

**HAMPSHIRE COUNTY COUNCIL****Decision Report**

<b>Decision Maker:</b>	Audit Committee
<b>Date:</b>	25 June 2015
<b>Title:</b>	Annual Treasury Outturn Report 2014/15
<b>Reference:</b>	6704
<b>Report From:</b>	Director of Corporate Resources – Corporate Services

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### **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 2014/15, 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 2014/15, 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. Economic Background**

#### **Growth and Inflation**

- 3.1. The robust pace of GDP growth of 3% in 2014 was underpinned by a buoyant services sector, supplemented by positive contributions from the production and construction sectors. Resurgent house prices, improved consumer confidence and healthy retail sales added to the positive outlook for the UK economy given the important role of the consumer in economic activity.
- 3.2. Annual CPI inflation fell to zero for the year to March 2015, down from 1.6% a year earlier. The key driver was the fall in oil prices (which fell to \$44.35 a barrel; a level not seen since March 2009) and a steep drop in wholesale energy prices with extra downward momentum coming from supermarket competition resulting in lower food prices. Bank of England Governor, Mark Carney, wrote an open letter to the Chancellor in February, explaining that the Bank expected CPI to temporarily turn negative, but rebound around the end of 2015 as the lower prices dropped out of the annual rate calculation.

### **Labour Market**

- 3.3. The UK labour market continued to improve and remains resilient across a broad base of measures including real rates of wage growth. January 2015 showed a headline employment rate of 73.3%, while the rate of unemployment fell to 5.7% from 7.2% a year earlier. Comparing the three months to January 2015 with a year earlier, employee pay increased by 1.8% including bonuses and by 1.6% excluding bonuses.

### **UK Monetary Policy**

- 3.4. The Bank of England's Monetary Policy Committee (MPC) maintained interest rates at 0.5% and asset purchases (QE) at £375bn. Its members held a wide range of views on the response to zero CPI inflation, but just as the MPC was prepared to look past the temporary spikes in inflation to nearly 5% a few years ago, they felt it appropriate not to get panicked into a response to the current low rate of inflation. The minutes of the MPC meetings reiterated the Committee's stance that the economic headwinds for the UK economy and the legacy of the financial crisis meant that increases in the Bank Rate would be gradual and limited, and below average historical levels.
- 3.5. Arlingclose's expectation for the first rise in official interest rates remains Quarter 2 of 2016. The risks to this forecast remain weighted to the downside; in particular, signs of more widespread deflation or political uncertainty could prompt a further downward revision to the forecast. The pace of interest rate rises will be gradual and the extent of rises limited.
- 3.6. A continuation of Base Rates being held at record lows has limited the return that can be made on investment balances. Also, despite positive economic indicators there remain risks for investors due to 'bail-in' legislation. The credit risk associated with making unsecured bank deposits has increased relative to the risk of other investment options available to the County Council. Whilst the likelihood of suffering a loss from the default of a bank remains relatively unchanged, the 'bail-in' regime has significantly increased the impact a default would have in terms of the scale of loss the County Council could be exposed to.

#### **4. Local Context**

- 4.1. At 31/03/2015 the County Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £761.6m, while usable reserves and working capital, which are the underlying resources available for investment, were £498.1m.
- 4.2. At 31/03/2015, the County Council had £361m of borrowing and £491m 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 remain constant in 2015/16. The County Council's reserves are forecast to remain stable and therefore the current internally borrowed position can be maintained if this continues to be advantageous.

#### **5. Borrowing Strategy**

- 5.1. At 31/03/2015 the County Council held £361m of loans, (a decrease of £12m since 31/03/2014) 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 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.
- 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 2014/15

	Balance on 31/03/2014 £m	Net new borrowing £m	Balance on 31/03/2015 £m
CFR	758.6		761.6
Short Term Borrowing <sup>1</sup>	14.6	(3.1)	11.5
Long Term Borrowing	358.6	(8.8)	349.8
<b>TOTAL BORROWING</b>	<b>373.2</b>	<b>(11.9)</b>	<b>361.3</b>
Other Long Term Liabilities	160.0	20.2	180.2
<b>TOTAL EXTERNAL DEBT</b>	<b>533.2</b>	<b>8.3</b>	<b>541.5</b>
Increase/ (Decrease) in Borrowing £m			(11.9)

- 5.5. During 2014/15 the County Council repaid £14.54m 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.

#### **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 2014/15.

#### **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.

#### **Abolition of the PWLB**

- 5.8. In January 2015 the Department of Communities and Local Government (CLG) confirmed that HM Treasury (HMT) would be taking the necessary steps to abolish the Public Works Loans Board. HMT has confirmed however that its lending function will continue unaffected and local authorities will retain access to borrowing rates which offer good value for money. The County Council intends to use the PWLB's replacement as a potential source of borrowing if required.

### **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 (DGSD) is to promote deposits of individuals and SMEs above those of public authorities, large corporates

<sup>1</sup> Loans with maturities less than 1 year.

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 2014/15 the County Council's investment balances have ranged between £491 and £700 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 2014/15

<b>Investments</b>	Balance on 31/03/2014 £m	Balance on 31/03/2015 £m	Average Rate/Yield on 31/03/2015 %	Average Life on 31/03/2015 Years
Short term Investments				
- Banks & Building Societies:				
- Unsecured	305.0	207.1	0.85%	0.17
- Secured	0.0	15.0	0.74%	0.98
- Money Market Funds	26.0	47.8	0.46%	0.00
- Local Authorities	95.0	28.0	0.69%	0.64
- Corporate Fixed Bonds	0.0	15.9	0.75%	0.73
Long term Investments				
- Local Authorities	80.5	137.5	1.89%	2.80
Long terms Investments – high yielding strategy				
- Local Authorities				
- Fixed deposits	15.0	20.0	3.96%	19.03
- Fixed bonds	0.0	10.0	3.74%	19.55
- Pooled Funds	0.0	10.0	10.14% <sup>2</sup>	n/a
<b>TOTAL INVESTMENTS</b>	521.5	491.3	1.46%	3.13
Increase/ (Decrease) in Investments £m		(30.2)		

- 6.5. During 2014/15 the County Council diversified its range of investments in order to reduce the risk of loss of funds. Over the year the County Council made new investments in short term secured bank instruments and corporate fixed bonds. In the longer term the County Council has achieved a greater amount of investments with Local Authorities, which increases the security of

<sup>2</sup> Rate of return based on 11 months of monthly returns.

the County Council's funds. The County Council has also invested more of the allocation to the high yield strategy through further investing with Local Authority fixed deposits, as well as new Local Authority fixed bonds, and an investment in a pooled property fund.

- 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 in the current financial year has limited the opportunities that have been available for advantageous long term investments. Of the £105m available £40m has been invested, and in addition £15m has been committed to a second long-term pooled property fund.
- 6.8. 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 2014/15.
- 6.9. Counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.
- 6.10. 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.
- 6.11. The County Council's average cash balances were £612m during the year and interest earned for the year was £7.1m, giving a yield of 1.17%.

## **7. Compliance with Prudential Indicators**

- 7.1. The County Council confirms compliance with its Prudential Indicators for 2014/15, which were set in February 2014 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 4 – Interest Rate Exposures

	<b>Approved Limits for 2014/15</b>	<b>Maximum during 2014/15</b>	<b>Compliance with Limits:</b>
Upper limit on fixed interest rate investment exposure	£250m	£175m	Yes
Upper limit on variable interest rate investment exposure	£750m	£570m	Yes
Upper limit on fixed interest rate borrowing exposure	£810m	£463m	Yes
Upper limit on variable interest rate borrowing exposure	£810m	£122m	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 5 – Maturity Structure of Borrowing

	<b>Upper</b>	<b>Lower</b>	<b>Actual</b>
Under 12 months	50%	0%	3%
12 months and within 24 months	50%	0%	3%
24 months and within 5 years	50%	0%	9%
5 years and within 10 years	75%	0%	14%
10 years and within 20 years	75%	0%	39%
20 years and within 30 years	75%	0%	27%
30 years and above	100%	0%	5%

#### **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 6 – Principal Sums Invested for Periods Longer than 364 days

	<b>2014/15</b>	<b>2015/16</b>	<b>2016/17</b>
Limit on principal invested beyond year end	£250m	£285m	£250m
Actual	£178m		

**9. Recommendation**

9.1. 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.

**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 Pension Fund'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**

**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.)**

<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 2014/15

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.

Capital Expenditure and Financing	2014/15 Approved £m	2014/15 Revised £m	2014/15 Actual £m	2015/16 Estimate £m	2016/17 Estimate £m
<b>Total expenditure</b>	<b>284</b>	<b>257</b>	<b>245</b>	<b>236</b>	<b>168</b>
Capital receipts	8	11	13	16	5
Grants and other income	145	147	161	120	114
Revenue contributions	29	29	29	68	35
Contributions from reserves	60	26	6	6	1
<b>Total financing</b>	<b>242</b>	<b>213</b>	<b>209</b>	<b>210</b>	<b>155</b>
Supported borrowing	4	0	0	0	0
Prudential borrowing	9	17	14	31	24
Less repayments from capital receipts etc	0	(5)	(5)	(5)	(11)
Finance lease	29	32	27	0	0
<b>Total funding</b>	<b>42</b>	<b>44</b>	<b>36</b>	<b>26</b>	<b>13</b>
<b>Total financing and funding</b>	<b>284</b>	<b>257</b>	<b>245</b>	<b>236</b>	<b>168</b>

### Estimates of Capital Financing Requirement

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

<b>Capital Financing Requirement</b>	<b>31.03.15 Approved £m</b>	<b>31.03.15 Revised £m</b>	<b>31.03.15 Actual £m</b>	<b>31.03.16 Estimate £m</b>	<b>31.03.17 Estimate £m</b>
General Fund	761	771	762	765	741

The CFR is forecast to fall by £30m 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.

<b>Debt</b>	<b>31.03.15 Approved £m</b>	<b>31.03.15 Revised £m</b>	<b>31.03.15 Actual £m</b>	<b>31.03.16 Estimate £m</b>	<b>31.03.17 Estimate £m</b>
Borrowing	351	354	<b>361</b>	343	330
PFI liabilities	184	185	<b>180</b>	176	168
<b>Total Debt</b>	<b>535</b>	<b>539</b>	<b>541</b>	<b>519</b>	<b>498</b>

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.

<b>Operational Boundary</b>	<b>2014/15 Approved £m</b>	<b>2014/15 Revised £m</b>	<b>2014/15 Actual £m</b>	<b>2015/16 Boundary £m</b>	<b>2016/17 Boundary £m</b>
Borrowing	620	620	<b>366</b>	620	610
Other long-term liabilities	190	190	<b>180</b>	180	170
<b>Total Debt</b>	<b>810</b>	<b>810</b>	<b>546</b>	<b>800</b>	<b>780</b>

### **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.

<b>Authorised Limit</b>	<b>2014/15 Approved £m</b>	<b>2014/15 Revised £m</b>	<b>2014/15 Actual £m</b>	<b>2015/16 Limit £m</b>	<b>2016/17 Limit £m</b>
Borrowing	640	640	<b>366</b>	650	630
Other long-term liabilities	230	240	<b>180</b>	220	210
<b>Total Debt</b>	<b>870</b>	<b>880</b>	<b>546</b>	<b>870</b>	<b>840</b>

### **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.

<b>Ratio of Financing Costs to Net Revenue Stream</b>	<b>2014/15 Approved %</b>	<b>2014/15 Revised %</b>	<b>2014/15 Actual %</b>	<b>2015/16 Estimate %</b>	<b>2016/17 Estimate %</b>
General Fund	7.53%	7.14%	7.07%	6.99%	6.92%

### **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.