Treasury Management Annual Report 2015/16

1.1 Introduction

1.1.1 This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2015/16 **[Appendix 1]**. 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).

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

- an annual treasury strategy in advance of the year;
- a mid-year treasury update; and
- an annual review following the end of the year describing the activity compared to the strategy (this report).

In addition, treasury management updates have been presented to each meeting of the Audit Committee throughout the 2015/16 financial year. Treasury performance was also considered at the Finance, Innovation and Property Advisory Board through the regular Financial Planning and Control reports.

1.1.3 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.

1.1.4 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 Committee before they were reported to full Council.

1.2 The Economy and Interest Rates

1.2.1 Market expectations for the first increase in Bank Rate moved considerably during 2015/16, starting at quarter 3 2015 but soon moving back to quarter 1 2016. However, by the end of the year, market expectations had moved back radically to quarter 2 2018 due to many fears including concerns that China's economic growth could be heading towards a hard landing; the potential destabilisation of some emerging market countries particularly exposed to the Chinese economic slowdown; and the continuation of the collapse in oil prices during 2015 together with continuing Eurozone growth uncertainties.

1.2.2 These concerns have caused sharp market volatility in equity prices during the year with corresponding impacts on bond prices and bond yields due to safe haven flows. Bank Rate, therefore, remained unchanged at 0.5% for the seventh successive year. Economic growth (GDP) in the UK surged strongly during both 2013/14 and 2014/15 to make the UK the top performing advanced

economy in 2014. However, 2015 has been disappointing with growth falling steadily from an annual rate of 2.9% in quarter 1 2015 to 2.1% in quarter 4.

1.2.3 The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in money market investment rates falling materially. These rates continued at very low levels during 2015/16.

1.2.4 The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back. In addition, a notable trend in the year was that several central banks introduced negative interest rates as a measure to stimulate the creation of credit and hence economic growth.

1.2.5 The ECB had announced in January 2015 that it would undertake a full blown quantitative easing programme of purchases of Eurozone government and other bonds starting in March 2015 at €60bn per month. This put downward pressure on Eurozone bond yields. There was a further increase in this programme of QE in December 2015. The anti-austerity government in Greece, elected in January 2015 eventually agreed to implement an acceptable programme of cuts to meet EU demands after causing fears of a Eurozone breakup. Nevertheless, there are continuing concerns that a Greek exit may only have been delayed.

1.2.6 As for America, the economy has continued to grow healthily on the back of resilient consumer demand. The first increase in the US central rate occurred in December 2015 since when there has been a return to caution as to the speed of further increases due to concerns around the risks to global growth.

1.2.7 Elsewhere on the international scene, concerns have increased about the slowing of the Chinese economy and also its potential vulnerability to both the bursting of a property bubble and exposure of its banking system to bad debts. The Japanese economy has also suffered disappointing growth in this financial year despite a huge programme of quantitative easing, while two of the major emerging market economies, Russia and Brazil, are in recession. The situations in Ukraine, and in the Middle East with ISIS, have also contributed to volatility.

1.2.8 The UK elected a majority Conservative Government in May 2015, removing one potential concern but introducing another due to the promise of a referendum on the UK remaining part of the EU. The government maintained its tight fiscal policy stance but the more recent downturn in expectations for economic growth will make it more difficult to return the public sector net borrowing to a balanced annual position within the period of this parliament.

1.3 Treasury Position at 31 March 2016

1.3.1 At the beginning and the end of 2015/16 the Council‘s debt and investment position was as follows:

	31 March 2015 £m	Rate / Return %	Average duration Days	31 March 2016 £m	Rate / Return %	Average duration Days
Variable rate debt:						
Overdraft	0.00	-	-	0.00	-	-
Total debt	**0.00**	-	-	**0.00**	-	-
Fixed rate investments:						
Cash flow	2.00	0.95	13	2.00	0.85	204
Core funds	6.00	0.78	109	8.75	0.87	139
Variable rate investments:						
Cash flow	4.02	0.64	1	6.62	0.59	1
Core funds	7.45	0.73	66	6.85	0.73	89
Total investments	**19.47**	**0.75**	**61**	**24.22**	**0.75**	**92**

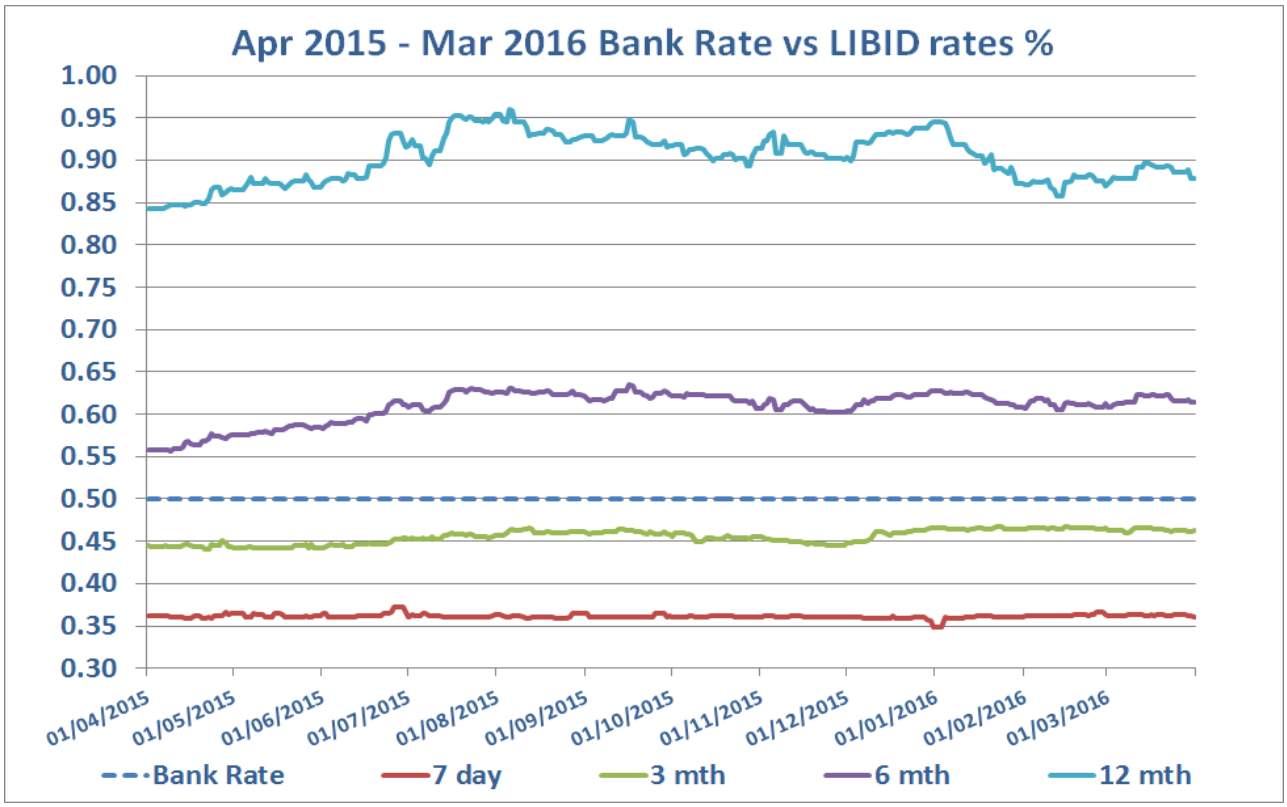
1.3.2 The rise in investment balances between the start and end of the financial year runs counter to the expectation that core cash will be consumed over time as a proportion is used each year to finance capital expenditure and to finance the revenue account deficit until such time as the authority achieves a balanced budget. The rise in investment balances is wholly attributed to provisions under the Business Rates Retention Scheme to meet the cost of appeals which have yet to be determined by the Valuation Office. As at 31st March 2016, the provision to meet business rate appeals was some £8m.

1.4 The Strategy for 2015/16

1.4.1 The expectation for interest rates within the treasury management strategy for 2015/16 anticipated a low but rising Bank Rate starting in quarter 1 of 2016. In addition, 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.

1.5 Investment Rates in 2015/16

1.5.1 The Bank Rate remained at its historic low of 0.5% throughout the year and has now remained at that level for seven years. Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 2016 but then moved back to around quarter 2 2018 by the end of the year. Deposit rates remained depressed throughout 2015/16 due to the effects of the Funding for Lending Scheme and continuing weak expectations as to when Bank Rate would start rising.



1.6 Investment Outturn for 2015/16

1.6.1 The Council's investment policy sets out the approach for choosing investment counterparties and is based on credit ratings provided by the three main credit rating agencies. This is supplemented by additional market information including credit rating outlooks and credit default swap data. The 2015/16 Annual Investment Strategy was approved by the Council in February 2015 and subjected to a mid-year review in September 2015. In undertaking the review, no changes were made to the Council's minimum counterparty credit requirement (Fitch A-, F1 unless UK state owned) or counterparty exposure limits (20% for non-UK state owned financial institutions). However, as a consequence of performance achieved in the early part of the year, the review indicated that investment income for 2015/16 would be better than originally anticipated. Subsequent to this and as part of the budget setting process, income from investments for 2015/16 was increased by £22,500 to £190,000.

1.6.2 **Cash Flow Investments**. The Council maintained an average balance of £17.0m in cash flow funds. These funds earned an average rate of return of 0.65%. The comparable performance indicator is the average 7-day LIBID rate which was 0.36%. The return achieved also compares with a revised budget assumption of £14.1m investment balances earning an average rate of 0.60%. The majority of cash flow funds are required to meet our regular payment obligations and as a consequence are invested overnight in bank deposit accounts and money market funds which allow next day access. However, the opportunity to invest for longer durations and generate additional yield is taken when cash flow surpluses permit. Throughout 2015/16 cash balances were

higher than previously experienced reflecting a beneficial change by Government in the pattern of business rates paid to them, KCC and Kent Fire and Rescue.

1.6.3 **Core Fund Investments**. Responsibility for the management of core funds transferred from the Council's external fund manager, Investec Asset Management, to in-house management in August 2014. Throughout 2015/16 core funds were managed in-house. The average core fund balance of £14.1m earned an average rate of return of 0.82%. The 3-month LIBID rate used as a comparator was 0.46%. The return achieved also compares with a revised budget assumption of £13m in balances earning an average rate of 0.80%. Unlike cash flow, core fund balances are not required to meet our regular payment obligations and are available to invest for longer durations including durations exceeding one year. This added flexibility allows core funds to generate a better return relative to cash flow investments.

1.6.4 Performance for the financial year as a whole is summarised in the table below:

	2015/16 Average Balance £m	Return %	2015/16 Interest Earned £	2015/16 Revised Estimate £	Variance Better (worse) £
Cash flow	17.0	0.65	109,850	85,000	24,850
Core funds	14.1	0.82	116,250	105,000	11,250
Total	31.1	0.73	226,100	190,000	36,100

1.6.5 The combined performance of the Authority's cash flow and core funds bettered the revised estimate by £36,100 (£58,600 better when compared to the 2015/16 original estimate).

1.7 Compliance with the Annual Investment Strategy

1.7.1 Throughout the period April 2015 to March 2016 the requirements set out in the 2015/16 Annual Investment Strategy which aim to limit the Council's exposure to investment risks (minimum counterparty credit criteria; sovereign, counter-party and group exposure limits; type of investment instrument; and investment duration limits) have been complied with. No liquidity issues were experienced resulting in nil borrowing throughout 2015/16.

Financial Services
May 2016