REPORT REFERENCE NO.	**RC/16/1**
MEETING	**RESOURCES COMMITTEE**
DATE OF MEETING	**10 FEBRUARY 2016**
SUBJECT OF REPORT	**TREASURY MANAGEMENT PERFORMANCE 2015-2016 – QUARTER 3**
LEAD OFFICER	**TREASURER**
RECOMMENDATIONS	***That the performance in relation to the treasury management activities of the Authority for 2015-2016 (to December) be noted.***
EXECUTIVE SUMMARY	The Chartered Institute of Public Finance and Accountancy (CIPFA) issued a Code of Practice for Treasury Management. The Code suggests that members should be informed of Treasury Management activities at least twice a year, but preferably quarterly. This report therefore ensures this Authority is embracing Best Practice in accordance with CIPFA's Code of Practice.
RESOURCE IMPLICATIONS	As indicated within the report.
EQUALITY IMPACT ASSESSMENT	An initial assessment has not identified any equality issues emanating from this report.
APPENDICES	Appendix A – Investments held as at 31 December 2015.
LIST OF BACKGROUND PAPERS	Treasury Management Strategy (including Prudential and Treasury Indicators) Report DSFRA/15/3 – as approved at the meeting of the DSFRA meeting held on the 20 February 2015.

1. INTRODUCTION

1.1 The Treasury Management Strategy for Devon and Somerset FRA had been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) 2011 Treasury Management in Public Services Code of Practice (the Code) and the CIPFA Prudential Code. The Authority fully complies with the primary requirements of the Code, which includes:

- The creation and maintenance of a Treasury Management Policy Statement, which sets out the policies and objectives of the Authority's treasury management activities.
- The creation and maintenance of Treasury Management Practices, which set out the manner in which the Authority will seek to achieve those policies and objectives.
- The Receipt by the full Authority of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.
- The delegation by the authority of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

1.2 Treasury management in this context 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. "

1.3 The preparation of this report demonstrates that the Authority is implementing best practice in accordance with the code.

2. ECONOMIC BACKGROUND

<u>Economic performance</u>

2.1 UK Growth Domestic Product (GDP) growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a slight increase in quarter 2 to +0.5% (+2.3% y/y) before falling back to +0.4% (+2.1% y/y) in quarter 3.

2.2 Growth is expected to improve to about +0.6% in quarter 4 but the economy faces headwinds for exporters from the appreciation of Sterling against the Euro and weak growth in the European Union (EU), China and emerging markets, plus the dampening effect of the Government's continuing austerity programme, although the pace of reductions was eased in the November autumn statement.

2.3 Despite these headwinds, the Bank of England November Inflation Report included a forecast for growth over the three years of 2015, 2016 and 2017 to be around 2.7%, 2.5% and 2.6% respectively, although statistics since then would indicate that an actual outturn for 2015 is more likely to be around 2.2%. Nevertheless, this is still moderately strong growth which is being driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that Consumer Prices Index (CPI) inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth.

2.4 The November Bank of England Inflation Report forecast was notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction and Iran expected to soon re-join the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

2.5 There are, therefore, considerable risks around whether inflation will rise in the near future as strongly as previously expected; this will make it more difficult for the Bank of England to make a start on raising Bank Rate as soon as had been expected in early 2015, especially given the subsequent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets during 2015, which could potentially spill over to impact the real economies rather than just financial markets.

2.6 The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015 before easing back to +2.0% in quarter 3. While there had been confident expectations during the summer that the Federal Reserve could start increasing rates at its meeting on 17 September, downbeat news during the summer about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Federal Reserve's decision to pull back from making that start. The nonfarm payrolls figures for September and revised August, issued on 2 October, were also disappointingly weak. However, since then concerns on both the domestic and international scene have abated and so the Federal Reserve made its long anticipated start in raising rates at its December meeting.

2.7 In the Eurozone, the European Commission Bank (ECB) fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it was intended to run initially to September 2016. At the ECB's December meeting, this programme was extended to March 2017 but was not increased in terms of the amount of monthly purchases. The ECB also cut its deposit facility rate by 10bps from -0.2% to -0.3%.

2.8 This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and a start to some improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.3% y/y) but has then eased back to +0.4% (+1.6% y/y) in quarter 2 and to +0.3% (+1.6%) in quarter 3. Financial markets were disappointed by the ECB's lack of more decisive action in December and it is likely that it will need to boost its quantitative easing programme if it is to succeed in significantly improving growth in the European zone and getting inflation up from the current level of around zero to its target of 2%.

Interest Rate Forecasts

2.9 The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Bank rate	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%	2.00%	2.00%
5yr PWLB rate	2.40%	2.60%	2.70%	2.80%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%
10yr PWLB rate	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%
25yr PWLB rate	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.30%	4.30%	4.40%	4.40%	4.40%	4.50%
50yr PWLB rate	3.60%	3.70%	3.80%	3.90%	4.00%	4.00%	4.10%	4.20%	4.20%	4.30%	4.30%	4.30%	4.40%

2.10 Capita Asset Services undertook a review of its interest rate forecasts on 9 November after the August Bank of England Inflation Report. This latest forecast includes no change in the timing of the first increase in Bank Rate as being quarter 2 of 2016. With CPI inflation now likely to be at or near zero for most of 2015 and into early 2016, it is currently very difficult for the Monetary Policy Committee (MPC) to make a start on increasing Bank Rate. In addition, the Inflation Report forecast was also notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon.

2.11 Despite average weekly earnings excluding bonuses hitting 2.5% in quarter 3, this has subsided to 1.9% and is unlikely to provide ammunition for the MPC to take action to raise Bank Rate soon as labour productivity growth would mean that net labour unit costs are still only rising by less than 1% y/y. The significant appreciation of Sterling against the Euro in 2015 has also acted to dampen UK growth while volatility in financial markets since the Inflation Report has resulted in volatility in equity and bond prices and bond yields (and therefore Public Works Loan Board rates). But CPI inflation will start sharply increasing around mid-year 2016, once initial falls in fuel and commodity prices fall out of the 12 month calculation of inflation; this will cause the MPC to take a much keener interest in the forecasts for inflation over their 2-3 year time horizon from about mid-year.

2.12 The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual after they do start. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when average disposable income is only just starting a significant recovery as a result of recent increases in the rate of wage inflation, though some consumers will not have seen that benefit come through for them.

3. TREASURY MANAGEMENT STRATEGY STATEMENT

ANNUAL INVESTMENT STRATEGY

3.1 The Authority's Annual Investment Strategy, which is incorporated in the Treasury Management Strategy Statement (TMSS) was approved by the Authority on the 20th February 2015. It outlines the Authority's investment priorities as follows:

- Security of Capital
- Liquidity

3.2 The Authority will also aim to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep a significant proportion of investments short term to cover short term cash flow needs but also to seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions using the Capita suggested creditworthiness matrices, including Credit Default Swap (CDS) overlay information provided by Capita.

3.3 A full list of investments held as at 31 December 2015 are shown in Appendix A.

3.4 Investment rates available in the market have been broadly stable during the quarter and have continued at historically low levels as a result of the ultra-low.

3.5 The average level of funds available for investment purposes during the quarter was £30.437m (£34.399m in previous quarter). These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

Benchmark	Benchmark Return	Authority Performance	Investment interest to quarter 3
3 Month LIBID	0.45%	0.49%	£90,719

3.6 As illustrated, the authority outperformed the 3 month LIBID benchmark by 0.04bp. It is also forecast that the Authority's budgeted investment target for 2015-2016 of £0.116m will be overachieved.

Opportunities for Higher Investment Returns

3.7 At the meeting held on the 19 November 2015, the Committee requested consideration was given to the diversification of the investment portfolio into higher risk/higher yield instruments, and specifically, to consider investments into Property Funds and Peer-to-Peer Lending.

3.8 Whilst the current Investment Strategy ensures that priority is given to security over yield and it is accepted that this results in investment returns being relatively low, the Authority should be open to new investment opportunities with potentially higher returns. Consideration should be given to the point that any amendment to the Treasury Management Strategy needs to be balanced with the potential change in risk appetite and the possibility of capital losses.

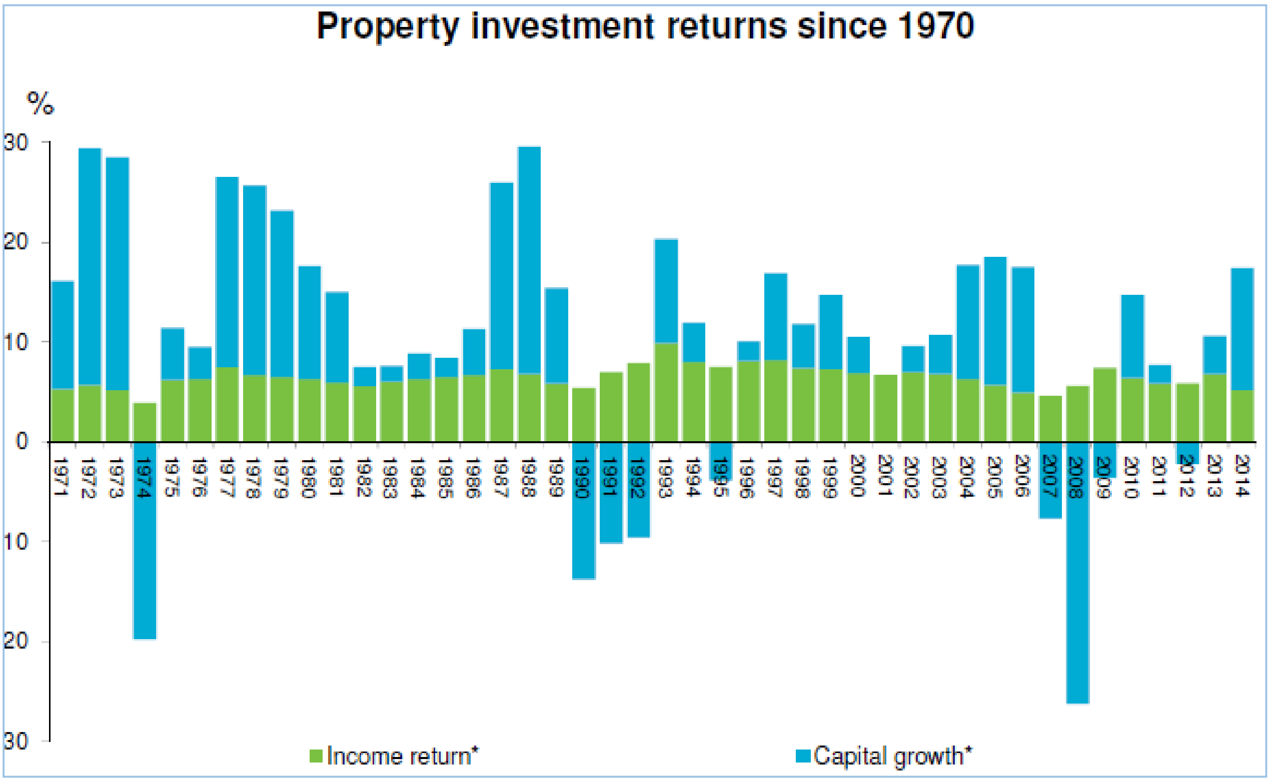
3.9 In response to the request made at the previous meeting, this report sets out below further information in relation to two potential new investment instruments, i.e., Property Funds and Peer-to-Peer lending, including an assessment of the risks associated with each instrument.

Local Authority Property Funds (LAPF)

3.10 Property funds invest in commercial properties and provide returns from income, through rental streams, and from capital growth. The Local Authority Property Funds is managed by CCLA Ltd and is a particular fund operated solely for Local Authority membership which stands at 123 (including parishes) and a total fund size of approximately £300m.

3.11 Income yields tend to be generally consistent between 5% and 10% year on year due to the quality of contracted lease tenants, whilst capital growth tends to deliver higher yields but can be volatile. Performance for 2014 shows a gross return of 16.74%, Chart 1 reports gross returns since 1971.

Chart 1



3.12 Clearly the level of returns in recent years has been significantly higher than the Authority's performance, however, the performance figures also highlight the risk of capital losses e.g. -28.59% in 2008.

3.13 On the negative side, fees and charges associated with the Fund tend to be expensive with an entry fee in the region of 7% and an exit fee of around 1% of the amount invested. CCLA Ltd will also charge an annual management fee of 0.65%.

3.14 It is also important to recognise that this is a long term investment and cannot be classified as a liquid asset. This means that this is only suitable for core cash and recommended for investments of a minimum of 5 years to cover fees and charges and any potential capital loss.

3.15 A summary of risks/benefits is shown in the table below:

Benefits	Risks	Mitigation of Risk
Potential for significant returns.	Potential for capital losses	Long term investment – minimum of 5 years
	High fees and charges	Long term investment – minimum of 5 years
	Not a liquid asset (assets only available once specific property sold).	Amount of Core Cash to be informed from Cash Flow forecasts.

Peer-to-Peer Lending

3.16 Peer-to-peer lending websites work by enabling savers/investors to lend directly to borrowers. Banks are cut out and without their margins participants can get slightly better rate deals than through traditional loan methods.

3.17 As part of the Business Finance Partnership scheme the government has committed £60million of funding to British businesses through the Funding Circle website. Over a dozen Local Authorities are lending through the Funding Circle, predominantly to local businesses. The Funding Circle has to date facilitated over £1bn of loans with over 46,000 live lenders.

3.18 Borrowers are checked and assessed by the website and categorised as to risk (A+ to E). Lenders set their own risk and rate appetite and can select appropriate loans themselves (bespoke lending) or delegate the task to an automated process. This process spreads an investment over a number of loans, the lender taking a share (loan "part") in the overall loan total. It is recommended that an investment is diversified over at least 100 different loan parts to spread the risk of any capital loss through bad loans. It may take some time to lend out a full investment amount and any unlent cash will not attract interest.

3.19 It is accepted that there will be an element of bad debts (ranging from 0.6% for risk category A to 8.0% for category E), however, experience to date has evidenced that this is more than offset by higher returns. The Funding Circle will levy a servicing fee of 1% of outstanding principal deducted from loan repayments.

3.20 The Funding Circle website advertises an expected return of 7.2% after fees and bad debts.

3.21 A summary of risks/benefits is shown in the table below:

Benefits	Risks	Mitigation of Risk
Potential for returns higher than current Authority performance.	Potential for capital losses	Authority can set its own risk appetite and select its own loans. Recommended to spread investment over at least 100 different loan parts to spread the risk.
Liquidity can be achieved through selling of loan parts.	Fees of 1% on outstanding principal.	Experience suggests that fees and charges are offset by higher returns.
	May take some time to lend out full investment and no interest on unlent cash.	Experience suggests that this can be offset by higher overall returns.
	Suitable for medium to long term investments only.	Amount of Core Cash to be informed from Cash Flow forecasts.

BORROWING STRATEGY

Prudential Indicators:

3.22 It is a statutory duty for the Authority to determine and keep under review the "Affordable Borrowing Limits". The Authority's' approved Prudential Indicators (affordability limits) are outlined in the approved TMSS.

3.23 A full list of the approved limits (as amended) are included in the Financial Performance Report 2015-2016, considered elsewhere on the agenda, which confirms that no breaches of the Prudential Indicators were made in the period to December 2015 and that there are no concerns that they will be breached during the financial year.

Current external borrowing

3.24 External borrowing as at 31 December 2015 was £25.817m (£25.880m in previous quarter). All of this debt was at fixed rate with the remaining principal having an average rate/life of 4.231%/30.09 years.

Loan Rescheduling

3.25 No debt rescheduling was undertaken during the quarter. The Authority has carried out some options appraisal work to determine if it there are opportunities to repay existing loans but the current Public Works Loan Board early repayment rates mean there is no benefit in undertaking premature loan repayment. It will be kept under review and further updates will be provided in the quarterly Treasury Management reports.

Borrowing in Advance of Need

3.26 The external borrowing position at the end of the previous financial year of £25.943m exceeded the Capital Financing Requirement of £22.582m, which reflects that borrowing of £3.361m had been taken out in advance of spending. This was as a result of slippage against the 2013-14 and 2014-15 capital programme being more than forecast. As reported to the Authority at its meeting in May 2015, in considering the final Treasury Management Performance Report for 2014-15, this does not represent a breach of prudential indicators, as borrowing is permitted to be above current Capital Financing Requirement as long as future Capital Financing Requirement estimates for current and next two financial years will utilise these loans.

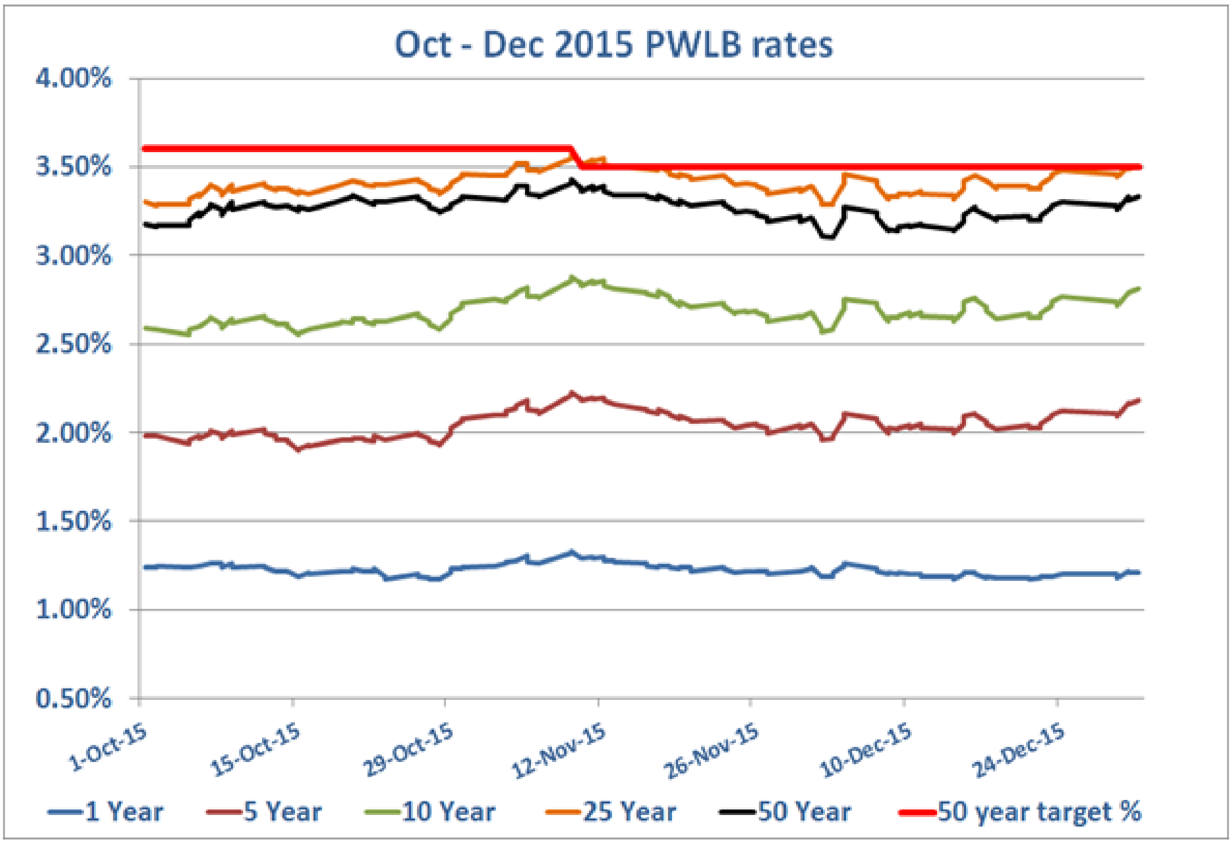
3.27 For the current financial year it is forecast that by 31 March 2016 external borrowing will be £25.817m, which will match the Capital Financing Requirement figure as at the same date. This will mean that there will be no over-borrowing position by the end of the current financial year. .

New Borrowing

3.28 As outlined below, the general trend in Public Works Loan Board rates has been an increase in interest rates during the first quarter followed by a fall during the second quarter: in the third quarter rates have been volatile with no overall direction. The 50 year Public Works Loan Board target (certainty) rate for new long term borrowing, for the quarter ending 31st December, fell slightly during the quarter from 3.60% to 3.50% after the November Bank of England Inflation report.

3.29 No new borrowing was undertaken during the quarter and none is planned during 2015-16. It is anticipated that use of internal borrowing will avoid the need to borrow from the Public Works Loan Board in year; however this will be subject to certainty rates on offer and the delivery of the capital programme.

3.30 Borrowing rates for this quarter are shown below.



3.31 Public Works Loan Board certainty rates for the quarter ended 31 December 2015 are shown below. Devon and Somerset Fire and Rescue Authority is eligible to borrow at certainty rates.

Public Works Loan Board rates quarter ended 31 December 2015

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.17%	1.90%	2.55%	3.28%	3.10%
Date	23/10/2015	15/10/2015	05/10/2015	02/10/2015	03/12/2015
High	1.33%	2.23%	2.88%	3.57%	3.43%
Date	09/11/2015	09/11/2015	09/11/2015	09/11/2015	09/11/2015
Average	1.23%	2.05%	2.69%	3.41%	3.27%

4. SUMMARY

4.1 In compliance with the requirements of the Chartered Institute of Public Financial Accountants (CIPFA) Code of Practice of Treasury Management, this report provides the Committee with the third quarter report of the treasury management activities for 2015-2016 to December 2015. As is indicated in this report, none of the Prudential Indicators have been breached, and a prudent approach has been taken in relation to investment decisions taken so far, with priority being given to liquidity and security over yield. Whilst investment returns are still low as a consequence of the fall in interest rates, the Authority is anticipating that investment returns will over achieve the budgeted target.

KEVIN WOODWARD
Treasurer

APPENDIX A TO REPORT RC/16/1

	Investments as at 31 December 2015				
Counterparty	Maximum to be invested	Total amount invested	Call or Term	Period invested	Interest rate(s)
	£m	£m			
Bank of Scotland	5.000	2.100	T	1 yr	1.000%
		1.400	T	1 yr	1.000%
		1.500	T	1 yr	1.020%
Barclays	8.000	2.500	T	6 mths	0.690%
		3.300	T	6 mths	0.660%
		2.000	T	6 mths	0.700%
		0.700	C	Instant Access	0.200%
Santander	5.000	1.000	T	6 mths	0.600%
		2.000	T	3 mths	0.690%
		2.000	T	6 mths	0.690%
Coventry Building Society	2.000	2.000	T	6 mths	0.600%
Nationwide Building Society	2.000	2.000	T	6 mths	0.660%
Black Rock Money Market Fund	5.000	1.773	C	Instant Access	Variable
Ignis Sterling Liquidity Money Market Fund	5.000	2.837	C	Instant Access	Variable
Total invested as at 31 December 2015		£27.110M			