APPENDIX 1

FLINTSHIRE COUNTY COUNCIL

TREASURY MANAGEMENT

ANNUAL REPORT 2015/16

1.00 INTRODUCTION

1.01 The Council approved the Treasury Management Strategy (Strategy) 2015/16 including key indicators, limits and an annual investment strategy on 17th February 2015.

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 2015/16 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 2015/16

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

Growth, Inflation, Employment: The UK economy slowed in 2015 with Gross domestic product (GDP) growth falling to 2.3% from a robust 3.0% the year before. Consumer price index (CPI) inflation hovered around 0.0% through 2015 with deflationary spells in April, September and October. The prolonged spell of low inflation was attributed to the continued collapse in the price of oil from $67 a barrel in May 2015 to just under $28 a barrel in January 2016, the appreciation of sterling since 2013 pushing down import prices and weaker than anticipated wage growth resulting in subdued unit labour costs. CPI picked up to 0.3% year/year in February, but this was still well below the Bank of England's 2% inflation target. The labour market continued to improve through 2015 and in Q1 2016, the latest figures (Jan 2016) showing the employment rate at 74.1% (the highest rate since comparable records began in 1971) and the unemployment rate at a 12 year low of 5.1%. Wage growth has however remained modest at around 2.2% excluding bonuses, but after a long period of negative real wage growth (i.e. after inflation) real earnings were positive and growing at their fastest rate in eight years, boosting consumers' spending power.

Global influences: The slowdown in the Chinese economy became the largest threat to the South East Asian region, particularly on economies with a large trade dependency on China and also to prospects for global growth as a whole. The effect of the Chinese authorities' intervention in their currency and equity markets was temporary and led to high market volatility as a consequence. There were falls in prices of equities and risky assets and a widening in corporate credit spreads. As the global economy entered 2016 there was high uncertainty about growth, the outcome of the US presidential election and the consequences of June's referendum on whether the UK is to remain in the EU. Between February and March 2016 sterling had depreciated by around 3%, a significant proportion of the decline reflecting the uncertainty surrounding the referendum result.

UK Monetary Policy: The Bank of England's MPC (Monetary Policy Committee) made no change to policy, maintaining the Bank Rate at 0.5% (in March it entered its eighth year at 0.5%) and asset purchases (Quantitative Easing) at £375bn. In its *Inflation Reports* and monthly monetary policy meeting minutes, the Bank was at pains to stress and reiterate that when interest rates do begin to rise they were expected to do so more gradually and to a lower level than in recent cycles.

Improvement in household spending, business fixed investment, a strong housing sector and solid employment gains in the US allowed the Federal Reserve to raise rates in December 2015 for the first time in nine years to take the new Federal funds range to 0.25%-0.50%. Despite signalling four further rate hikes in 2016, the Fed chose not to increase rates further in Q1 and markets pared back expectations to no more than two further hikes this year.

However central bankers in the Eurozone, Switzerland, Sweden and Japan were forced to take policy rates into negative territory. The European Central Bank also announced a range of measures to inject sustained economic recovery and boost domestic inflation which included an increase in asset purchases (Quantitative Easing).

Market reaction: From June 2015 gilt yields were driven lower by the a weakening in Chinese growth, the knock-on effects of the fall in its stock market, the continuing fall in the price of oil and commodities and acceptance of diminishing effectiveness of central bankers' unconventional policy actions. Added to this was the heightened uncertainty surrounding the outcome of the UK referendum on its continued membership of the EU as well as the US presidential elections which culminated in a significant volatility and in equities and corporate bond yields.

10-year gilt yields moved from 1.58% on 31/03/2015 to a high of 2.19% in June before falling back and ending the financial year at 1.42%. The pattern for 20-year gilts was similar, the yield rose from 2.15% in March 2015 to a high of 2.71% in June before falling back to 2.14% in March 2016. The FTSE All Share Index fell 7.3% from 3664 to 3395 and the MSCI World Index fell 5.3% from 1741 to 1648 over the 12 months to 31 March 2016.

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 20 basis points on the Standard Rate.

3.02 Borrowing Activity in 2015/16.

The total long term borrowing outstanding, brought forward into 2015/16 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 5.02%.

	Balance 01/04/2015 £m	**Debt Maturing £m**	**New Debt £m**	**Balance 31/03/2016 £m**
Capital Financing Requirement	**190.4**	7.7	97.6	**280.3**
Short Term Borrowing	0.00	0.00	0.00	0.00
Long Term Borrowing	**172.1**	0.00	79.2	**251.3**
TOTAL BORROWING	172.1	0.00	0.00	251.3
Other Long Term Liabilities	7.1	0.6	0.00	6.5
TOTAL EXTERNAL DEBT	**179.1**	**0.6**	**0.00**	**257.8**
Increase/(Decrease in Borrowing (£m)	-	-	79.2	

3.03 The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31st March 2016 was £280.3m. The Council's total external debt was £257.8m.

3.04 **Welsh HRA Subsidy Reform**

The Housing (Wales) Act 2014 became law in Wales on 17th September 2014 and provided for the abolition of the Housing Revenue Account Subsidy (HRAS) system. The Authority was required to buy itself out of the previous 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 2nd April 2015.

3.05 Loans at Variable Rates

The Council has £10m of PWLB variable rate loans, at an average rate of 0.66% 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 2.95%. The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding £18.4m 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 2016/17 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 PWLB continued to operate a spread of approximately 1% between “premature repayment rate” and “new loan” rates so 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).

4.00 INVESTMENT ACTIVITY

4.01 The Welsh Government’s Investment Guidance gives priority to security and liquidity and the Authority’s aim is to achieve a yield commensurate with these principles.

4.02 Investment Activity in 2015/16

Summary of investments as at 31st March 2016.

Country	Total	<1 month	1 –12 months	>12 months
	£m	%	£m	£m
UK BANKS	5.0	3.0	2.0	
UK BUILDING SOCIETIES	8.0	7.0	1.0	
OVERSEAS	5.2	5.2		
MMF’s				
LOCAL AUTHORITIES	6.4	3.4	3.0	
DMO	8.0	8.0		
TOTAL	**32.6**	**26.6**	**6.0**	**0.0**
% OF PORTFOLIO		81.6%	18.4%	0.0%
TARGET 2015/16		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 2015/16. 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
- Treasury Bills
- Certificates of Deposit

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 2015/16 treasury strategy was A-/A-/A3 across rating agencies Fitch, S&P and Moody's.

4.06 Counterparty Update

The transposition of two European Union directives into UK legislation placed the burden of rescuing failing EU banks disproportionately onto unsecured institutional investors which include local authorities and pension funds. During the year, all three credit ratings agencies reviewed their ratings to reflect the loss of government support for most financial institutions and the potential for loss given default as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions saw upgrades due to an improvement in their underlying strength and an assessment that that the level of loss given default is low.

Fitch reviewed the credit ratings of multiple institutions in May. Most UK banks had their support rating revised from 1 (denoting an extremely high probability of support) to 5 (denoting external support cannot be relied upon). This resulted in the downgrade of the long-term ratings of Royal Bank of Scotland (RBS), Deutsche Bank, Bank Nederlandse Gemeeten and ING. JP Morgan Chase and the Lloyds Banking Group however both received one notch upgrades.

Moody's concluded its review in June and upgraded the long-term ratings of Close Brothers, Standard Chartered Bank, ING Bank, Goldman Sachs International, HSBC, RBS, Coventry Building Society, Leeds Building Society, Nationwide Building Society, Svenska Handelsbanken and Landesbank Hessen-Thuringen.

S&P reviewed UK and German banks in June, downgrading the long-term ratings of Barclays, RBS and Deutsche Bank. S&P also revised the outlook of the UK as a whole to negative from stable, citing concerns around the referendum on EU membership and its effect on the economy.

At the end of July 2015, Arlingclose advised an extension of recommended durations for unsecured investments in certain UK and European institutions following improvements in the global economic situation and the receding threat of another Eurozone crisis. A similar extension was advised for some non-European banks in September, with the Danish Danske Bank being added as a new recommended counterparty and certain non-rated UK building societies also being extended.

In December the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies which showed that the Royal Bank of Scotland and Standard Chartered Bank were the weakest performers. However, the regulator did not require either bank to submit revised capital plans, since both firms had already improved their ratios over the year.

In January 2016, Arlingclose supplemented its existing investment advice with a counterparty list of high quality bond issuers, including recommended cash and duration limits. As part of this, Bank Nederlandse Gemeeten was moved to the list of bond issuers from the unsecured bank lending list and assigned an increased recommended duration limit of 5 years. Interest rates are likely to stay low for longer making long-term bonds an increasingly attractive option. The Council did not make use of these long-term investment options during 2015/16.

The first quarter of 2016 was characterised by financial market volatility and a weakening outlook for global economic growth. In March 2016, following the publication of many banks' 2015 full-year results, Arlingclose advised the suspension of Deutsche Bank and Standard Chartered Bank from the counterparty list for unsecured investments. Both banks recorded large losses and despite improving capital adequacy this will call 2016 performance into question, especially if market volatility continues. Standard Chartered had seen various rating actions taken against it by the rating agencies and a rising CDS level throughout the year. Arlingclose will continue to monitor both banks.

The end of bank 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 continues to be elevated relative to other investment options. The Authority therefore increased investments in diversified alternatives such as non-bank investments and pooled funds.

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 2015/16 at a rate of 1.05% provided some cushion against the low interest rate environment.

The Authority's budgeted investment income for the year had been estimated at £130k. The average cash balances were £61.7m during the period and interest earned was £277k, at an average interest rate of 0.51%.

5.00 COMPLIANCE

5.01 The Council can confirm that it has complied with its Prudential Indicators for 2015/16, which were approved on 17th February 2015 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 2015/16. 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 2015/16.

6.00 OTHER ITEMS

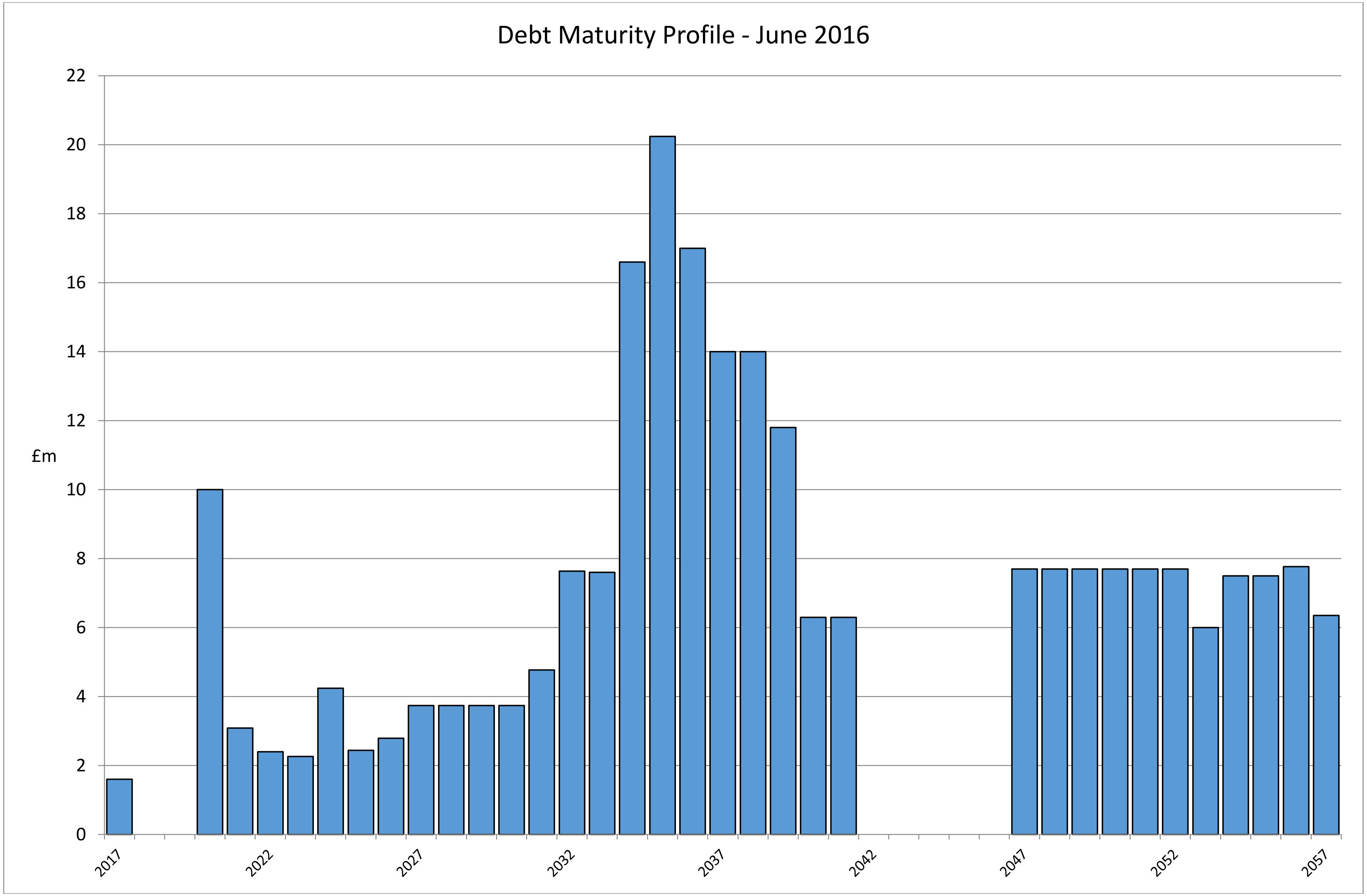
6.01 The following were the main treasury activities during 2015/16:

- The Council received a Mid-Year Report on 16th February 2016.
- Quarterly update reports were presented to the Audit Committee.
- All Members were invited to a training session undertaken by Arlingclose Ltd on 26th January 2016, which was hosted by Audit Committee.
- The 2016/17 Investment Strategy Statement was approved by Council on 16th February 2016.
- 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 £67.1m and the maximum long-term borrowing at any one time was £251.3m.

7.00 CONCLUSION

7.01 The treasury management function has operated within the statutory and local limits detailed in the 2015/16 Treasury Management Strategy.

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



Debt Maturity Profile - June 2016
£m
22
20
18
16
14
12
10
8
6
4
2
0
2017
2022
2027
2032
2037
2042
2047
2052
2057