City of Westminster

Housing, Finance and Corporate Services Policy and Scrutiny Committee

Date:	**13th June 2016**
Classification:	**General Release**
Title:	**Treasury Outturn Report**
Report of:	**City Treasurer**
Cabinet Member Portfolio:	**Cabinet Member for Finance and Corporate Services**
Wards Involved:	**All**
Policy Context:	**The efficient management of the Council's financial affairs**
Financial Summary:	**Treasury management continues to operate in a challenging environment.**
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1. EXECUTIVE SUMMARY

1.1. This report presents the Council's Annual Treasury Outturn Report for 2015/16 in accordance with the Council's treasury management practices.

1.2. Under Part 1 of the Local Government Act 2003 (the Act), local authorities are required by regulation to have regard to the CIPFA Treasury Management Code (The TM Code) when carrying out their duties. The TM Code recommends that Full Council receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close. The code also recommends that a separate Committee scrutinise the report prior to its submission to Full Council.

1.3. Westminster has adopted the TM Code. The outturn report considers the performance of the treasury management function, the effects of the decisions taken and the transactions executed in the past year, and any circumstances of non-compliance with the organisation's treasury management policy statement and Practices.

1.4. As well as the Act and relevant regulations, authorities are also required to have regard to guidance issued by the Secretary of State and the Chartered Institute of Public Finance and Accountancy (CIPFA); namely:

- Guidance on Local Government Investments
- Guidance on Minimum Revenue Provision
- CIPFA Code of Practice on Treasury Management in the Public Services
- CIPFA Prudential Code for Capital Finance

This report meets the requirements set out in the above guidance.

1.5. The Act also requires Authorities to determine an affordable borrowing limit for the year, which cannot be breached. This report confirms that borrowing remained well within the limit set prior to the start of the financial year.

1.6. There are two aspects of Treasury performance – debt management and cash investments. Debt management relates to the City Council's borrowing and cash investments to the investment of surplus cash balances. This report covers:

- investment activity during 2015/16
- borrowing activity during 2015/16
- the capital expenditure and financing for 2015/16;
- the UK economy and interest rates
- compliance with treasury limits and prudential indicators
- way forward for treasury in 16/17

1.7. The key Prudential Indicators and treasury position is set out as follows:

Prudential Indicator	2014/15 Actual £m	2015/16 Indicator £m	2015/16 Actual £m
Capital Expenditure	**184**	**269**	**124**
Capital Financing Requirement			
General Fund	165	115	209
Housing Revenue Account	276	278	262
Total	**441**	**393**	**471**
Total investments	605	533	629
Total borrowing	283	294	252
Total Net Investment	**322**	**239**	**377**

1.8 Capital expenditure was significantly below the estimate for the year mainly as a result of slippage. The Capital Financing Requirement (CFR) is greater than projected due to reserving capital receipts to offset against future years capital expenditure on short life assets. The net surplus for the authority increased from £322m to £377m over the year; this cash inflow of £55m was predominantly as a result of positive reserve movements and working capital.

This was reflected in the increase in investment balances. Borrowings are lower due to the repayment of principal on maturity.

1.9 Net investment above is substantially higher than that envisaged in the strategy due to reduced capital expenditure and other factors described in paragraph 1.8.

2. KEY MATTERS FOR COMMITTEE'S CONSIDERATION

Committee is asked to note this report.

3. BACKGROUND

3.1. The Council has fully adopted the recommendations in CIPFA's Code of Practice on Treasury Management in the Public Services. Specifically this includes:

- creation of a Treasury Management Policy Statement
- development and maintenance of Treasury Management Practices setting out how the treasury objectives will be met
- production of reports to Council including annual strategy in advance of the start of the year, a mid-year review and an annual review following the year-end
- delegation to City Treasurer of the responsibility for implementation and monitoring the policies and practices as well as the execution and administration of the treasury management decisions

3.2. This report presents the Council's Annual Treasury Report for 2015/16 in accordance with the Council's treasury management practices. This report covers:

- investment activity during 2015/16
- borrowing activity during 2015/16
- capital Expenditure & Financing
- the UK economy and interest rates
- compliance with treasury limits and prudential indicators
- the way forward in 2016/17

4. INVESTMENT ACTIVITY DURING 2015/16

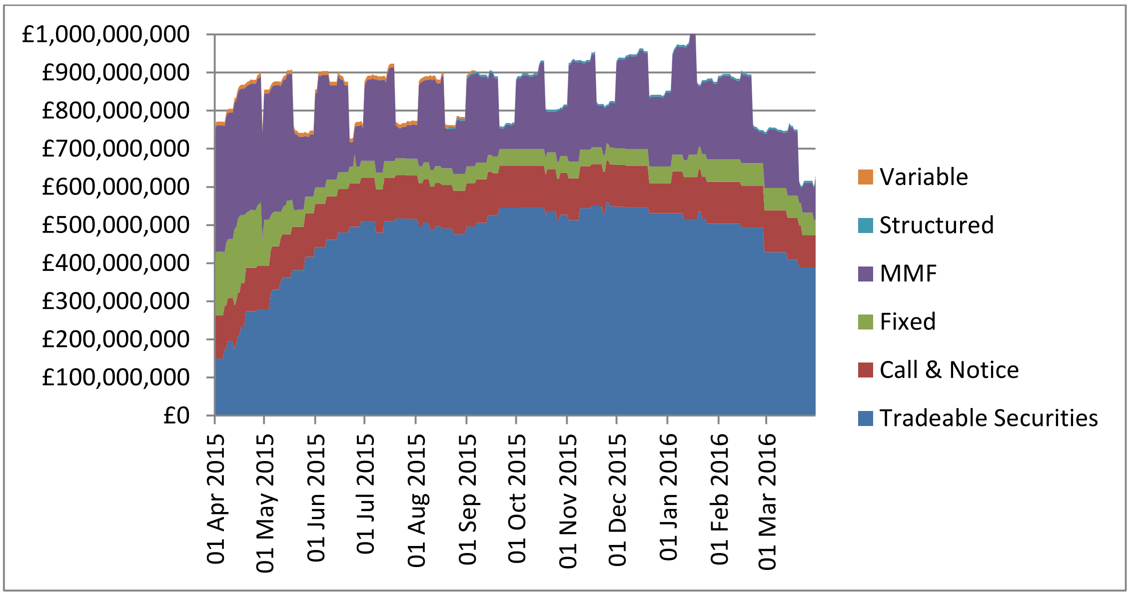
Position at 31st March 2016

4.1. The table below provides a breakdown of the cash deposits, together with comparisons from the previous year. Cash balances increased by £24.5 million over the year. Increased use was made of tradable securities (UK Government treasury bills and other shorted dated bonds) to increase credit quality while maintaining liquidity and yield.

Investment Type	Investment balance 31 March 2015 (£m)	Investment balance 31 March 2016 (£m)	Movement (£m)
Money Market Funds	200.00	79.90	(120.10)
Call Accounts	35.00	6.00	(29.00)
Notice Accounts	78.72	78.91	0.19
Term Deposits	109.70	44.00	(65.70)
Tradable Securities	149.99	388.68	238.69
Enhanced Cash Funds	31.32	31.71	0.39
Total:	**604.73**	**629.20**	**24.47**

Activity During 2015/16

4.2. Total cash balances during 2015/16 varied considerably, predominantly as a result of the significant peaks and troughs arising from the payment profile of business rates collection and rates retention payments to CLG and GLA. The investment balance therefore ranged between £603m and £1.018bn and averaged £848m. The table below indicates the daily composition of investment balances.



4.3. Liquidity was managed through cashflow forecasting and by maintaining sufficient call accounts and money market funds to meet unexpected transactions. At year end there was just one call account balance held with a highly rated European bank (Svenska Handelsbanken) and a further £80m of liquid balances invested in four money market funds. The funds return 0.40% - 0.55% depending on their investment approach (all are rated AAA by at least one, and in most cases two, rating agencies). The average money market balance was £204m over the course of the year, and peaked at £332m.

4.4. There are two notice accounts utilised, where rates are based on LIBOR plus a margin and notice is required for 65 days and 3 months. The balances have remained relatively static throughout the year, although for one of the accounts interest is added to the balance in the account rather than being repaid to the Council.

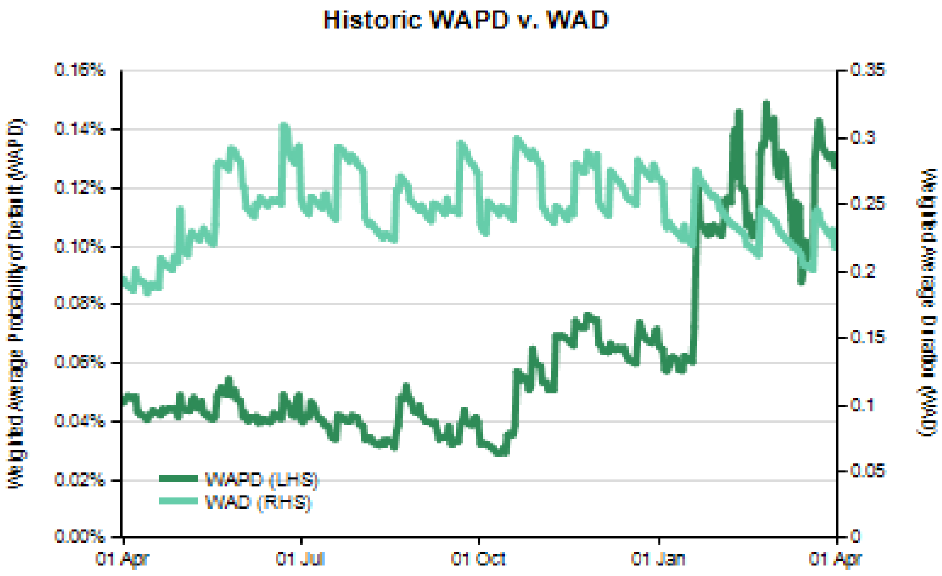
4.5. The term deposits at year-end comprise five fixed term bank deals. The longest duration is a two year deposit with RBS earning 1.1% and maturing August 2017. The remaining deposits are all shorter term fixed rate deals and were raised during 2015/16.

4.6. The Council has been reasonably active in tradable securities during the year, comprising commercial paper issued by Transport for London, Network Rail bonds, Supranational Bank bonds, UK Government issued gilts and treasury bills. The vast majority of these securities have been short dated and purchased on the secondary market (except UK Government treasury bills that are generally purchased on issue) with a few months remaining until maturity. It is the Council's policy to hold these assets to maturity and has no intention of disposing prior to this unless credit quality concerns arise. During 15/16 no securities were sold prior to maturity.

4.7. As at 31st March 2016 the Council had investments in two enhanced cash funds. These funds do not distribute income and instead any gains are accumulated into the unit price. Therefore the returns on the funds are reflected as unrealised gains which only become realised once units are sold. During 2015/16 there were no transactions in these funds.

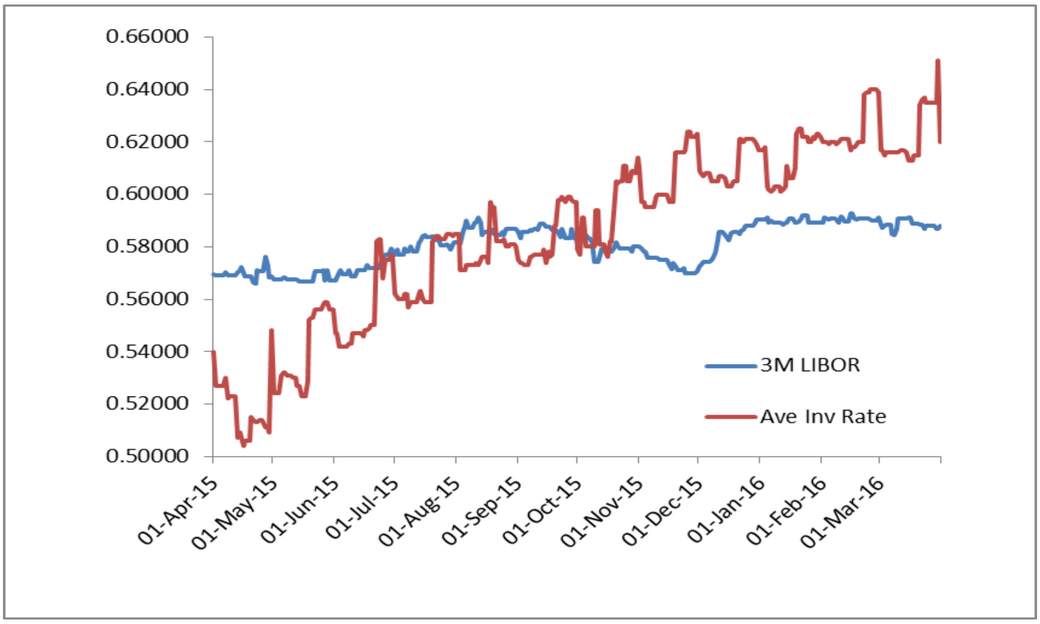
Performance

4.8. All investments entered into by the authority during 2015/16 were fully compliant with the Annual Investment Strategy. The strategy makes clear that the investment priorities are given to security of principal then liquidity over yield. To this extent all investments have only been made with counterparties of high credit quality. The chart below quantifies the credit exposure over the year by calculating the weighted average probability of default (WAPD) for each investment entered into over the course of the year and compares to the weighted average duration (WAD) of the portfolio.



5.9 This chart shows the daily volatility (light blue) in the duration of the portfolio; generally as a result of the large swings in money market fund balances, which effectively have zero duration as a result of the instant liquidity. Over the course of the year the WAD did not materially increase. The credit risk of the portfolio (green line) has spiked at the year-end as global concerns on economic growth and exposures to a slowing China caused bank CDS rates to increase. This is expected to reverse in the current financial year.

5.10 The daily weighted average interest rate of return on the investments over the year is shown in the table below.



5.11 The average yield achieved has increased steadily in the year due to switching from money market funds to term deposits that earn additional interest due to their longer maturity. The rate achieved over the course of the year was in line with the benchmark 3 month LIBOR.

6. BORROWING ACTIVITY DURING 2015/16

Position at 31st March 2016

6.1 The Council operates a two-pool approach to the apportionment of its debt, with each revenue account bearing an appropriate proportion of external debt; reflecting the manner in which historic capital has been incurred. The HRA's gross indebtedness is measured by its Capital Financing Requirement and where the actual level of borrowing falls below this level, this is considered as borrowing from the General Fund in order that each revenue account is appropriately charged with the costs of its indebtedness.

6.2 The table below shows the details around the Council's external borrowing (as at 31 March 2016), split between the General Fund and HRA. This is a gross position not taking into account any internal cross lending.

	31/03/2015 Balance £m	31/03/2016 Balance £m	Average Balance £m	Average Rate
General Fund	26.04	25.48	25.52	4.111%
HRA	257.78	226.05	255.97	4.768%
Total	**283.82**	**251.53**	**281.49**	**4.709%**

6.3 The outstanding loans comprise a combination of PWLB and Market loans, with a very small amount of historic mortgages advanced in the 1960s.

Activity During 2015/16

6.4 Total borrowings decreased by £32.3m as loans matured during the year and no new borrowing was undertaken.

6.5 Whilst opportunities for debt restructuring / repayment continued to be monitored, it was not considered that it was an appropriate opportunity at this stage to pursue this strategy as discount rates were deemed to be very low, and consequently premia considered high.

Performance

6.6 The portfolio average rate reduced slightly from 4.74% as a result of the small value of high coupon loans maturing.

	Average Balance £m	Average Rate
PWLB Loans	211.5	4.586%
Market Loans	70.0	5.08%
Total	**281.5**	**4.709%**

6.7 Market loans are structured as Lender Option Borrower Option (LOBO). The lenders, who are European banks, have the opportunity to increase the rate of interest but if this option is exercised the Council can immediately repay at no additional cost. These loans were advanced between 1984 and 2005 with maturity between 2024 and 2065. The attraction of LOBO loans is that they offered a lower rate of interest than PWLB debt. To date, no lender has exercised an option and if this occurs the default position is to repay using treasury cash balances. There is no intention of using this structure for future borrowing. Opportunities to repay these loans are being investigated. To date, the LOBO loans have reduced interest paid expenses compared with the alternative of PWLB loans of the same term.

Municipal Bond Agency

6.8 Existing debt has been sourced mainly from the Public Works Loan Board, with occasional use of banks when these offered competitive rates. Prior to 2012, PWLB rates were priced at 0.15% over gilts. This was increased to effectively 0.8% (certainty rate) over gilts. Whereas a margin of 0.15% offered little scope for conventionally structured local authority borrowing to be priced below PWLB, a margin of 0.8% could potentially be improved upon.

6.9 A number of local authorities, including Westminster, have sponsored the Municipal Bond Agency with the aim of issuing collective bonds at prices below PWLB rates. The MBA hopes to make its first bond issue in late 2016. The Council is considering whether to participate either in the first or subsequent bond issues. The borrowing terms include a joint and several guarantee of the entire bond issue. The legality and risks associated with this guarantee are being evaluated.

7 CAPITAL EXPENDITURE & FINANCING

Capital Expenditure

7.1 The level and financing decisions of capital spend have a major impact on the treasury management position of the Council. The Council has a number of available sources of financing to apply to capital expenditure and makes decisions based on maximising the available resources.

7.2 The Prudential Code requires indicators to be set in respect of the overall level of Capital Expenditure for the General Fund and Housing Revenue Account. The table below sets out the indicator and the sources of financing used to fund this spend:

	2014/15 Actual £m	**2015/16 Indicator £m**	**2015/16 Actual £m**
General Fund Capital Expenditure	76	90	69
HRA Capital Expenditure	108	179	55
Total Capital Expenditure	**184**	**269**	**124**
Financed by:			
Capital Receipts	9	40	14
Capital Grants	58	88	39
Funded from Revenue	35	31	18
Major Repairs Allowance	17	17	23
Prudential Borrowing	65	93	30

7.3 The underspend on capital is mostly due to delays to HRA projects.

Capital Financing Requirement

7.4 Ultimately all expenditure incurred by the Council has to be resourced in some way. Revenue expenditure must be resourced using revenue sources of finance. Capital expenditure, as shown by the table above, has a number of financing options available. If the Council is able to receive a grant for certain schemes, or charge to a revenue account, by way of example, this has the impact of immediately resourcing that expenditure. However, if these sources are not available, or sufficient to meet the extent of the planned expenditure, then Prudential Borrowing can be undertaken which defers the total resourcing. The amount of historic capital expenditure which has yet to be resourced is measured by the Capital Financing Requirement (CFR).

7.5 Ultimately this resourcing will take place through the Minimum Revenue Provision (MRP) mechanism which requires authorities to make an annual charge to the revenue account over the lifetime of the assets being financed in this way. Guidance issued by the Secretary of State set out recommendations for authorities to follow when determining this provision. The guidance requires authorities to produce an annual MRP policy in advance of the start of the year. The policy for 2015/16 was included within the Treasury Management Strategy report approved by Council in February 2015. The CFR increases each year by the value of capital expenditure met by Prudential Borrowing, and reduces as MRP resources this spend on an annual basis.

7.6 In addition to MRP which reduces the underlying need to borrow over time, authorities can also make additional MRP charges to revenue known as Voluntary MRP or apply capital receipts up to the value of any debt that has been repaid.

7.7 Another component of the CFR is the element relating to other long term liabilities; specifically finance leases and PFI contracts. This element of the CFR is written down each year by the principal elements of the lease repayments.

7.8 One of the key Prudential Indicators relates to the CFR and ensuring that gross borrowing does not exceed the CFR. The Prudential Indicator in respect of the CFR is set out below:

	General Fund £m	Housing Revenue Account £m	Total £m
Adjusted Opening CFR 31/03/2015	**180.18**	**276.40**	**456.58**
Prudential Borrowing in 2015/16	27.90	2.30	30.20
Capital Receipts applied to reduce CFR	(11.23)	(0.70)	(11.93)
Minimum Revenue Provision	(2.69)	-	(2.69)
MRP in respect of Other Long Term Liabilities	(0.90)	-	(0.90)
Closing CFR	**193.26**	**278.00**	**471.26**
Prudential Indicator projected closing position 2015/16	**114.84**	**278.17**	**393.01**

7.9 The increase in the General Fund CFR for 2015/16 is predominantly as a result of capital expenditure financed by Prudential Borrowing during the year.

8 THE ECONOMY AND INTEREST RATES

8.1 Market expectations for the first increase in Bank Rate moved considerably during 2015/16, starting at quarter 3 2015 but soon moving back to quarter 1 2016. However, by the end of the year, market expectations had moved back radically to quarter 2 2018 due to many fears including concerns that China's economic growth could be heading towards a hard landing; the potential destabilisation of some emerging market countries particularly exposed to the Chinese economic slowdown; and the continuation of the collapse in oil prices during 2015 together with continuing Eurozone growth uncertainties.

8.2 These concerns have caused sharp market volatility in equity prices during the year with corresponding impacts on bond prices and bond yields due to safe haven flows. Bank Rate, therefore, remained unchanged at 0.5% for the seventh successive year. Economic growth (GDP) in 2015/16 has been disappointing with growth falling steadily from an annual rate of 2.9% in quarter 1 2015 to 2.1% in quarter 4.

8.3 The sharp volatility in equity markets during the year was also reflected in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back. In addition, a notable trend in the year was that several central banks introduced negative interest rates as a measure to stimulate the creation of credit and hence economic growth.

8.4 The ECB commenced a full blown quantitative easing programme of purchases of Eurozone government and other bonds starting in March at €60bn per month. This put downward pressure on Eurozone bond yields. There was a further increase in this programme of QE in December 2015.

8.5 As for America, the economy has continued to grow healthily on the back of resilient consumer demand. The first increase in the central rate occurred in

December 2015 since when there has been a return to caution as to the speed of further increases due to concerns around the risks to world growth.

8.6 The UK elected a majority Conservative Government in May 2015, removing one potential concern but introducing another due to the promise of a referendum on the UK remaining part of the EU. The government maintained its tight fiscal policy stance but the more recent downturn in expectations for economic growth has made it more difficult to return the public sector net borrowing to a balanced annual position within the period of this parliament.

9 COMPLIANCE WITH TREASURY LIMITS AND PRUDENTIAL INDICATORS

9.1 During the financial year to March 2016, the Council operated within the treasury limits as set out in the TMS. The outturn for the Treasury Management Prudential Indicators are shown below.

External debt indicator	Approved limit (£m)	Maximum Borrowing in year	Days exceeded
Authorised limit[1]	516	285	None
Operational boundary[2]	496	285	None

Maturity structure of borrowing	Lower limit (%)	Upper limit (%)	Actual at 31 March 2016 (%)
Under 12 months	0	40	0.0
1-2 years	0	35	0.0
2-5 years	0	35	18.0
5-10 years	0	50	13.0
10 years and over	35	100	69.0

Upper limits on interest rate exposure	Approved maximum limit	Actual as at 31 March 2016
Borrowing		
Fixed interest rate exposures	100%	72.17%
Variable interest rate exposures[3]	50%	27.83%
Investments		
Fixed interest rate exposures	50%	4.7%
Variable interest rate exposures[4]	100%	95.3%

[1] Authorised limit for external debt is the limit above which external debt must not go without changing Council Policy.
[2] Operational boundary for external debt is the limit against which external debt will be constantly monitored.
[3] Variable interest rate include all debt under 1 year to maturity and LOBOs.
[4] Includes all investments with maturity less than 1 year.

£ million	**Approved maximum limit** **£m**	**Actual as at 31 March 2016** **£m**
Limit on investments for periods over 364 days	300	43.9

10. THE WAY FORWARD

10.1 The Council has a clear ambition to be a leader amongst its peers for effective performance of financial management, including treasury management function. As part of the Tri-Borough team for Treasury & Pensions, there is opportunity to learn from and influence other authorities to constantly improve the service.

10.2 Officers are currently exploring a range of options to improve on the treasury management and related investment strategies to ensure the best use of the available resources. During 2016/17 a report will be presented for Members to consider these future initiatives.

Background Papers

Cabinet Reports