Policy and Scrutiny

**Open Report on behalf of Executive Director of Finance and Public Protection**

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| Report to: | **Value for Money Scrutiny Committee** |
| Date: | **23 June 2015** |
| Subject: | **Treasury Management Annual Report 2014/15** |

**Summary:**

This report has been prepared in accordance with the reporting recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice 2011 and details the results of the Council's treasury management activities for the financial year 2014/15. The report compares this activity to the Treasury Management Strategy for 2014/15, approved by the Executive Councillor for Finance on 25th March 2014. It will also detail any issues arising in treasury management during this period.

**Actions Required:**

That the report be noted and any comments be passed onto the Executive Councillor with responsibilities for Finance.

**1. Background**

1. Introduction

Treasury Management relates to the policies, strategies and processes associated with managing the cash and debt of the Council through appropriate borrowing and lending activity. It includes the effective control of the risks associated with the lending and borrowing activity and the pursuit of optimum performance consistent with the risks.

1.1. This Annual Treasury Report will cover the following positions for the year 2014/15:

- An economic overview and interest rate review.
- Investment outturn and comparison with strategy.
- Annual investment strategy/ authorised lending list changes during the year.
- Borrowing outturn and debt rescheduling activity and comparison with strategy.
- Other treasury issues during 2014/15.

2. <u>Economic Overview and Interest Rate Review 2014/15</u>

2.1. At the time of setting the Strategy in February 2014, the markets were forecasting short-term Bank Rate to remain at 0.50% throughout 2014/15, with an increase not expected until June 2016, later brought forward to March 2015.

2.2. Long term rates were forecast to rise gradually in 2014/15 by only 0.10% or so, remaining at relatively low levels, but remaining volatile and difficult to predict due to external market influences.

2.3. The graph below shows the actual movement of both UK long term and short term interest rates over 2014/15.

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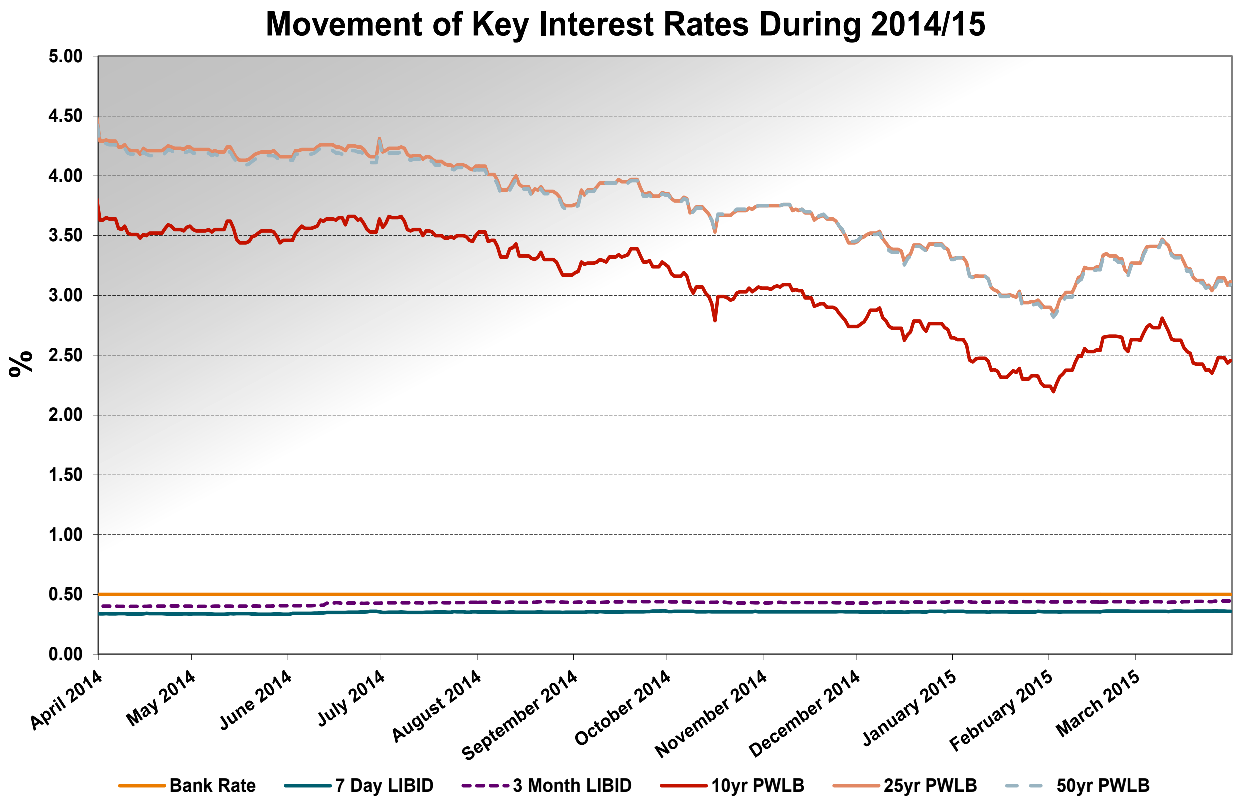


2.4. The graph shows short term rates have remained level as anticipated. Long term rates however started to fall in August and have continued to fall quite significantly ending the year just over 1.00% lower than at the start of the year. This fall has been due to a number of factors, namely concerns over economic and political events worldwide and a fall in oil prices leading to a low inflation environment. Strong growth in the US and the possibility of strong growth in the UK led to an increase in rates from February 2015, but this was reversed again by the announcement by the EU of its quantitative easing programme from March 2015.

2.5. The table below shows the current forecast for interest rates, provided by the Council's treasury advisors Capita Asset Services Ltd in May 2015:

| | NOW | Jun-15 | Sep-15 | Dec-15 | Mar-16 | Jun-16 | Sep-16 | Dec-16 | Mar-17 | Jun-17 | Sep-17 | Dec-17 | Mar-18 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| BANK RATE | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.75 | 0.75 | 1.00 | 1.00 | 1.25 | 1.50 | 1.50 | 1.75 |
| 3 month LIBID | 0.52 | 0.50 | 0.50 | 0.60 | 0.70 | 0.80 | 0.90 | 1.10 | 1.30 | 1.40 | 1.50 | 1.80 | 1.90 |
| 6 month LIBID | 0.66 | 0.70 | 0.70 | 0.80 | 0.90 | 1.00 | 1.10 | 1.30 | 1.50 | 1.60 | 1.70 | 2.00 | 2.10 |
| 12 month LIBID | 0.98 | 1.00 | 1.00 | 1.10 | 1.20 | 1.30 | 1.40 | 1.60 | 1.80 | 1.90 | 2.00 | 2.30 | 2.40 |
| | | | | | | | | | | | | | |
| 5 yr PWLB | 2.10 | 2.20 | 2.30 | 2.40 | 2.50 | 2.60 | 2.80 | 2.90 | 3.00 | 3.10 | 3.20 | 3.30 | 3.40 |
| 10 yr PWLB | 2.80 | 2.80 | 2.90 | 3.00 | 3.20 | 3.30 | 3.40 | 3.50 | 3.70 | 3.80 | 3.90 | 4.00 | 4.10 |
| 25 yr PWLB | 3.40 | 3.50 | 3.60 | 3.70 | 3.80 | 4.00 | 4.10 | 4.20 | 4.30 | 4.40 | 4.40 | 4.50 | 4.60 |
| 50 yr PWLB | 3.40 | 3.50 | 3.60 | 3.70 | 3.80 | 4.00 | 4.10 | 4.20 | 4.30 | 4.40 | 4.40 | 4.50 | 4.60 |

2.6. This forecast from Capita followed the issue of the latest Bank of England Inflation Report in May 2015 and pushes forward the predicted rise in Bank Rate to June 2016. It shows a gradual increase in long term rates by around 1.3% by March 2018. Capita point out that the risks to economic recovery in the UK are currently evenly balanced. Upside and downside risks to this forecast remain as follows:

<u>Upside Risks (of rates being higher than forecast)</u>:

- Uncertainty around the risk of a UK exit from the EU.
- The ECB quantitative easing programme proving insufficient to stimulate growth in the Eurozone.
- The commencement of an increase in interest rates in the US leading to investor confidence and a flight to equity purchasing from bonds.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

<u>Downside Risks (of rates being lower than forecast)</u>:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK strong economic growth weaker than anticipated.
- Weak growth or recession in the UK's main trading partners – the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.

3. Investment Outturn 2014/15 and Comparison with Strategy

3.1. The Council's investment activity, position and return as at 31st March 2015 are detailed in the table below:

| **Investment Activity 2014/15** | **£m** | | |
|---|---|---|---|
| Opening Balance at 01.4.2014 | 186.47 | | |
| Investments Made In 2014/15 | 957.45 | | |
| Investments Repaid In 2014/15 | 985.10 | | |
| **Closing Balance at 31.3.2015** | **158.82** | | |
| **Investment Return 2014/15** | **Return Annualised** | **Weighted Benchmark Annualised** | **Outperformance** |
| Year to 31.03.2015 | 0.66% | 0.41% | 0.25% |

3.2. The investment balance at 31st March 2015 comprised general and earmarked reserves, Pension Fund Cash (£7.8m), income received but not yet used/spent and general movement of working capital. The average value of investments during 2014/15 was £231.4m. The investment balance has fallen from the previous year. This is due to the Council paying down it's outstanding creditors in March 2015 in preparation for switching to a new financial system Agresso on 1st April 2015.

3.3. In line with the strategy, investments were made in all periods of 3 weeks to 1 year to lock into rates above base rate level, and extensive use of bank call accounts and money market funds have been made that offer returns ranging from 0.40% to 0.65%. The weighted average maturity of the investment portfolio lengthened only slightly over the year as a result of maintaining the longer dated investments, starting at 109 days and ending at 117 days on 31 March 2015.

3.4. The benchmark target return for investments used is a weighted benchmark that uses both the 7 day LIBID and 3 month LIBID market rates, weighted to better reflect the maturity of the investments made and therefore the risk parameters of the investment portfolio. Being a market rate, this benchmark moves relative to market movement, however market rates have remained flat over the year. The cumulative benchmark rate for 2014/15 was 0.41% compared to 0.38% in 2013/14. The Council outperformed this benchmark by 0.25% in 2014/15 with a return of 0.66%, compared to 0.69% in 2013/14, and produced an investment return of £1.396m, (£1.412m in 2013/14), compared to a forecast of £1.3m. This outperformance was largely achieved due to a number of fixed rate investments in place for most of the year at an average of 1% compared to a lower benchmark rate.

3.5. The investment return was also benchmarked in two other areas for 2014/15 as follows:

- **Capita Benchmarking Analysis**: includes a mixture of 8 authorities in the East Midlands area and 13 English counties.
- **CIPFA Benchmarking Analysis**: includes a mixture of 17 other authorities UK wide.

3.6. The results of this benchmarking for 2014/15 are shown in the table below:

| **Capita Benchmarking – Position at 31/3/2015** | | | |
|---|---|---|---|
| | **LCC** | **Benchmark Group(8)** | **English Counties (13)** |
| **March Return %** | 0.75% | 0.67% | 0.69% |
| **Risk Banding** | 0.62% -0.75% | 0.59% - 0.72% | 0.61% -0.74% |
| **WAM (days)** | 117 | 80 | 84 |
| **CIPFA Benchmarking – 2014/15 Position (over year)** | | | |
| | **LCC** | **Club (17)** | |
| **Annualised Return %** | 0.66% | 0.64% | |
| **WAM (days)** | 117 | 156 | |

3.7. The benchmarking results show that the Council is above par with the investment returns achieved by its Capita comparators in 2014/15. In some part this is due to the slightly longer Weighted Average Maturity (WAM) position taken by the Council. This is good result given the conservative nature of the Counterparties allowed on the Authorities Lending List (restricted to a Long Term minimum rating of AA-) for which these comparators were not restricted to. Capita calculates a risk banding return that should be achievable for the level of risk being taken on investments and the Council is in line with this banding. The Council is on par with the CIPFA comparators with a lower WAM, again a good result given its conservative investment policy.

3.8. Temporary borrowing totalling £12.0m was taken throughout the year to cover a shortfall in liquidity predicted at certain times. The average cost of this temporary borrowing was 0.399%, which was cost neutral as surplus borrowing was invested in money market funds at 0.43%. This was in line with strategy and as an alternative to drawing on higher yielding Notice Accounts when necessary.

4. Annual Investment Strategy/Authorised Lending List Changes During 2014/15

4.1. The Council's Annual Investment Strategy for 2014/15 was approved, along with the Treasury Strategy, by the Executive Councillor for Finance on 25th March 2014 after being scrutinised by this Committee. This outlines the Council's investments priorities as the security of capital and the liquidity of investments with the aim to achieve the optimum return on investments commensurate with proper levels of security and liquidity.

4.2. Investments are only placed with highly credit rated financial institutions, using Capita's suggested creditworthiness approach, including Sovereign Credit Ratings and Credit Default Swap overlay information provided by Capita. In addition to Capita's advice, the Council also sets additional minimum limits of AAA Sovereign, (UK excepted), and AA- Long Term Rating for lending to Counterparties. Appendix A shows the Council's Authorised Lending List at 31st March 2015 based on this creditworthiness methodology together with a key explaining the credit rating scores.

4.3. The table below details the changes (primarily due to rating changes) to the Authorised Lending List during 2014/15:

| Counterparty | Limits |
|---|---|
| **Additions:**<br>None | |
| **Removals:**<br>Nordea Bank (Finland) | Loss of Finland AAA Sovereign status. |
| **Changes:**<br>National Australia Bank (Australian) | Limit changed from 6 months to 364 Day due to change in CDS price. |
| Toronto Dominion Bank (Canada) | Limit changed from £25m/24 months to £20m/364 days due to revised credit methodology. |
| DBS Bank(Singapore) | Limit changed from £25m/24 months to £20m/364 days due to revised credit methodology. |
| Oversea Chinese Banking Corporation Ltd (Singapore) | Limit changed from £25m/24 months to £20m/364 days due to revised credit methodology. |
| United Overseas Bank Ltd (Singapore) | Limit changed from £25m/24 |

| | |
|---|---|
| | months to £20m/364 days due to revised credit methodology. |

4.4. A full list of the investments held at 31st March 2015, compared to Capita's creditworthiness list and changes to credit rating of counterparties during March 2015 are shown in Appendix B.

5. Borrowing Outturn & Debt Rescheduling Activity 2014/15 and Comparison with Strategy

5.1. The Capital Programme expenditure plans were revised during 2014/15 from that agreed by Full Council at its meeting on 21st February 2014 and actual spending was under budget. The result on the corresponding Borrowing Requirement for the year is shown in the table below:

| | **Original Budget at 1/4/2014 £m** | **Final Budget at 31/3/2015 £m** | **Actual at 31/3/2015 £m** | **Underspend £m** |
|---|---|---|---|---|
| Net Capital Expenditure Programme 2014/15 | 87.315 | 74.310 | 53.053 | 21.257 |
| Borrowing Requirement 2014/15 | 80.815 | 35.300 | 16.988 | 18.312 |

5.2. The Strategy for 2014/15 stated that new borrowing would be undertaken in all periods with the aim of achieving an even spread of maturity profile and avoiding an increase in the average cost of the Council's debt. Borrowing would be undertaken at a time appropriate to coincide with an identified dip in borrowing rates available.

5.3. The Council's actual borrowing and debt rescheduling position as at 31st March 2015 and activity during 2014/15, is detailed in the table below:

| **Borrowing Activity 2014/15** | **Maturing Debt £m** | **Debt To Fund Capital Expenditure £m** | **Total £m** | **% Cost** |
|---|---|---|---|---|
| Opening Balance at 1.4.2014 | 0.0 | 452.807 | 452.807 | 4.141% |
| New Borrowing in 2014/15 | 0.0 | 20.000 | 20.000 | 4.000% |
| Borrowing Matured/Repaid in 2014/15 | (11.354) | (0.000) | (11.354) | |
| | | | | |
| Debt Rescheduling:- | | | | |
| Borrowing Repaid in 2014/15 | 0.0 | 0.0 | 0.0 | |
| Borrowing Replaced in 2014/15 | 0.0 | 0.0 | 0.0 | |
| | | | | |
| **Closing Balance at 31.3.2015** | **(11.354)** | **472.807** | **461.453** | **4.147%** |
| | | | | |

| | | | | |
|---|---|---|---|---|
| Authorised Limit For External Debt 2014/15 | | | 594.125 | |

5.4. The table above shows that a total of £20.0m of external borrowing was taken during the year. This was in the form of LOBO loans (Lenders Option Borrowers Option) from BAE Systems Pension Fund at a cost of 4%. This type of borrowing gives the Lender the option to change the rate at various call intervals and the Borrower the option to either accept or repay. To save on cost of carry (paying interest at 4% and investing it at 0.60% until utilised), this borrowing was arranged on 16th June 2014 for a start date of 31st December 2014. This borrowing was in accordance with the Strategy whereby it maintained an even maturity profile and kept the cost of the Councils borrowing at its existing level of 4.14%.

5.5. Appendix C shows the maturity profile of the Council's long term debt as at 31st March 2015, including the variability effect of the LOBO maturity. This shows a fairly even maturity profile with no debt maturing in any one year exceeding 10.4% of the total debt portfolio.

5.6. Details of the borrowing undertaken is shown in the following table:

| **Lender** | **Amount £** | **Start Date** | **Maturity Date** | **Length** | **Rate %** | **Call Option** |
|---|---|---|---|---|---|---|
| BAE Systems Pension Fund | £10m | 31/12/2014 | 31/12/2061 | 47 years | 4.00% | Every 5 years on/after 31/12/2026 |
| BAE Systems Pension Fund | £10m | 31/12/2014 | 31/12/2057 | 43 years | 4.00% | Every 3 years on/after 31/12/2027 |

5.7. Total LOBO debt the Council has secured now stands at £30m, well within the limit set in the strategy of 10% of total external debt (equating to £46m). A limit is set on this type of borrowing to limit the amount of variability within the debt portfolio of debt repayment.

5.8. Internal Borrowing is using internal balances to finance capital spend, instead of external borrowing. This strategy reduces interest rate risk (the risk of unexpected adverse changes in interest rate) and credit risk (the risk of default by counterparties to whom investments are held as investment exposure falls) and also provides a net saving in interest costs in the short term. The balance of internal borrowing at 31st March 2015 fell, after taking into account the external borrowing undertaken and the underspend of borrowing requirement in the year and is broken down as follows:

| | |
|---|---|
| 2011/12 | £15.459m |
| 2012/13 | £56.486m |
| 2013/14 | £26.028m |
| 2014/15 | - £13.417m |
| Total | £84.556m |

A further £18.312m of internal borrowing will be carried forward to 2015/16 along with the Capital Programme and Borrowing Requirement underspends. Scope for further internal borrowing after this will be limited as cash balances are run down going forward.

5.9. It is worth pointing out that the internal borrowing balance detailed above can be taken externally at any time if investment interest rate yield curves reverse and move higher than long term borrowing rates in the future.

5.10. The table below shows how the final borrowing requirement for 2014/15 was utilised.

| | £m |
|---|---|
| Final Borrowing Requirement 2014/15 | 16.987 |
| **Made Up Of:** | |
| Voluntary Repayment Debt 2014/15 | 10.404 |
| Actual Borrowing Undertaken in 2014/15 | 20.000 |
| Internal Borrowing CF from 2013/14 | 7.031 |
| Internal Borrowing 2014/15 | -2.136 |
| Internal Borrowing Underspend CF to 2015/16 | -18.312 |
| **Total** | **16.987** |

5.11. No debt rescheduling activity took place during the year due to all existing borrowing loans being in premium position. (Meaning that the coupon rate of existing debt is higher than the current market rate for equivalent outstanding periods and so a premium would be incurred to repay this debt back early).

5.12. Due to the significant underspend of the capital programme borrowing requirement in 2014/15 as detailed in 5.1 above, which has been carried forward to 2015/16, interest paid on long term borrowing was some £2.0m under budget at £18.737m.

5.13. For information purposes the cost of the Council's borrowing was benchmarked by the CIPFA Benchmarking Club (a mix of 17 other authorities UK wide). The average cost of borrowing paid by the members was 4.35% for the year. At 4.14%, the Council's cost of borrowing is below this average.

5.14. Full Council, at its meeting on 21st February 2014, approved the Council's Prudential Indicators for 2014/15, set as a requirement of the Prudential Code to ensure the Council's capital financing, in particular its long term borrowing, is prudent, affordable and sustainable. It can be confirmed that no Prudential Indicator limits were breached during 2014/15. Appendix D compares actual key treasury Prudential Indicators with those estimated for 2014/15.

6. Other Treasury Issues 2014/15

6.1. Shorter term borrowing was maintained throughout 2014/15 to secure the most advantageous position in the event that the Home Office commute to a single lump sum their future liability for grant on loan debt repayments in respect of Magistrates Courts Debt. The balance of this short term debt stood at £187k at 31.3.2015.

**2. Conclusion**

Short term Interest rates have remained flat over the period but long term rates have fallen by around 1.00%, reacting to a combination of worldwide concerns affecting markets, including the plunge in oil prices. Forecasts for future direction of rates are very hard to predict due to these external factors, but Capita forecast a gradual increase in long term rates of around 1.3% by March 2018 and now believe downside risks for any movement in rates are balanced with upside risks. The Council's investment return outperformed the market benchmark by 0.25% and the WAM at 31 March 2015 stood at 117 days. This is in line with other benchmark comparators. The cost of the Council's borrowing was 4.147%, which was lower than benchmark comparators. A sum of £20m LOBO borrowing was taken on 31st December 2014 at 4% in line with the Strategy. This borrowing reduced the Council's internal borrowing to £84.556m at 31st March 2015. A total of £18.312m internal borrowing will be carried forward into 2015/16 along with underspends. Temporary borrowing of £12m was undertaken in 2014/15 to cover predicted liquidity issues. This sum was repaid before 31st March 2015.

**3. Consultation**

**a) Policy Proofing Actions Required**

As the contents of this report are factual and the activities being reported on have taken place within existing policies, policy proofing has not been necessary.

## 4. Appendices

| These are listed below and attached at the back of the report | |
|---|---|
| Appendix A | Authorised Lending List at 31st March 2015 and Credit Rating Key. |
| Appendix B | Investment Analysis Review at 31st March 2015 - Capita Asset Services Ltd |
| Appendix C | LCC Long Term Maturity Profile as at 31st March 2015. |
| Appendix D | Prudential Indicators - Actuals Compared to Estimates 2014/15. |

## 5. Background Papers

The following background papers as defined in the Local Government Act 1972 were relied upon in the writing of this report.

| Document title | Where the document can be viewed |
|---|---|
| Treasury Management Strategy Statement and Annual Investment Strategy 2014/15 25th March 2014. | Lincolnshire County Council, Finance and Public Protection Directorate. |
| County Council Report: Council Budget 2014/15 21/2/2014 | Lincolnshire County Council, Finance and Public Protection Directorate. |

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