Kirklees COUNCIL

**Name of meeting:** Council 29 June 2016

Corporate Governance and Audit Committee 17 June 2016

**Title of report:** Annual Report on Treasury Management 2015-16

| | |
|---|---|
| **Is it likely to result in spending or saving £250k or more, or to have a significant effect on two or more electoral wards?** | N/A |
| **Is it in the Council's Forward Plan?** | Yes |
| **Is it eligible for "call in" by Scrutiny?** | No |
| **Date signed off by Director**<br><br>**Is it signed off by the Assistant Director – Legal and Governance?** | David Smith, Director of Resources 12 May 2016<br><br>No legal implications |
| **Cabinet member portfolio** | Resources |

**Electoral wards affected and ward councillors consulted:** All

**Public or private:** **Public**

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## 1. Purpose of report

1.1 Financial Procedure Rules require that the Council receives an annual report on Treasury Management activities for the previous financial year. The report reviews borrowing and investment performance.

## 2. Key points

2.1 Background

2.1.1 The Council has adopted the CIPFA Code of Practice on Treasury Management and operates its treasury management service in compliance with this Code and various statutory requirements. These require that the prime objective of the activity is to secure the effective management of risk, and that borrowing is undertaken on a prudent, affordable and sustainable basis.

2.1.2 Financial Procedure Rules require that the Council receives a report on Treasury Management activities for the previous financial year. Cabinet is responsible for the implementation and monitoring of the treasury management policies. Corporate Governance and Audit Committee undertake a scrutiny role with regard to treasury management.

2.1.3 In reviewing performance, reference will be made to the Treasury Management Strategy Report approved by Council on 27 February 2015.

2.2 Borrowing and Investment Strategy 2015/16

2.2.1 With the continuation of instabilities in the financial markets and fragility of economic activity, the over-riding policy was one of ensuring the security of the Council's balances. The Council chose to invest externally balances of around £30 million, largely for the purpose of managing day-to-day cash flow requirements, with any remaining balances invested "internally", offsetting borrowing requirements. The investment strategy was designed to minimise risk, investments being made primarily in instant access accounts or short-term deposits, with the major British owned banks and building societies, or Money Market Funds.

2.2.2 It was expected that the Council's external borrowing would increase by up to £13.6 million, arising from the need to finance capital expenditure and replace balances used. Short term borrowing rates were forecast to stay low and it was suggested to look for opportunities to take short term loans either at fixed or variable rates. However, with long term rates forecast to rise in the coming years, any such short term savings would need to be balanced against potential longer term costs.

2.3 The economy and interest rates

2.3.1 The UK economy slowed in 2015 with GDP growth falling to 2.3% from a robust 3.0% the year before. The labour market further improved (the unemployment rate of 5.1% was a 12 year low). Inflation continued around 0.0% and wage growth remained modest at around 2.2% excluding bonuses. The slowdown in the Chinese economy has affected global growth and this might be further affected by the outcome of the US presidential election and the UK's EU referendum.

2.3.2 Whilst the Bank of England maintained the Bank Rate at 0.5% (its eighth year at this level), the US increased their rate for the first time in nine years in December but the Eurozone, Switzerland and Japan were forced to move their policy rates into negative territory. Longer term rates have been kept low by uncertainties around growth, the election and referendum results.

2.3.3 At the beginning of each quarter, interest rates for the UK were as follows:

| | | Base rate | 50 year PWLB (maturity)* |
|---|---|---|---|
| 2015 | Apr | 0.5% | 3.11% |

| | | | |
|---|---|---|---|
| | Jul | 0.5% | 3.41% |
| | Oct | 0.5% | 3.18% |
| | Jan | 0.5% | 3.27% |
| 2016 | Apr | 0.5% | 2.95% |

*Includes the 0.20% discount that the Council can access as part of the "certainty rate" scheme.

2.4 Investment activity

2.4.1 The Council's treasury management investments totalled £38.3 million as at 31 March 2016 (£38.7 million 31 March 2015). The Council invested an average balance of £59.0 million externally during the year (£54.8 million 2014/15). Central Government has flattened the payment profile for Revenue Support Grant for 2016/17 onwards, so it expected that the Council will not be as cash rich going forward. Income of £0.264 million was generated through these investments (£0.229 million 2014/15). Appendix 1 shows where investments were held at the beginning of April, the end of September and the end of March, by counterparty, by sector and by country. The Council's average lending rate for the year was 0.45% (0.42% 2014/15), being below the weighted average 7 day London Interbank borrowing rate of 0.49%.

2.4.2 The change in regulations on bank bail-ins has been reflected in movements in credit ratings, along with other factors such as changes in underlying strength. Some institution's ratings have improved whilst others have suffered, notably in terms of the Council's investment activity –

- Coventry Building Society improving its ratings such that it has moved into the Council's specified category, thus increasing potential investment limits (up to £10 million)
- Nottingham and Yorkshire Building Societies improving their ratings such that they moved into the Council's non-specified category, thus increasing potential counterparties (up to £3 million)
- Barclays' ratings falling such that it moved into the Council's non-specified category from specified, thus reducing potential investment limits (down from £10 million to £3 million)

2.5 Borrowing requirement and debt management

2.5.1 In terms of borrowing, long-term loans at the end of the year totalled £408.4 million and short-term loans (excluding interest accrued) £16.0 million (£422.6 million and £21.1 million 31 March 2015). There was no new long-term borrowing taken during the year and repayments are detailed in Appendix 2. Largely because of slippage on the Capital Plan, the level of external borrowing for the year decreased -

| | Actual £m |
|---|---|

| | |
|---|---|
| Decrease in Capital Financing Requirement excluding PFI | -15.1 |
| Increase in net balances | -4.2 |
| Net external borrowing requirement | -19.3 |

2.5.2 Fixed rate loans account for 75% of total long-term debt giving the Council stability in its interest costs. The maturity profile for fixed rate long-term loans is shown in Appendix 3 and shows that no more than 10% of fixed rate debt is due to be repaid in any one year. This is good practice as it reduces the Council's exposure to a substantial borrowing requirement in future years when interest rates might be at a relatively high level.

2.5.3 The primary source of the Council's borrowing is from the Government ie Public Works Loan Board (PWLB). In January 2015, DCLG announced that the PWLB would be abolished and proposals on new arrangements have recently been published. It is likely that Treasury will take over the PWLB's responsibilities and lending arrangements will remain unaffected. The Council also has £106.6 million of LOBO (Lender's Option, Borrower's Option) loans as at 31 March 2016. The lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No options were exercised during the year.

2.5.4 The Local Capital Finance Company established in 2014 by the Local Government Association as an alternative source of local authority finance opened for business in early 2016. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for three reasons: borrowing authorities may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans; there will be a lead time of several months between committing to borrow and knowing the interest rate payable; and up to 5% of the loan proceeds may be withheld from the authority and used to bolster the Agency's capital strength instead. Officers will continue to monitor developments of this new funding source.

2.5.5 In terms of debt rescheduling, the premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling activity.

2.5.6 The average borrowing rate for 2015/16 was 4.95% (5.03% 2014/15). Other than a small amount of borrowing in the first week of the financial year, the Council undertook no further temporary borrowing during the year. The borrowing in April was taken from another local authority at a rate of 0.28%.

2.6 <u>Trends in treasury management activity</u>

2.6.1 Appendix 4 shows the Council's borrowing and investment trends over the last 9 years. The analysis shows that at the onset of the "Credit Crunch" (2008), the Council was externally investing over £100 million, with average investment rates over 5%. From 2009/10 onwards as the banking crisis grew worse and investment rates fell, the Council adopted a policy of holding external investments for cash flow purposes only, initially at around £50 million and then further reduced to £30 million. Any further balances have effectively been "invested internally" to offset new borrowing requirements. It can be seen that the current level of internal investment is £175 million.

2.6.2 The Capital Financing Requirement (CFR) is the authority's underlying need to borrow for a capital purpose. It is funded by external borrowing and balances internally invested. The CFR for both General Fund and HRA has fallen since the end of 2011, the former by £47.6 million and the latter by £50.0 million. The fall on HRA CFR includes £31 million of debt repaid by Central Government in March 2012 as part of the housing finance reforms.

2.7 <u>Revenue Budget Monitoring</u>

2.7.1 The outturn showed an under-spend of £2.5 million on a net spend of £34.2 million. The under-spend was due to savings on principal and interest arising from capital slippage and the full year effect of £10.5 million capital receipt/revenue contribution/capital grant applied to service debt in 2014/15. The unspent budget contributed towards a year end revenue contribution of £6.8 million to fund capital expenditure which will reduce future capital financing costs.

2.8 <u>Risk and Compliance Issues</u>

2.8.1 The Council can confirm that it has complied with its prudential indicators for 2015/16, which were approved as part of the Treasury Management Strategy. Details can be found in Appendix 5. Indicators relating to affordability and prudence are reported in the Capital Outturn report.

2.8.2 There has been some adverse publicity during the year, including a Channel 4 documentary on 6 July, about LOBO (Lender's Option, Borrower's Option) loans, claiming that these loans are offering poor value for money for local authorities. The publicity has resulted in a DCLG Select Committee taking evidence from various areas, including the participants of the documentary. The Council currently has eleven LOBOs with various UK and foreign banks, totalling £105 million. They were all taken between 1997 and 2008, and their average interest rate equates to 4.4% compared to the Council's PWLB loan average interest rate of 5.1%. All the LOBOs are on their original terms – in one case, where a bank proposed to increase an interest rate from 3.36% to 4.20%, the Council decided to immediately repay that loan. The Council has no "inverse floating" LOBOs, of which the Channel 4 documentary was particularly critical.

2.8.3 The Council moved its current account banking arrangements from the Co-Operative to Barclays on 1 July 2015, on an initial five year contract. The service being provided is good and a strong working relationship has been built up with the bank.

2.8.4 On four occasions when the Council has received unexpected monies late in the day, officers have had no alternative but to put the monies into the Barclays Business Reserve Account overnight. This has led to a marginal breach of the investment limit on Barclays on each occasion. Other than those circumstances, the Council has complied with all of the relevant statutory, regulatory and internal requirements which limit the levels of risk associated with its treasury management activities. Officers have adapted investment policies during the year in order to minimise risk in light of changes in counterparty credit ratings and other changes in circumstances. The Council's adoption and implementation of both the Prudential Code and the CIPFA Code of Practice on Treasury Management means that its capital expenditure is prudent, affordable and sustainable.

2.8.5 The Council is aware of the risks of passive management of the treasury portfolio and, with the support of the Council's consultants (Arlingclose), has proactively managed the debt and investments over the year. Arlingclose were re-appointed as the Council's advisors for the next three years from the beginning of February.

2.8.6 The CIPFA Code of Practice requires that treasury management performance be subject to regular member scrutiny. The Corporate Governance and Audit Committee performs this role and members have received reports on strategy, half yearly monitoring and now the outturn for the year 2015/16. Arlingclose provided training to Members on 30 March 2015.

## 3. Implications for the Council

3.1 The effect of the reduced borrowing requirements, additional balances and the continuation of lower interest rates will be reflected in revenue budget monitoring reports during the year.

## 4. Consultees and their opinions

None.

## 5. Next steps

Report submitted to Council.

## 6. Officer recommendations and reasons

Members are asked to note the review of treasury management activity for 2015/16.

## 7. Cabinet portfolio holder recommendation

The report be received and noted by Council.

## 8. Contact officer and relevant papers

Tim Mitchell 01484 221000
Finance Manager

CIPFA's Code of Practice on Treasury Management in the Public Services.
CIPFA's Prudential Code for Capital Finance in Local Authorities.
Public Works Loan Board Website.

## 9. Assistant Director responsible

Debbie Hogg 01484 221000

**APPENDIX 1**

| Kirklees Council Investments 2015-16 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Credit | 1 April 2015 | | | 30 September 2015 | | | 31 March 2016 | | |
| **Counterparty** | | **Rating Mar 2016*** | **£m** | **Interest Rate** | **Type of Investment** | **£m** | **Interest Rate** | **Type of Investment** | **£m** | **Interest Rate** | **Type of Investment** |
| **Specified Investments** | | | | | | | | | | | |
| LB Merton | Local Govt | | 3.2 | 0.40% | 1 mth fixed | | | | | | |
| Nationwide | Bldg Soc | F1/A | 6.5 | 0.43% | 1 mth fixed | 8.0 | 0.43% | 1 mth fixed x 3 | | | |
| Bank of Scotland | Bank | F1/A+ | | | | 2.0 | 0.40% | Instant Access | | | |
| Handelsbanken | Bank | F1+/AA- | 9.0 | 0.45% | Instant Access | 5.0 | 0.45% | Instant Access | 2.9 | 0.45% | Instant Access |
| Std Life (Ignis) | MMF** | AAAmmf | 10.0 | 0.47% | MMF-Instant | 7.6 | 0.49% | MMF-Instant Acc | 7.5 | 0.50% | MMF-Instant |
| Aviva | MMF** | Aaa-mf | 5.0 | 0.39% | MMF-Instant | 7.6 | 0.46% | MMF-Instant Acc | 7.3 | 0.48% | MMF-Instant |
| Aviva - Govt | MMF** | Aaa-mf | | | | 10.0 | 0.39% | MMF-Instant Acc | | | |
| Deutsche | MMF** | AAAmmf | | | | 7.5 | 0.45% | MMF-Instant Acc | 6.7 | 0.46% | MMF-Instant |
| Goldman Sachs | MMF** | AAAmmf | 5.0 | 0.41% | MMF-Instant | 7.1 | 0.45% | MMF-Instant Acc | 6.0 | 0.44% | MMF-Instant |
| Coventry | Bldg Soc | F1/A | | | | 4.7 | 0.41% | 1 mth fixed x 2 | | | |
| Santander UK | Bank | F1/A | | | | | | | 5.0 | 0.65% | 31 day notice |
| **Non-specified investments** | | | | | | | | | | | |
| Barclays | Bank | F1/A | | | | 2.9 | 0.10%+0.40% | Instant Access | 2.9 | 0.10%+0.40% | Instant Access |
| Nottingham | Bldg Soc | P2/Baa1 | | | | 3.0 | 0.40% | 1 mth fixed | | | |
| | | | **38.7** | | | **65.4** | | | **38.3** | | |
| **Sector analysis** | | | | | | | | | | | |
| Bank | | | 9.0 | 23 | | 9.9 | 15 | | 10.8 | 28 | |
| Building Society | | | 6.5 | 17 | | 15.7 | 24 | | | | |
| MMF** | | | 20.0 | 52 | | 39.8 | 61 | | 27.5 | 72 | |
| Local Authorities/Cent Govt | | | 3.2 | 8 | | | | | | | |
| | | | **38.7** | 100 | | **65.4** | 100 | | **38.3** | 100 | |
| **Country analysis** | | | | | | | | | | | |
| UK | | | 9.7 | 25 | | 20.6 | 31 | | 7.9 | 21 | |
| Sweden | | | 9 | 23 | | 5.0 | 8 | | 2.9 | 7 | |
| MMF** | | | 20 | 52 | | 39.8 | 61 | | 27.5 | 72 | |
| | | | **38.7** | 100 | | **65.4** | 100 | | **38.3** | 100 | |

*Fitch short/long term ratings, except Aviva MMF (highest Moody rating). See next page for key. ** MMF – Money Market Fund. These funds are domiciled in Ireland for tax reasons, but the funds are made up of numerous diverse investments with highly rated banks and other institutions. The credit risk is therefore spread over numerous countries, including the UK. The exception to this is the Aviva Government Liquidity Fund which invests directly in UK government securities and in short-term deposits secured on those securities.

**<u>Key – Fitch's credit ratings</u>:**

| | | **Long** | **Short** |
|---|---|---|---|
| Investment Grade | Extremely Strong | AAA | |
| | | AA+ | |
| | Very Strong | AA | F1+ |
| | | AA- | |
| | | A+ | |
| | Strong | A | F1 |
| | | A- | |
| | | BBB+ | F2 |
| | Adequate | BBB | |
| | | BBB- | F3 |
| Speculative Grade | | BB+ | |
| | Speculative | BB | |
| | | BB- | |
| | | B+ | B |
| | Very Speculative | B | |
| | | B- | |
| | | CCC+ | |
| | | CCC | |
| | Vulnerable | CCC- | C |
| | | CC | |
| | | C | |
| | Defaulting | D | D |

**Appendix 2**

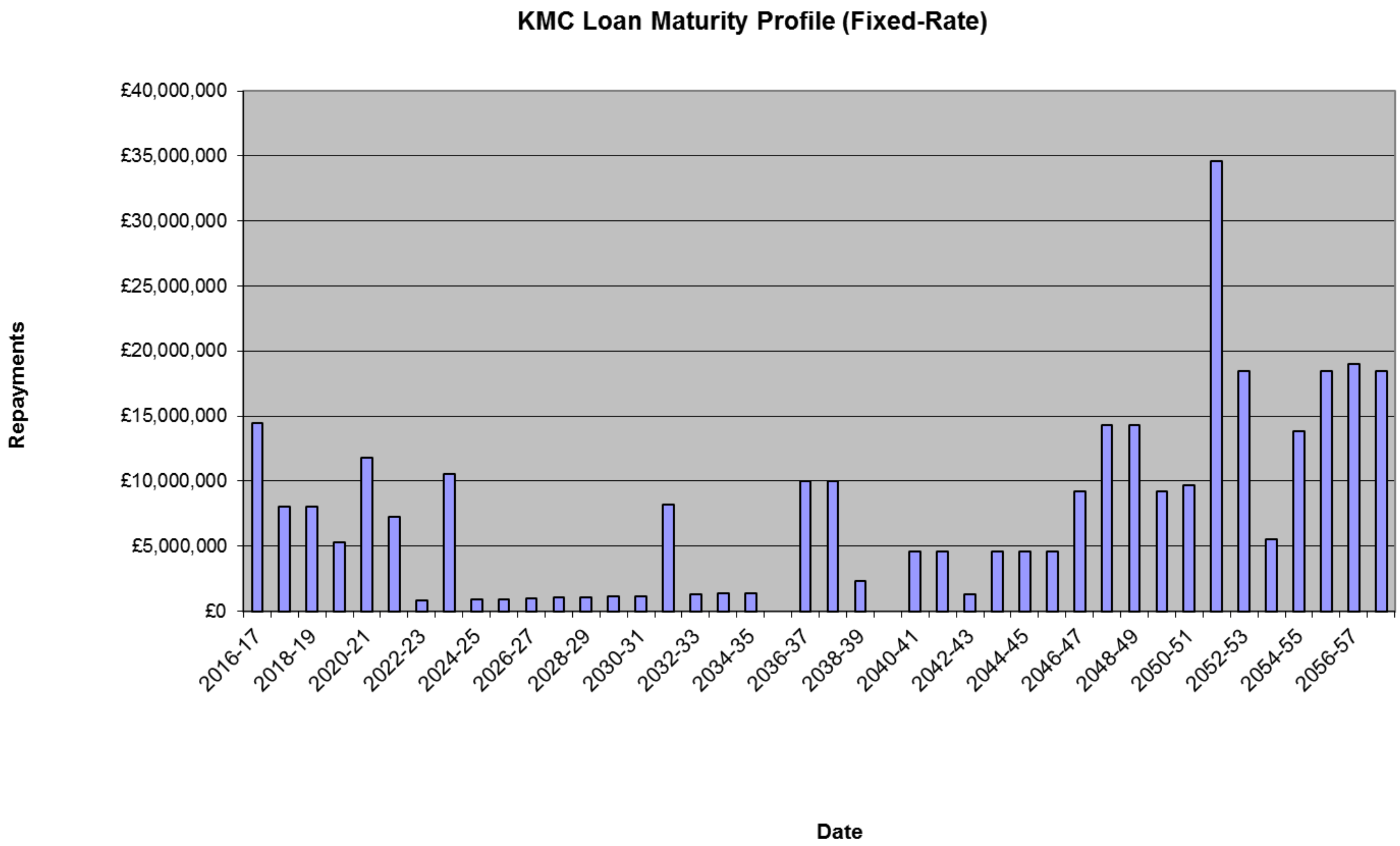
MOVEMENT IN PWLB BORROWING

LOANS REPAID 2015/16

| | Rate % | Date repaid | Amount £000s |
|---|---|---|---|
| **Repayments on maturity** | | | |
| PWLB (467195) | 9.25 | 7 Aug 15 | 9,225 |
| | | | |
| **Repayments on annuity loans** | | | |
| PWLB (496956)* | 4.58 | 29 Sep 15 | 294 |
| PWLB (496956)* | 4.58 | 29 Mar 16 | 301 |
| | | | |
| **Total** | | | |

* represents loan extended to Kirklees College, for which the College is making similar repayments to the Council

Appendix 3


KMC Loan Maturity Profile (Fixed-Rate)
Repayments
£40,000,000
£35,000,000
£30,000,000
£25,000,000
£20,000,000
£15,000,000
£10,000,000
£5,000,000
£0
2016-17
2018-19
2020-21
2022-23
2024-25
2026-27
2028-29
2030-31
2032-33
2034-35
2036-37
2038-39
2040-41
2042-43
2044-45
2046-47
2048-49
2050-51
2052-53
2054-55
2056-57
Date

**Appendix 4**

**Kirklees Council - Borrowing and Investment Trends**

| At 31 March | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|---|---|---|---|
| Investments | 38.3m | 38.7m | 33.1m | 30.2m | 19.3m | 42.7m | 38.7m | 102.1m | 134.8m |
| ST Borrowing (excl interest accrued) | 16.0m | 21.1m | 29.6m | 27.3m | 30.6m | 33.2m | 18.6m | 9.1m | 1.8m |
| LT Borrowing | 408.4m | 422.6m | 432.4m | 452.1m | 471.5m | 527.1m | 525.1m | 528.4m | 553.4m |
| Total Borrowing | 424.4m | 443.7m | 462.0m | 479.4m | 502.1m | 560.3m | 543.1m | 537.5m | 555.2m |
| Deferred liabilities (non PFI) | 4.3m | 4.4m | 4.5m | 4.7m | 4.8m | 5.0m | 5.1m | 5.2m | 5.3m |
| **Net debt position** | **390.4m** | **409.4m** | **433.4m** | **453.9m** | **487.6m** | **522.6m** | **509.5m** | **440.6m** | **425.7m** |
| Capital Financing Requirement (excl PFI) | | | | | | | | | |
| General Fund | 411.3m | 422.2m | 447.5m | 448.5m | 458.6m | 458.9m | 435.9m | 369.5m | 327.8m |
| HRA | 192.4m | 196.6m | 203.3m | 209.3m | 215.6m | 242.4m | 241.0m | 241.0m | 241.0m |
| **Total CFR** | **603.7m** | **618.8m** | **650.8m** | **657.8m** | **674.2m** | **701.3m** | **676.9m** | **610.5m** | **568.8m** |
| Balances “internally invested” | 175.0m | 170.7m | 184.3m | 173.7m | 167.3m | 136.0m | 128.7m | 67.8m | 8.3m |
| Ave Kirklees’ investment rate for financial year | 0.4% | 0.4% | 0.4% | 0.5% | 0.6% | 0.8% | 1.5% | 5.2% | 5.9% |
| Ave Base rate | 0.5% | 0.5% | 0.5% | 0.5% | 0.5% | 0.5% | 0.5% | 0.5% | 5.25% |
| Ave LT Borrowing rate | 3.2% | 3.7% | 4.3% | 4.1% | 4.4% | 5.3% | 4.7% | 4.6% | 4.4% |

**APPENDIX 5**

## Treasury Management Prudential Indicators

Interest Rate Exposures

While fixed rate borrowing can contribute significantly to reducing the uncertainty surrounding future interest rate scenarios, the pursuit of optimum performance justifies retaining a degree of flexibility through the use of variable interest rates on at least part of the treasury management portfolio. The Prudential Code requires the setting of upper limits for both variable rate and fixed interest rate exposure:

| | Limit Set 2015-16 | Actual 2015-16 |
|---|---|---|
| Interest at fixed rates as a percentage of net interest payments | 60% - 100% | 78% |
| Interest at variable rates as a percentage of net interest payments | 0% - 40% | 22% |

The interest payments were within the limits set.

Maturity Structure of Borrowing

This indicator is designed to prevent the Council having large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

| Amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate | Limit Set 2014-16 | Actual Levels 2015-16 |
|---|---|---|
| Under 12 months | 0% - 20% | 0% - 5% |
| 12 months to 2 years | 0% - 20% | 2% - 5% |
| 2 years to 5 years | 0% - 60% | 5% - 8% |
| 5 years to 10 years | 0% - 80% | 6% - 10% |
| More than 10 years | 20% - 100% | 78% - 79% |

The limits on the proportion of fixed rate debt were adhered to.

Total principal sums invested for periods longer than 364 days

The Council has not invested any sums longer than 364 days.