yielding investments such as long-term investments with other Local Authorities, or equity, bond or property investments. This amount is in addition to £15m that was identified for long term investments associated with the Street Lighting PFI. Investments yielding higher returns will contribute additional income to the County Council, although some come with the risk that they may suffer falls in the value of the principal invested.

6.7. The fall in long term interest rates since the decision to target higher returns has limited the opportunities that have been available for advantageous long term investments. Of the £105m available £65m has been invested, and in

² Income return at 31/03/2016

addition £20m in total has been committed to two long-term pooled equity funds.

- 6.8. The investments in property funds allow the County Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. The funds which are operated on a variable net asset value (VNAV) basis offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short-term. All of the County Council's pooled fund investments are in the respective fund's distributing share class which pay out the income generated.
- 6.9. Although money can be redeemed from the pooled funds at short notice, the County Council's intention is to hold them for the medium-term. Their performance and suitability in meeting the County Council's investment objectives are monitored regularly and discussed with Arlingclose.
- 6.10. 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.
- 6.11. Counterparty credit quality was assessed and monitored with reference to credit ratings, for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.
- 6.12. The County Council will also consider the use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.
- 6.13. The County Council maintained a sufficient level of liquidity through the use of call accounts and money market funds. The County Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate has been maintained at 0.5% since March 2009 and short-term money market rates have remained at relatively low levels which continued to have a significant impact on cash investment income.
- 6.14. The County Council's average cash balances were £558m during the year and interest earned for the year was £8.0m, giving a yield of 1.43%.

7. Compliance with Prudential Indicators

- 7.1. 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.

8. Treasury Management Indicators

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

Interest Rate Exposures

- 8.2. This indicator is set to control the County Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed will be:

Table 3 – Interest Rate Exposures

	Approved limits for 2015/16	Maximum during 2015/16	Compliance with limits:
Upper limit on fixed interest rate investment exposure	£285m	£178m	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 investment exposure	£800m	£128m	Yes

- 8.3. 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

- 8.4. This indicator is set to control the County Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 4 – Maturity Structure of Borrowing

	Upper	Lower	Actual
Under 12 months	50%	0%	3.6%
12 months and within 24 months	50%	0%	3.9%
24 months and within 5 years	50%	0%	8.8%
5 years and within 10 years	75%	0%	12.6%
10 years and within 20 years	75%	0%	44.8%
20 years and within 30 years	75%	0%	24.5%
30 years and above	100%	0%	1.8%

Principal Sums Invested for Periods Longer than 364 days

- 8.5. The purpose of this indicator is to control the County 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:

Table 5 – Principal Sums Invested for Periods Longer than 364 days

	2015/16	2016/17	2017/18
Limit on principal invested beyond year end	£285m	£250m	£250m
Actual	£244m		

9. Changes to the 2016/17 Treasury Management Strategy

- 9.1. In the 2016/17 Treasury Management Strategy, the County Council authorised a revised limit on principal sums invested for periods longer than 364 days of £285m in line with the limit set for 2015/16. Due to the stability of funds, it would be prudent to increase this limit to £350m for 2016/17 (and £300m for 2017/18 and 2018/19) to allow for further funds to be invested over a longer period so as to provide greater flexibility for managing investments, and to take advantage of current investment opportunities in the full range of investments that meet the County Council's objectives of security of capital whilst maximising yield.

Table 6 – Principal Sums Invested for Periods Longer than 364 days

	2016/17	2017/18	2018/19
Limit on principal invested beyond year end	£350m	£300m	£300m

- 9.2. Increasing the principle sum invested for periods longer than 364 days requires other limits to also be increased so as to comply with the new limit. These new limits are shown in the tables below.

Table 7 – Non-Specified Investment Limits

	Cash limit
Total long-term investments	£350m
Total investments without credit ratings or rated below A- (excluding investments with other local authorities)	£190m
Total non-Sterling investments	£0m
Total investments in foreign countries rated below AA+	£0m
Total non-specified investments	£540m

Table 8 – Interest Rate Exposures

	2016/17	2017/18	2018/19
Upper limit on fixed interest rate investment exposure	£350m	£300m	£300m
Upper limit on variable interest rate investment exposure	£700m	£700m	£700m
Upper limit on fixed interest rate borrowing exposure	£780m	£760m	£740m
Upper limit on variable interest rate borrowing exposure	£780m	£760m	£740m

10. Recommendation

- 1.1. The Audit Committee are asked to note the following recommendations that are being reported to Cabinet and Full Council:
1. That the contents of this outturn report are noted.
 2. That approval is given to change the 2016/17 Treasury Management Strategy to increase the limit of principal sums invested for periods longer than 364 days to £350m for 2016/17, and £300m for 2017/18 and 2018/19, as detailed in section 9.

CORPORATE OR LEGAL INFORMATION:

Links to the Corporate Strategy

This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because the management of the County Council’s cash balance needs to be decided.

Other Significant Links

Links to previous Member decisions:		
<u>Title</u>	<u>Reference</u>	<u>Date</u>
Direct links to specific legislation or Government Directives		
<u>Title</u>	<u>Date</u>	

Section 100 D - Local Government Act 1972 - background documents	
<p>The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)</p>	
<u>Document</u>	<u>Location</u>
None	

IMPACT ASSESSMENTS:

1. Equality Duty

1.1. The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited under the Act;
- Advance equality of opportunity between persons who share a relevant protected characteristic (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, gender and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

Due regard in this context involves having due regard in particular to:

- a) The need to remove or minimise disadvantages suffered by persons sharing a relevant characteristic connected to that characteristic;
- b) Take steps to meet the needs of persons sharing a relevant protected characteristic different from the needs of persons who do not share it;
- c) Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity which participation by such persons is disproportionately low.

1.2. Equalities Impact Assessment:

1.3. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- a) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

Prudential Indicators 2015/16

The Local Government Act 2003 requires the County 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 County 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 County Council's planned capital expenditure and financing may be summarised as follows. Further detail is provided in the capital programme report.

Capital Expenditure and Financing	2015/16 Approved £m	2015/16 Revised £m	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m
Total expenditure	236	243	204	237	219
Capital receipts	16	13	10	6	9
Grants and other income	120	134	139	195	176
Revenue contributions	68	11	9	12	7
Contributions from reserves	6	68	29	11	13
Total financing	210	226	187	224	205
Prudential borrowing	31	17	19	22	19
Less repayments from capital receipts etc	(5)	(5)	(5)	(9)	(5)
Finance lease	-	5	3	-	-
Total funding	26	17	17	13	14
Total financing and funding	236	243	204	237	219

Estimates of Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the County Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31.03.16 Approved £m	31.03.16 Revised £m	31.03.16 Actual £m	31.03.17 Estimate £m	31.03.18 Estimate £m
General Fund	765	753	756	739	724

The CFR is forecast to fall by £32m over the next three years as capital expenditure financed by debt is outweighed by 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 County 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	31.03.16 Approved £m	31.03.16 Revised £m	31.03.16 Actual £m	31.03.17 Estimate £m	31.03.18 Estimate £m
Borrowing	343	343	370	330	316
PFI liabilities	176	177	178	168	159
Total Debt	519	520	548	498	475

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 County Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

Operational Boundary	2015/16 Approved £m	2015/16 Revised £m	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m
Borrowing	620	620	370	610	600
Other long-term liabilities	180	180	178	170	160
Total Debt	800	800	548	780	760

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 County Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	2015/16 Approved £m	2015/16 Revised £m	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m
Borrowing	650	640	370	640	630
Other long-term liabilities	220	230	178	210	200
Total Debt	870	870	548	850	830

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	2015/16 Approved %	2015/16 Revised %	2015/16 Actual %	2016/17 Estimate %	2017/18 Estimate %
General Fund	6.99	5.87	5.97	5.73	5.61

Adoption of the CIPFA Treasury Management Code

The County Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* in February 2010.