AGENDA ITEM NO. 3

LICENSING & GENERAL PURPOSES COMMITTEE
28 MAY 2015

DIRECTORATE OF RESOURCES
HEAD OF FINANCIAL SERVICES
REPORT NO. FIN1510

TREASURY MANAGEMENT OPERATIONS 2014/15

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 2014/15 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 2014/15 and compares these to the indicators set in the Annual Treasury Management Strategy for the year, approved by Council in February 2014.

2 TREASURY MANAGEMENT ADVICE

2.1 In April 2013, the Council changed treasury advisors from Sector Treasury Services to Arlingclose Ltd. Arlingclose is an independent treasury advisory company who 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 Ltd, 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.

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 2014/15, staff attended workshops on Treasury Management Practices, Investments and Year-End Accounting guidance provided by Arlingclose.

3 ECONOMIC BACKGROUND

3.1 **Growth and Inflation**: 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.

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 the oil price (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.

3.2 **Employment**: The UK labour market continued to improve and remains resilient across a broad base of measures including real rates of wage growth. In January 2015 unemployment was at 5.7% (7.2% January 2014). During the year Jan 2014-2015 pay increased by 1.8% including bonuses and by 1.6% excluding bonuses.

3.3 **UK Monetary Policy**: The Bank of England's Monetary Policy Committee (MPC) maintained interest rates at 0.5%. Whilst Its members held a wide range of views on the response to zero CPI inflation, they felt it appropriate not to get panicked into response to the current low rate of inflation.

Political uncertainty had a large bearing on market confidence this year. The possibility of Scottish independence was of concern to the financial markets, however this dissipated following the outcome of September's referendum.

3.4 **Global**: Eurozone inflation continued to fall towards zero, and there was mounting evidence that the already feeble recovery was losing pace. The unemployment rate remained high at 11.5%. The European Central Bank lowered its official benchmark interest rate from 0.15% to 0.05%.

The US economy rebounded strongly in 2014, employment growth was robust and there were early signs of wage pressures building. The Federal Reserve made no change to US policy rates. The central bank however continued with 'tapering', i.e. a reduction in asset purchases by $10 billion per month, and ended them altogether in October 2014.

3.5 **Market reaction**: From July, gilt yields were driven lower by a combination of factors: geo-political risks emanating from the Middle East and Ukraine, the slide towards deflation within the Eurozone and the big slide in the price of oil and its transmission though into lower prices globally. 5, 10 and 20-year gilt yields fell to their lows in January (0.88%, 1.33% and 1.86% respectively) before ending the year higher at 1.19%, 1.57% and 2.14% respectively.

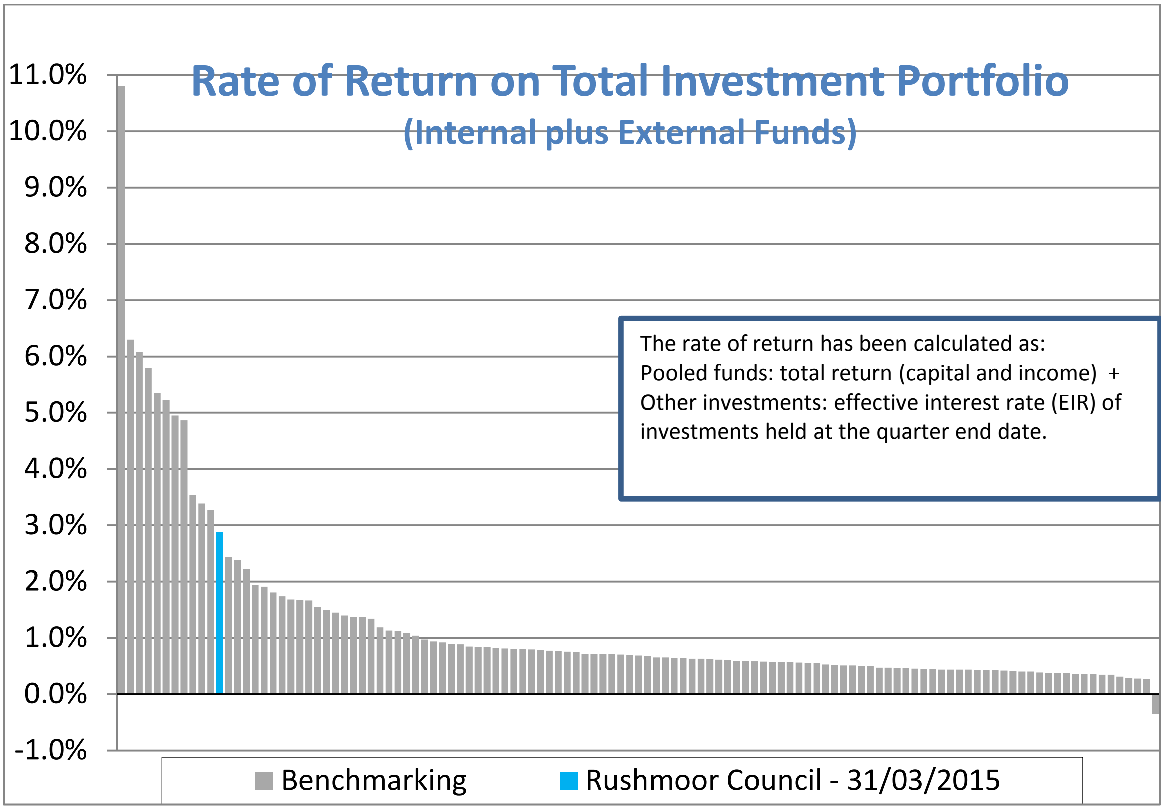
3.6 **Interest Rate Forecast**: The stronger economic growth seen in the UK over the past year is likely to use up spare capacity more quickly than previously assumed. Expectations are that rates will rise slowly and to a lower level than in the past. The latest forecast (March 2015) from Arlingclose is that interest rates will rise to 0.75% by June 2016 and increase to 1.5% by December 2017. The average forecast interest rate for the 3 year period June 2015 – June 2018 is 0.96%.

4 BORROWING ACTIVITY IN 2014/15

4.1 The Council remains debt free. The 2014/15 capital programme was funded from grants, other contributions and capital receipts.

5 INVESTMENT ACTIVITY IN 2014/15

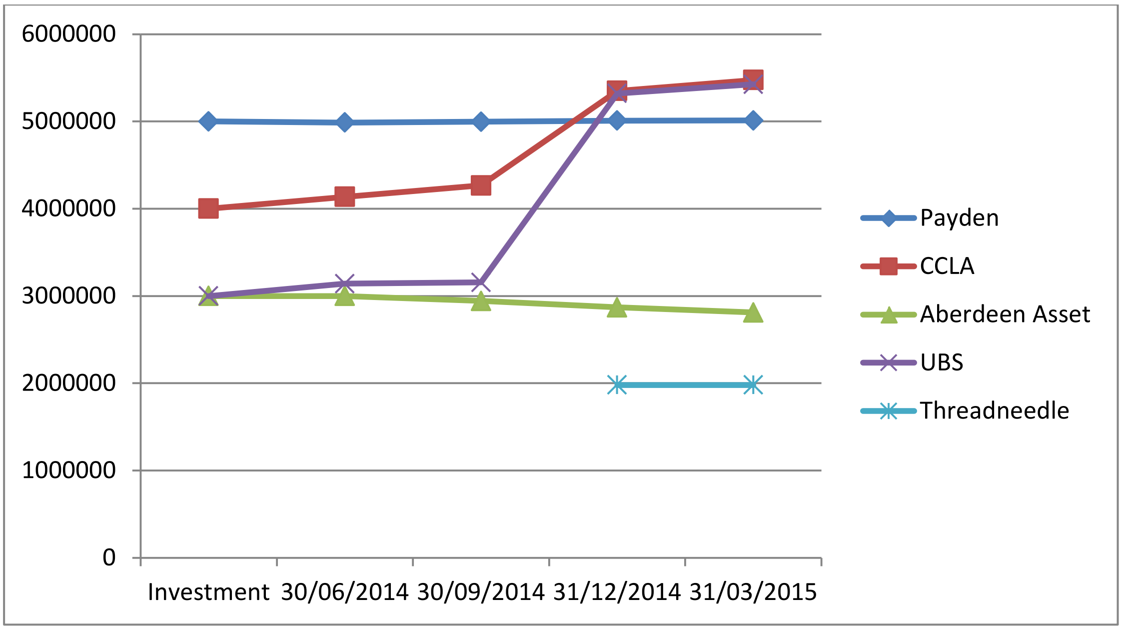
5.1 The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles. The graph below has been produced by Arlingclose and demonstrates that the Council's 2014/15 return on total investment portfolio at 2.9% is amongst the highest when benchmarked against their other local authority clients:



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. To counrteract these risks during 2014/15 Rushmoor 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. Details of the Council's investment activity together with returns generated during 2014/15 are outlined below:

5.2 **Pooled Funds** - the Council's pooled funds have performed well during 2014/15 with good total returns (combination of income and growth of capital).

Pooled Fund Capital Growth - The chart below plots the growth in initial capital investment per fund to 31st March 2015. With the exception of Aberdeen Absolute Return Bond Fund all fund have returned growth on the initial capital investment. As these are long term investments (3-5 year window) we monitor the capital value of these investments on a monthly basis. At this stage the dip in value of the Aberdeen Absolute Return Bond fund does not give cause for concern however, we will continue to monitor all funds closely.



Pooled Fund Income Returns – The income returned by fund for the period to 31st March 2015 is analysed below:

- £5 million investment with Payden & Rygel's Sterling Reserve Fund. 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 2015 0.93% income return.

- We invested an additional £1 million in September 2014 with CCLA's Local Authorities' Mutual Investment Trust. The Council's total investment in this UK property fund is £5 million. The fund has returned 5.52% income during 2014/15.

- £3 million was invested during March 2014 in the Aberdeen Absolute Return Bond Fund. 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 the 12 month period January-December 2014 is 2.32% income return.

- £3 million invested during March 2014 in the UBS Multi-Asset Income Fund. 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 4.2% income return during 2014.

- In December 2014 we invested £2 million in the Threadneedle Strategic Bond Fund. The fund aims to provide income and capital appreciation through investment grade and high yield bonds. This fund has generated a 4.41% income return during the period to 31st March 2015.

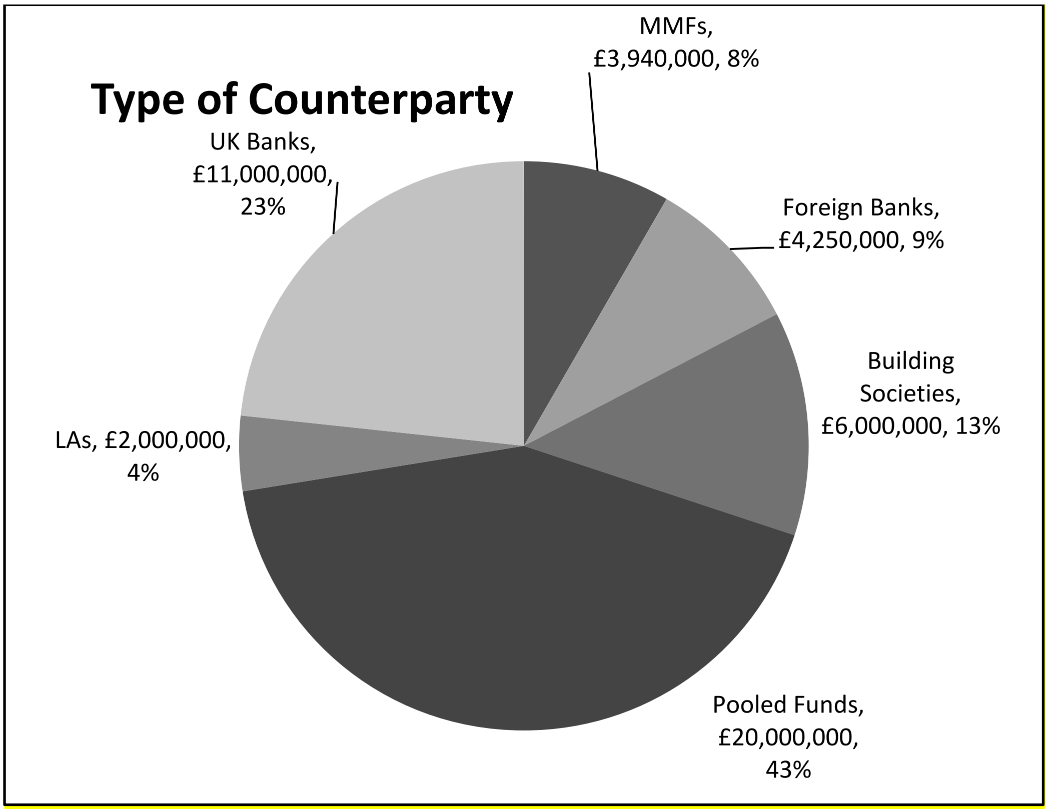
5.3 **Bonds -** debt instruments in which an investor lends money for a specified period of time at a fixed rate of interest. **Covered bonds** are conventional bonds that are backed by a separate group of loans (usually prime residential mortgages). When the covered bond is issued, it is over collateralised, with the pool of assets being greater than the value of the bond. During the year we invested in the following covered bonds:
- £1 million Leeds Building Society at a fixed rate of Libor + 0.27bp
- £1 million Yorkshire Building Society at a fixed rate of 1.18%

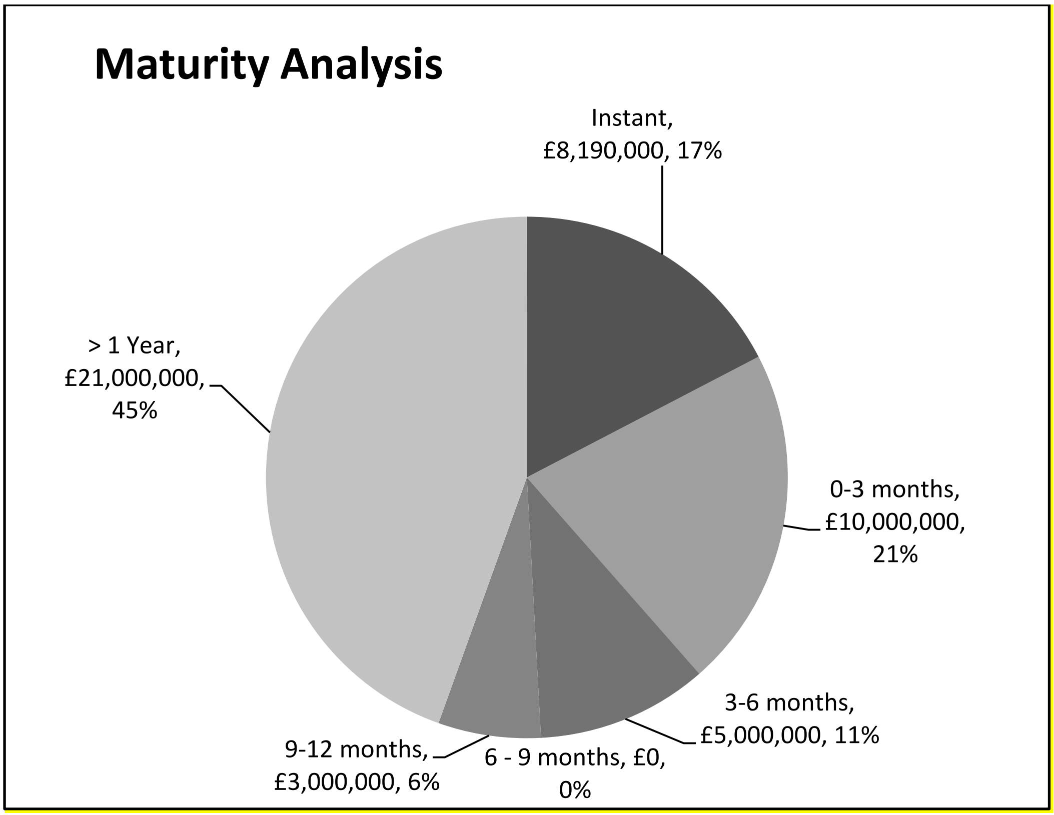
5.4 **Other Investments** – During the year we have further diversified our portfolio by investing the following in institutions other than UK banks:
- £2 million at a fixed rate of 1% for 18 months with Lancashire County Council.
- £2 million with Nationwide Building Society over a 9 month period at a rate of 0.8%.
- £1 million with Nationwide Building Society over a 6 month period at a rate of 0.66%

5.5 The table below summarises deposit/investment activity during the year to 31st March 2015. Overall, there was a net increase of £13.1m invested during the period.

Investment Counterparty	*Balance on 01/04/14 £m*	*Investments Made £m*	*Maturities/ Investments Sold £m*	*Balance on 31/03/15 £m*	*Avg Rate % and Avg Life (yrs)*
UK Local Authorities	*0.0*	*2.0*		*2.0*	*1.0% -18mths*
UK Banks and Building Societies: *Short-term* *Long-term*	 *2.0* *12.0*	 *19.5* *3.0*	 *9.5* *12.0*	 *12.0* *3.0*	 *(0.51%-0.80%)* *0.95%*
Foreign Banks	*3.5*	*0.8*		*4.3*	*0.40% - 0.55% call account*
Covered Bonds		*2.0*		*2.0*	*1.18% & LIBOR+0.27bp - 3 Yrs*
AAA-rated Money Market Funds	*1.6*	*2.3*		*3.9*	*Varies daily <0.40%*
Pooled Funds: • *Payden* • *CCLA* • *Aberdeen Absolute* • *UBS* • *Threadneedle*	 *5.0* *4.0* *3.0* *3.0*	 *1.0* *2.0* *2.0*		 *5.0* *5.0* *3.0* *5.0* *2.0*	 *0.93* *5.52* *2.32* *4.20* *4.41*
TOTAL INVESTMENTS	*34.1*	*34.6*	*21.5*	*47.2*	
Increase/ (Decrease) in Investments £m				*13.1*	

5.6 The following pie charts illustrate the spread of investments (excluding Icelandic) by counterparty along with a maturity analysis. These illustrate continued diversity and move towards longer term investments within our portfolio.


Type of Counterparty
MMFs, £3,940,000, 8%
Foreign Banks, £4,250,000, 9%
Building Societies, £6,000,000, 13%
Pooled Funds, £20,000,000, 43%
LAs, £2,000,000, 4%
UK Banks, £11,000,000, 23%


Maturity Analysis
Instant, £8,190,000, 17%
0-3 months, £10,000,000, 21%
3-6 months, £5,000,000, 11%
6 - 9 months, £0, 0%
9-12 months, £3,000,000, 6%
> 1 Year, £21,000,000, 45%

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 2015. 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 - specifically the 3 year covered bonds & 18 month local authority investments.

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
Q4 2013/14	5.50	A+	5.99	A
Q1 2014/15	5.17	A+	5.79	A
Q2 2014/15	5.12	A+	5.03	A+
Q3 2014/15	4.94	A+	4.62	A+
Q4 2014/15	4.68	A+	2.77	AA

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:

	2014/15 Approved Limit	2014/15 Actual Minimum
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
Under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

As Rushmoor had no borrowing requirement during 2014/15 the actual performance against this indicator is 0%.

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:

	2014/15 Approved Limit	2014/15 Actual Performance
Limit on principal invested beyond year end at any one time	£50m	£30m

7 BUDGETED INCOME & OUTTURN

7.1 The Council's budgeted investment income for the year was estimated at £400,000. The UK Bank Rate has been maintained at 0.5% since March 2009 and is not expected to rise until June 2016. The Council anticipates an investment outturn of £699k for the year. The position has resulted om improved returns generated from existing pooled fund investments, increased diversification within the Council's investments portfolio and current plans for some additional long-term investments.

8 ICELANDIC INVESTMENTS UPDATE

8.1 As previously reported, the bulk of the Council's investment with the Icelandic bank, Glitnir, was returned in 2012. The distributions were made in a basket of currencies, fixed at exchange rates existing at a point in time just after the collapse of the bank. All currencies were repaid and converted to Sterling with the exception of that part distributed in Icelandic Krone (ISK), which could not be converted due to Icelandic foreign exchange controls introduced after the Icelandic banking collapse. The ISK is being held in an escrow account in Iceland earning interest of 4.2%. The value of the account as at 31st March 2014 is £442,300.

8.2 Legal proceedings relating to one of the other failed Icelandic banks, Landsbanki, have established that a different date should have been used to determine the exchange rates for the redistribution of currencies to creditors. This led the Glitnir Winding-Up Board to seek to apply that date to their own distributions, which resulted in a net overpayment having been made to the Council of £23,000. This amount has subsequently been repaid to the Glitnir Winding-Up Board.

8.3 In January 2015 Bevan Brittan issued a briefing updating creditors of the current position in respect of ISK repatriation options in particular:

- A "single price" currency auction scheduled to take place in February 2015, which our legal advisors felt represented a good opportunity to exchange a substantial proportion of creditor's ISK. The results of previous auctions was that participants had exchanged their ISK for between 65% and 83% of the Central Bank of Iceland (CBI) selling rate. In addition, we were advised that this would be the final currency auction.
- An offer from Deutsche Bank to purchase creditor's escrowed ISK, which would equate to approximately 66% of it's value.
- The risk of leaving the ISK in the escrow account until capital controls are lifted, being that creditors may suffer a loss when converting the ISK. In additional, it is widely anticipated that this may involve the payment of an "exit tax" (up to 30%-40%).

The above options were considered and it was agreed that the currency auction represented the best opportunity to maximize the return on the remaining monies held in ISK. Rushmoor participated in the currency auction and sold its ISK for £311k in February 2015.

9 CONCLUSIONS

9.1 2014/15 proved to be another challenging year for treasury management. The Council's treasury team has concentrated as always on the security of investments while still having regard to the returns available. Revision to the treasury management strategy has enabled the Council to further diversity its investment portfolio and benefit from alternative investments during 2014/15. Despite low interest rates and the lack of suitable counterparties with whom to invest, investment income outperformed the original budget by around £300k and contributed £699k to the Council's General Fund during 2014/15.

9.2 All treasury management activity during 2014/15 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.

10 RECOMMENDATIONS

10.1 Members are requested to note the contents of the report in relation to the activities carried out during 2014/15.

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	**2014/15 Revised £m**	**2014/15 Actual £m**	**2015/16 Estimate £m**	**2016/17 Estimate £m**
General Fund	4.480	2.202	4.673	1.455
Total Expenditure	**4.480**	**2.202**	**4.673**	**1.455**
Capital Receipts	2.603	0.692	1.156	0.156
Capital Grants & Contributions	1.078	0.711	2.667	0.399
Reserves	0.099	0.099	0	0
Revenue	0.700	0.700	0.850	0.900
Total Financing	**4.480**	**2.202**	**4.673**	**1.455**

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	**31.03.15 Revised £m**	**31.03.15 Actual £m**	**31.03.16 Estimate £m**
General Fund	0.280	0.280	0.000
Finance lease (MRP)	-0.280	-0.280	0.000
Total CFR	**0**	**0**	**0**

As shown in indicator 1 above, Rushmoor is able to finance all of its capital expenditure without the need to borrow, however CFR now includes embedded leases brought onto the balance sheet under International Financial Reporting Standards (IFRS). The MRP above includes the finance lease annual principal payments.

This is purely an accounting adjustment and does not indicate any requirement to borrow hence this indicator is zero. This prudential indicator will remain at zero for as long as Rushmoor remains debt free.

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	**31.03.15 Revised £m**	**31.03.15 Actual £m**	**31.03.16 Estimate £m**
Borrowing	0.000	0.000	3.000
Finance leases	0.280	0.280	0.000
Total Debt	**0.280**	**0.280**	**3.000**

During 2015/16, the Council is expecting to make 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	**2014/15 Revised £m**	**2014/15 Actual £m**	**2015/16 Estimate £m**
Borrowing	5.0	0.0	5.0
Other long-term liabilities	0.0	0.0	0.0
Total Debt	**5.0**	**0.0**	**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	**2014/15 Revised £m**	**2014/15 Actual £m**	**2015/16 Estimate £m**
Borrowing	10.0	0.0	10.0
Other long-term liabilities	0.0	0.0	0.0
Total Debt	**10.0**	**0.0**	**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	2014/15 Revised %	2014/15 Actual %	2015/16 Estimate %	2016/17 Estimate %
General Fund	-3.1	-3.5	-7.1	-7.5

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	2014/15 Revised £	2014/15 Actual £	2015/16 Estimate £	2016/17 Estimate £
General Fund - increase in annual band D Council Tax	0.88	0.88	1.54	2.99

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.