CABINET
15 DECEMBER 2015

HEAD OF FINANCIAL SERVICES
REPORT NO. FIN1522

TREASURY MANAGEMENT OPERATIONS MID-YEAR REPORT 2015/16

1 INTRODUCTION

1.1 The Treasury Management Strategy for 2015/16 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year. The Code also recommends that members are 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 This report sets out the main activities of the Treasury Management Operations during the first half of 2015/16, provides an update on the current economic conditions affecting Treasury Management decisions and a forward look for the remainder of 2015/16.

- Appendix A shows the actual prudential indicators relating to capital and treasury activities for the first half of 2015/16 and compares these to the indicators set in the Annual Treasury Management Strategy for the year, which was approved by Council in February 2015.

2 TREASURY MANAGEMENT ADVICE

2.1 The Council receives independent treasury advisory services from Arlingclose Ltd. Arlingclose provide treasury advice to 25% of UK local authorities 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.

2.4 Officers involved in treasury activities have attended Credit Risk, Treasury Management Practices and Decision Making workshops and a Treasurers' Investment Forum during the 6 months to 30th September 2015.

3 ECONOMIC BACKGROUND

3.1 **UK Economy:** The economy has remained resilient over the last six months. GDP has now increased for ten consecutive quarters, breaking a pattern of slow and erratic growth from 2009. The annual rate for consumer price inflation (CPI) briefly turned negative in April, falling to -0.1%, before fluctuating between 0.0% and 0.1% over the next few months. In the August Quarterly Inflation Report, the Bank of England projected that GDP growth will continue around its average rate since 2013. The Bank of England's current projections for inflation anticipate inflation to gradually increase to around 2% over the next 18 months and then remain there in the near future. Further improvement in the labour market saw the ILO unemployment rate for the three months to July fall to 5.5%. In the September report, average earnings excluding bonuses for the three months to July rose 2.9% year/year.

3.4 **Global**: Economic data has been largely overshadowed by events in Greece. On 12th July, following a weekend European Union Summit, it was announced that the terms for a third bailout of Greece had been reached. The deal amounting to €86 billion was agreed under the terms that Greece would see tax increases, pension reforms and privatisations.

The summer also saw attention shift towards China as the Shanghai composite index (representing China's main stock market), which had risen a staggering 50%+ since the beginning of 2015, dropped by 43% in less than three months with a reported $3.2 trillion loss to investors. On 24th August, Chinese stocks suffered their steepest one-day fall on record, driving down other equity markets around the world and soon becoming known as another 'Black Monday'. Chinese stocks have recovered marginally since and are trading around the same level as the start of the year. Concerns remain about slowing growth and potential deflationary effects.

The US economy slowed to 0.6% in Q1 2015 due to bad weather, spending cuts by energy firms and the effects of a strong dollar. However, Q2 GDP showed a large improvement at 3.9% (annualised). This was largely due to a broad recovery in corporate investment alsongside a stronger performance from consumer and government spending and construction and exports.

3.5 **Market reaction:** Equity markets initially reacted positively to the pickup in the expectations of global economic conditions, but were tempered by the breakdown of creditor negotiations in Greece. China led stock market turmoil around the globe in August, with the FTSE 100 falling by around 8% overnight on "Black Monday". Indices have not recovered to their previous levels but some improvement has been seen.

3.6 **Interest Rate Forecast**: Arlingclose's expectation for the first rise in the Bank base rate remains the third calendar quarter of 2016. The pace of interest rate rises will be gradual and the extent of rises limited.

4. BORROWING ACTIVITY IN 2015/16

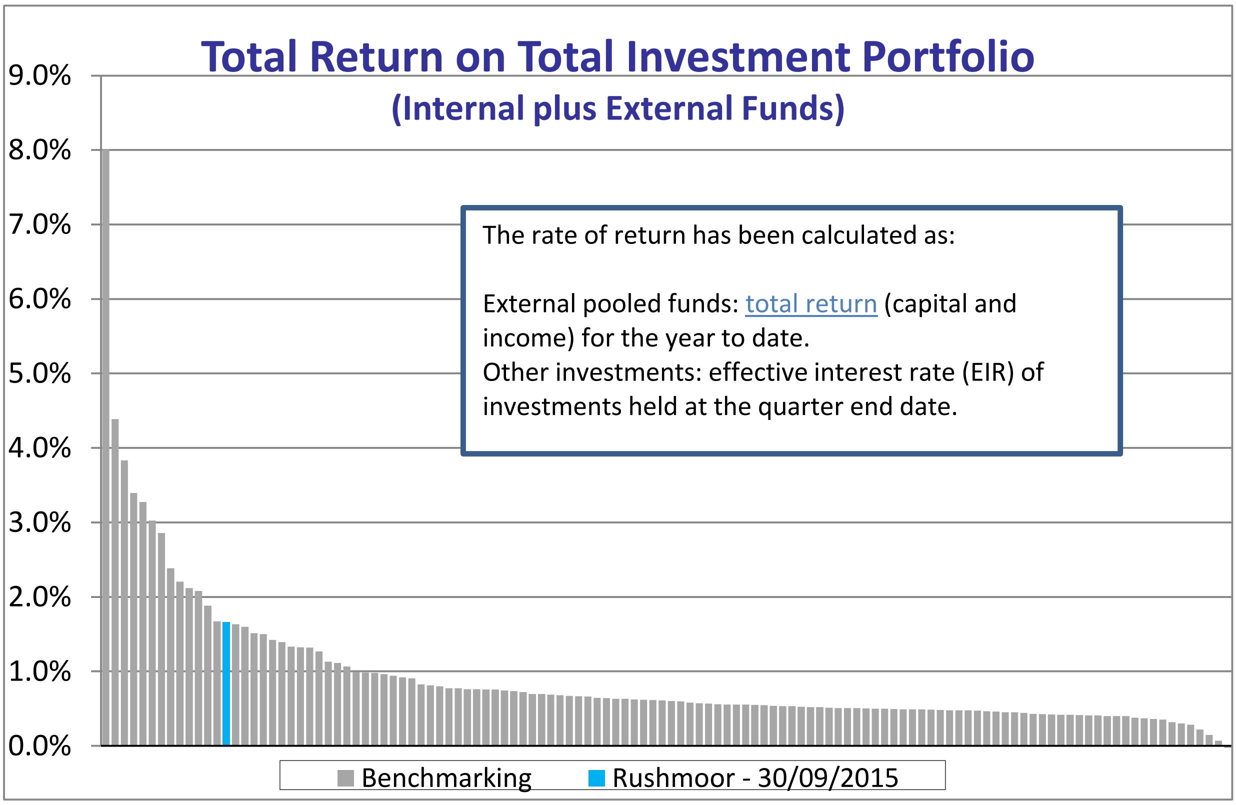
4.1 The Council does not expect to borrow in 2015/16 but is making use of a revolving infrastructure fund from the Local Enterprise Partnership by borrowing £3 million to progress the Aldershot regeneration schemes, and £1.7 million for Ball Hill SANG.

4.2 As part of the Council's plans for financial sustainability we are reviewing various income generation and investment opportunities, which include various property investment and housing initiatives. Potential future borrowing requirements may be explored as part of the financial appraisal process of any capital investment schemes identified.

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 graph below has been produced by Arlingclose and demonstrates that during the six months to 30th September 2015 the Council's returns on total investment portfolio at 1.7%. Whilst this represents a decline against the returns generated during 2014/15 (2.9%) this is amongst the highest when benchmarked against the average of 0.87% of 122 local authority clients.

As this is a total rate of return it includes movements on the capital value of pooled funds. As outlined below (para 5.2) economic events in China and Greece have impacted upon the value of equities. The reduction in capital value has reduced the total return on total investment portfolio for all authorities with this type of investment.

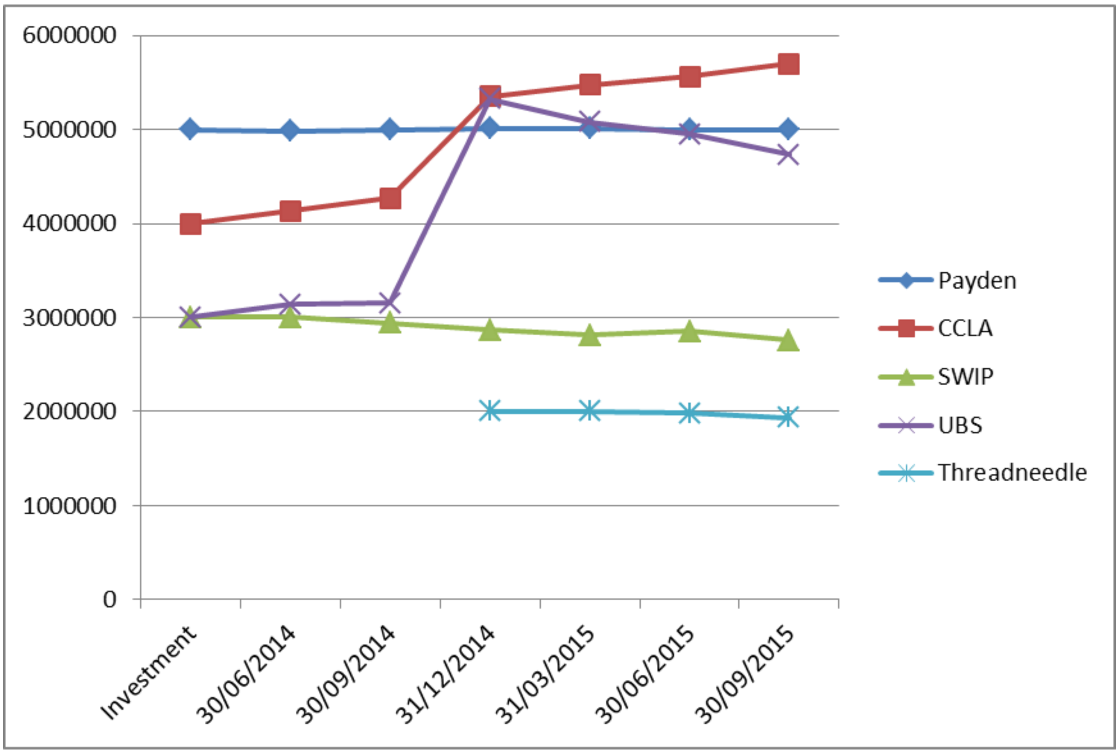


5.2 **Pooled Funds** - the Council's pooled funds are performing well and are continuing to generate good returns (as outlined below).

Pooled Fund Capital Growth - The chart below plots the growth in initial capital investment per fund to 30th September 2015. With the exception of SWIP and UBS all funds have either returned growth or a break even position on the initial capital investment. We have discussed this with Arlingclose who have confirmed that the situation China and Greece has affected equity markets. This is usual with pooled funds, which on average and over the long-term pay higher returns (income plus capital gains) than lower risk alternatives.

Arlingclose have confirmed that "we review all our advised funds regularly, and if we think the fund manager is under performing, or the fund holdings are no longer suitable for clients, then we will advise you to sell". The most recent news from Greece should benefit the equity and multi-asset funds.

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 funds 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 30th September 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 6 months to 30th September 2015 is 0.99% income return.

- CCLAs Local Authorities' Mutual Investment Trust. The Council's total investment in this UK property fund is £5 million. The fund has generated an impressive 5.23% income return during the 6 months to 30th September 2015.

- £3 million investment with Aberdeen Asset Management Absolute Return 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 6 months to 30th June 2015 is a 2.67% income return.

- £5 million investment 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 3.8% income return during the 6 months to 30th September 2015.

- £2 million investment in the Threadneedle Strategic Bond Fund. This Fund aims to provide income and capital appreciation through investment grade and high yield bonds. This fund has generated a 4.29% income return during the 6 months to 30th September 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 over periods ranging between 15 months to 3 years 5 month:

- £1 million Bank of Scotland at fixed rate of 0.96% (15 mths)
- £1 million Yorkshire BS at a fixed rate of 1.33% (2 yrs 9 mths)
- £2 million Leeds BS at a fixed rate of 1.47% (3 yrs 5mths)

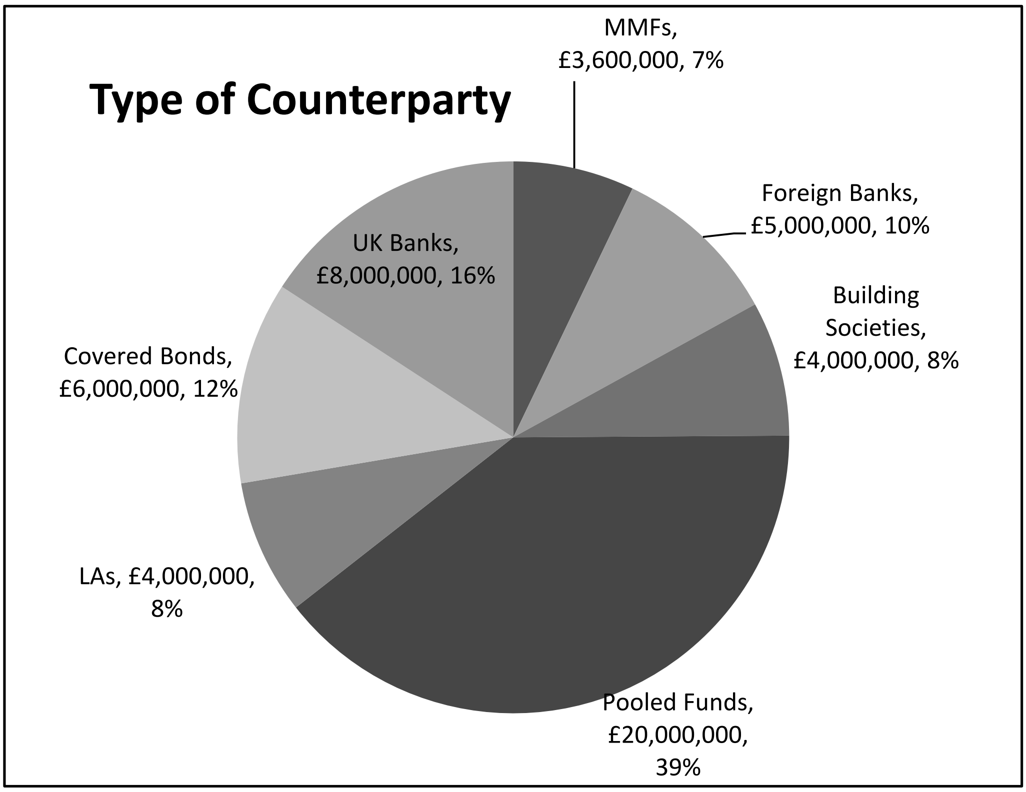
Other Investments – During the 6 months to 30th September 2015 we have further diversified our portfolio by investing the following in institutions other than UK banks:

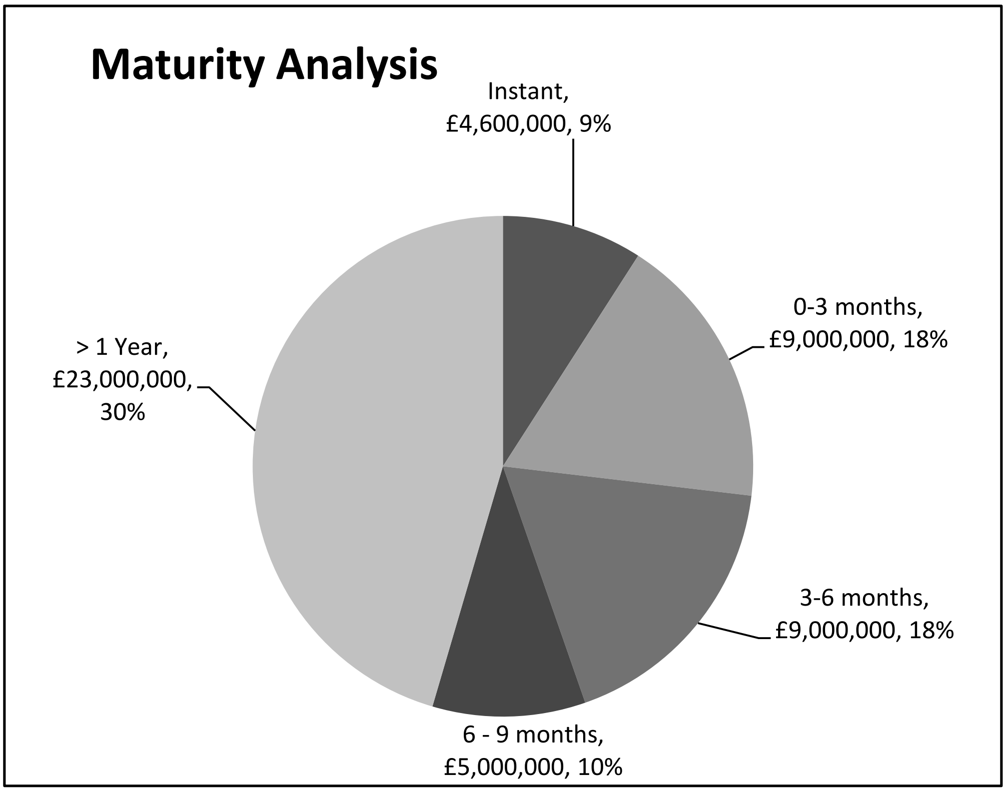
- £2 million at a fixed rate of 1% for 2 years with Dumfries and Galloway Council.
- Various temporary investments across a range of approved unsecured banks and building society counterparties all for durations of 6 months or less at rates ranging between 0.51% - 0.70%.

5.4 The table below summarises deposit/investment activity during the 6-month period to 30th September 2015. Overall, there was a net increase of £3.4m invested during the period. The additional funds available for investment during 2015/16 have been generated from additional (short term) NNDR receipts, which Rushmoor will pay over to precepting authorities.

Investment Counterparty	Balance on 01/04/15 £m	Investments Made £m	Maturities/ Investments Sold £m	Balance on 30/09/15 £m	Avg Rate % and Avg Life (yrs)
UK Local Authorities	2.0	2.0	0.0	4.0	1%- 18mths/2 Yrs
UK Banks and Building Societies (unsecured): Short-term Long-term	 12.0 3.0	 12.0	 12.0 3.0	 12.0 0.0	0.51%-0.80% (100 days – 6 mths)
Foreign Banks	4.3	4.0	3.3	5.0	0.4% call account
Covered Bonds	2.0	4.0		6.0	0.96% - 1.47% (15mths– 3 Yrs 5 mths)
AAA-rated Money Market Funds	3.9		0.3	3.6	Varies daily <0.45%
Pooled Funds: • Payden • CCLA • SWIP Absolute • UBS Multi Asset • Threadneedle	 5.0 5.0 3.0 5.0 2.0			 5.0 5.0 3.0 5.0 2.0	 0.99 5.23 2.67 3.80 4.29
TOTAL INVESTMENTS	47.2	22.0	18.6	50.6	
Increase/ (Decrease) in Investments £m				3.4	

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





6 CREDIT RISK (Credit Score Analysis)

6.1 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.

6.2 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).

6.3 The table below summarises the Council's internal investment credit score for deposits during the 6-month period to 30th September 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. When comparing performance between quarters, quarter 2 reflects an improved credit risk score from the position in quarter 1. This is due to the increased security associated with some of the recent investments (eg covered bonds & local authorities) combined with the increasing diversity within the Council's investment portfolio (as outlined above).

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-	1.78	AA+

6.4 **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	2014/15 Actual Minimum
Upper limit on fixed interest rate exposure	-£27m	-£16m
Upper limit on variable interest rate exposure	-£19m	-£23m

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.

6.5 **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 has no current borrowing requirement the performance against this indicator remains at 0%.

6.6 **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	£29m

7 COUNTERPARTY UPDATE

7.1 All three credit ratings agencies have reviewed their ratings in the six months to reflect the loss of government support for most financial institutions and the potential for varying loss given defaults as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions have seen upgrades due to an improvement in their underlying strength and an assessment that that the level of loss given default is low.

7.2 At the end of July, the Council's treasury advisors Arlingclose advised an extension of recommended durations for unsecured investments in certain UK and European institutions following improvements in the global economic situation and the receding threat of another Eurozone crisis. A similar extension was advised for some non-European banks in September and certain non-rated UK building societies also being extended. The Council continues to only invest in counterparties as recommended by Arlingclose.

8 FORWARD LOOK

8.1 The latest advice from Arlingclose indicates that the Council should:

- Continue to focus on diversification of risk, spreading smaller amounts over an increasing number of counterparties. The Council currently uses 24 different counterparties compared with an average of 14 used by Arlingclose's 122 local authority clients.

- Aim to invest longer term with counterparties other than banks.

Overall, this should counteract the increasing risk of bank bail-ins and generate better returns as current long-term interest rates remain low.

8.2 In addition to continuing to spread risk by investing in a diverse range of counterparties, the Council's in-house team is also currently evaluating a number of future investment options if sufficient cash is available. These options are all in accordance with the current Treasury Management Strategy. These include the following:

Housing Associations (RSLs) – offer a strong asset base (residential property), inflation linked rents and relatively high credit ratings. We are currently exploring the option of a fixed term investment with an RSL. The investment would be in the form of a loan of approximately £2.5 million over a 3-5 year term. The anticipated return is approximately 3.25 - 3.5% (1.5% - 1.75% over benchmark gilt yield (Sept)).

Reverse Repurchase Agreements (repos) – are agreements (usually short term) to buy securities e.g. bonds, gilts, or other government securities with an agreement to sell them back at a specified date and price (the difference in price being the return on investment). Repos provide additional security as the investor receives extra protection through the ownership of collateral. If the bank counterparty defaults, the investor can sell the collateralised security. It has previously been agreed that the Council will not enter into any REPO arrangements without the prior agreement of the Portfolio holder.

9 BUDGETED INCOME & OUTTURN

9.1 The Council's budgeted investment income for the year was estimated at £800,000. 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 £849,000 for the year. The position has resulted from enhanced returns generated from existing pooled fund investments, additional (short term NNDR) cash available to invest during 2015/16 together with increased diversification within the Council's investments portfolio.

10 CONCLUSIONS

10.1 2015/16 continues to be a challenging time for treasury management. The Council's treasury team has concentrated as always on the security of deposits/investments while having regard to the returns available. Estimated interest receipts currently stand at £849,000 for the year 2015/16, compared to the original budget estimate of £800,000.

10.2 The Council continues to seek to diversify its investments in order to maximise returns and to safeguard the Council's deposits/investments.

10.3 The Council can confirm that it has complied with its Treasury and Prudential Indicators for 2015/16, which were set in February 2015 as part of the Council's Treasury Management Strategy.

11 RECOMMENDATION

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

AMANDA FAHEY
HEAD OF FINANCIAL SERVICES

Background papers: CIPFA Code of Practice -'Treasury Management in the Public Services'

Loans and Investments records

Contact: Amanda Fahey, Head of Financial Services, x8440

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 Estimate £m**	**2015/16 Revised £m**	**2016/17 Estimate £m**	**2017/18 Estimate £m**
General Fund	7.332	9.339	9.461	1.455
Total Expenditure	**7.332**	**9.339**	**9.461**	**1.455**
Capital Receipts	2.552	6.139	6.156	0.888
Capital Grants & Contributions	4.080	2.401	2.455	0.497
Reserves	0	0.099	0	0
Revenue	0.700	0.700	0.850	0.900
Total Financing	**7.332**	**9.339**	**9.461**	**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	**31.03.16 Estimate £m**	**31.03.16 Revised £m**	**31.03.17 Estimate £m**	**31.03.18 Estimate £m**
General Fund	0	0	0	0
Finance lease (MRP)	0	0	0	0
Total CFR	**0**	**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	31.03.16 Estimate £m	31.03.16 Revised £m	31.03.17 Estimate £m	31.03.18 Estimate £m
Borrowing	3.00	4.70	4.70	4.70
Finance leases	0.00	0.00	0.00	0.00
Total Debt	**3.00**	**4.70**	**4.70**	**4.70**

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	2015/16 Estimate £m	2015/16 Revised £m	2016/17 Estimate £m	2017/18 Estimate £m
Borrowing	5.0	5.0	5.0	5.0
Other long-term liabilities	0.0	0.0	0.0	0.0
Total Debt	**5.0**	**5.0**	**5.0**	**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	2015/16 Estimate £m	2015/16 Revised £m	2016/17 Estimate £m	2017/18 Estimate £m
Borrowing	10.0	10.0	10.0	10.0
Other long-term liabilities	0.0	0.0	0.0	0.0
Total Debt	**10.0**	**10.0**	**10.0**	**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	2015/16 Estimate %	2015/16 Revised %	2016/17 Estimate %	2017/18 Estimate %
General Fund	-7.1	-7.5	-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 Estimate £	2015/16 Revised £	2016/17 Estimate £	2017/18 Estimate £
General Fund - increase in annual band D Council Tax	1.10	1.10	2.53	3.92