Policy and Scrutiny

Open Report on behalf of Executive Director of Finance & Public Protection

Report to:	**Value for Money Scrutiny Committee**
Date:	**21 September 2015**
Subject:	**Treasury Management Update 2015/16 -Quarter 1 Update Report to 30 June 2015**

Summary:

This report has been prepared in accordance with the reporting recommendations of the CIPFA Code of Practice 2011 and details the Council's treasury management activities for the 1st quarter of 2015/16 to 30 June 2015, comparing this activity to the Treasury Management Strategy for 2015/16, approved by the Executive Councillor for Finance on 23 March 2015. It will also detail any issues arising in treasury management during this period.

Actions Required:

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

1. Background

1. Introduction and Background

    1.1. 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.

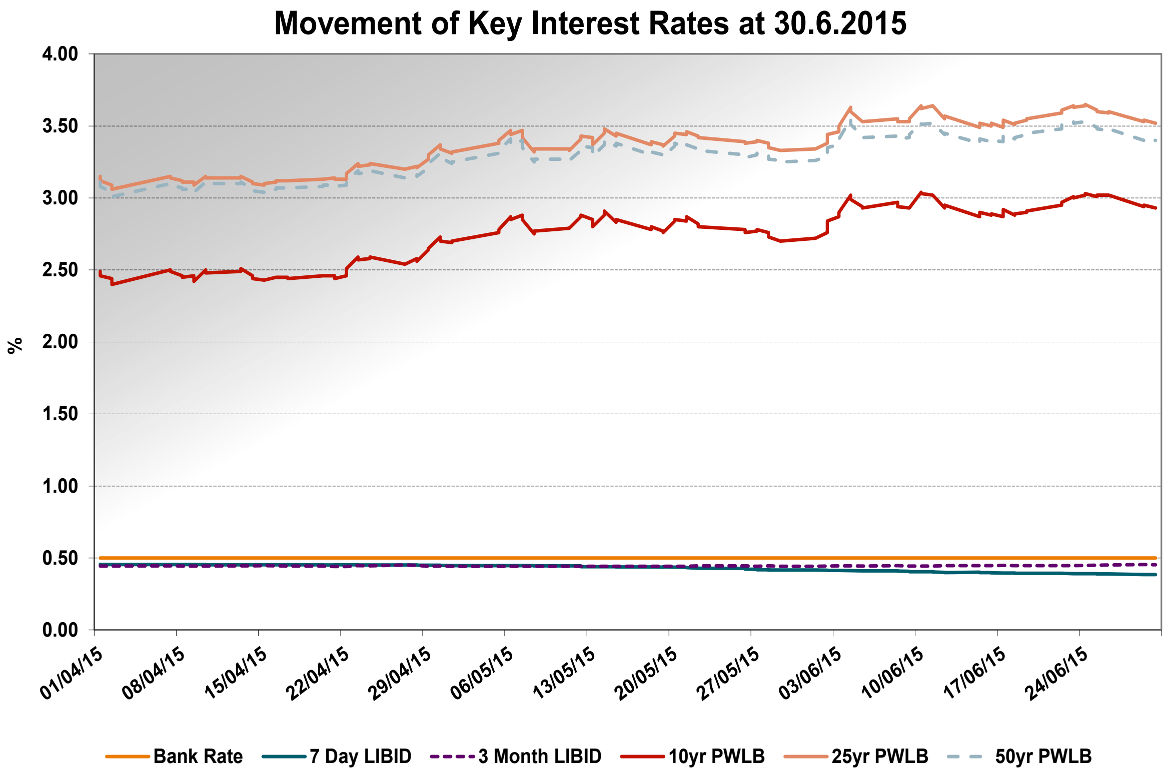
    1.2. This Treasury Report will cover the following positions to 30th June 2015:
    - Interest rate review, economic overview and revised interest rate forecast.
    - Annual investment strategy/ authorised lending list changes during the quarter.
    - Investment position and comparison with strategy.
    - Borrowing & debt rescheduling position and comparison with strategy

2. Interest Rate Review, Economic Overview and Revised Interest Rate Forecast to 30th June 2015

2.1. At the time of setting the Strategy in February 2015, the markets were forecasting short-term Bank Rate to increase to 0.75% from 0.50% in the last quarter of the financial year for the first time since 2008 in response to the low inflation strong growth environment in the UK.

2.2. Long term rates were forecast to rise over 2015/16 by around 0.50%, but remain extremely volatile and difficult to predict due to upside and downside external market influences.

2.3. The graph below shows the actual movement of both UK long term and short term interest rates over the first three months of 2015/16.



2.4. The graph shows that short term rates have remained flat over the quarter as expected and long term rates have risen by around 0.40% from a low dip at the start of the year, bringing them back to forecast levels.

2.5. Economic Background -The quarter ended 30th June 2015 saw the following:

- UK GDP growth was strong in 2014 at 3.0%. Quarter 1 of 2015 was disappointing at only 0.4%. The Bank of England reduced its GDP forecast for 2015 from 2.9% to 2.5% and from 2.9% to 2.7% in 2016.
- Retail sales over Quarter 2 as a whole look to have risen by 0.9%, matching the rise in Quarter 1.
- The unemployment rate fell to 5.5%, not far above pre-crisis levels and the employment rate is the highest since records began. Because of this wage growth is picking up (2.7% in April), with the subdued outlook for inflation underpinning real wage growth.
- Deflation lasted just one month. CPI inflation rose from -0.1% in April to +0.1% in May, reflecting the slower pace of falls in food prices and a rebound in petrol prices and an appreciation of sterling, rather than weakness in demand. Inflation looks set to hover just above zero for the next six months and would not take much to tip back into deflation. The low inflation environment does not appear to be affecting general spending decisions.
- There is no rush to raise interest rates by the Monetary Policy Committee due to the low interest rate environment. The next raise not now being predicated until June 2016.
- Uncertainties have started over the referendum on the UK's membership of the European Union which could happen in 2016 and could hinder the UK's economic recovery going forward.
- The possible exit of Greece from the Eurozone continues to be a concern which could lead to market instability worldwide.

2.6. Capita Asset Services Ltd, the Councils treasury advisors, have recently provided its latest forecast for interest rates, following the Bank of England's (BoE's) Quarterly Inflation Report in August 2015, as follows:

	NOW	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
BANK RATE	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.50	1.50	1.75	1.75
3 month LIBID	0.46	0.50	0.60	0.70	0.80	0.90	1.10	1.30	1.40	1.50	1.80	1.90	1.90
6 month LIBID	0.63	0.70	0.80	0.90	1.00	1.10	1.30	1.50	1.60	1.70	2.00	2.10	2.10
12 month LIBID	0.94	1.00	1.10	1.20	1.30	1.40	1.60	1.80	1.90	2.00	2.30	2.40	2.40
5 yr PWLB	2.19	2.30	2.40	2.50	2.60	2.80	2.90	3.00	3.10	3.20	3.30	3.40	3.50
10 yr PWLB	2.77	2.90	3.00	3.20	3.30	3.40	3.50	3.70	3.80	3.90	4.00	4.10	4.20
25 yr PWLB	3.31	3.40	3.60	3.80	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.60
50 yr PWLB	3.17	3.40	3.60	3.80	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.60

The forecast shows that the first increase in Bank Rate has been pushed forward to June 2016 from March 2016 and the forecasted increase in longer term PWLB rates interest rate have been pegged back by around 0.20%. Capita have also revised their target levels for new borrowing to 2.30% (5 year), 2.90% (10 year) and 3.40% (25y to 50yr), from 2.20%, 2.80% and 3.40% respectively, as recorded in the Strategy in March.

Capita stress that caution must be exercised in respect of all interest rate forecasts at the current time with risks of upward and downward movement evenly balanced. Some of this risks are detailed below:

Downside Risks: (Rates Falling)

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth is weaker than is 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.

Upside Risks: (Rates Increasing)

- Uncertainty around the risk of a UK exit from the EU.
- The ECB severely disappointing financial markets with a programme of asset purchases (QE), which proves insufficient to significantly stimulate growth in the Eurozone.
- The commencement by the US Federal Reserve of increases in the Fed. Funds rate in 2015, causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

3. Annual Investment Strategy/ Authorised Lending List Changes to 30th June 2015

3.1. The Council's Annual Investment Strategy was approved, along with the Treasury Strategy, by the Executive Councillor for Finance on 23rd March 2015 after being scrutinised by this Committee. This outlines the Council's investment 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.

3.2. As such 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 credit methodology, the Council also maintains a minimum A+ Long Term Rating (Fitch) and AAA Sovereign Rating, (two out of three agencies), minimum limit for all its Counterparties, excluding the UK and part-nationalised UK banks. Appendix A shows the Council's existing Authorised Lending List based on this creditworthiness approach together with a key explaining the credit rating scores.

3.3. Capita's credit methodology concentrates solely on Short Term and Long Term ratings and is in line with the Credit Rating Agencies, who have removed the uplift in ratings they give to institutions from implied levels of sovereign support, which they feel will no longer be there going forward.

3.4. As part of the Annual Investment Strategy for 2015/16, the minimum Long Term Rating requirement was reduced to A+ from AA- to mitigate the expected reduction in credit ratings of institutions by Rating Agencies in 2015 as a result of the banking legislation leading to the sovereign support withdrawal.

3.5. The table below details changes to the Authorised Lending List during the first quarter up to 30th June 2015, primarily as a result of these changes to the lower minimum requirements.

Counterparty	**Action**	**Reason**
Westpac Banking Corporation (Austalia)	Addition: Limit £20m / 364 Day.	Revised Credit Methodology.
Nordea Bank (Finland)	Addition: Limit £20m / 364 Day.	Revised Credit Methodology.
Nordea Bank (Sweden)	Addition: Limit £20m / 364 Day.	Revised Credit Methodology.
Pohjola Bank (Finland)	Addition: Limit £20m / 364 Day.	Revised Credit Methodology.
DZ Bank (Germany	Addition: Limit £20m / 364 Day.	Revised Credit Methodology.
Landwirtschaftliche Rentenbank (Germany)	Addition: Limit £25m / 24 Months.	Revised Credit Methodology.
NRW Bank (Germany)	Addition: Limit £25m / 24 Months.	Revised Credit Methodology.

Clearstream Banking (Luxemberg)	Addition: Limit £25m / 24 Months.	Revised Credit Methodology.
Bank Nederlande Gemeenten (Netherlands)	Addition: Limit £25m / 24 Months.	Revised Credit Methodology.
Rabobank (Netherlands)	Addition: Limit £20m / 364 Days.	Revised Credit Methodology.
Nederlandse Waterschapsbank (Netherlands)	Addition: Limit £25m / 24 Months.	Revised Credit Methodology.
DnB Bank (Norwegian)	Addition: Limit £20m / 364 Days.	Revised Credit Methodology.
Skandinaviska Enskilda Banken (Sweden)	Addition: Limit £20m / 364 Days.	Revised Credit Methodology.
Swedbank (Sweden)	Addition: Limit £20m / 364 Days.	Revised Credit Methodology.
Bank of New York Mellon (USA)	Addition: Limit £25m / 24 Months.	Revised Credit Methodology.
JP Morgan Chase Bank (USA)	Addition: Limit £20m / 364 Days.	Revised Credit Methodology.
Northern Trust Company (USA)	Addition: Limit £20m / 364 Days.	Revised Credit Methodology.
State Street Bank (USA)	Addition: Limit £20m / 364 Days.	Revised Credit Methodology.
LloydsTSB Group (UK)	Removal From List	Loss of Part Nationalised Status

3.6. The Government brought down its holding in Lloyds Bnaking Group to below 20% in May 2015. As such Capita suggested that their Part-Nationalised status be removed from the Credit Methodology. Without this status the Bank does not meet the Council's minimum credit limit and hence was removed from the Lending List in May. Currently £40m is invested in the Lloyds Group, with Bank of Scotland, which will mature in March 2016. There is no concern over the non-repayment of this sum.

3.7. A full list of the investments held at 30th June 2015, compared to Capita's creditworthiness list, and changes to credit rating of counterparties during June 2015 are shown in Appendix B.

4. Investment Position to 30th June 2015 – Comparison With Strategy

4.1. The Council's investment position and cumulative annualised return at 30th June 2015 are detailed in the table below:

Investment Position At 30.06.15	Return (Annualised %)	Weighted Benchmark (Annualised %)	Outperformance
£238.320m	**0.67%**	**0.39%**	**0.28%**

4.2. The investment balance is made up of general and earmarked reserves, Pension Fund cash, borrowing and other income received but not yet used/spent and general movement in debtor and creditor amounts.

4.3. In line with the strategy, investments during the quarter have been made in all periods of 6 months 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 0.67%. Several 364 day investments have been made during the quarter to take advantage of the enhanced yields offered. This has increased the investment portfolio weighted average maturity (WAM) slightly to 139 days at 30th June 2015 from 117 days at 31st March 2015. (Highlighted in Appendix B). The outperformance of the benchmark in the first quarter is a reflection of this strategy.

4.4. The benchmark target return 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 movements and is therefore the target rate used for investments.

4.5. The investment performance was also benchmarked against the Capita quarterly benchmark analysis, comprising a mixture of 8 other authorities in the East Midlands area and 13 English Counties. The results of this benchmarking for the 1st quarter are detailed below, which shows that the Council's return was above that of the comparators, achieved by having a longer WAM. The Council's return is also above Capita's suggested risk banding achievable for the level of risk being taken on its investments.

Capita Benchmarking – Position at 30/6/2015			
	LCC	**Benchmark Group(8)**	**English Counties (13)**
30 June Return %	0.69%	0.68%	0.67%
Risk Banding	0.54% -0.65%	0.58% - 0.68%	0.60% -0.71%
WAM (days)	139	98	93

5. <u>Borrowing & Debt Rescheduling Position to 30th June 2015 – Comparison with Strategy</u>

   5.1. The Council's external borrowing position at 30th June 2015 is detailed in the table below and shows no borrowing has been undertaken to date and the cost of the Council's debt is 4.148%.

Borrowing Position at 30.6.2015	**Maturing Debt £m**	**Debt To Fund CapEX £m**	**Total £m**	**% Cost**
Balance at 1.4.2015 New Borrowing to 30.6.2015 Borrowing Repaid to 30.6.2015	0.0 0.0 (5.000)	461.453 0.0 (0.677)	461.453 0.0 (5.677)	4.147%
Debt Rescheduling to 30.6.2015 -Borrowing Repaid -Borrowing Replaced	 0.0 0.0	 0.0 0.0	 0.0 0.0	
Balance at 30.6.2015	**(5.000)**	**460.776**	**455.776**	**4.148%**
Projected Further Borrowing Required in 2015/16 (net of internal borrowing CF)	0.0	73.862	73.862	
Projected Further Borrowing Repayments – Actual - Voluntary	(5.000) (0.0)	(0.677) (10.433)	(5.677) (10.433)	
Projected Borrowing Position at 31.03.2016	**(10.000)**	**523.528**	**513.528**	
Authorised Limit For External Debt 2015/16			592.052	

5.2. The Strategy for 2015/16 stated that new borrowing would be undertaken in all periods with the aim of achieving an even spread of maturity profile and keeping an increase in the average cost of the Council's debt to a minimum. Borrowing would be undertaken at a time appropriate to coincide with an identified dip in borrowing rates available.

5.3. Internal borrowing is using internal balances instead of taking external borrowing to finance the capital programme. 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, provided that Council balances are sufficiently available to maintain this strategy. The balance of internal borrowing stood at £84.556m at 31st March 2015. A further £18.312m of internal borrowing will be made in 2015/16 to cover the 2014/15 carry forward of capital expenditure. Scope for further internal borrowing after this will be assessed throughout the year against current levels of cash.

5.4. 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 £51m). A limit is set on this type of borrowing to limit the amount of variability within the debt portfolio of debt repayment. The average cost of the Council's LOBO debt is 3.99%.

5.5. No debt rescheduling activity of existing debt has taken place to 30th June 2015, 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).

5.6. Full Council, at its meeting on 20th February 2015, approved the Council's Prudential Indicators for 2015/16, 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 have been breached in the first quarter to 30th June 2015.

2. Conclusion

Short Term Interest Rates have remained flat, whilst long term rates rose over the quarter. Weakness in growth and inflation have lowered and pushed forward expected increases in rates during 2015/16. The Council's investment return is outperforming the market benchmark by 0.28% and also the Capita benchmarking comparators. The WAM has increased slightly in the first quarter as a result of making a series of 1 year investments in the period. The cost of the Council's borrowing is still 4.138%. No external borrowing has been taken to date.

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 and Credit Rating Key,
Appendix B	Investment Analysis Review at June 2015 - Capita Asset Services Ltd

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 2015/16 23/3/2015	Lincolnshire County Council, Finance and Public Protection
Council Budget 2015/16 and Capital Programme Change 2014/15 - 20/02/2015	Lincolnshire County Council, Finance and Public Protection

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