BODY:	**CABINET**
DATE:	**14th September 2016**
SUBJECT:	**Treasury Management Annual Report 2015-16**
REPORT OF:	**Deputy Chief Executive**

Ward(s):	All
Purpose:	To report on the activities and performance of the Treasury Management service during 2015/2016
Decision Type	
Contact:	Alan Osborne, Deputy Chief Executive, Financial Services Telephone Number 01323 415149.
Recommendations:	Cabinet is recommended to: 1. Agree the annual Treasury Management report for 2015/16. 2. Specifically approve the 2015/16 prudential and treasury indicators included.

1.0 Introduction

1.1 This Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the actual prudential and treasury indicators for 2015/16. 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).

During 2015/16 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 17 February 2016)
- a mid year (minimum) treasury update report (Council 17 February 2016)
- an annual report following the year describing the activity compared to the strategy (this report)

In addition Treasury Management updates are included in the quarterly performance management reports, considered by both the Cabinet and Scrutiny Committee.

Recent changes in the regulatory environment place a much greater onus on Members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit & Governance Committee before they were reported to the full Council. Member training on treasury management issues was undertaken on 23 November 2015 in order to support Members' scrutiny role.

1.2 This report summarizes:

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- Reporting of the required prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Debt activity and investment activity.

2.0 The Council's Capital Expenditure and Financing 2015/16

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

	2014/15 Actual £m	2015/16 Estimate £m	2015/16 Actual £m
Non-HRA capital expenditure	9.92	16.5	10.89
HRA capital expenditure	7.66	9.7	7.04
LAMS	-	-	-
Total capital expenditure	**17.58**	**26.2**	**17.93**
Resourced by:			
• Capital receipts	1.98	4.3	1.78
• Capital grants & external funding	2.73	11.0	2.67
• Capital Reserves	3.90	5.3	5.38
• Revenue	2.10	0.8	0.01

Use of internal balances/ borrowing	**6.87**	**4.8**	**8.08**

3.0 The Council's overall borrowing need

3.1 The Capital Financing Requirement (CFR) represents the Council's total underlying need to borrow to finance capital expenditure, i.e. capital expenditure that has not been resourced from capital receipts, capital grants and contributions or the use of reserves. Some of this borrowing is from the internal use of cash balances.

3.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

3.3 **Reducing the CFR** – the Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP), to reduce the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need (there is no statutory requirement to reduce the HRA CFR). This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

3.4 The Council's 2015/16 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2015/16 on 4 February 2015.

The Council's CFR for the year is shown below, and represents a key prudential indicator. The figures include a credit sales agreement on the balance sheet, which increases the Council's borrowing need, the CFR.

CFR	31 March 2015 Actual £m	31 March 2016 Original Indicator £m	31 March 2016 Actual £m
Opening balance	62.49	68.1	68.23
Add unfinanced capital expenditure (as above)	6.87	4.8	8.09
Less MRP	(1.13)	(1.4)	(1.23)
Closing balance	68.23	71.5	75.09

3.5 The borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorized limit.

Net borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2015/16 plus the expected changes to the CFR over 2016/17 and 2017/18. This indicator allows the Council some flexibility to borrow in advance of its immediate capital need in 2015/16. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2015 Actual £m	31 March 2016 Original £m	31 March 2016 Actual £m
Net borrowing position	45.32	55.1	53.15
CFR	68.23	71.4	75.09

The authorized limit - the authorized limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2015/16 the Council has maintained gross borrowing within its authorized limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorized limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2015/16
Authorized limit	£86.4m
Maximum gross borrowing position	£53.1m
Operational boundary	£71.4m
Average gross borrowing position	£51.2m
Financing costs as a proportion of net revenue stream: Non HRA HRA	 8.24% 11.60%

4.0 Treasury Position as at 31 March 2016

4.1 The Council's debt and investment position is organised by staff within Financial Services in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2015/16 the Council's treasury position was as follows:

TABLE 1	31 March 2015 Principal	Rate/Return	31 March 2016 Principal	Rate/Return
Fixed rate funding:				
-PWLB	£36.53m		£38.55m	
-Market	£11.50m		£13.50m	
- Serco Paisa	£1.29m		£1.05m	
Total debt	**£49.32m**	**4.54%**	**£53.10m**	**4.14%**
CFR	£68.23m		£75.1m	
Over/ (under) borrowing	(£18.91m)		(£21.95m)	
Total investments	**£4.00m**	**0.80%**	**£0m**	

The Council held cash balances of £1.9m in a current account on which interest of 0.4% was being earned.

4.2 The maturity structure of the debt portfolio excluding Serco Paisa was as follows:

	31 March 2015 Actual £m	2015/16 Original limits £m	31 March 2016 Actual £m
Under 12 months	1.98	4.00	6.00
12 months and within 24 months	4.00	7.00	7.00
24 months and within 5 years	7.00	9.02	9.02
5 years and within 10 years	12.40	4.14	4.14
10 years and above	22.65	26.63	25.89

The exposure to fixed and variable rates (including Serco Paisa) was as follows:

	31 March 2015 Actual £m	2015/16 Original Limits £m	31 March 2016 Actual £m
Principal - Debt Fixed rate	49.32	51.84	53.10
Principal – Investments Variable rate	(4.00)	N/a	0

5.0 The Strategy for 2015/16

5.1 The expectation for interest rates within the strategy for 2015/16 anticipated low Bank Rate until quarter 4 of 2015. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 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.

In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and reduce counterparty risk.

The actual movement in interest rates was lower than expected; rates have continued to decrease and are not expected to fall further in quarter 2 2016 and then rise from quarter 2 of 2018.

During 2015/16 the Council used internal balances and temporary borrowing at historically low interest rates to ensure new borrowing was taken at the most advantageous rates. In quarter 1 of 2016 the Council took long term borrowing to lock into historically low rates and thereby reduce the risk of interest rate increases expected in the future.

6.0 Borrowing Outturn for 2015/16

6.1 **Treasury Borrowing**.

Borrowing – two new loans totaling £4.0m were drawn down on 2 February 2016 and 3 March 2016 to fund the net unfinanced capital expenditure and to replace maturing loans. The loans drawn were all fixed rate as follows:

Lender	Principal	Interest Rate	Maturity
PWLB	£2m	2.98%	24/9/64
PWLB	£2m	2.95%	24/9/65

This compares with a budget assumption of borrowing at an interest rate of 3.50%.

A temporary loan was taken from Lewes District Council for £2.0m at 0.50% on 24 March 2016 for 69 days to cover year end cash flow requirements.

Rescheduling – no debt rescheduling was carried out during the year as there was no financial benefit to the Council.

Repayment – £1.98m of long term PWLB debt was repaid at maturity on 24th September 2015.

Summary of debt transactions – the overall position of the debt activity resulted in a fall in the average interest rate by 0.40%, representing a saving to the General Fund.

7.0 Interest Rates in 2015/16

7.1 The tight monetary conditions following the 2008 financial crisis continued through 2015/16 with little material movement in the shorter term deposit rates.

7.2 Bank Rate remained at its historical low of 0.5% throughout the year. Investment rates remained very low. With many financial institutions failing to meet the Council's investment criteria, the opportunities for investment returns were limited. The investment rates at the beginning and end of the year are provided below.

Investment Term	Interest Rate March 2016	Interest rate April 2015
Overnight	0.40%	0.36%
1 Month	0.40%	0.38%
3 Months	0.55%	0.44%
6 Months	0.70%	0.58%
12 Months	0.95%	0.87%

The PWLB rates at the beginning and end of the year are provided below.

Loan Term	Interest Rate March 2016	Interest rate April 2015

1 Year	1.36%	1.11%
5 Years	1.89%	1.87%
10 Years	2.54%	2.45%
20 Years	3.23%	3.10%
50 Years	3.12%	3.08%

8.0 Investment Outturn for 2015/16

8.1 **Investment Policy** – the Council's investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council on 4 February 2015. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

8.2 The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

8.3 **Resources** – the Council's longer term cash balances comprise, primarily, revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and met the expectations of the budget:

Balance Sheet Resources	31 March 2015 £m	31 March 2016 £m
Balances	4.90	3.28
Earmarked reserves	6.35	8.30
HRA	3.15	3.68
Major Repairs Reserve	0	0
Capital Grants & Contributions	5.53	4.28
Usable capital receipts	5.49	6.05
Total	**25.42**	**25.59**

8.4 **Investments held by the Council** - the Council maintained an average balance of £8.9m of internally managed funds. The internally managed funds earned an average rate of return of 0.60%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.36%. This excludes the Council's investment with Lloyds Bank of £1m for 5 years at 3.03% which supports the Local Authority Mortgages Scheme (LAMS).

9.0 The Economy and Interest Rates Forecast

9.1 Economic background:

During the period to 30 June 2016:

- - The UK voted to leave the EU;
- - The economic recovery lost some momentum ahead of the vote;
- - Growth remained highly dependent on consumer spending;
- - The jobs recovery slowed, but wage growth picked up;

- \- Inflation remained stuck at very low levels;
- \- Sharp fall in sterling following the referendum result;
- \- Post-referendum uncertainty brought the prospect of a near-term rate cut onto the agenda;
- \- Both the ECB and the Federal Reserve kept policy unchanged.

9.2 The Council's treasury advisor, Capita, provides the following forecast as at 8 August 2016:

	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.25%	0.25%	0.10%	0.10%	0.10%	0.10%	0.10%
5yr PWLB rate	1.00%	1.00%	1.00%	1.10%	1.10%	1.10%	1.10%
10yr PWLB rate	1.50%	1.50%	1.50%	1.60%	1.60%	1.60%	1.60%
25yr PWLB rate	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.40%
50yr PWLB rate	2.10%	2.10%	2.10%	2.20%	2.20%	2.20%	2.20%

The Capita central forecast is for the Bank Rate to increase to 0.25% in quarter 1 of 2019.

9.3 **Summary Outlook**

Economic forecasting remains difficult with so many external influences weighing on the UK. Capita's Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities.

Capita have pointed out consistently that the Fed. rate is likely to go up more quickly and more strongly than Bank Rate in the UK and recent events have not changed that view, just that the timing of such increases may well have been deferred somewhat. While there is normally a high degree of correlation between the two yields, Capita would expect to see a growing decoupling of yields between the two i.e. they would expect US yields to go up faster than UK yields.

The overall balance of risks to economic recovery in the UK remains to the downside.

PWLB rates and bond yields are at present extremely unpredictable. We are experiencing exceptional levels of volatility which are highly correlated to emerging market, geo-political and sovereign debt crisis developments. Capita's revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to this Council since 1st November 2012.

Apart from the uncertainties already explained above, downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a further flight to safe havens (bonds).
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- A resurgence of the Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.
- Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the Eurozone and Japan.

  - The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -
  - The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
  - UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

10.0 Executive Summary and Conclusion

10.1 During 2015/16, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Actual prudential and treasury indicators	2014/15 Actual £m	2015/16 Original £m	2015/16 Actual £m
Actual capital expenditure	17.58	21.9	17.93
Total Capital Financing			

Requirement: • Non-HRA • HRA • Total	 27.95 40.28 68.23	 33.9 41.4 75.3	 34.01 41.08 75.09
Net borrowing	45.32		52.05
External debt	49.32		52.05
Investments (all under 1 year)	4.00		-

Other prudential and treasury indicators are to be found in the main body of this report. The Deputy Chief Executive also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the authorized limit), was not breached.

The financial year 2015/16 continued the challenging environment of previous years; low investment returns and continuing counterparty risk continued.

11.0 Consultation

Not applicable

Background Papers:

The Background Papers used in compiling this report were as follows:

CIPFA Treasury Management in the Public Services code of Practice (the Code)
Cross-sectorial Guidance Notes
CIPFA Prudential Code
Treasury Management Strategy and Treasury Management Practices adopted by the Council on 18 May 2010.

To inspect or obtain copies of background papers please refer to the contact officer listed above.