APPENDIX 5

# FLINTSHIRE COUNTY COUNCIL

## TREASURY MANAGEMENT

DRAFT

## MID YEAR REPORT 2015/16

## 1.00 PURPOSE OF REPORT

1.01 To provide members with a mid-year update on matters relating to the Council's Treasury Management function.

## 2.00 BACKGROUND

2.01 Treasury management comprises the management of the Council'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.

2.02 The Council's primary objectives for the investment of its surplus funds are to protect the principal sums invested from loss, and to ensure adequate liquidity so that funds are available for expenditure when needed. The generation of investment income to support the provision of local authority services is an important, but secondary, objective.

2.03 The Council's policy is to appoint external consultants to provide advice on its treasury management function. The current external adviser is Arlingclose Ltd.

2.04 The Council has adopted the 2012 edition of the CIPFA Treasury Management in the Public Services: Code of Practice, which requires the Council to approve a treasury management strategy before the start of each financial year, a mid-year report, and an annual report after the end of each financial year.

2.05 In addition, the Welsh Government (WG) Guidance on Local Government Investments recommends that local authorities amend their investment strategies in light of changing internal or external circumstances.

2.06 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the WG Guidance.

2.07 The Council approved the 2015/16 Treasury Management Strategy at its meeting on 17th February 2015.

## 3.00 ECONOMIC & INTEREST RATE REVIEW APRIL – SEPTEMBER 2015.

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

*Global:*

As the year began, economic data was largely overshadowed by events in Greece. Markets' attention centered on the never-ending Greek issue stumbled from turmoil to crisis, running the serious risk of a disorderly exit from the Euro. The country's politicians and the representatives of the 'Troika' of its creditors - the European

Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF) – barely saw eye to eye. Greece failed to make a scheduled repayment to the IMF on 30th June, in itself not a default until the IMF's Managing Director declares it so. Prime Minister Tsipras blindsided Greece's creditors by calling a referendum on 5th July on reform proposals which by then were off the table anyway. The European Central Bank froze liquidity assistance provided to Greek banks and capital controls within the country severely restricted individuals' and corporates' access to cash.

On 12th July, following a weekend European Union Summit, it was announced that the terms for a third bailout of Greece had been reached. The deal amounting to €86 billion was agreed under the terms that Greece would see tax increases, pension reforms and privatisations; the very reforms Tsipras had vowed to resist. This U-turn saw a revolt within the ruling Syriza party and on 27th August, Alexis Tsipras resigned from his post as Prime Minster of Greece after just eight months in office by calling a snap election, held on 20th September. This gamble paid off as Tsipras led his party to victory once again, although a coalition with the Independent Greeks was needed for a slim parliamentary majority. That government must now continue with the unenviable task of guiding Greece through the continuing economic crisis – the Greek saga is far from over.

The summer also saw attention shift towards China as the Shanghai composite index (representing China's main stock market), which had risen a staggering 50%+ since the beginning of 2015, dropped by 43% in less than three months with a reported $3.2 trillion loss to investors, on the back of concerns over growth and after regulators clamped down on margin lending activity in an effort to stop investors borrowing to invest and feeding the stock market bubble. Chinese authorities intensified their intervention in the markets by halting trading in many stocks in an attempt to maintain market confidence. They surprised global markets in August as the People's Bank of China changed the way the yuan is fixed each day against the US dollar and allowed an aggressive devaluation of the currency. This sent jitters through Asian, European and US markets impacting currencies, equities, commodities, oil and metals. On 24$^{th}$ August, Chinese stocks suffered their steepest one-day fall on record, driving down other equity markets around the world and soon becoming known as another 'Black Monday'. Chinese stocks have recovered marginally since and are trading around the same level as the start of the year. Concerns remain about slowing growth and potential deflationary effects.

*UK Economy:*
The economy has remained resilient over the last six months. Although economic growth slowed in Q1 2015 to 0.4%, year/year growth to March 2015 was a relatively healthy 2.7%. Q2 2015 GDP growth bounced back and was confirmed at 0.7%, with year/year growth showing slight signs of slowing, decreasing to 2.4%. GDP has now increased for ten consecutive quarters, breaking a pattern of slow and erratic growth from 2009. The annual rate for consumer price inflation (CPI) briefly

turned negative in April, falling to -0.1%, before fluctuating between 0.0% and 0.1% over the next few months. In the August Quarterly Inflation Report, the Bank of England projected that GDP growth will continue around its average rate since 2013. The Bank of England's projections for inflation remained largely unchanged from the May report with them expecting inflation to gradually increase to around 2% over the next 18 months and then remain there in the near future. Further improvement in the labour market saw the ILO unemployment rate for the three months to July fall to 5.5%. In the September report, average earnings excluding bonuses for the three months to July rose 2.9% year/year.

The outcome of the UK general election, largely fought over the parties' approach to dealing with the consequences of the structural deficit and the pace of its removal, saw some very big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics.

The US economy slowed to 0.6% in Q1 2015 due to bad weather, spending cuts by energy firms and the effects of a strong dollar. However, Q2 GDP showed a large improvement at a twice-revised 3.9% (annualised). This was largely due to a broad recovery in corporate investment alongside a stronger performance from consumer and government spending and construction and exports. With the Fed's decision on US interest rate dependent upon data, GDP is clearly supportive. However it is not as simple as that and the Fed are keen to see inflation rise alongside its headline economic growth and also its labour markets. The Committee decided not to act at its September meeting as many had been anticipating but have signalled rates rising before the end of the year.

*Market reaction:*
Equity markets initially reacted positively to the pickup in the expectations of global economic conditions, but were tempered by the breakdown of creditor negotiations in Greece. China led stock market turmoil around the globe in August, with the FTSE 100 falling by around 8% overnight on 'Black Monday'. Indices have not recovered to their previous levels but some improvement has been seen. Government bond markets were quite volatile with yields rising (i.e. prices falling) initially as the risks of deflation seemingly abated. Thereafter yields fell on the outcome of the UK general election and assisted by reappraisal of deflationary factors, before rising again. Concerns around China saw bond yields dropping again through August and September. Bond markets were also distorted by the size of the European Central Bank's QE programme, so large that it created illiquidity in the very markets in which it needed to acquire these bonds, notably German government bonds (bunds) where yields were in negative territory.

*Outlook for Q3 and Q4 2015/16:*

Arlingclose's expectation for the first rise in the Bank Rate (interest base rate) remains the second calendar quarter of 2016. The pace of interest rate rises will be gradual and the extent of rises limited. The appropriate level for Bank Rate for the post-crisis UK economy is likely to be lower than the previous norm. We would suggest this is between 2.0% and 3.0%. There is also sufficient momentum in the US economy for the Federal Reserve to raise interest rates in 2015, although risks of issues from China could possibly push this back.

The weak global environment and resulting low inflation expectations are likely to dampen long term interest rates. We project gilt yields will follow a shallow upward path in the medium term, with continuing concerns about the Eurozone, and other geo-political events, weighing on risk appetite, while inflation expectations remain subdued. The uncertainties surrounding the timing of UK and US interest rate rises, and the Chinese stock market-led turmoil, are likely to prompt short term volatility in gilt yields.

The table below details the latest forecast for the Bank of England base rate as provided by our advisors Arlingclose:

| | Dec 15 | Mar 16 | Jun 16 | Sep 16 | Dec 16 | Mar 17 | Jun 17 | Sep 17 | Dec 17 | Mar 18 | Jun 18 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Interest Rate | 0.50% | 0.50% | 0.75% | 0.75% | 1.00% | 1.00% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% |

## 4.00 BORROWING REQUIREMENTS AND DEBT MANAGEMENT

4.01 PWLB (Public Works Loans Board) Certainty Rate Update.

The Authority qualified for borrowing at the 'Certainty Rate' (0.2% below the PWLB standard rate) for a 12 month period from 1st November 2014. In August 2015, the Authority submitted its application to WG along with the 2015-16 Capital Estimates Return to access this reduced rate for a further 12 months from 1st November 2015.

4.02 Borrowing Activity to 30th September 2015.

The total long term borrowing outstanding, brought forward into 2015/16 totalled £172.1 million. As reported in the 2015/16 Treasury Management Strategy, the UK and Welsh Governments, along with all 11 stock retaining authorities in Wales were preparing to sign a voluntary agreement to change the financing arrangements for council housing in Wales in early 2015/16.

The negative subsidy system in operation, which required Flintshire to make annual payments of circa £6m in to Welsh Government ceased at the end of 2014/15. The Council was required to buy itself out of the arrangement by making a one-off 'settlement payment' to the Welsh Government on 2nd April 2015.

Part of the agreement was that the Council would borrow in full for the settlement payments 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.

Flintshire's settlement payment amounted to £79.2m, and the Council 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.

The agreement will generate revenue savings allowing the Council to increase its investment in existing stock and support the delivery of additional supply of housing.

4.03 Loans with the Public Works Loans Board are in the form of fixed rate (£222.35m) and variable rate (£10m). The remaining £18.95m is variable in the form of Lobo's (Lender's Option, Borrower's Option). The Council's average borrowing rate is currently 5.02%.

| | **Balance 01/04/2015 £m** | **Debt Maturing £m** | **New Debt £m** | **Balance 30/09/2015 £m** |
|---|---|---|---|---|
| **Long Term Borrowing** | 172.1 | 0.00 | 79.2 | 251.3 |
| **TOTAL BORROWING** | **172.1** | **0.00** | **79.2** | **251.3** |
| **Other Long Term Liabilities *** | 7.1 | 0.00 | 0.00 | 7.1 |
| **TOTAL EXTERNAL DEBT** | **179.2** | **0.00** | **0.00** | **258.4** |
| **Increase/ (Decrease) in Borrowing £m** | | | | **79.2** |

4.04 The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and financing.

4.05 No other new long term borrowing has been undertaken so far during 2015/16.

Affordability (interest costs charged on new loans) and the "cost of carry" (costs associated with new loans) remain important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing.

4.06 Loans at Variable Rates

The extent of variable rate borrowing the Council can potentially undertake is influenced by the level of Reserves and Balances. The interest rate on the Council's £10m variable rate loans averaged 0.633%.
The Council has determined that exposure to variable rates is warranted. It also

assists with the affordability and budgetary perspective in the short-to-medium term. Any upward movement in interest rates and interest paid on variable rate debt would be offset by a corresponding increase in interest earned on the Council's variable rate investments. The interest rate risk associated with the Council's strategic exposure of £10m is regularly reviewed with our treasury advisor against clear reference points, this being a narrowing in the gap between short and longer term interest rates by 0.5%. If appropriate, the exposure to variable interest rates will be reduced by switching into fixed rate loans.

4.07 Internal Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the strategy will be 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 3.21%.

The use of internal resources in lieu of borrowing has therefore continued to be the most cost effective means of funding capital expenditure, with a projection for £30m to be utilised for this purpose by the end of 2015/16. This has lowered overall treasury risk by reducing both external debt and temporary investments.

The Council acknowledges that this position is not sustainable over the medium term and borrowing options and the timing of such borrowing continue to be assessed, with current expectations that the Council will need to borrow for capital purposes from 2016/17 onwards.

4.08 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. The option to change the terms on £18.95m of the Council's LOBOs was not exercised by the lender. The Authority acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

4.09 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.

The Corporate Finance Manager, in conjunction with the Council's treasury advisors will continue to review any potential opportunities 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).

## 5.0 INTERIM INVESTMENT AND PERFORMANCE REPORT

5.01 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.

5.02 The maximum investments the Authority had on deposit at any one time totalled £65.4m. The average investment balance for the period was £55.6m and the average rate of return was 0.48%, generating investment income of £133k. The investment income received for the reporting period exceeded the budgeted figure of £65k by £68k.

5.03 Investments have been made with UK banks and building societies up to periods of 12 months, as well as utilising investment opportunities afforded by money market funds, instant access accounts, Debt Management Office, other Local Authorities and other financial instruments such as Certificates of Deposit (CD's).

5.04 The average debt balance held was £251.3m and the average rate paid was 5.02%, generating interest payable of £3.551m in line with budget forecasts (to date).

| | Investments | | Borrowing | |
|---|---|---|---|---|
| | Interest received £'000 | Interest rate % | Interest paid £'000 | Interest rate % |
| Actual | 133 | 0.48 | 3,551 | 5.02 |
| Budget | 65 | 0.65 | 3,579 | 4.53 |
| Difference | +68 | - | -28 | - |

Year end projections are as follows:

| | Investments | | Borrowing | |
|---|---|---|---|---|
| | Interest received £'000 | Interest rate % | Interest paid £'000 | Interest rate % |
| Actual | 200 | 0.5 | 12,597 | 5.02 |
| Budget | 130 | 0.65 | 12,600 | 4.53 |
| Difference | +70 | - | +3 | - |

5.06 *Credit Risk (security)*

Counterparty credit quality was assessed and monitored 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; any potential support mechanisms and share price. The minimum counterparty credit rating outlined in the 2014/15 Treasury Management Strategy was A-/A3/A- across rating agencies Fitch, S&P and Moody's.

*Counterparty Update (provided by Arlingclose Ltd)*

All three credit ratings agencies have reviewed their ratings in the six months to reflect the loss of government support for most financial institutions and the potential for varying loss given defaults as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions have seen 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) to BBB+ from A, Deutsche Bank to A from A+, Bank Nederlandse Gemeeten to AA+ from AAA and ING to A from A+. 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-Thueringen.

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

At the end of July, the council's treasury advisors 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.

5.07 *Liquidity*

In keeping with the WAG's Government's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds and call accounts.

5.08 *Yield*

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The Council's investment yield is outlined in 5.02.

## 7.00 COMPLIANCE

7.01 The Council can confirm that it has complied with its Prudential Indicators for the period April to September 2015. These were approved on 17th February 2015 as part of the Council's 2015/16 Treasury Management Strategy.

7.02 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 the period April – September 2015. 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.

## 8.00 OTHER ITEMS

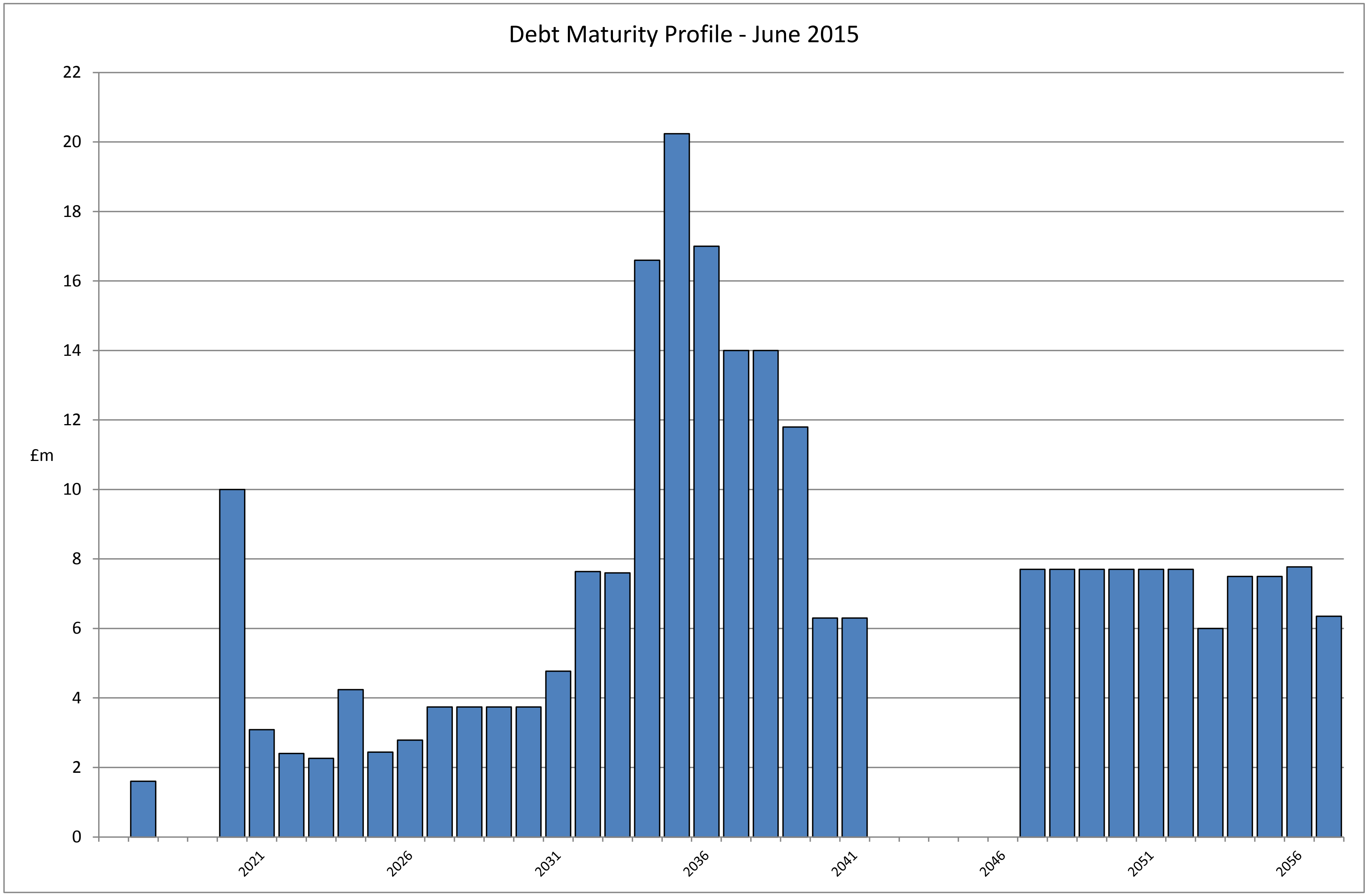
8.01 Other treasury management related activity that took place during April – September 2015 includes:

- The Treasury Management Annual Report 2014/15 was reported to Audit Committee in July. Cabinet and Council reviewed and approved the report in September.
- Quarterly Treasury Management updates were reported to the Audit Committee.
- The Council continues to be a member of the CIPFA Treasury Management Forum and the TM Network Advisory Group.

## 9.00 CONCLUSION

9.01 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 the first half of 2015/16.

9.02 As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.


Debt Maturity Profile - June 2015
£m
22
20
18
16
14
12
10
8
6
4
2
0
2021
2026
2031
2036
2041
2046
2051
2056