

## **Appendix A – Economic Summary and Counterparty Update – Provided by Arlingclose**

### **Economic Summary**

**Growth and Inflation:** The UK economy slowed in 2015 with Gross Domestic Product (GDP) growth falling to 2.3% from a robust 3.0% the year before. The annual Consumer Prices Index (CPI) measure of inflation hovered around zero through 2015 with deflationary spells in April, September and October. The prolonged spell of low inflation was attributed to the continued collapse in the price of oil from \$67 a barrel in May 2015 to just under \$28 a barrel in January 2016, the appreciation of sterling since 2013 pushing down import prices and weaker than anticipated wage growth resulting in subdued unit labour costs. The labour market continued to improve through 2015 and in Q1 2016, the latest figures (Jan 2016) showing the employment rate at 74.1% (the highest rate since comparable records began in 1971) and the unemployment rate at a 12 year low of 5.1%. Wage growth has however remained modest at around 2.2% excluding bonuses, but after a long period of negative real wage growth (i.e., after inflation) real earnings were positive and growing at their fastest rate in eight years, boosting consumers' spending power.

**Global influences:** The slowdown in the Chinese economy became the largest threat to the South East region, particularly on economies with a large trade dependency on China and also to prospects for global growth as a whole. The effect of the Chinese authorities' intervention in their currency and equity markets was temporary and led to high market volatility as a consequence. There were falls in prices of equities and risky assets and a widening in corporate credit spreads. As the global economy entered 2016 there was high uncertainty about growth, the outcome of the US presidential election and the consequences of June's referendum on whether the UK is to remain in the EU. Between February and March 2016 sterling had depreciated by around 3%, a significant proportion of the decline reflecting the uncertainty surrounding the referendum result.

**UK Monetary Policy:** The Bank of England's Monetary Policy Committee (MPC) made no change to policy, maintaining the Bank Rate at 0.5% (in March it entered its eighth year at 0.5%) and asset purchases (Quantitative Easing) at £375bn. In its *Inflation Reports* and monthly monetary policy meeting minutes, the Bank was at pains to stress and reiterate that when interest rates do begin to rise they were expected to do so more gradually and to a lower level than in recent cycles.

Improvement in household spending, business fixed investment, a strong housing sector and solid employment gains in the US allowed the Federal Reserve to raise rates in December 2015 for the first time in nine years to take the new Federal funds range to 0.25%-0.50%. Despite signalling four further rate hikes in 2016, the Fed chose not to increase rates further in Q1 and markets pared back expectations to no more than two further hikes this year.

However central bankers in the Eurozone, Switzerland, Sweden and Japan were forced to take policy rates into negative territory. The European Central Bank also announced a range of measures to inject sustained economic recovery and boost domestic inflation which included an increase in asset purchases (Quantitative Easing).

**Market reaction:** From June 2015, gilt yields were driven lower by a weakening in Chinese growth, the knock-on effects of the fall in its stock market, the continuing fall in the price of oil and commodities and acceptance of diminishing effectiveness of central bankers' unconventional policy actions. Added to this was the heightened uncertainty surrounding the outcome of the UK referendum on its continued membership of the EU as well as the US presidential elections which culminated in significant volatility in equities and corporate bond yields.

10-year gilt yields moved from 1.58% on 31/03/2015 to a high of 2.19% in June before falling back and ending the financial year at 1.42%. The pattern for 20-year gilts was similar, the yield rose from 2.15% in March 2015 to a high of 2.71% in June before falling back to 2.14% in March 2016. The FTSE All Share Index fell 7.3% from 3664 to 3395 and the MSCI World Index fell 5.3% from 1741 to 1648 over the 12 months to 31 March 2016.

The movement in rates at which local authorities can borrow from the Public Works Loan Board (PWLB) is set out in the table below.

Period	31 March 2015	31 March 2016
1 year	1.1%	1.1%
3 year	1.5%	1.3%
5 year	1.9%	1.6%
10 year	2.5%	2.3%

The rates above reflect the PWLB's 'Certainty Rate'. The Government after 1<sup>st</sup> November 2012, reduced by 0.2% the interest rates on loans from the PWLB to local authorities who provide information to Government on their plans for long-term borrowing and associated capital spending. The Council has provided the required information and can therefore access this Certainty Rate.

PWLB interest rates have fluctuated during the year. Overall at the year end the rates were generally lower than those at the start of the 2015/16 financial year. This gave support to the Council's strategy of sourcing its borrowing from other local authorities on a short term rolling basis in order to achieve significant revenue cost savings over the more traditional route of borrowing long term from the PWLB.

## **Counterparty Update**

The UK's implementation of the bail-in provisions of the EU Bank Recovery and Resolution Directive in 2015 led to credit rating downgrades for a number of UK banks and Building Societies to reflect the reduced likelihood of Central Government support. A bail-in forces the bank's bondholders and depositors to bear some of the burden by having part of the debt they are owed written off. Despite reductions in Government support, many institutions saw upgrades due to an underlying strength and an assessment that the level of loss given default is low.

Aside from maintaining minimal cash levels for operational purposes, the Council also mitigates the higher risk arising from the introduction of the new bank bail-in provisions by spreading its cash balance across a diversified range of investment counterparties.

Fitch reviewed the credit ratings of multiple institutions in May 2015. Most UK banks had their support rating revised from 1 (denoting an extremely high probability of support) to 5 (denoting external support cannot be relied upon). This resulted in the downgrade of the long-term ratings of Royal Bank of Scotland (RBS), Deutsche Bank, Bank Nederlandse Gemeenten and ING. JP Morgan Chase and the Lloyds Banking Group however both received one notch upgrades.

Moody's concluded its review in June 2015 and upgraded the long-term ratings of Close Brothers, Standard Chartered Bank, ING Bank, Goldman Sachs International, HSBC, RBS, Coventry Building Society, Leeds Building Society, Nationwide Building Society, Svenska Handelsbanken and Landesbank Hessen-Thuringen.

Standard & Poor's (S&P) reviewed UK and German banks in June 2015, downgrading the long-term ratings of Barclays, RBS and Deutsche Bank. S&P also revised the outlook of the UK as a whole to negative from stable, citing concerns around the referendum on EU membership and its effect on the economy.

At the end of July 2015, Arlingclose advised an extension of recommended durations for unsecured investments in certain UK and European institutions following improvements in the global economic situation and the receding threat of another Eurozone crisis. A similar extension was advised for some non-European banks in September 2015, with the Danish Danske Bank being added as a new recommended counterparty and certain non-rated UK building societies also being extended.

In December 2015 the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies which showed that the Royal Bank of Scotland and Standard Chartered Bank were the weakest performers. However, the regulator did not require either bank to submit revised capital plans, since both firms had already improved their ratios over the year.

The first quarter of 2016 was characterised by financial market volatility and a weakening outlook for global economic growth. In March 2016, Arlingclose advised the suspension of Deutsche Bank and Standard Chartered Bank from the counterparty list for unsecured investments. This did not affect the Council, which does not use either of these banks for investment purposes.

## **Appendix B - Borrowing and Investment Activities**

### **The Borrowing Requirement and Debt Management**

The Council's capital expenditure is financed by external funding, revenue contributions or capital receipts. The Council is allowed to borrow to fund any shortfall in financing, provided the level of borrowing is prudent and sustainable. The Council increases its Capital Financing Requirement (CFR) when incurring any capital expenditure which is not financed by grants, contributions, capital receipts or revenue contributions. In addition to paying interest on debt, local authorities are required to set cash aside annually to repay the principal General Fund debt balance by means of a Minimum Revenue Provision (MRP). The borrowing requirement is reduced by the amount of any in-year MRP.

### **Borrowing Activity in 2015/16**

	Balance on 01/04/2015 £m	Debt Maturing £m	New Borrowing £m	Reclassification	Balance on 31/03/2016 £m
<b>CFR</b>	<b>446.9</b>				<b>475.8</b>
Short Term Borrowing <sup>1</sup>	30.4	(30.4)	55.9	6.6	62.5
Long Term Borrowing	282.2			(6.6)	275.6
<b>TOTAL BORROWING</b>	<b>312.6</b>	<b>(30.4)</b>	<b>55.9</b>	<b>0</b>	<b>338.1</b>
Other Long Term Liabilities	16.3	(0.6)			15.7
<b>TOTAL EXTERNAL DEBT</b>	<b>328.9</b>	<b>(31.0)</b>	<b>55.9</b>	<b>0</b>	<b>353.8</b>

The Council's underlying need to borrow, as measured by the Capital Financing Requirement (CFR) as at 31/3/2016, was estimated at £475.8m – up by £28.9m from the previous year.

The Council did not repay any debt prematurely in the 2015/16 financial year, as discount rates made the costs involved unattractive.

The Council's strategy of borrowing from other local authorities on a short term rolling basis assumes that interest rates will continue to remain low for longer than previously envisaged, in line with advice from the Council's treasury advisers, Arlingclose Ltd. However, the Council will continue to monitor long term rates with a view to fixing a portion of its borrowing if rates are favourable.

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<sup>1</sup> Loans with maturities less than 1 year and excludes short term borrowing for cash flow purposes borrowed and repaid in year.

## Internal Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the strategy followed was to minimise debt interest payments without compromising the longer term stability of the portfolio. The differential between the cost of new longer term debt and the return generated on the Council's temporary investment returns was significant, between 2% - 3%. The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding capital expenditure. This has lowered overall treasury risk by reducing temporary investments to minimal operational levels and has limited the extent of increase in external debt. Internal borrowing has been utilised to the full extent and there will be a need to borrow externally for capital purposes during 2016/17 and beyond.

## Lender's Option Borrower's Option Loans (LOBOs)

The CIPFA Treasury Management Code requires the Prudential Indicator relating to Maturity of Fixed Rate Borrowing to reference the maturity of LOBO loans to the earliest date on which the lender can require payment, i.e., the next call date. LOBO loans with a principal of £13.5m are therefore disclosed as reaching maturity in less than 12 months.

## Debt Rescheduling / Restructuring

No debt rescheduling or restructuring was undertaken in 2015/16.

## Investment Activity

CLG's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield.

### Investment Activity in 2015/16

<b>Investments</b>	<b>Balance on 01/04/2015 £m</b>	<b>Investments Made / Capital Appreciation £m</b>	<b>Investments Repaid £m</b>	<b>Balance on 31/03/2016 £m</b>
Short Term Investments (call accounts, deposits)	8.3	116.4	121.4	<b>3.3</b>
Money Market Funds	5.5	285.2	285.7	<b>5.0</b>
Other Pooled Funds	5.0	0.2		<b>5.2</b>
<b>TOTAL INVESTMENTS</b>	<b>18.8</b>	<b>401.8</b>	<b>407.1</b>	<b>13.5</b>

Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2015/16.

Investments during the year included:

- Investments in AAA-rated Money Market Funds;
- BBB-rated UK banks and Building Societies.

### **Credit Risk**

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum counterparty rating of BBB+ or equivalent across rating agencies Fitch, Standard & Poor's and Moody's), share prices, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

### **Liquidity**

In keeping with the CLG's Guidance on Investments, the Council has maintained a sufficient level of liquidity through the use of Money Market Funds/overnight deposits/call accounts.

### **Yield**

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Base Rate was maintained at 0.5% through the year.

The Council considered an appropriate risk management response to uncertain and deteriorating credit conditions in Europe was to shorten maturities for new investments. Short term money market rates also remained at very low levels which had a significant impact on investment income, as investments were placed overnight or for short periods.

The Council's investment income for the year was £0.3m, with the Council's long term investment in the Lime Fund providing some cushioning against the low interest rate environment.

The average cash balance representing the Council's reserves, contributions/grants in advance, and working balances, was £22.1m during the period.

### **Compliance**

To support financial strategic planning and decision making, the Council approves annually a series of Prudential Indicators which are regularly monitored. The Council did not exceed any of the various limits determined by the Treasury Management Strategy and specific Prudential Indicators. Full details of performance in respect of all of the Prudential Indicators for 2015/16 are set out in Appendix C.

In compliance with the requirements of the CIPFA Code of Practice this report provides Members with a summary report of the treasury management activity during 2015/16. The Council can confirm it has taken a prudent approach in relation to investment activity with priority being given to security and liquidity over yield.

The Council can confirm that during 2015/16 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.

### **Other Items**

**Training:** The needs of the Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

During 2015/16 staff attended training courses, seminars and conferences provided by Arlingclose Ltd and CIPFA.



## **Appendix C - Prudential Indicators**

The Local Government Act 2003 requires the Council to have regard to CIPFA's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

### **Capital Financing Requirement (CFR)**

Estimates of the Council's cumulative maximum external borrowing requirement for 2015/16 to 2018/19 are shown in the table below:

	<b>31/03/16 Actual £m</b>	<b>31/03/17 Estimate £m</b>	<b>31/03/18 Estimate £m</b>	<b>31/03/19 Estimate £m</b>
General Fund CFR	310.8	355.9	370.1	385.9
HRA CFR	165.0	165.0	163.5	162.0
<b>Gross CFR</b>	<b>475.8</b>	<b>520.9</b>	<b>533.6</b>	<b>547.9</b>
Less: PFI liabilities	(15.7)	(15.3)	(14.6)	(13.6)
<b>Borrowing CFR</b>	<b>460.1</b>	<b>505.6</b>	<b>519.0</b>	<b>534.3</b>
External borrowing	(338.1)	(395.4)	(408.6)	(432.2)
Internal borrowing:				
- Usable Reserves	(85.6)	(85.2)	(85.4)	(77.1)
- Working capital	(36.4)	(25.0)	(25.0)	(25.0)
<b>Total</b>	<b>(460.1)</b>	<b>(505.6)</b>	<b>(519.0)</b>	<b>(534.3)</b>

The Gross CFR is forecast to rise by £72.1m over the next three years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

## Gross Debt and the Capital Financing Requirement

The Prudential Code states that the Chief Finance Officer should make arrangements for monitoring with respect to gross debt and the Capital Financing Requirement (CFR) such that any deviation is reported, since any such deviation may be significant and should lead to further investigation and action as appropriate.

In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for the current and next two financial years. This is a key indicator of prudence.

The Council has had no difficulty meeting this requirement nor are any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

	<b>31/03/16 Actual £m</b>	<b>31/03/17 Estimate £m</b>	<b>31/03/18 Estimate £m</b>	<b>31/03/19 Estimate £m</b>
Capital Financing Requirement	475.8	520.9	533.6	547.9
Gross Debt	353.8	410.7	423.2	445.8
<b>Difference</b>	<b>122.0</b>	<b>110.2</b>	<b>110.4</b>	<b>102.1</b>
<b>Borrowed in excess of CFR? (Yes/No)</b>	<b>No</b>	<b>No</b>	<b>No</b>	<b>No</b>

## Authorised Limit and Operational Boundary for External Debt

The Authorised Limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. This is a statutory limit which should not be breached. It is the maximum amount of debt that the Council can legally owe. The Authorised Limit provides headroom over and above the Operational Boundary for unusual cash movements.

The Operational Boundary is based on the Council's estimate of most likely, i.e., prudent, but not worst case scenario for external debt. It links directly to the Council's estimates of capital expenditure, the Capital Financing Requirement (CFR) and cash flow requirements, and is a key management tool for in-year monitoring. Other long term liabilities comprise finance leases, Private Finance Initiatives and other liabilities that are not borrowing but form part of the Council's debt.

The Chief Finance Officer confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year.

	<b>Authorised Limit (Approved) 2015/16 £m</b>	<b>Operational Boundary (Approved) 2015/16 £m</b>	<b>Actual External Debt as at 31/03/2016 £m</b>
Borrowing	512.2	502.2	338.1
Other Long-term Liabilities	21.2	18.7	15.7
<b>Total</b>	<b>533.4</b>	<b>520.9</b>	<b>353.8</b>

## Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

- These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.
- The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

	<b>Approved Limits for 2015/16</b>	<b>Maximum during 2015/16</b>
Upper Limit for Fixed Rate Exposure	100%	79%
<b>Compliance with Limits</b>	<b>Yes</b>	<b>Yes</b>
Upper Limit for Variable Rate Exposure	40%	33%
<b>Compliance with Limits</b>	<b>Yes</b>	<b>Yes</b>

## Maturity Structure of Fixed Rate Borrowing

This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

<b>Maturity Structure of Fixed Rate Borrowing</b>	<b>Upper Limit %</b>	<b>Lower Limit %</b>	<b>Actual Fixed Rate Borrowing as at 31/03/2016 %</b>	<b>Compliance with Set Limits?</b>
Under 12 months	30	0	7	<b>Yes</b>
12 months and within 24 months	20	0	0	<b>Yes</b>
24 months and within 5 years	60	0	0	<b>Yes</b>
5 years and within 10 years	100	0	36	<b>Yes</b>
10 years and within 15 years	100	0	35	<b>Yes</b>
15 years and within 20 years	100	0	0	<b>Yes</b>
20 years and above	100	0	22	<b>Yes</b>

(The 2011 revision to the CIPFA Treasury Management Code requires the Prudential Indicator relating to Maturity of Fixed Rate Borrowing to reference the maturity of LOBO loans to the earliest date on which the lender can require payment, i.e., the next call date).

## Capital Expenditure

The Council needs to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council tax and in the case of the HRA, housing rent levels.

The Council's actual and planned capital expenditure and financing can be summarised as follows.

<b>Capital Expenditure and Financing</b>	<b>2015/16 Actual £m</b>	<b>2016/17 Estimate £m</b>	<b>2017/18 Estimate £m</b>	<b>2018/19 Estimate £m</b>
General Fund	95.1	105.4	92.2	68.8
HRA	16.7	11.3	19.3	16.3
<b>Total Expenditure</b>	<b>111.8</b>	<b>116.7</b>	<b>111.5</b>	<b>85.1</b>
Capital receipts	(5.1)	(14.5)	(13.5)	(11.7)
Government Grants	(52.9)	(55.4)	(59.9)	(34.4)
Reserves	(3.9)	(2.2)	(11.5)	(10.1)
Revenue contributions	(12.1)	(5.1)	(2.4)	(2.0)
Minimum Revenue Provision (MRP) / PFI	(8.9)	(8.5)	(10.1)	(10.9)
Borrowing	(28.9)	(31.0)	(14.1)	(16.0)
<b>Total Financing</b>	<b>(111.8)</b>	<b>(116.7)</b>	<b>(111.5)</b>	<b>(85.1)</b>

## Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

<b>Ratio of Financing Costs to Net Revenue Stream</b>	<b>2015/16 Actual %</b>	<b>2016/17 Estimate %</b>	<b>2017/18 Estimate %</b>	<b>2018/19 Estimate %</b>
General Fund	7.9	8.1	9.5	10.5
HRA	13.8	13.8	14.5	15.3

It measures the proportion of the revenue budget that is required to meet the ongoing financing costs of past capital expenditure which was funded from borrowing. Future year estimates incorporate the additional financing costs of planned capital expenditure to be funded from borrowing. It is important that the total capital investment of the Council remains within sustainable limits. However, the level of capital investment that can be supported will be a matter for local decision.

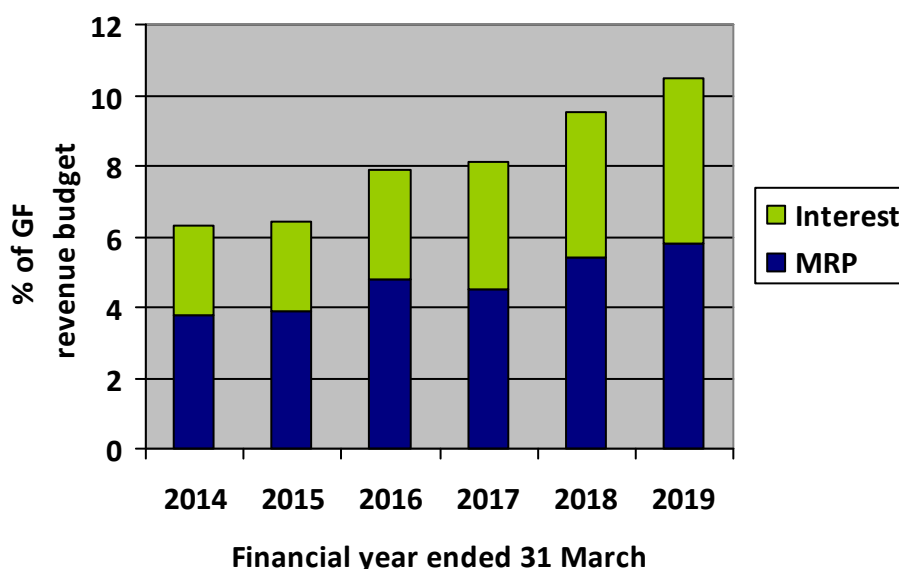
The Prudential Indicators are designed to support and record local decision making in a manner that is publicly accountable. They are not designed to be comparable performance indicators. Nonetheless, it is interesting to note that Central Bedfordshire's Ratio of Financing Costs to Net Revenue Stream (General Fund) is currently broadly consistent with its nearest local authority neighbours:

	<b>2015/16</b>
Milton Keynes	11.2%
Cambridgeshire	9.2%
Luton	8.2%
<b>Central Bedfordshire</b>	<b>7.9%</b>
Northamptonshire	7.1%
Bedford Borough	5.6%
Buckinghamshire	5.5%

\* Comparative figures are based on estimates for 2015/16 sourced from each local authority's treasury management strategy published on the internet.

Central Bedfordshire's ratio is expected to increase relative to its peers given the Council's significant commitment to capital investment over the next few years.

The growing impact of borrowing to fund new capital expenditure is shown below, with Minimum Revenue Provision (MRP) and interest costs taking up an increasingly greater proportion of the Council's net revenue budget over time:



\* 2015/16 includes a Voluntary Revenue Provision of £0.7M within the Minimum Revenue Provision figure

The figures in the chart above are based on the current Medium Term Financial Plan. The Council will need to carefully consider this increasing cost when determining its future plans for capital expenditure.

## Adoption of the CIPFA Treasury Management Code

The Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* in November 2012.

## Upper Limit for Total Principal Sums Invested Over 364 Days

The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested.

Upper limit for total principal sums invested over 364 days	2015/16 Approved Limit £m	2015/16 Actual £m	2016/17 Approved Limit £m	2017/18 Approved Limit £m	2018/19 Approved Limit £m
	10.0	0.0	10.0	10.0	10.0

## Housing Revenue Account (HRA) Debt

The purpose of this limit is to report the level of debt imposed on the Council at the time of the implementation of self-financing by the Department for Communities and Local Government (CLG).

	2015/16 Actual £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
HRA Debt Cap (as prescribed by CLG)	165.0	165.0	165.0	165.0
HRA CFR	165.0	165.0	163.5	162.0
<b>Difference</b>	<b>0.0</b>	<b>0.0</b>	<b>(1.5)</b>	<b>(3.0)</b>

It should be noted that the HRA's Business Plan includes provision for the repayment of debt with effect from 2017/18.