Mole Valley District Council

Agenda Item 5

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Ward(s) affected	The annual report covers the whole District

Subject	Treasury Management – Annual Report and Prudential Indicators – 2014/2015

RECOMMENDATIONS

That Audit Committee is asked to recommend to Council;

1. That the Treasury Management Annual Outturn report for 2014/2015 be noted.
2. That the actual Prudential Indicators reported for 2014/2015, as detailed in Appendix A to this report, be approved.

EXECUTIVE SUMMARY

Treasury management is the control and management of all the Council's cash, regardless of its source. It covers management of the daily cash position and investments. The Council has no borrowings. Officers carry out this function within the parameters set by the Council each year in the Treasury Management Strategy Report.

This report reviews the performance of the Prudential Indicators and Treasury Management Strategy and Annual Plan 2014/2015 as agreed by Council on 18th February 2014.

The report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code). The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003. The primary requirements of the Codes are the:

- Creation and maintenance of a Treasury Management Policy Statement (TMPS) that sets out the policies and objectives of the Council's treasury management activities.

- Creation and maintenance of Treasury Management Practices (TMPs) that set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by Council of an annual strategy report for the year, a mid-year treasury update report and a subsequent annual review report (this report) after the end of the financial year.

Changes in recent years in the regulatory environment place a much greater onus on Members' for the review and scrutiny of treasury management policy and activity. This report is important in that respect, as it provides details of the outturn position for treasury management activities and highlights compliance with the Council's policies previously approved by Members.

Council have delegated the responsibilities for implementing and monitoring treasury management policies and practices to the Audit Committee and for the operation and administration of treasury management decisions to the Deputy Chief Executive (Section 151 Officer), who will act in accordance with the organisation's treasury management policy statement and TMP's, and CIPFA's Standard of Professional Practice on Treasury Management.

In summary, the Council's in-house team together with some externally managed funds achieved a rate of return on investments of 1.58%. The Council achieved an overall return of £507,312 in 2014/15 approximately £30,000 above budget. Investment balances at balance sheet dates increased from £25.983m (31/03/14) to £26.615m (31/03/15). The 2014/15 financial year continued the challenging environment of previous years with low investment returns and continuing counterparty risk.

In conducting the treasury management activities of the Council there were no breaches of the agreed Strategy and the in-house team operated within the Prudential Indicators set by Council.

CORPORATE PRIORITIES

This report is an update on the Council's Prudential Indicators and treasury operations as contained in the Treasury Management Strategy for 2014/15.

1. BACKGROUND

1.1 Treasury management is defined as:

"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."

1.2 The annual treasury management outturn report for 2014/15 covers:

- The economy and interest rates

- The Council's capital expenditure and financing
- Investment rates
- Borrowing strategy
- Borrowing outturn
- Compliance with Prudential and Treasury Management Indicators (and Appendix B)
- Investment strategy
- Investment outturn
- Debt rescheduling
- Other issues

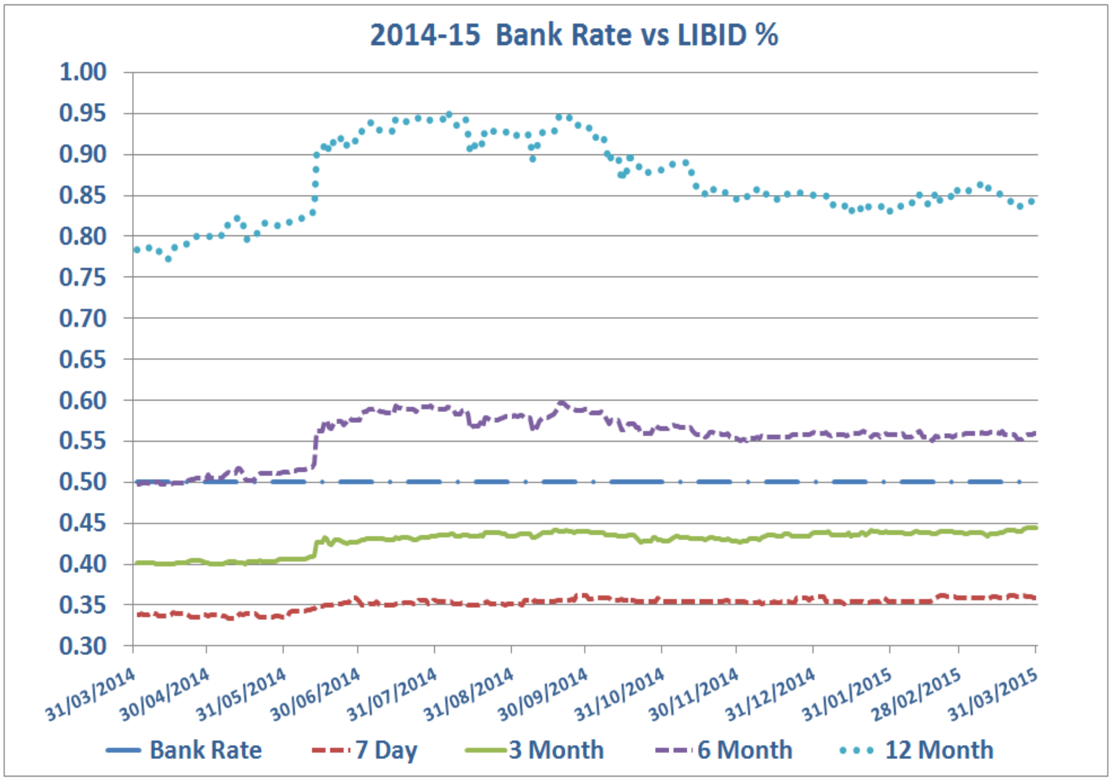
2. The economy and interest rates in 2014/15

The original market expectation at the beginning of 2014/15 was for the first increase in Bank Rate to occur in quarter 1 of 2015 as the unemployment rate had fallen much faster than expected through the Bank of England's initial forward guidance target of 7%. In May, however, the Bank revised its forward guidance. A combination of very weak pay rises and inflation above the rate of pay rises meant that consumer disposable income was still being eroded and in August the Bank halved its forecast for 'pay' inflation in 2014 from 2.5% to 1.25%. Expectations for the first increase in Bank Rate therefore started to recede as growth was still heavily dependent on buoyant consumer demand. During the second half of 2014 financial markets were caught out by a halving of the oil price and the collapse of the peg between the Swiss franc and the euro. Fears also increased considerably that the European Central Bank (ECB) was going to do too little too late to ward off the threat of deflation and recession in the Eurozone. In mid-October, financial markets had a major panic for about a week. By the end of 2014, it was clear that inflation in the UK was going to head towards zero in 2015 and possibly even turn negative. In turn, this made it clear that the Monetary Policy Committee (MPC) would have great difficulty in starting to raise the Bank Rate in 2015 while inflation was around zero and so market expectations for the first increase receded back to around quarter 3 of 2016.

Gilts (long-term fixed income debt security (bond) issued by the UK government. Generally highly rated investments with a low risk but consequent low yield). Yields were on a falling trend for much of the last eight months of 2014/15 but were then pulled in different directions by increasing fears after the anti-austerity parties won power in Greece in January. Developments since then have increased fears that Greece could be heading for an exit from the euro. While the direct effects of this would be manageable by the EU and ECB, it is very hard to quantify quite what the potential knock on effects would be on other countries in the Eurozone (EZ) once the so called impossibility of a country leaving the EZ had been disproved. Another downward pressure on gilt yields was the announcement in January that the ECB would start a major programme of quantitative easing, purchasing EZ government and other debt in March. On the other hand, strong growth in the US caused an increase in confidence that the US was well on the way to making a full recovery from the financial crash and would be the first country to start increasing its central rate, probably by the end of 2015. The UK would be closely following it due to strong growth over both 2013 and 2014 and good prospects for a continuation into 2015 and beyond. However, there was also an increase in concerns around political risk from the general election due in May 2015.

Bank Rate remained at its historic low of 0.5% throughout the year. It has now remained unchanged for six years (since 5th March 2009). Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 2015 but then moved back to around quarter 3 2016 by the end of the year. Deposit rates remained depressed during the whole of the year, primarily due to the effects of the Funding for Lending Scheme.

Bank Rate v London Interbank BID (LIBID) investment rates



3. **Capital Expenditure and Financing 2014/15**

3.1 The Council finances capital expenditure resulting in an increase in long-term assets. These may either be;

- Financed immediately through the application of capital receipts, capital grants or contributions from revenue expenditure, or
- If insufficient financing is available the expenditure will give rise to a borrowing need

3.2 The Council finances capital expenditure out of capital reserves and does not currently have a borrowing need.

3.3 The table below shows how capital expenditure was financed over the past two years. The decrease in actual expenditure over the estimate and subsequent financing was mainly as a result of slippage on minor works projects, dial-a-ride vehicles and play schemes and underspend on Pippbrook House remedial works. Members approved carry forward to 2015/16 of £745,000 capital minor works scheme provision at 21st July Executive meeting.

	2013/14 Actual £000	2014/15 Estimate £000	2014/15 Actual £000
Total capital expenditure	**3,264**	**5,396**	**3,764**
Resourced by :			
Capital receipts	2,047	2,286	2,462
Capital grants	412	270	370
Capital reserves	805	1,138	932
Repairs & Renewals Fund	0	1,702	0
Total Resources Applied	**3,264**	**5,396**	**3,764**

4. **Investment Rates in 2014/15**

4.1 The market interest rates at the start and end of the year are shown below. As can be seen rates have stabilised albeit at historically low levels. The reduction in interest rates, including the effect of the introduction of the Funding for Lending Scheme by the Government, has had a significant bearing on the interest earnings of the Authority on internal investments and will do so moving forward.

Market Rates:

Notice	31/03/13	31/03/14	31/03/15
	%	%	%
Overnight	0.45	0.45	0.45
1 Week	0.48	0.48	0.48
1 Month	0.46	0.46	0.50
3 Months	0.55	0.55	0.60
6 Months	0.70	0.65	0.75
364 Day	0.84	0.90	1.10

5. **Borrowing Strategy for 2014/15**

5.1 The major objectives to be followed in 2014/15 if there had been an underlying borrowing requirement were:

- To forecast average future interest rates and movements in future interest rates
- To secure the cheapest cost for financing capital schemes commensurate with future risk
- To ensure that, where possible, the Council’s debt free status is retained
- To manage the Council’s short-term debt, if any so arises, ensuring prompt payment of interest and principal on the due dates

6. **Borrowing Outturn for 2014/15**

6.1 The Council did not raise any funds through the money market or through the Public Works Loans Board (PWLB), either in the short or long term, during 2014/15. This has been the case since 1987. The Council's last external loan was repaid in February 1997 and Mole Valley became debt free on 1st April 1997.

6.2 Whilst there was no need to borrow in 2014/15 the increased size of the capital programme in 2015/16 means that the Council will be drawing heavily on its reserves. A relatively small increase in capital expenditure may make borrowing a necessity. The position will be closely monitored.

7. **Compliance with Prudential and Treasury Management Indicators**

7.1 During the financial year the Council operated within the Prudential and Treasury Management Indicators 2014/15 – 2016/17 and Treasury Management Strategy and Plan 2014-15 as agreed by Council on 18th February 2014. The outturn for the Prudential and Treasury Management Indicators is detailed in Appendix A of this report.

8. **Investment Strategy for 2014/15**

8.1 The Investment Strategy's primary objectives are safeguarding the re-payment of the principal and interest of its investments on a timely basis first and ensuring adequate liquidity second, with the investment return being the third objective.

8.2 Members will recall that in recent Treasury Management Strategy Reports agreement was given to increased licence in terms of the scope and range of its investments. The change was required as work on the Medium Term Financial Strategy had demonstrated an imbalance between reducing funding sources and increased costs.

8.3 The focus of the revised Strategy remained primarily on safeguarding sufficient of the Council's balances in secure and liquid investments to ensure overall stability. However, it was recommended that between £8m and £12m could be diverted in the interests of securing a higher return and providing a more substantial income stream for the Council's revenue account. This was dependent on the options that became available. These options would include extending the investment portfolio (eg through longer term investments or property funds) and/or diverting part of the investment portfolio into property purchases.

8.4 The Council predominantly manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council primarily invests for a range of periods less than one year dependent on the Council's cash flows, its interest rate view and the rates of interest on offer. The Base Rate remained at 0.50% for the duration of the financial year.

8.5 The expectation for interest rates within the Strategy for 2014/15 anticipated the Bank Rate remaining steady at 0.50%. 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 compared to borrowing rates.

8.6 No institutions in which investments were made during 2014/15 had any difficulty in repaying principal and interest in full during the year.

9. Investment Outturn for 2014/15

9.1 The Council's Investment Policy is governed by Communities and Local Government (CLG) guidance, which has been implemented in the annual investment strategy approved by the Council on 18th February 2014. This Policy sets out the approach for selecting investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data, such as rating outlooks, credit default swaps, bank share prices etc. Counterparties are selected and limits applied using rating criteria. The application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with the CIPFA Treasury Management Code of Practice. Credit rating information is supplied by our treasury management advisor (Capita Asset Services).

9.2 Detailed below is the result of the investment strategy undertaken by the Council.

Internally Managed Funds

9.3 The Council maintained its investment activities during the year, as agreed by Council on 18th February 2014.

9.4 During the year all investments were made in full compliance with the Council's treasury management policies and practices and the Council had no liquidity difficulties.

9.5 The limit to be placed, with each counterparty, remained at £7.5 million. The Council also operated a 'group limit', whereby the collective investment exposure to individual banks within the same banking group was restricted to a group total set also at £7.5 million.

9.6 The analysis below shows the activity undertaken on internally managed funds during 2014/15.

	£
Balance outstanding 01/04/14	25,983,000
Investments made during the year	126,115,000
Upward revaluation of CCLA Property Fund investment (at 31/03/15)	605,000
	152,703,000
Less: Investments maturing during the year	126,088,000
Balance outstanding 31/03/15	26,615,000

9.7 These investments generated interest of approximately £507,000 in the year (£426,000 in 2013/14), gross of all associated charges against a budget of £477,000. The majority of income is received from short-term investments (investments that mature in, or are held for, 12 months or less) but the increase over the budget has been achieved by investing some funds longer-term (investments that are placed for a period longer than 12 months). In particular attractive yields are still being achieved on a 'cap and collar' investment (arrangements where limits are placed on the minimum and maximum coupon rates receivable against a benchmark). Also good returns are being achieved on the investment of £5m that was made in the CCLA Property Fund on 30th June 2013 (refer to paragraph 9.10). There has been no movement in the Base Rate since the 0.50% reduction on 5th March 2009 to the current level of 0.50%.

	Original Estimate 2014/15 £	**Actual Outturn 2014/15 £**	**Variance 2014/15 £**
Internally Managed Funds	477,000	507,312	30,312

9.8 Mole Valley achieved a rate of return of 1.58% on its internally managed funds during the year, this was based on an average fund value of approximately £32,153,000. The formal method used to compare performance is to contrast the rate of return against the average uncompounded 7-day LIBID rate (0.352% for 2014/15). The long-term 'cap and collar' investments previously alluded to have in part enhanced the return on internally managed funds when compared to the benchmark.

9.9 Detailed below is the result of the investment strategy undertaken by the Council.

Funds	**Average Fund Value**	**Rate of Return**	**Benchmark Return ***
Internally / Externally Managed	£32,153,000	1.58%	0.352%

* 7-day LIBID uncompounded 0.352%

The uncompounded rates are for internally managed funds and exclude the roll-up of principal and interest. Upon maturity of the investment, interest is paid over with the original principal sum.

Externally Managed Funds – Churches, Charities and Local Authorities (CCLA)

9.10 On 30th June 2013 the Council invested £5m in the Charities, Churches and Local Authorities (CCLA) Property Fund. To realise the full potential of this investment it should be considered as a medium to long term placement. Income is received quarterly and in the current economic climate good yields are anticipated.

9.11 The Fund offers all of the advantages of a professionally managed property portfolio, with broadly diversified exposure to high quality properties in the strongest areas of the market. The Fund is a high quality, well diversified commercial and industrial property portfolio. There is a focus on delivering attractive income returns and the Fund is actively managed to add value.

9.12 CCLA has been appointed by the Local Authorities' Mutual Investment Trust (LAMIT) to manage and administer the Local Authorities' Property Fund. LAMIT was established around 30 years ago to provide investment services for local authorities in the UK. It is controlled by Members and Officers appointed by the Associations of Local Authorities in the United Kingdom and by Trust Members representing the Funds' unit holders.

9.13 Excellent returns of 5.87% were achieved from this Fund during the year. With the property market remaining buoyant it is anticipated that these returns will continue during 2015/16.

10. **Debt rescheduling**

10.1 The Council did not raise any funds through the money market or through the Public Works Loans Board (PWLB) during the year. The last external loan was repaid in February 1997 and Mole Valley became debt free on 1st April 1997. Therefore, debt rescheduling was not an issue.

11. **Other issues**

11.1 The Treasury Management Strategy Report for 2016/17 to 2018/19 will be presented to the November Audit Committee.

12. **Financial Implications** – are covered in the body of this report.

13. **Legal Implications** - The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity.
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (no restrictions were made in 2014/15).
- The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act.

- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities. The Prudential Code required indicators to be set, some of which are limits, for a minimum of three forthcoming years.
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services.
- Under the Act the DCLG has issued Investment Guidance to structure and regulate the Council's investment activities. Updated guidance became available on 1st April 2010. The emphasis of the Guidance is on the security and liquidity of investments.

The Council has complied with all of the above relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

14. CORPORATE IMPLICATIONS

Monitoring Officer commentary – The Monitoring Officer confirms that all relevant legal implications have been taken into account.

S151 Officer commentary - The S151 Officer confirms that all financial implications have been taken into account.

Risk Implications - The Council considers security, liquidity and yield, in that order, when making investment decisions:

Security – counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swaps, gross domestic product (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 long-term counterparty credit rating determined for 2014/15 was A/A3/A (Fitch/Moody's/Standard and Poors).

Liquidity – the Council maintained a sufficient, though not excessive, level of liquidity during the year using various call accounts and short-term, fixed-rate, deposits.

Yield – the Council sought to optimise returns commensurate with its objectives of security and liquidity. Short-term money market rates remained at very low levels throughout the year which had a significant impact on investment income.

A high reliance on investment income can place the Council at significant risk of budget variation as interest rates rise and fall, which has an impact upon future Council Tax levels. The Council's Medium Term Financial Strategy addresses this risk and seeks to reduce this reliance over time.

Locking significant investments into long-term fixed-rate deals means the Council has a potential disadvantage in a rising interest market, especially if the interest rate rises above the assumption made when the long-term deal was placed.

To mitigate this, the Council's in-house team predominantly invest up to periods of three months only, hence advantage can be taken of prevailing interest rates upon the investments maturity. This minimises the disadvantage whilst maintaining certainty over the level of future return and stability in planned future Council Tax levels. With interest rates remaining at historically low levels the Authority has made some longer term investments that are higher yielding, although less liquid. This has proved to be a good decision as interest rates have remained at low levels throughout the year.

The Council will continue to look to diversify its investment portfolio and the 2015/16 Treasury Management Strategy provides for alternative investment funds should the opportunity arise.

Equalities Implications – There are no equalities implications arising as a direct consequence of this report.

Employment Issues - None within the report.

Sustainability Issues - None within the report.

Consultation – A number of meetings were convened during the year involving Capita Asset Services, Members and Officers.

15. **BACKGROUND PAPERS**

CIPFA Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes (2011 edition).

CIPFA Treasury Management in the Public Services – Guidance Notes for Local Authorities including Police Authorities and Fire Authorities (2011 edition).

CIPFA the Prudential Code for Capital Finance in Local Authorities (2013 edition).

Treasury Management Annual Strategy Report 2014-15 and Prudential Indicators 2014-15 to 2016-17.

Performance management information from Capita Asset Services.

2014/15 final accounts working papers.