POLICY AND RESOURCES SCRUTINY COMMITTEE – 1ST MARCH 2016

SUBJECT: TREASURY MANAGEMENT AND CAPITAL FINANCING PRUDENTIAL INDICATORS QUARTER 3 MONITORING REPORT (1ST APRIL 2015 TO 31ST DECEMBER 2015)

REPORT BY: ACTING DIRECTOR OF CORPORATE SERVICES AND SECTION 151 OFFICER

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1. PURPOSE OF REPORT

1.1 To present Members with details of Treasury Management activities and Capital Financing, together with the related Prudential Indicators for the period 1st April 2015 to 31st December 2015.

1.2 To review the Treasury Management Strategy for 2015/16 as set out in the Annual Investment Strategy and Capital Financing Prudential Indicators Report.

2. SUMMARY

2.1 The Code of Practice on Treasury Management in the Public Services 2009, which was adopted by the Council on 12th October 2010, sets out a framework of operating procedures, which is encompassed in the Treasury Management Practices (TMPs). TMP6 (Reporting Requirements and Management Information Arrangements) provides for the submission of monitoring reports to the appropriate Committee on a quarterly basis.

2.2 Under the provisions of the Local Government Act 2003, The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 [The Capital Regulations], and the CIPFA's "The Prudential Code for Capital Finance in Local Authorities" [the Code], the Authority is obliged to approve and publish a number of indicators relevant to Capital Finance and Treasury Management.

2.3 The Authority's Annual Investment Strategy and Capital Financing Prudential Indicators for 2015/16 were approved by Council on 25th February 2015.

3. LINKS TO STRATEGY

3.1 Treasury Management Strategy 2015/16 as agreed by Council on 25th February 2015.

4. THE REPORT

4.1 Treasury Management

4.1.1 Borrowing Activity

The current policy of internal borrowing is not sustainable in the long-term, but where prudent the policy of internal borrowing will be utilised. As at the 31st March 2015 the internal borrowing position was £8m.

The Annual Treasury Management Strategy approved by Council in February 2015 indicated that there would be a need to borrow £12.3m in 2015/16 to part fund the General Fund Capital Programme. £5.0m of this total would be met through supported borrowing approvals; £4m for Bargoed Cinema; and £3.3m LGBI 21st Century Schools. Since the approval of the Treasury Management Strategy, the Authority will not be borrowing for Bargoed Odeon Cinema as the project has been terminated. A further £75.9m was planned to be borrowed for the HRA Subsidy Buyout as reported to Members on 17th December 2014.

During the period covered by this report a single PWLB loan of £75.9m was raised for the HRA and for the purpose of exiting the Subsidy arrangement. The loan was raised on the 2nd April 2015 at a rate of 4.17% and will be held for 21.6 years. Loan proceeds were transferred to the Welsh Government that resulted in the Authority exiting the Subsidy arrangement. No General Fund borrowing has been undertaken as at 31st December 2015.

Borrowing rates during the reported period have remained volatile and have averaged higher than the forecasted rates as reported in the 2015/16 Treasury Management Strategy, but remain lower than the budget rate. Although Economic recovery in the UK continues to strengthen, falling inflation is considered to be a threat towards UK economic recovery, as well as external global economic activity. Since PWLB rates are priced off UK Gilts, the trend for Gilt yields remain on an upward path in the medium term with continuing concerns about the Eurozone, China and other geo-political events, weighing on risk appetite, while inflation expectations remain subdued. Uncertainty surrounding the timing of UK monetary policy tightening still remains. Falling oil prices and the Chinese stock market led turmoil, are likely to prompt short term volatility in gilt yields as investors sought safe-haven investments.

During the period covered by this report, PWLB loans to the value of £5.0m were repaid on maturity. Such loans had an average interest rate of 4.61%. £30k of the WRU Loan was also repaid. Total debt outstanding as at 31st December 2015 was £288.9m and comprised of £248.7m PWLB loans; £40m market loans (LOBOs); and £240k WRU loan.

The Authority holds four LOBO (Lender’s Option Borrower’s Option) loans with a total value of £40m. Two of the four loans have a six monthly interest rate review option. With respect to all four LOBO loans the lender has the option to increase 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. £20m of these LOBOs had options reviewed during quarter three, none of which were exercised by the lender. As at 31st December a further £10m LOBO loan has an option that will be reviewed by the lender during the remainder of 2015/16 financial year. This represents 3.5% of the Authority’s debt portfolio that is subjected to variable interest rate movement, which is within the Council’s determination of 30%. 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.

4.1.2 Rescheduling

The Annual Strategy allows for the utilisation of debt rescheduling providing for both in year and future year savings and additional revenue resources. No rescheduling opportunities presented themselves during the period covered by this report.

4.1.3 Long-Term Investments

During the reported period the Authority was holding £27.6m of long-term investments where the maturity date is greater than 365 days. These investments are in accordance with the new Investment Strategy. The long-term investments comprise of covered bonds with UK banks/ building societies and have an AAA rating. The covered bonds are secured investments and collateralised against the counterparty's assets.

4.1.4 Short-Term Investments (Deposits) – Up to 364 Days

The value of investments as at 31st December 2015 was £122.7m and is made up of a spread of periods up to 2.5 years. The average rate for these deposits was 0.62%, which is a significant improvement over placing deposits with the Debt Management Office (DMO) who continue to pay a rate of 0.25%. The rate of return is above the target rate, as detailed in the Annual Treasury Management Strategy report to Council, of 0.25%. The improvement in returns reflect the Authority's change in investment strategy and lending to high creditworthy counterparties that consist of banks; building societies; supranational institutions; the DMO, local authorities; and corporates using a range of investment instruments such as corporate bonds; covered bonds; cash deposits and treasury bills. Whilst the returns have improved, the riskiness of the investment portfolio has been quantified with a weighted average credit score equivalent to an AA rating. The UK government is currently rated by two credit rating agencies at AA+. Therefore the Authority's portfolio is one notch below the UK Government rating.

The portfolio as at 31st December 2015 comprised of the following types of investments:

Counterparty	Investment Product	Sector	£m
Banks	Call Accounts	Financial	5.0
Banks	Certificate of Deposits	Financial	15.0
Banks & building societies	Fixed-term cash deposits	Financial	20.6
Banks & building societies	Covered bonds	Financial	13.4
Corporates	Bonds	Transport Infrastructure/ Banks	16.1
Debt Management Office	Fixed-term cash deposits	UK Government	4.5
Local Authorities	Fixed-term cash deposits	Public sector	20.9
Supranational Institutions	Bonds	Sovereign/ Financial	10.1
UK Government	Treasury Bills	UK Government	17.1
Total Investments as at 31st December 2015			122.7

4.1.5 Economic Outlook

The UK economy had a solid 2015 with overall growth estimated to be around 2.5%. The labour market was also strong. Data released in December for the period to October 2015, showed employment the highest at 73.9% and unemployment at 5.2% the lowest it had been since 2006. As a result, wage growth was generally strong over the year. Consumer price inflation was very low over the second half of 2015. Stronger wage growth and low inflation allowed real earnings to grow at the fastest rate in eight years.

With respect to the Bank Rate, the general consensus was that the Bank of England's Monetary Policy Committee would look to raise interest rates in early 2016. However a number of factors have pushed back the expectation of a rate rise to quarter 3 or quarter 4 of 2016, with further potential increases in 2017. The delay in interest rate rise is due to low inflation, (having dipped below zero earlier in 2015); the collapse in oil prices and the slowdown in the Chinese economy.

In the US, the Federal Reserve raised interest rates in December 2015 for the first time in nine years due to continuing tightening of the labour market, the solid improvement in economic household spending and business fixed investment and a strong housing sector. The consensus is that there will be four interest rate rises in the US throughout 2016. During 2015, the US dollar appreciated by 8%, leading to lower import prices driving down inflation. Uncertainty may creep back into the US economy leading up to the 2016 presidential elections until a new president is elected.

In the Eurozone, the ECB extended their asset purchase programme by 6 months to March 2017. Overall, the Eurozone economic activity was stronger over 2015 and there was an improvement in the unemployment rate. Eurozone CPI inflation fell below zero during 2015.

The slowdown in the Chinese economy became the largest threat to the region and to the prospects for global growth as a whole. The effect of the Chinese authorities' intervention in their currency and equity markets led to further market volatility as a consequence. As the global economy entered 2016, there was a high uncertainty about growth, the outcome of the US presidential election and the consequences of the EU vote whether the UK is to remain in the EU, the timing of which could well likely be summer 2016.

4.1.6 Counterparty Update

All three credit ratings agencies have reviewed their ratings in the past 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.

In September 2015, Volkswagen (VW) was found to have been cheating emissions tests over several years in many of their diesel vehicles. This scandal is still playing out and the full extent of the financial implications yet to become clear. The Authority was holding two VW Financial Services corporate bonds with a total nominal value of £3.7m, with a maturity date of May 2016. The authority disposed of its holdings in November 2015 (by way of selling the bonds in the secondary capital markets) and received the nominal investment in full.

4.2 Prudential Indicators

4.2.1 Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose. In accordance with best professional practice, the Authority does not associate borrowing with particular items or types of expenditure. In practice, the raising and repaying of loans is determined primarily by professional / expert advice, and may not necessarily take place in the relevant year. In order to create an operating environment within which the Treasury Manager can legitimately react to appropriate advice, the various authorised limits as identified in Appendix 1 are set at a level in excess of the CFR. In the financial year to date, the Authority has been operating within the approved limits.

Appendix 2 shows a projected CFR value of £342.66m as at 31st March 2016. The actual CFR as at 31st March 2015 was £273.49m. The increase in the projected CFR is due to the HRA Subsidy buyout and treating the cost of buyout as capital expenditure.

4.2.2 Prudential Indicators – "Prudence"

The Prudential Indicators for Treasury Management are shown in Appendix 1 and the Authority is currently operating within the approved limits.

4.2.3 Prudential Indicators – "Affordability"

There is a requirement to analyse and report the capital financing costs, and express those costs as a percentage of the net revenue streams of the Authority. These are identified in Appendix 2 and currently show a projected reduction from the original budget. The reduction in the debt management costs is due to future borrowing rates being revised down, a reduced MRP charge based on the opening 2015/16 CFR being lower than estimated and the HRA being recharged for its fair share of debt costs following the exit from the Subsidy system.

4.2.4 Capital Expenditure and Funding

A summary of capital expenditure and funding is attached at Appendix 3 and shows no change against the planned position.

5. EQUALITIES IMPLICATIONS

5.1 This report is for information purposes, so the Council's Equalities Impact Assessment (EqIA) process does not need to be applied.

6. FINANCIAL IMPLICATIONS

6.1 As detailed throughout the report.

7. PERSONNEL IMPLICATIONS

7.1 There are no direct personnel implications arising from this report.

8. CONSULTATIONS

8.1 There are no consultation responses that have not been reflected in this report.

9. RECOMMENDATIONS

9.1 Members are asked to note the contents of this report.

10. REASONS FOR THE RECOMMENDATIONS

10.1 Compliance with the CIPFA "Code of Practice for Treasury Management in the Public Services".

11. STATUTORY POWER

11.1 Local Government Acts 1972 and 2003.

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Appendices:

Appendix 1 – Treasury Management Prudential Indicators – Prudence
Appendix 2 – Capital Finance Prudential Indicators – Affordability
Appendix 3 – Capital Expenditure and Funding