APPENDIX 2

DRAFT

FLINTSHIRE COUNTY COUNCIL

TREASURY MANAGEMENT

ANNUAL REPORT 2014/15

1.00 INTRODUCTION

1.01 The Council approved the Treasury Management Strategy (Strategy) 2014/15 including key indicators, limits and an annual investment strategy on 18th February 2014.

1.02 The Strategy was produced based on the 2011 edition of the CIPFA Treasury Management in the Public Services: Code of Practice.

1.03 The purpose of this report is to review the outcomes from 2014/15 treasury management operations and compare with the Strategy.

1.04 Treasury management comprises the management of the local authority's 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.

2.00 ECONOMIC & INTEREST RATE REVIEW 2014/15

Provided by Arlingclose Ltd the Council's Treasury Management advisors.

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.

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.

Labour Market: The UK labour market continued to improve and remains resilient across a broad base of measures including real rates of wage growth. January 2015 showed a headline employment rate of 73.3%, while the rate of unemployment fell to 5.7% from 7.2% a year earlier. Comparing the three months to January 2015 with a year earlier, employee pay increased by 1.8% including bonuses and by 1.6% excluding bonuses.

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 get 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.

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 a closely contested general election campaign and markets braced for yet another hung parliament.

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 moribund 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.

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.

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.

3.00 BORROWING REQUIREMENTS AND DEBT MANAGEMENT

3.01 PWLB (Public Works Loans Board) Certainty Rate

The Council again qualified for the PWLB Certainty Rate, allowing the authority to borrow at a reduction of 20bps on the Standard Rate.

3.02 Borrowing Activity in 2014/15.

The total long term borrowing outstanding, brought forward into 2014/15 totalled £172.1 million. Loans with the Public Works Loans board were in the form of fixed rate (£143.2m) and variable rate (£10m). The remaining £18.95m was variable in the form of LOBO's (Lender's Option, Borrower's Option). The Council's average borrowing rate throughout the year was 5.41%.

	Balance 01/04/2014 £m	**Debt Maturing £m**	**New Debt £m**	**Balance 31/03/2015 £m**
Capital Financing Requirement	**188.4**	**-**	**-**	**190.4**
Short Term Borrowing	0.00	0.00	0.00	0.00
Long Term Borrowing	**172.1**	**0.00**	**0.00**	**172.1**
TOTAL BORROWING	172.1	0.00	0.00	172.1
Other Long Term Liabilities	7.6	0.5	0.00	7.1
TOTAL EXTERNAL DEBT	**179.7**	**0.5**	**0.00**	**179.1**
Increase/(Decrease in Borrowing (£m)	**-**	**-**	**-**	**(0.5)**

3.03 The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31st March 2015 was £190.4m. The Council's total external debt was £179.1m.

3.04 No new long term borrowing was undertaken during 2014/15.

3.05 Loans at Variable Rates

The Council has £10m of PWLB variable rate loans, at an average rate of 0.59% which mitigate the impact of changes in variable rates on the Authority's overall treasury portfolio (the Authority's investments are deemed to be variable rate investments due to their short-term nature). This strategic exposure to variable interest rates will be regularly reviewed and, if appropriate, reduced by switching into fixed rate loans.

3.06 Internal Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the strategy followed was to minimise debt interest payments without compromising the longer-term stability of the portfolio. The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant at around 3.42%. The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding £10.29m of capital expenditure. This has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. However, this position is not sustainable and the Council expects it will need to borrow for capital purposes from 2015/16 onwards.

3.07 Lender's Option Borrower's Option Loans (LOBOs)

The Authority holds £18.95m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. All of these LOBOS had options during the year, none of which were exercised by the lender.

3.08 Debt Rescheduling

The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Authority's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence. However, The Chief Finance Officer, along with the Council's Treasury Management Advisors, keeps under review any opportunities which may arise for restructuring the Council's debt in order to take advantage of potential savings as interest rates change and to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility).

3.09 Abolition of the PWLB

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.

3.10 Welsh HRA Subsidy Reform

The Housing (Wales) Act 2014 became law in Wales on 17th September 2014 and provided for the abolition of the negative Housing Revenue Account Subsidy (HRAS) system. The Authority was required to buy itself out of the current arrangement by making 'settlement payments' to the Welsh Government. In return the Authority will be able to keep all future rental revenues generated from the housing stock. A cap has been set by the Welsh Government for how much the Authority can continue to borrow for the HRA in the future. The Authority was required to enter into a Voluntary Agreement with Welsh Ministers under section 80B of the Local Government and Housing Act 1989. This Agreement set out all the terms and conditions of settlement.

The Authority was required to make an application for loans totalling £79.2m on the morning of 31st March 2015. As part of the settlement, the Authority was required to borrow for the full settlement amount from the PWLB at special Welsh HRA Subsidy Reform interest rates. These were set at a margin above PWLB Standard rates due to the methodology adopted by the Welsh Government and HM Treasury in determining the settlement amounts. The Authority was required to draw down loans that would deliver a minimum interest payment to the PWLB of £3.3m for each of the first five years following settlement.

Receipt of funding from the PWLB took place on 2 April 2015 on which date the Authority was required to make its settlement payment to the Welsh Government to exit the HRA Subsidy system.

4.00 INVESTMENT ACTIVITY

4.01 The Welsh Assembly Government's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield.

4.02 Investment Activity in 2014/15

Summary of investments as at 31st March 2015.

Country	Total	<1 month	1 –12 months	>12 months
	£m	%	£m	£m
UK BANKS	7.0	4.0	3.0	
UK BUILDING SOCIETIES	9.2	4.2	5.0	
OVERSEAS	5.0	5.0		
MMF's				
LOCAL AUTHORITIES	6.0	4.0	2.0	
DMO	21.7	21.7		
TOTAL	**48.9**	**38.9**	**10.0**	**0.0**
% OF PORTFOLIO		79.5%	20.5%	0.0%
TARGET 2014/15		35%	55%	10%

4.03 Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Strategy for 2014/15. Investments during the year included:

- Deposits with the Debt Management Office
- Deposits with other Local Authorities
- Investments in AAA-rated Constant Net Asset Value Money Market Funds
- Call accounts and deposits with Banks and Building Societies

4.05 Credit Risk

The Authority assessed and monitored counterparty credit quality with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP and share price. The minimum long-term counterparty credit rating determined by the Authority for the 2014/15 treasury strategy was A-/A-/A3 across rating agencies Fitch, S&P and Moody's.

4.06 Counterparty Update

The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on April 15, 2014. Taking the view that potential extraordinary government support available to banks' senior unsecured bondholders will likely diminish, over 2014-15 Moody's revised the Outlook of several UK and EU banks from Stable to Negative (note, this is not the same as a rating review negative) and S&P placed the ratings of UK and German banks on Credit Watch with negative implications, following these countries' early adoption of the bail-in regime in the BRRD.

S&P also revised the Outlook for major Canadian banks to negative following the government's announcement of a potential bail-in policy framework.

The Bank of England published its approach to bank resolution which gave an indication of how the reduction of a failing bank's liabilities might work in practice. The Bank of England will act if, in its opinion, a bank is failing, or is likely to fail, and there is not likely to be a successful private sector solution such as a takeover or share issue; a bank does not need to be technically insolvent (with liabilities exceeding assets) before regulatory intervention such as a bail-in takes place.

The combined effect of the BRRD and the UK's Deposit Guarantee Scheme Directive (DGSD) is to promote deposits of individuals and SMEs above those of public authorities, large corporates and financial institutions. Other EU countries, and eventually all other developed countries, are expected to adopt similar approaches in due course.

In December the Bank's Prudential Regulation Authority (PRA) stress tested eight UK financial institutions to assess their resilience to a very severe housing market shock and to a sharp rise in interest rates and address the risks to the UK's financial stability. Institutions which 'passed' the tests but would be at risk in the event of a 'severe economic downturn' were Lloyds Banking Group and Royal Bank of Scotland. Lloyds Banking Group, [whose constituent banks are on the Authority's lending list], is taking measures to augment capital and the PRA does not require the group to submit a revised capital plan. RBS, which is not on the Authority's lending list for investments, has updated plans to issue additional Tier 1 capital. The Co-operative Bank failed the test.

The European Central Bank also published the results of the Asset Quality Review (AQR) and stress tests, based on December 2013 data. 25 European banks failed the test, falling short of the required threshold capital by approximately €25bn (£20bn) in total – none of the failed banks featured on the Authority's lending list.

In October following sharp movements in market signals driven by deteriorating global growth prospects, especially in the Eurozone, Arlingclose advised a reduction in investment duration limits for unsecured bank and building society investments to counter the risk of another full-blown Eurozone crisis. Durations for new unsecured investments with banks and building societies which were previously reduced. Duration for new unsecured investments with some UK institutions was further reduced to 100 days in February 2015.

The outlawing of bail-outs, the introduction of bail-ins, and the preference being given to large numbers of depositors other than local authorities means that the risks of making unsecured deposits rose relative to other investment options. The Authority, therefore increasingly favoured secured investment options or diversified alternatives such as T-bills and pooled funds over unsecured bank and building society deposits.

4.07 Liquidity

In keeping with the WG's Guidance on Investments, the Authority maintained a sufficient level of liquidity through the use of Money Market Funds and call accounts. The Authority uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed.

4.08 Yield

The UK Bank Rate was maintained at 0.5% through the year. Short term money market rates also remained at very low levels which continued to have a significant impact on investment income. The low rates of return on the Authority's short-dated money market investments reflect prevailing market conditions and the Authority's objective of optimising returns commensurate with the principles of security and liquidity.

Income earned on £2m of longer-dated investments made in 2013/14 at a rate of 0.95% provided some cushion against the low interest rate environment.

The Authority's budgeted investment income for the year had been estimated at £300k. The average cash balances were £61.7m during the period and interest earned was £323k, at an average interest rate of 0.54%.

5.00 COMPLIANCE

5.01 The Council can confirm that it has complied with its Prudential Indicators for 2014/15, which were approved on 18th February 2014 as part of the Council's Treasury Management Strategy.

5.02 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2014/15. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

5.03 The treasury function operated within the limits detailed in the Treasury Management Policy and Strategy Statement 2014/15.

6.00 <u>OTHER ITEMS</u>

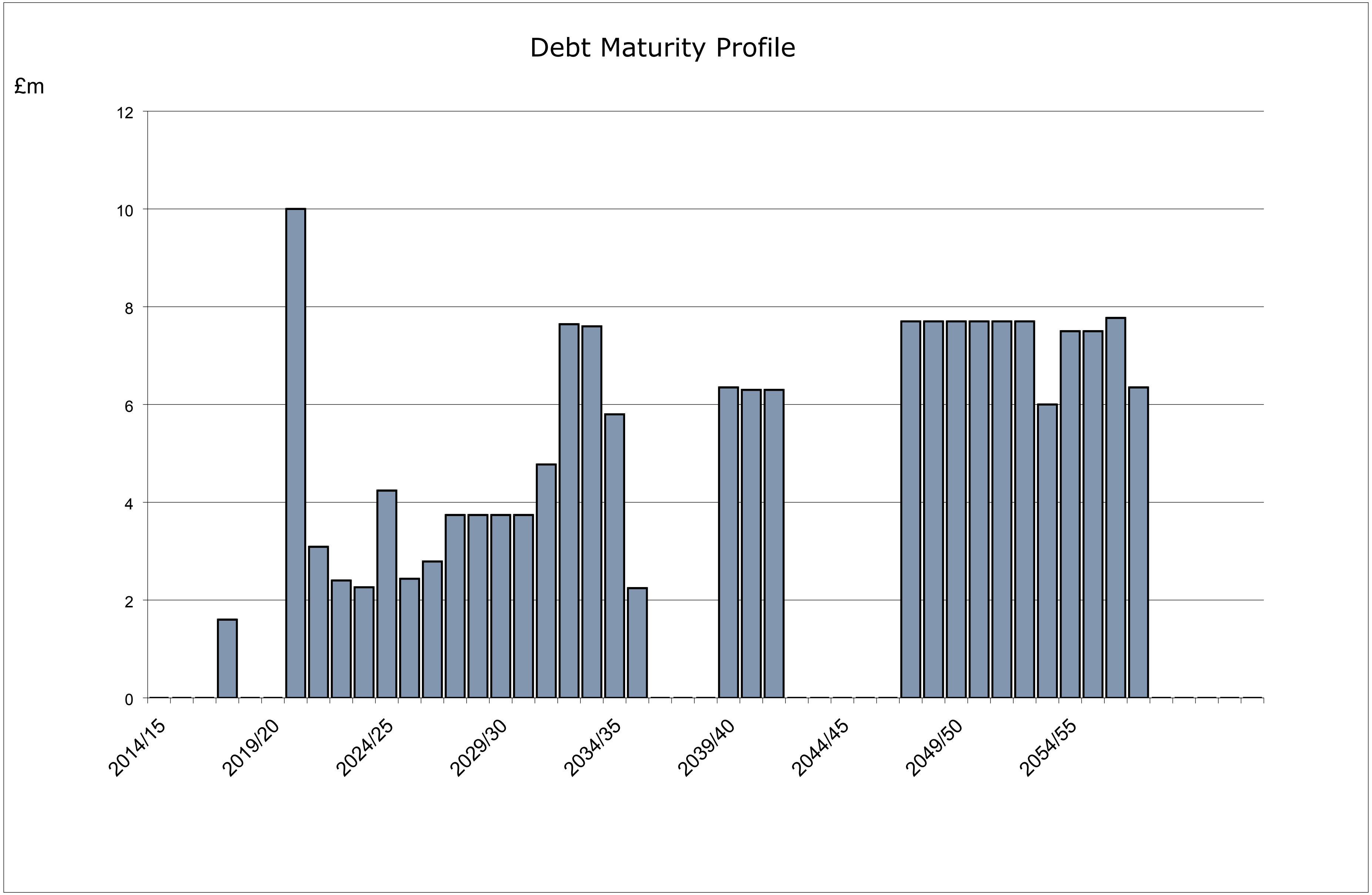
6.01 The following were the main treasury activities during 2014/15:

- The Chief Finance Officer received a monthly update on treasury activities.
- The Council received a Mid-Year Report on 27th January 2015.
- Quarterly updates reports were presented to the Audit Committee.
- All Members were invited to a training session undertaken by Arlingclose Ltd on 21st January 2015, which was hosted by Audit Committee.
- The 2015/16 Statement was approved by Council on 17th February 2015.
- The Council continues to be an active member of the CIPFA Treasury Management Network.
- The Council's cash flow was managed on a daily basis. During the year the Authority acted both as a borrower and as a lender and was a net borrower over the year in question. The maximum investments the Authority had on deposit at any one time was £75.2m and the maximum long-term borrowing at any one time was £172.1m.

7.00 <u>CONCLUSION</u>

7.01 The treasury management function has operated within the statutory and local limits detailed in the 2014/15 Treasury Management Strategy.

7.02 The Policy was implemented in a pro-active manner with security and liquidity as the focus.


Debt Maturity Profile
£m
12
10
8
6
4
2
0
2014/15
2019/20
2024/25
2029/30
2034/35
2039/40
2044/45
2049/50
2054/55