Gedling Borough Council

# Report to Cabinet

**Subject:** Annual Treasury Activity Report 2014/15

**Date:** 25 June 2015

**Author:** Corporate Director (Chief Financial Officer)

**Wards Affected**

All

**Purpose**

To inform members of the outturn in respect of the 2014/15 Prudential Code Indicators, and to advise members of the outturn on treasury activity, both as required by the Treasury Management Strategy.

**Key Decision**

This is not a key decision.

**Background**

1.1 The Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury review of its activities, and the actual prudential and treasury indicators for 2014/15. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

1.2 For 2014/15 the minimum reporting requirements were that the Full Council should receive the following reports:

- An annual treasury strategy in advance of the year (the TMSS).
- A mid-year treasury update report (members will note that, as in previous years and in accordance with best practice, quarterly monitoring reports for treasury activity have been provided, and that this exceeds the minimum requirements).
- An annual review following the end of the year describing the activity compared to the strategy (this report).

1.3 The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is therefore important in that respect, as it provides details of the outturn position for treasury activities during the year, and highlights compliance with the Council's policies, previously approved by members.

1.4 The Council has complied with the requirement under the Code to give prior scrutiny to all the above treasury management reports by submitting them to Cabinet before they are reported to Full Council.

1.5 Member training on treasury management issues is undertaken by the Chief Financial Officer as it is needed in order to support members' scrutiny role.

**Proposal**

2.1 The economy and interest rates in 2014/15

2.1.1 The financial year 2014/15 continued the challenging investment environment of previous years, with rates remaining low. The original expectation was for the first increase in Bank Rate to occur in Q1 of 2015, as unemployment had fallen faster than expected through the Bank of England's (BOE) forward guidance target of 7%. In May 2014 however, the BOE revised this guidance. A combination of weak pay rises and inflation above the rate of pay rises meant that consumer disposable income was still being eroded. Expectations for the first rise in Bank Rate therefore receded, as growth was still heavily dependent on buoyant consumer demand.

2.1.2 During the second half of 2014 the financial markets were caught out by a halving of the oil price. Fears increased that the European Central Bank (ECB) would do too little, too late, to ward off the threat of deflation and recession in the Eurozone. By the end of 2014 it was clear that inflation in the UK was heading towards zero and could turn negative. In turn, this made it clear that the Monetary Policy Committee (MPC) would have great difficulty in starting to raise Bank Rate in 2015 while inflation was around zero, and market expectations for the first rise receded to around Q3 of 2016.

2.1.3 Gilt yields were on a falling trend for much of 2014/15 but were pulled in different directions by increasing fears following the success of the anti-austerity parties in Greece, and the potential for Greece to exit the euro. Whilst the direct effects of this would be manageable by the European Union (EU) and the ECB, the potential knock-on effect on other countries within the Eurozone are harder to quantify. A further downward pressure on gilt yields was the announcement that the ECB would start a major programme of quantitative easing in March 2015.

2.1.4 Strong growth in the US caused an increase in confidence that it was

heading towards a full recovery from the financial crash, and would be the first country to start increasing its central rate, probably by the end of 2015. The UK had strong growth over 2013 and 2014 and prospects for 2015 and beyond remain good.

2.2 The borrowing requirement

The Council's underlying need to borrow to finance its capital expenditure is termed the capital financing requirement (CFR).

| | 1 April 2014 (Actual) £000s | 31 March 2015 (Orig. Est) £000s | 31 March 2015 (Actual) £000s |
|---|---|---|---|
| Capital Financing Requirement | 12,384 | 12,546 | 11,850 |

The variance is mainly due to amendments to the capital programme during 2014/15, including slippage of schemes to 2015/16.

2.3 The overall treasury position 31 March 2015

The Council's debt and investment position is organised to ensure adequate liquidity for revenue and capital activities, security of investment, and to manage risks within all treasury management activities. At the beginning and end of 2014/15, the treasury position was as follows:

| | 1 April 2014 £000s | 31 March 2015 £000s |
|---|---|---|
| Total external debt | 10,812 | 9,812 |
| Capital Financing Requirement (CFR) | 12,384 | 11,850 |
| **Over/(Under) borrowing to CFR** | **(1,572)** | **(2,038)** |
| | | |
| Total external debt | 10,812 | 9,812 |
| Total investments | (8,950) | (8,850) |
| **Net debt** | **1,862** | **962** |

2.4 The treasury strategy for 2014/15

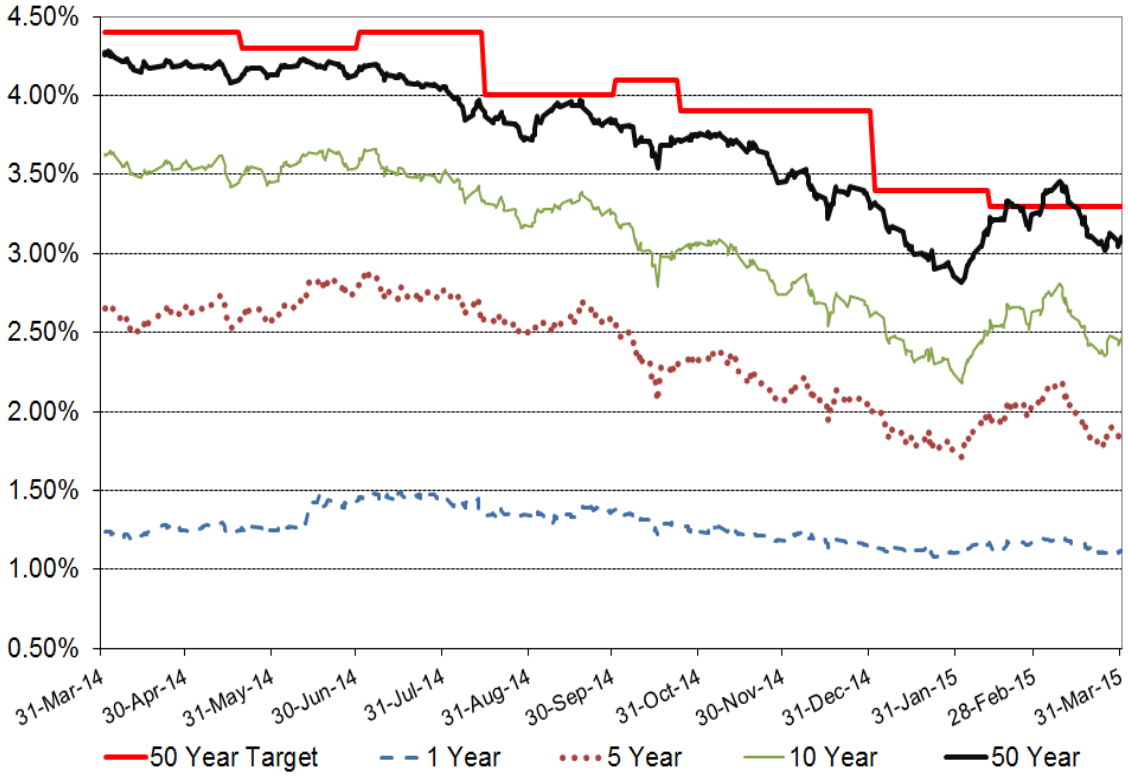
2.4.1 The expectation for interest rates within the strategy for 2014/15 anticipated Bank Rate to be low, but rising gradually from Q1 of 2015. Medium and longer term fixed rates were also expected to rise gradually, with variable or short term borrowing expected to be the cheaper option over the period. Continued uncertainty in the aftermath of the financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates. Given this scenario, the treasury strategy

was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

2.4.2 The actual movement in gilt yields meant that PWLB rates saw little overall change during the early part of the year, but there was then a downward trend for the rest of the year, with a partial reversal during February.

2.5 Borrowing rates in 2014/15

The graph below, provided by the Council's treasury advisers, illustrates that PWLB certainty rates have fallen to historically low levels during the year.



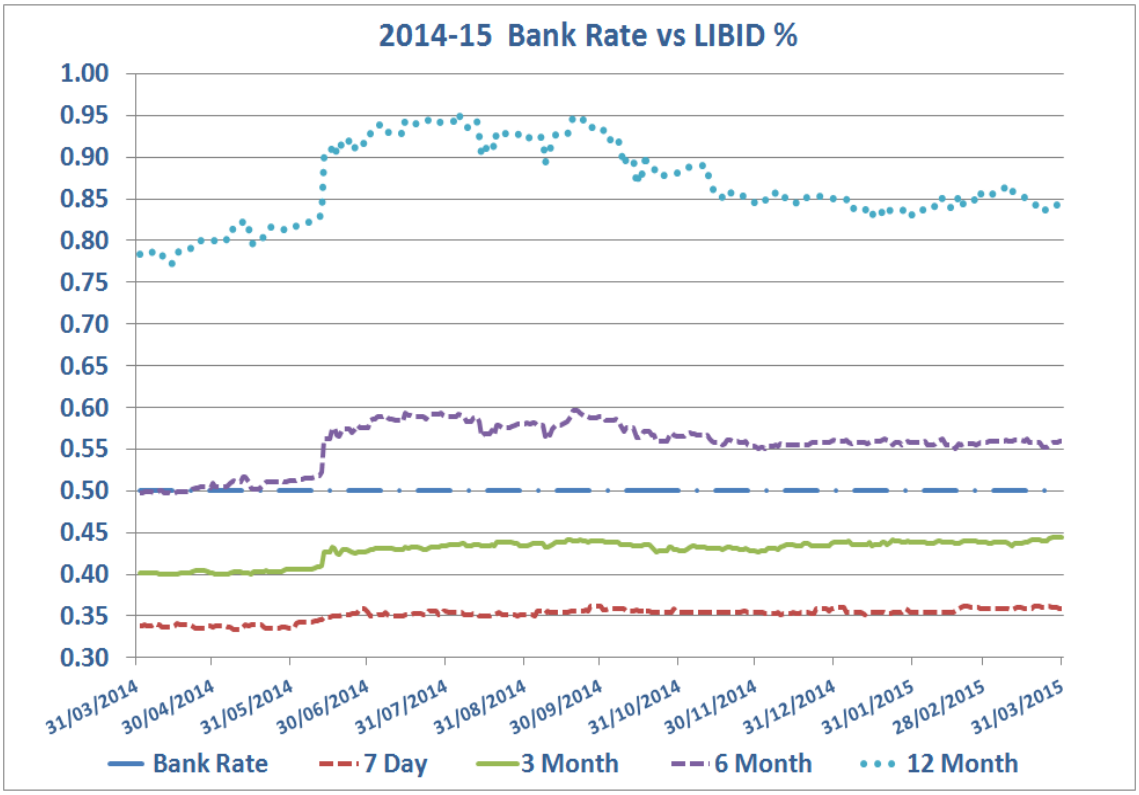

2.6 The borrowing outturn for 2014/15

2.6.1 There was no new long term debt taken during 2014/15. Two temporary loans were arranged during the year for cashflow purposes, but the maximum duration of these was only seven days, and the rate paid 0.30%.

2.6.2 There was no rescheduling of PWLB debt undertaken during the year, as the average 1% differential between PWLB new borrowing rates and premature repayment rates made such action unviable.

2.7 Investment rates in 2014/15

Bank Rate remained at its historic low of 0.5% throughout the year and has now remained unchanged for six years. Market expectations as to the timing of the start of monetary tightening started the year at Q1 of 2015 but then moved back to around Q3 2016 by the end of the year. Deposit rates remained depressed throughout the year, primarily due to the effects of the Funding for Lending Scheme.




2.8 Investment outturn for 2014/15

2.8.1 The Council's investment policy is governed by CLG guidance implemented by the annual investment strategy, which formed part of the TMSS approved on 3 March 2014. This policy sets out the approach for selecting investment counterparties, and for 2014/15 was based on credit ratings provided by the three main credit agencies, supplemented by additional market data such as rating outlooks, credit default swaps, and bank share prices. Whilst credit ratings advice is taken from the Council's treasury advisers, the ultimate decision on what is prudent and manageable for the Council is taken by the Chief Financial Officer under the approved scheme of delegation.

2.8.2 The Council's investment priorities in 2014/15 remained the security of capital and good liquidity. Whilst the Council always seeks to obtain the optimum return (yield) on its investments, this is at all times

commensurate with proper levels of security and liquidity. In the current economic climate it has remained appropriate either to keep investments short–term to cover cashflow needs, or to take advantage of fixed period up to one year with selected government-backed counterparties.

2.8.3 During 2014/15, significant use was made of a money market fund achieving around 0.40%. This fund is an AAA rated investment vehicle which allows the pooling of many billions of pounds worth of assets into a highly diversified fund, thus reducing risk.

2.8.4 Investment interest or £96,749 was generated in the year, representing an equated rate of 0.76%. This outperforms the benchmark 7 day LIBID rate, which ended the year at 0.35%, and in cash terms represents additional income to the General Fund of £52,200. This was achieved as result of positive investment management. Performance in respect of the longer 3 month LIBID rate still represents additional income of £42,000.

2.8.5 Investment activity during the year conformed to the approved strategy and the Council had no liquidity difficulties.

2.8.6 The Treasury Activity Report for the year ended 31 March 2015 is attached at Appendix 1 in accordance with the TMSS. For reference, definitions of LIBOR and LIBID are given at Appendix 2.

2.9 Compliance with Prudential and treasury indicators

2.9.1 It is a statutory duty for the Council to determine and keep under review the affordable borrowing limit. The Council's approved Prudential and Treasury Indicators (affordability limits) are included in the Treasury Management Strategy Statement (TMSS) approved by Council on 3 March 2014.

2.9.2 During the financial year 2014/15 the Council has at all times operated within the treasury limits and Prudential Indicators set out in the council's TMSS, and in compliance with the Council's Treasury Management Practices. A summary of the outturn in respect of the 2014/15 Prudential and Treasury Indicators is shown at Appendix 3.

a) Prudential Indicators:

i) Capital Expenditure

Capital expenditure for 2014/15 totalled £2,635,908.

ii) Capital Financing Requirement (CFR)

The CFR represents the Council's underlying need to borrow and totalled £11,850,453 at 31 March 2015. This is lower than the approved indicator of £12,546,300 due to amendments to the capital programme during the year, including slippage to 2015/16 and additional capital receipts generated.

iii) Ratio of Financing Costs to Net Revenue Stream

The outturn of 7.26% represents an increase from the approved indicator of 6.44%. This is due to the inclusion of revenue contributions to capital expenditure totalling £155,829 in 2014/15, together with a reduction in investment interest, partially offset by a reduction in MRP as a result of slippage on the capital programme in 2013/14.

iv) Maximum gross debt

The Council must ensure that its gross debt does not, except in the short term, exceed the opening capital financing requirement, plus estimates of any additional CFR for 2014/15 and the following two financial years. This allows flexibility for early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes. Gross debt at 31 March 2015 was £9.812m which was well within the approved indicator.

Treasury Management Indicators:

These indicators are based on limits, beyond which activities should not pass without management action, and the Council has operated within these limits at all times during 2014/15. They include two key indicators of affordability and four key indicators of prudence.

Affordability

i) Operational boundary for external debt.
ii) Authorised limit for external debt.

Prudence

iii) Upper limit for fixed interest exposure – represented by the maximum permitted net outstanding principal sum borrowed at fixed rates. Please note that a negative indicator represents a position of net investment.

iv) Upper limit for variable interest rate exposure – represented by the maximum permitted net outstanding principal sum borrowed at variable rates. Please note that a negative indicator represents a position of net investment.

v) Maximum new principal sums to be invested during 2014/15 for periods in excess of 364 days - such investments are classified as a "non-specified". This indicator is subject to the overall limit for non-specified investments set in the TMSS.

vi) Upper limits for the maturity structure of borrowing - set to reduce the Council's exposure to large fixed rate sums falling due for refinancing.

2.10 Other Issues

2.10.1 Change of creditworthiness methodology

Through much of the financial crisis the main rating agencies (Fitch, Moodys and Standard & Poors) provided some institutions with a rating "uplift" due to implied levels of sovereign support. In response to the evolving regulatory regime, agencies have begun to remove these uplifts, making their "support", "financial strength" and "viability" ratings redundant.

The Council currently sets the following criteria for the selection of its investment counterparties, based on Fitch ratings:

- Short term F1
- Long Term A
- Viability BBB – being removed
- Support 1 – being removed

In addition to this, Capita Asset Services (CAS) provide the Council with a creditworthiness methodology based on "colours" to suggest a maximum duration for investments made with individual counterparties. These vary from "no colour" for do not use, to yellow for 60 months.

It has previously been the Council's practice to try to "combine" these two approaches, however this has become increasingly problematic. For example an institution may fail on the first approach for not achieving a long term A rating and/or an F1 short term rating from Fitch, yet the CAS approach, which incorporates all the available information, suggests that it is an acceptable counterparty for a short, 3 month, investment. Now, with the removal of two key elements of the agencies' rating information, the combined approach is simply no longer viable.

The CAS methodology employs a sophisticated modelling approach utilising credit ratings from all three of the main rating agencies, rather than just one, to give a suggested maximum duration for investments. Accordingly, this method does not give undue preponderance to one agency's ratings.

The CAS methodology also applies an “overlay” to take account of positive and negative credit watches and/or credit outlook information, which may increase or decrease the suggested duration. It then applies a second overlay based on the credit default swap spreads for institutions, the monitoring of which has been shown to give an early warning of likely changes in credit ratings. It also incorporates sovereign ratings to ensure selection of counterparties from only the most creditworthy countries.

The modelling approach combines the various factors in a weighted scoring system and results in a series of colour coded bands which indicate the creditworthiness of counterparties. The colour bandings are as follows:

- Yellow 60 months (AAA rated Government debt or its equivalent)
- Purple 24 months
- Blue 12 months (nationalised or semi nationalised UK banks)
- Orange 12 months
- Red 6 months
- Green 100 days
- No colour not to be used

Following discussions with CAS at a recent treasury strategy meeting the Chief Financial Officer has now adopted the CAS creditworthiness methodology as the basis of the Council’s counterparty selection, and is taking this opportunity to advise members at the earliest opportunity in accordance with the Treasury Strategy. All credit ratings will be monitored weekly, however the Council is alerted to changes via its use of the CAS creditworthiness service.

2.10.2 No other significant treasury matters arose during the year 2014/15.

**Alternative Options**

There are no alternative options, this report being a requirement of the Council’s Treasury Management Strategy Statement (TMSS).

**Financial Implications**

No specific financial implications are attributable to this report.

**Appendices**

1. Annual Treasury Activity Report 2014/15.
2. Definitions of LIBOR and LIBID
3. Outturn Prudential and Treasury Indicators for 2014/15.

## Background Papers

None identified.

## Recommendation

That:

Members note the Annual Treasury Activity Report 2014/15, together with the appendices, and refer it to Council for approval.

## Reasons for Recommendations

To comply with the requirements of the Council's Treasury Management Strategy Statement.

## For more information, please contact:

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