

AUDIT & GOVERNANCE COMMITTEE – 8 JULY 2015

TREASURY MANAGEMENT OUTTURN 2014/15

Report by Chief Finance Officer

Introduction

1. The Chartered Institute of Public Finance and Accountancy's (CIPFA's) 'Code of Practice on Treasury Management (Revised) 2009' requires that the Council (via Cabinet) and Audit & Governance Committee receives an updated report on Treasury Management activities at least twice per year. This report is the second report for the financial year 2014/15 and sets out the position as at 31 March 2015.
2. Treasury management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."
3. The following annexes are attached
 - Annex 1 Debt Financing 2014/15
 - Annex 2 Public Works Loan Board (PWLB) Maturing Debt
 - Annex 3 Lending List Changes
 - Annex 4 Investment portfolio 31/03/2015
 - Annex 5 Prudential Indicators Outturn
 - Annex 6 Benchmarking

Strategy 2014/15

4. The Treasury Management Strategy for 2014/15 was based on an average base rate forecast of 0.50%. The budget for interest receivable assumed that an average interest rate of 0.80% would be achieved, 0.30% above base rate.
5. The Strategy for Long Term Borrowing was to continue to have the option to fund new or replacement borrowing up to the value of 25% of the portfolio through internal borrowing to reduce the Council's exposure to credit risk and reduce the cost of carry (difference between borrowing costs and investment returns) whilst debt rates remained higher than investment interest rates.
6. The Strategy included the Treasury Management Strategy Team (TMST) keeping external fund investments under review, with decisions to advance or withdraw funds to external fund managers delegated to the TMST.

Market Background – Provided by Arlingclose

7. **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 given the important role of the consumer in economic activity.
8. 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. Bank of England Governor Mark Carney wrote an open letter to the Chancellor in February, explaining that the Bank expected CPI to temporarily turn negative but rebound around the end of 2015 as the lower prices dropped out of the annual rate calculation.
9. **Labour Market:** The UK labour market continued to improve and at the time of writing remains resilient across a broad base of measures including real rates of wage growth. March 2015 showed a headline employment rate of 73.5%, while the rate of unemployment fell to 5.5% from 6.8% a year earlier. Comparing the three months to February 2015 with a year earlier, employee pay increased by 1.9% including bonuses and by 2.2% excluding bonuses.
10. **UK Monetary Policy:** The Bank of England's MPC maintained interest rates at 0.5% and asset purchases (QE) at £375bn. Its members held a wide range of views on the response to zero CPI inflation, but just as the MPC was prepared to look past the temporary spikes in inflation to nearly 5% a few years ago, they felt it appropriate not to be panicked into response to the current low rate of inflation. The minutes of the MPC meetings reiterated the Committee's stance that the economic headwinds for the UK economy and the legacy of the financial crisis meant that increases in the Bank Rate would be gradual and limited, and below average historical levels.
11. 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. The risk of upheaval (the pledge to devolve extensive new powers to the Scottish parliament; English MPs in turn demanding separate laws for England) lingers on. The highly politicised March Budget heralded the start of the general election campaign and markets braced for what was, at the time, predicted to be another hung parliament.
12. On the continent, the European Central Bank lowered its official benchmark interest rate from 0.15% to 0.05% in September and the rate paid on commercial bank balances held with it was from -0.10% to -0.20%. The much-anticipated quantitative easing, which will expand the ECB's balance sheet by €1.1 trillion was finally announced by the central bank at its January meeting in an effort to steer the euro area away from deflation and invigorate its waning economies.

The size was at the high end of market expectations and it will involve buying €60bn of sovereign bonds, asset-backed securities and covered bonds a month commencing March 2015 through to September 2016. The possibility of a Greek exit from the Eurozone refused to subside given the clear frustrations that remained between its new government and its creditors.

13. The US economy rebounded strongly in 2014, employment growth was robust and there were early signs of wage pressures building, albeit from a low level. 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. With the US economy resilient enough the weather the weakness of key trading partners and a strong US dollar, in March 2015 the Fed removed the word "patient" from its statement accompanying its rates decisions, effectively leaving the door open for a rise in rates later in the year.
14. **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.

Treasury Management Activity

Debt Financing

15. The Council's debt financing position for 2014/15 is shown in Annex 1.
16. The option to fund new or replacement borrowing requirements from internal balances, up to the value of 25% of the investment portfolio was retained in the 2014/15 annual treasury management strategy. This was intended to reduce the cost of carry of borrowing which is the difference between borrowing rates and investment returns.
17. No new borrowing was arranged during 2014/15 with either the Public Works Loan Board (PWLB) or through the money markets.
18. At 31 March 2015, the authority had 66 PWLB loans totalling £349.38m and 10 LOBO¹ loans totalling £50m. The average rate of interest paid on PWLB debt was 4.63% and the average cost of LOBO debt in 2014/15 was 3.94%. The combined weighted average for interest paid on long-term debt was 4.54%.
19. The Council continues to qualify for the Certainty Rate on PWLB loans, offering a 0.20% discount on the Standard Rate (currently gilts plus 1.00%). Qualification is based on provision of additional information on long-term borrowing and associated capital spending plans.

¹ LOBO (Lender's Option/Borrower's Option) Loans are long-term loans which include a re-pricing option for the bank at predetermined intervals.

20. In January 2015 the Department of Communities and Local Government (CLG) confirmed that HM Treasury (HMT) would be taking the necessary steps to abolish the Public Works Loans Board. HMT has confirmed however that its lending function will continue unaffected and local authorities will retain access to borrowing rates which offer good value for money. The authority intends to use the PWLB's replacement as a potential source of borrowing if required.

Maturing Debt

21. The Council repaid £2m of maturing PWLB loans during the year. The weighted average interest rate payable on the matured loans was 2.35%. The details are set out in Annex 2.

Debt Restructuring

22. No long term debt was restructured during 2014/15.

Investment Strategy

23. Security and liquidity of cash was prioritised above the requirement to maximise returns. The Council adopted a cautious approach to lending to financial institutions, and continuously monitored credit quality information regarding the institutions on the Council's approved Lending List.
24. During 2014/15 the Council limited the exposure to banks by lending to local authorities. At 31 March 2015 the Council had £47m of long term fixed deposits (deposits over 364 days), all of which were placed with local authorities or police authorities. The aim was to maintain a high level of security and manage exposure to interest rate and counterparty risk.
25. The weighted average maturity of all deposits at 31 March 2015, including money deposited in short-term notice accounts, was 165 days (compared with 296 days during 2013/14). This comprised £221m fixed deposits with a weighted average maturity of 184 days and £30.8m invested in money market funds with same day liquidity. The reduction in weighted average maturity was due to significant reductions to maximum duration limits with banks and building societies, as well as in-year forecasts signalling a move towards a rising interest rate environment, making long term lending less attractive.
26. The Council used fixed and structured deposits, as well as call accounts, money market funds and pooled funds to deposit its in-house temporary cash surpluses during 2014/15.

The Council's Lending List

27. The Council's in-house cash balances are deposited with institutions that meet the Council's approved credit rating criteria. The approved Lending List is regularly updated during the year to reflect changes in bank and building society credit ratings. Changes are reported to the Cabinet on a bimonthly basis. The

approved lending list may also be further restricted by officers, in response to changing conditions and perceived risk. Annex 3 shows the amendments incorporated into the Lending List during 2014/15, in accordance with the approved credit rating criteria and additional temporary restrictions.

Investment Outturn

28. The average daily balance of temporary surplus cash invested in-house was £341m in 2014/15. The Council achieved an average in-house return for the year of 0.77%, producing gross interest receivable of £2.636m. Temporary surplus cash balances include: developer contributions; council reserves and balances; trust fund balances; and various other funds to which the Council pays interest at each financial year end, based on the average three month London Interbank Bid (LIBID) rate.
29. Gross distributions from pooled funds totalling £0.235m were also realised in year, bringing total investment income to £2.871m.
30. Pooled fund investments saw an increase in value of £1.229m to £67.630m for the financial year. This has been recognised via an increase to the Council's available for sale reserve. Gains cannot be realised as investment income until the point at which fund units are sold.
31. During 2014/15 the average three month LIBID rate was 0.43%. The Council's average in-house return of 0.77% exceeded this benchmark by 0.34%. The average in-house return was 0.03% lower than the budgeted rate of interest of 0.80%. This was in part a result of significant reductions to bank and building society duration limits made in October 2014. This subsequently reduced the Council's capacity to pick up yield in durations between 6 and 12 months. Additionally, original forecasts included an increase in base rate towards the end of the financial year, which did not materialise.
32. The Council operates a number of instant access call accounts and money market funds to deposit short-term cash surpluses. During 2014/15 the average balance held on instant access was £34.8m.
33. At 31 March 2015, the Council's investment portfolio of £366.41m comprised £268m of fixed term deposits, £30.78m at short term notice in money market funds and £67.63m in pooled funds with a variable net asset value (VNAV). Annex 4 provides an analysis of the investment portfolio at 31 March 2015.
34. The council's Treasury Management Strategy Team regularly monitors the risk profile of the Council's investment portfolio. An analysis of the credit and maturity position of the portfolio at 31 March 2015 is shown in Annex 4.

External Fund Managers

35. Having reviewed further investment options in consultation with the Council's treasury advisors Arlingclose Ltd, the Treasury Management Strategy Team

approved decisions to invest £10m in the CCLA Local Authorities Property Fund and £5m in the Royal London Cash Plus Fund in October 2014 and December 2014 respectively.

36. The CCLA Local Authorities Property Fund is invested in commercial and industrial properties in the United Kingdom. It aims to provide, over the long term, a satisfactory total capital and income return on the units of the fund. The fund aims to maintain a suitable spread between different types of property and geographical location.
37. The Royal London Cash Plus Fund invests in cash, deposits, covered bonds and short-dated government securities. The performance of the funds will be monitored by the Treasury Management Strategy Team.

Prudential Indicators for Treasury Management

38. During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Report. The outturn for the Prudential Indicators is shown in Annex 5.

External Performance Indicators and Statistics

39. The County Council is a member of the CIPFA Treasury and Debt Management Benchmarking Club and completed returns for the financial year 2014/15. The results of this exercise are not yet available.
40. Arlingclose has also benchmarked Oxfordshire County Council's investment performance against its other clients. For 2014/15 the Council has achieved a yield on its deposits above the average for all Arlingclose clients, whilst simultaneously maintaining low credit risk. This is partly attributable to a higher than average allocation of deposits to local authorities, a significant proportion of which had durations of over a year when traded, thus providing favourable rates of interest. The investment performance benchmarking is shown on Annex 6.

Financial and Legal Implications

41. The combined activities of debt and investment management contribute to the strategic measures element of the Council's budget. The outturn for Interest Payable in 2014/15 was £18.227m, exceeding the budget of £18.181m in the Medium Term Financial Plan by £0.046m.
42. The 2014/15 budget for interest receivable was £2.404m, compared with the outturn of £2.871m (including pooled fund distributions), giving a net overachievement of £0.467m. The overachievement in interest received was due to higher than forecast average cash balances, due in part to slippage on the capital programme, as well as the introduction of two pooled funds paying

cash distributions, which performed solidly. In addition the 2014/15 accounts recognise an increase in the value of available for sale assets² of £1.229m.

RECOMMENDATION

43. **The Committee is RECOMMENDED to note the report, and to RECOMMEND Council to note the Council's Treasury Management Activity in 2014/15.**

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² Available for sale assets comprise variable net asset value pooled funds, comprised of short dated bond funds, strategic bond funds and property funds.