AGENDA ITEM NO. 4

LICENSING & GENERAL PURPOSES COMMITTEE
27 JUNE 2016

HEAD OF FINANCIAL SERVICES
REPORT NO. FIN1613

TREASURY MANAGEMENT OPERATIONS 2015/16

1 INTRODUCTION

1.1 The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year. The Code also recommends that members be informed of Treasury Management activities at least twice a year. This report therefore ensures this authority is embracing best practice in accordance with CIPFA's recommendations.

1.2 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.

1.3 This report sets out the main Treasury Management activities during 2015/16 and provides an update on the current economic conditions affecting Treasury Management decisions. Appendix A shows the actual prudential indicators relating to Capital Financing and treasury activities for 2015/16 and compares these to the indicators set in the Annual Treasury Management Strategy for the year, approved by Council on 26 February 2015.

2 TREASURY MANAGEMENT ADVICE

2.1 The Council continued to engage the services of Arlingclose for independent treasury advice during the year 2015/16. Arlingclose provide specialist treasury support to 25% of UK local authorities. They provide a range of treasury management services including technical advice on debt and investment management and long-term capital financing. They advise on investment trends, developments and opportunities consistent with the Council's Treasury Management Strategy.

2.2 With the exception of pooled funds all investment activity is carried out by the Council's own treasury team with advice from Arlingclose, as outlined in paragraph 2.1 above, and having due regard to information from other sources such as the financial press and credit-rating agencies.

2.3 Pooled funds are managed at the discretion of the external fund managers associated with each fund. It should however be noted that whilst the funds are externally managed, the decision as to whether to invest lies solely with the Council in accordance with its Treasury Management Strategy.

2.4 The needs of the Council's treasury management staff for training in investment management are assessed on an ongoing basis and as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. During 2015/16, staff attended relevant workshops provided by Arlingclose.

3 ECONOMIC BACKGROUND

3.1 **Growth and Inflation**: The UK economy slowed in 2015 with GDP growth falling to 2.3% from a robust 3.0% the year before. The prolonged spell of low inflation was attributed to the continued collapse in the price of oil, the appreciation of sterling since 2013 pushing down import prices and weaker than anticipated wage growth resulting in subdued unit labour costs. CPI inflation hovered around 0.0% through 2015 with deflationary spells in April, September and October of that year. CPI picked up to 0.3% year/year in February 2016, but this was still well below the Bank of England's 2% inflation target.

3.2 **Employment**: The labour market continued to improve through 2015/16 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.

3.3 **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 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).

3.4 **Global**: 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 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.

3.5 **Market reaction**: From June 2015 gilt yields were driven lower by the a 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 a significant volatility and in equities and corporate bond yields.

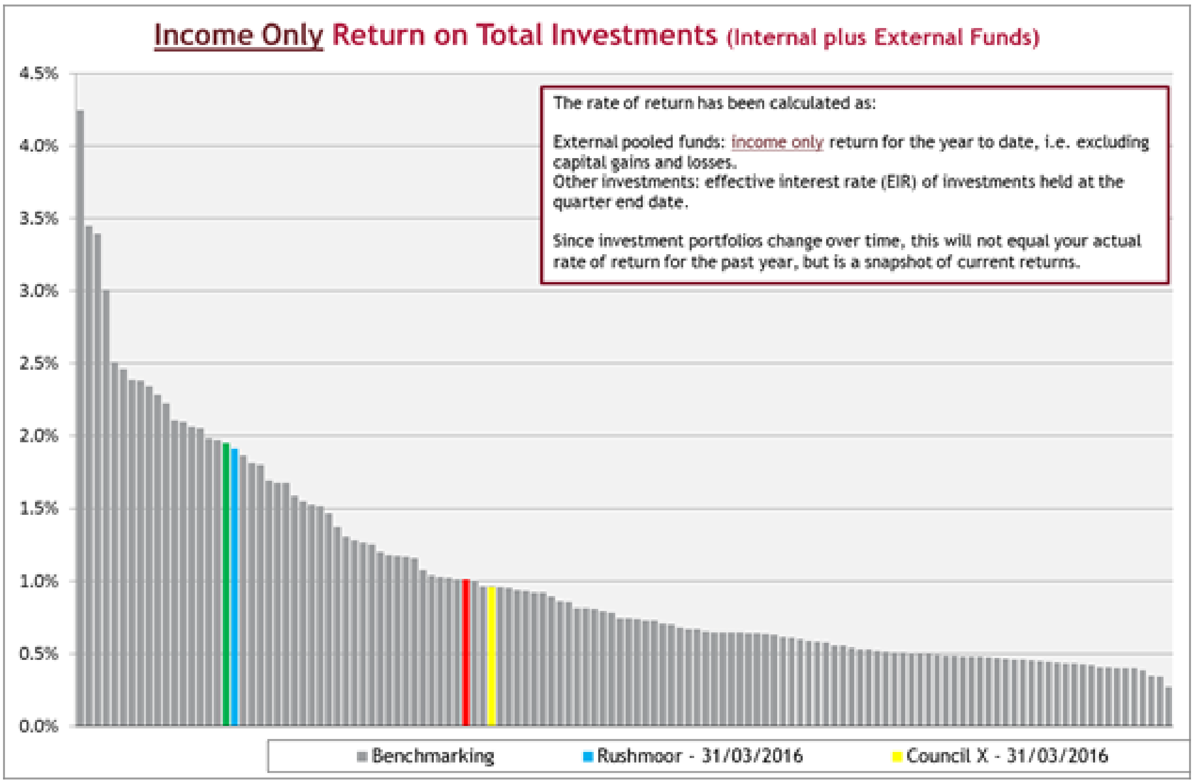
3.6 **Interest Rate Forecast**: The view from Arlinglcose is that the global outlook is weak and uncertain and risks remain weighted to the downside. The lack of inflationary pressures in 2016 and a lower growth profile than previously expected may push back a rise in UK Bank Rate to Q2 2018. Arlingclose estimates that when the rise in rates does occur it will eventually reach a 'normal' of between 2 and 3%.

4 BORROWING ACTIVITY IN 2015/16

4.1 The Council borrowed £4.7m from the M3 Local Enterprise Partnership during 2015/16. Capital expenditure for Activation Aldershot directly related to this borrowing amounted to £1.4m. This event therefore meant that the Council's capital financing requirement as at 31st March 2016 became £1.4m compared to zero for previous financial years. The remainder of the 2015/16 capital programme was funded from grants, other revenue contributions and capital receipts.

5 INVESTMENT ACTIVITY IN 2015/16

5.1 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. The total income yield return on the Council's investments amounted to 1.92% for the financial year 2015/16 excluding capital gains and losses. The following graph has been produced by Arlingclose and shows the Council's 2015/16 return on its total investment portfolio excluding capital gains and losses. The Council ranks well when benchmarked against their other local authority clients. Highlighted on the graph are three other non-metropolitan districts with a similar size portfolio to Rushmoor showing returns of one marginally higher and two at or just below 1%:



For 2015/16 the Council continued to use secured investment options or diversified alternatives such as covered bonds, non-bank investments and pooled funds over unsecured bank and building society deposits. Details of the Council's investment activity together with returns generated during 2015/16 are outlined as follows:

5.2 **Pooled Funds** - the Council's pooled funds have experienced some variations in performance during the year 2015/16.

Pooled Funds Capital Growth/Losses – Aggregation of the Council's pooled funds resulted in an overall net reduction in fair value for the year 2015/16 of around £150,000, although this net reduction is relatively modest compared to the overall investment sum (an aggregate reduction of 0.75%). The significant exceptions within this group are CCLA showing exceptional growth of 16% since acquisition, but offset by a capital reduction for the UBS Multi Asset Fund which has declined by 7% since acquisition. This group of investments are long term (3-5 year window) and monitoring of the capital value continues to be made on a monthly basis.

Pooled Fund Income Returns – The income returned by fund for the period to 31st March 2016 is analysed below:

- Payden & Rygel's Sterling Reserve Fund - £5 million investment. The Fund seeks to provide capital security, liquidity and income through investment in Sterling denominated investment-grade debt securities. The fund's performance for the 12 months to 31st March 2016 is 0.88% income return.

- CCLA's Local Authorities' Mutual Investment Trust - £5 million investment. The Council's total investment in this UK property fund is £5 million. The fund has returned 5.62% income during 2015/16.

- Aberdeen Absolute Return Bond Fund - £3 million investment. This fund aims for a target total return of 3-5% from a combination of investment income or capital appreciation. The fund's performance for 2015/16 is a 2.23% income return.

- UBS Multi-Asset Income Fund - £5 million investment. This Fund follows a strategy of reducing volatility exposure levels by spreading investments across a diversified range of asset classes. This fund has generated a 3.57% income return for the year.

- Threadneedle Strategic Bond Fund - £2 million investment. . The fund aims to provide income and capital appreciation through investment grade and high yield bonds. This fund has generated a 4.30% income return during the period to 31st March 2016.

Additional information is contained in Appendix B.

5.3 **Bonds** - debt instruments in which an investor lends money for a specified period of time at a fixed rate of interest. **Covered bonds** are conventional bonds that are backed by a separate group of loans (usually prime residential mortgages). When the covered bond is issued, it is over collateralised, with the pool of assets being greater than the value of the bond. During the year the Council invested in the following covered bonds:

• £1 million	Bank of Scotland at a fixed rate of 0.957%	Bond
• £1 million	Yorkshire Building Society at a fixed rate of 1.33%	Bond
• £2 million	Leeds Building Society at a fixed rate of 1.47%	Bond
• £1 million (matured)	Clydesdale Bank at a fixed rate of 0.54%	FRN
• £1.3 million (matured)	Rabobank Nederland at a fixed rate of 0.681%	FRN

5.4 **Other Investments** – During the year the Council further diversified its portfolio by investing the following in institutions other than UK banks:

- £1 million at a fixed rate of 0.54% for 100 days with National Counties Building Society
- £1 million at a fixed rate of 0.55% for 100 days with National Counties Building Society

- £1 million at a fixed rate of 0.54% for 100 days with Mansfield Building Society
- £2 million at a fixed rate of 0.66% for 6 months with Nationwide Building Society
- £1 million at a fixed rate of 0.55% for 100 days with Cumberland Building Society
- £2 million at a fixed rate of 1% for 2 years with Dumfries and Galloway Council

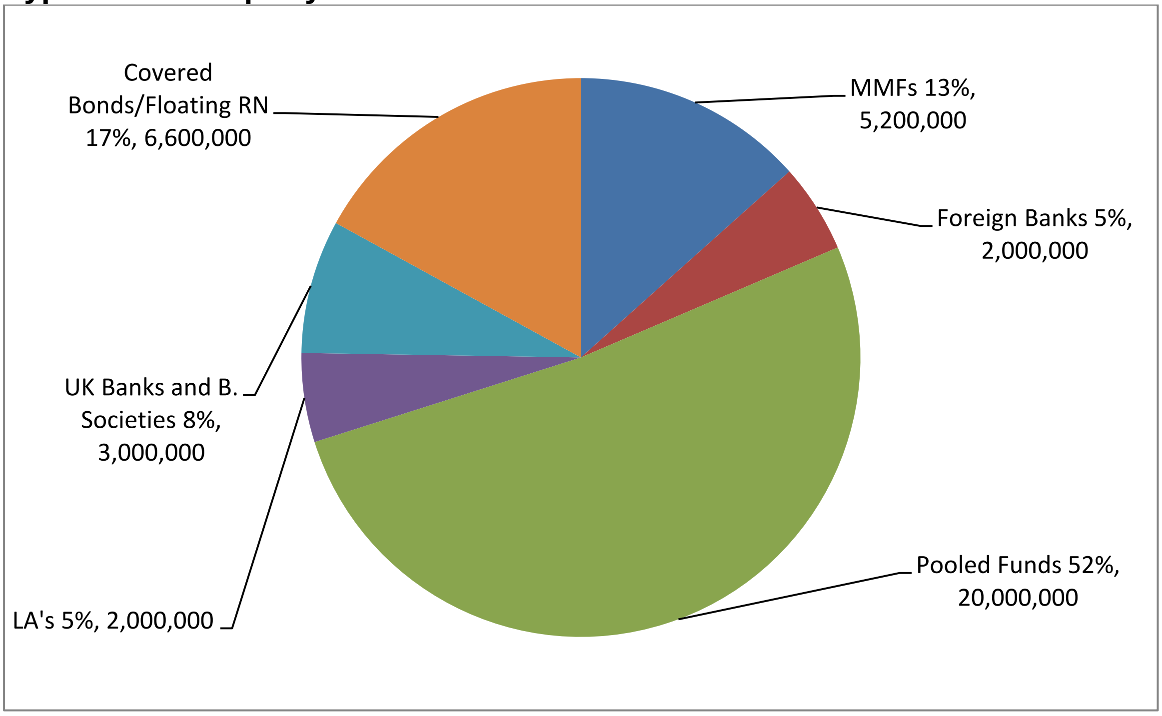
With the exception of the Dumfries and Galloway Council deposit, these all matured in 2015/16)

5.5 The table below summarises deposit/investment activity during the year to 31st March 2016. Overall, there was a net decrease of £8.4m invested during the period.

Investment Counterparty	*Balance on 31/03/15 £m*	*Investments Made £m*	*Maturities/ Investments Sold £m*	*Balance on 31/03/16 £m*	*Avg Rate % and Avg Life (yrs)*
UK Local Authorities	*2.0*	*2.0*	*2.0*	*2.0*	*1.0% - 2 years*
UK Banks and Building Societies:					
Short-term	*12.0*	*25.0*	*34.0*	*3.0*	*(0.51%-0.80%)*
Long-term	*3.0*	*-*	*3.0*	*-*	*0.95%*
Foreign Banks	*4.3*	*8.0*	*10.3*	*2.0*	*(0.40%-0.59%)*
Covered Bonds/Floating Rate Notes	*2.0*	*6.7*	*2.1*	*6.6*	*(0.54%-1.47%)& LIBOR+0.27bp - 1.3 Yrs*
AAA-rated Money Market Funds	*3.9*	*1.3*	*-*	*5.2*	*Varies daily – average 0.42%*
Pooled Funds:					
• *Payden*	*5.0*			*5.0*	*0.88*
• *CCLA*	*5.0*			*5.0*	*5.62*
• *Aberdeen Absolute*	*3.0*			*3.0*	*2.23*
• *UBS*	*5.0*			*5.0*	*3.57*
• *Threadneedle*	*2.0*			*2.0*	*4.3*
TOTAL INVESTMENTS	*47.2*	*43.0*	*51.4*	*38.8*	
Increase/ (Decrease) in Investments £m				*(8.4)*	

5.6 The following charts illustrate the spread of investments by counterparty and maturity analysis. These illustrate continued diversity and the continued move towards longer-term investments within our portfolio.

Type of counterparty as at 31st March 2016



Maturity Analysis as at 31st March 2016	Amount invested £	%
Instant	6,200,000	16
0-3 months	1,000,000	3
3-6 months	3,000,000	8
6-9 months	1,100,000	3
9-12 months	-	0
> 1 year	27,500,000	71
Total for all duration periods	**38,800,000**	**100**

6 TREASURY MANAGEMENT INDICATORS

6.1 The Treasury Management Code requires that local authorities set a number of indicators for treasury management performance, which have been set out below at paragraphs 6.5 to 6.7. The Council has also adopted a voluntary measure for credit risk as set out in paragraph 6.2

6.2 **Credit Risk (Credit Score Analysis):** Counterparty credit quality is assessed and monitored by reference to credit ratings. Credit ratings are supplied by rating agencies Fitch, Standard & Poor's and Moody's. Arlingclose assign values between 1 and 26 to credit ratings in the range AAA to D, with AAA being the highest credit quality (1) and D being the lowest (26). Lower scores mean better credit quality and less risk.

6.3 The advice from Arlingclose is to aim for an A-, or higher, average credit rating, with an average score of 7 or lower. This reflects the current investment approach with its focus on security. The scores are weighted according to the size of our deposits (value-weighted average) and the maturity of the deposits (time-weighted average).

6.4 The table below summarises the Council's internal investment credit score for deposits during the year to 31st March 2016. The Council's scores fall comfortably within the suggested credit parameters. This represents good credit quality deposits on the grounds of both size and maturity. The improved credit risk scores during the year reflect the increasing diversity within the Council's investment portfolio.

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
Q4 2014/15	4.68	A+	2.77	AA
Q1 2015/16	4.57	A+	2.28	AA+
Q2 2015/16	4.03	AA-	1.77	AA+
Q3 2015/16	3.68	AA-	1.50	AAA
Q4 2015/16	3.02	AA-	1.50	AAA

6.5 **Interest Rate Exposure**: This indicator is set to monitor the Council's exposure to the effects of changes in interest rates. The indicator calculates the relationship between the Council's net principal sum outstanding on its borrowing to the minimum amount it has available to invest. The upper limits on fixed and variable rate interest rate exposures expressed as the amount of net principal borrowed is:

	2015/16 Approved Limit	2015/16 Actual
Upper limit on fixed interest rate exposure	-£27m	-£13m
Upper limit on variable interest rate exposure	-£19m	£26m

It is expected that for most councils the interest rate exposure calculation would result in a positive figure. As the Council has more funds available to invest than it intends to borrow, the calculation has resulted in a negative figure.

6.6 **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 will be:

	Upper	Lower	2015/16 Actual Performance
Under 12 months	100%	0%	12%
12 months and within 24 months	100%	0%	14%
24 months and within 5 years	100%	0%	55%
5 years and within 10 years	100%	0%	19%
10 years and above	100%	0%	-

The Council borrowed £4.7m from the M3 Local Enterprise Partnership. The above table demonstrates the elements of principal repayment that arise from the sum borrowed expressed as a percentage of the original amount borrowed.

6.7 **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. Performance against the limits on the total principal sum invested to final maturities beyond the period end is:

	2015/16 Approved Limit	2015/16 Actual Performance
Limit on principal invested beyond year end at any one time	£50m	£28m

7 BUDGETED INCOME & OUTTURN

7.1 The Council's revised estimate regarding investment yield outturn for 2015/16 was £849,000 for the year. The actual yield in the General Fund Revenue Account was £894,000, resulting in a favourable variance of £45,000.

8 CONCLUSIONS

8.1 The Council's treasury team continued to concentrate on the security of investments taking due regard for the returns available. Continued low interest rates throughout the financial year coupled with a lack of suitable counterparties with whom to invest made the activity continued to make the activity challenging. However, overall investment income outperformed the original budget by around £94k and contributed £894k to the Council's General Fund during 2015/16.

8.2 All treasury management activity during 2015/16 was carried out in accordance with the Annual Treasury Management Strategy and complied with the treasury and prudential indicators set out in that report, and with the Treasury Management Code of Practice.

9 RECOMMENDATIONS

9.1 Members are requested to note the contents of the report in relation to the activities carried out during 2015/16.

AMANDA FAHEY
HEAD OF FINANCIAL SERVICES

APPENDIX A

1.1 Prudential Indicators

Estimates of Capital Expenditure: The Council's planned capital expenditure and financing may be summarised as follows.

Capital Expenditure and Financing	2015/16 Revised £m	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m
General Fund	9.340	3.991	8.802	5.317
Total Expenditure	**9.340**	**3.991**	**8.802**	**5.317**
Capital Receipts	5.780	0.835	5.477	3.470
Capital Grants & Contributions	2.401	0.653	2.575	1.097
Revenue	1.159	1.116	0.750	0.750
Borrowing	0.000	1.387	0.000	0.000
Total Financing	**9.340**	**3.991**	**8.802**	**5.317**

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

Capital Financing Requirement	31.03.16 Revised £m	31.03.16 Actual £m	31.03.17 Estimate £m
General Fund	3.000	1.387	2.570
Total CFR	**3.000**	**1.387**	**2.570**

During 2015/16, the Council made use of a revolving infrastructure fund from the Local Enterprise Partnership (M3 LEP). This will not give rise to any minimum revenue provision charges into the General Fund as the annual instalments will be funded from capital receipts received from the developer.

The Council therefore now carried a capital financing requirement within the terms of the Prudential Code.

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 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 Revised £m	31.03.16 Actual £m	31.03.17 Estimate £m
Borrowing	0.000	4.700	0.000
Total Debt	**0.000**	**4.700**	**0.000**

The information above refers to the use of a revolving infrastructure fund from the Local Enterprise Partnership (M3 LEP).

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt. It links directly to the Council's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary	2015/16 Revised £m	2015/16 Actual £m	2016/17 Estimate £m
Borrowing	5.0	4.7	5.0
Other long-term liabilities	0.0	0.0	0.0
Total Debt	**5.0**	**4.7**	**5.0**

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

Authorised Limit	2015/16 Revised £m	2015/16 Actual £m	2016/17 Estimate £m
Borrowing	10.0	4.7	10.0
Other long-term liabilities	0.0	0.0	0.0
Total Debt	**10.0**	**4.7**	**10.0**

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 Revised %	2015/16 Actual %	2016/17 Estimate %	2017/18 Estimate %
General Fund	-7.5	-8.0	-7.5	-8.2

Incremental Impact of Capital Investment Decisions: This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme proposed.

Incremental Impact of Capital Investment Decisions	2015/16 Revised £	2015/16 Actual £	2016/17 Estimate £	2017/18 Estimate £
General Fund - increase in annual band D Council Tax	1.10	0.60	2.53	3.92

Adoption of the CIPFA Treasury Management Code: The prudential indicator in respect of treasury management is that the Council adopt CIPFA's Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. The aim is to ensure that treasury management is led by a clear and integrated forward treasury management strategy, with recognition of the existing structure of the Council's borrowing and investment portfolios. The revised edition of the Code (November 2011) was adopted by the Council on 20th February 2014.