

**Open Report on behalf of
Pete Moore, Executive Director of Finance & Public Protection**

Report to:	Value for Money Scrutiny Committee
Date:	24 November 2015
Subject:	Treasury Management Update 2015/16 - Mid Term Report to 30 September 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 first half of 2015/16 to 30 September 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 September 2015:

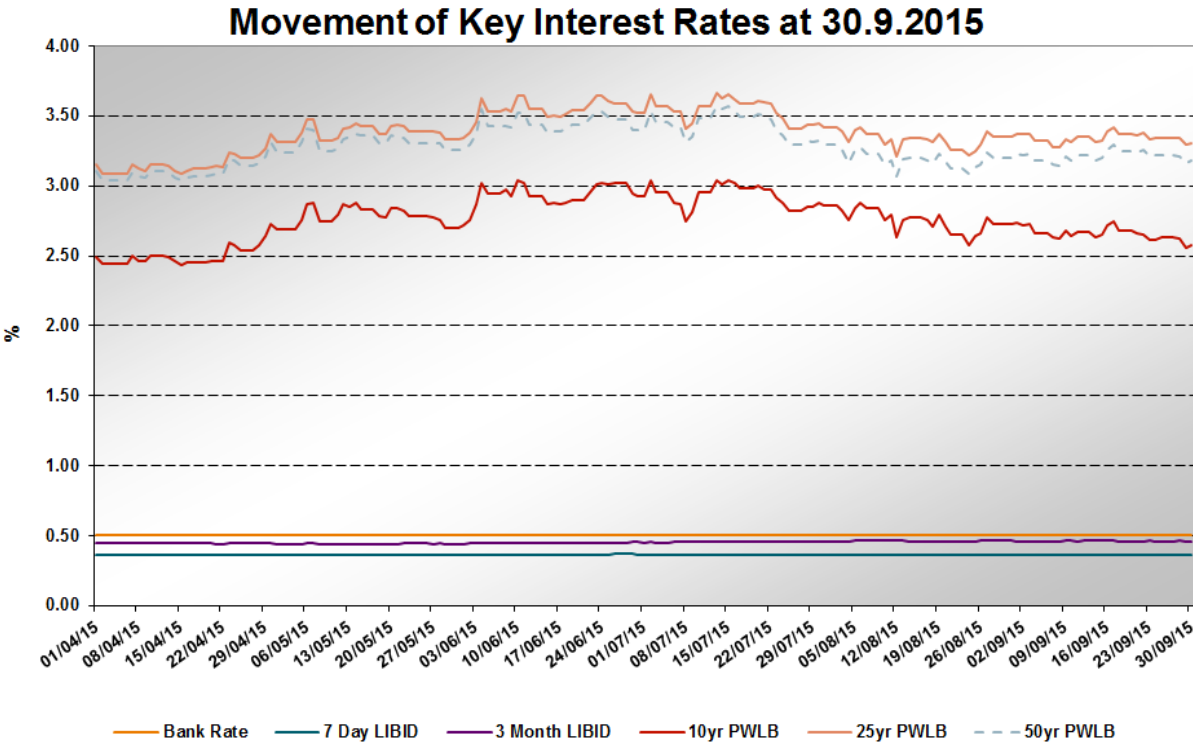
- Interest rate review, economic overview and revised interest rate forecast.
- Annual investment strategy/ authorised lending list changes during the quarter.
- Investment position and comparison with strategy.
- Borrowing & debt rescheduling position and comparison with strategy.

2. Interest Rate Review, Economic Overview and Revised Interest Rate Forecast to 30th September 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 half of 2015/16.



2.4. The graph shows that short term rates have remained flat over the period as expected. Long term rates have risen by 0.40% in June 2015, returning to historic low levels again at the end of September 2015 due to market turbulence causing major volatility.

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

- UK GDP growth was strong in 2014 at 2.9%. Quarters 1 to 3 of 2015 were 0.4%, 0.7% and 0.5% respectively with a yearly forecast of 2.4% predicted. The Bank of England August Inflation Report included a forecast for growth to remain around 2.4% to 2.8% over the next three years, driven mainly by consumer demand;
- The August Bank of England Inflation Report forecast CPI to barely get back up to the 2% target within the 2-3 year time horizon. The fall in oil price and the Chinese economic downturn depressing commodity prices may lead to several more months of low inflation to come;
- With the low inflation environment it will be difficult for central banks in the UK and US to raise rates as soon as predicted;
- The Governments revised Budget in July eased the pace of cut backs from achieving a budget surplus in 2018/19 to achieving that in 2019/20;
- Weakening of US growth had delayed any increase in rates.
- The Eurozone QE programme has had a beneficial impact in improving confidence and sentiment. And growth has marginally increased. A third bailout package for Greece of €86bn has averted their exit for the meantime.
- Japan has been hit hard by the downturn in China with growth close to 0%. China is struggling to hit a growth target of 7% with a major fall in its stock market, leading to volatility in financial markets in August and September.

2.6. Capita Asset Services Ltd, the Councils treasury advisors, provided its forecast for interest rates on 11 August 2015, following the Bank of England's (BoE's) Quarterly Inflation Report, as follows:

	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%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
5yr PwLB rate	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PwLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PwLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
50yr PwLB rate	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 2015.

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 these 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.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and/ or the start of the US rate increases, causing a flight to safe havens.

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 September 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 quarter up to 30th September 2015.

Counterparty	Action	Reason
Standard Chartered Bank (UK)	Reduction in Maturity Limit from 364 Day to 6 Months.	Increase in CDS price.
Bank of New York (International) Mellon Ltd (UK)	Removal from List.	Inactive in Market.
Landwirtschaftliche Rentenbank (Germany)	Removal from List.	Inactive in Market.
NRW Bank (Germany)	Removal from List.	Inactive in Market.
Clearstream Banking (Luxemberg)	Removal from List.	Inactive in Market.
Nederlandse Waterschapsbank (Netherlands)	Removal from List.	Inactive in Market.
DnB Bank (Norwegian)	Removal from List.	Inactive in Market.
Northern Trust Company (USA)	Removal from List.	Inactive in Market.
State Street and Trust Company (USA)	Removal from List.	Inactive in Market.

3.6. Lloyds Banking Group were removed from the Lending List in May 2015 following its loss of Part-Nationalised status after the Government brought down its holding to less than 20%. At 30th September 2015 the Council had £40m invested in the Lloyds Group, with Bank of Scotland, which will mature by March 2016. There is no concern over the non-repayment of this sum.

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

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

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

Investment Position At 30.09.15	Return (Annualised %)	Weighted Benchmark (Annualised %)	Outperformance
£256.692m	0.70%	0.43%	0.27%

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 investments greater than 6 months have been made during the quarter to take advantage of the enhanced yields offered, including the purchase of two Bonds with Nordea Bank and Svenska Bank. The investment portfolio weighted average maturity (WAM) was 104 days at 30th September 2015 from 139 days at 30th June 2015. (Highlighted in Appendix B). The outperformance of the benchmark over the period 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 15 English Counties. The results of this benchmarking for the 2nd quarter are detailed below, which shows that the Council's return was slightly 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 30/9/2015			
	LCC	Benchmark Group(8)	English Counties (13)
30 September Return %	0.73%	0.65%	0.67%
Risk Banding	0.63% -0.73%	0.60% - 0.69%	0.62% -0.71%
WAM (days)	104	74	74

5. Borrowing & Debt Rescheduling Position to 30th September 2015 – Comparison with Strategy

5.1. The Council's external borrowing position at 30th September 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 30.9.2015	Maturing Debt £m	Debt To Fund CapEX £m	Total £m	% Cost
Balance at 1.4.2015	0.0	461.453	461.453	4.147%
New Borrowing to 30.9.2015	0.0	0.0	0.0	
Borrowing Repaid to 30.9.2015	(5.000)	(0.677)	(5.677)	
Debt Rescheduling to 30.9.2015				
-Borrowing Repaid	0.0	0.0	0.0	
-Borrowing Replaced	0.0	0.0	0.0	
Balance at 30.9.2015	(5.000)	460.776	455.776	4.148%
Projected Further Borrowing Required in 2015/16 (net of internal borrowing CF)	0.0	68.421	68.421	
Projected Further Borrowing Repayments – Actual	(5.000)	(0.677)	(5.677)	
- Voluntary	(0.0)	(9.155)	(9.155)	
Projected Borrowing Position at 31.03.2016	(10.000)	519.365	509.365	
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. Minimum Revenue Provision (MRP) is the amount set aside by the Council to repay debt, required by regulation set in 2008. The Council's policy is to repay external debt at this MRP level. The Council calculate MRP by dividing its outstanding borrowing by the average life of those assets which have been financed by borrowing. Revision of certain asset lives under this policy has recently been undertaken resulting in the reduction in MRP for 2015/16 and hence a reduction in the voluntary debt repayment figure for the year (£9.155m from £10.433m).
- 5.4. 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.
- 5.5. 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%.
- 5.6. No debt rescheduling activity of existing debt has taken place to 30th September 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).
- 5.7. Temporary borrowing totalling £19m has been taken during the quarter at an average cost of 0.41% to cover a shortfall in liquidity forecast from December 2015 through to March 2016. In terms of interest this is cost neutral, as surplus funds generated have been invested in Money Market Funds earning on average 0.45%. This is in line with strategy and is an alternative to drawing on higher yielding Notice Accounts when needed. All temporary borrowing taken matures before 31st March 2016.

5.8. 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 half of 2015/16 to 30th September 2015.

2. Conclusion

Short term Interest rates have remained flat over the period but long term rates have been volatile rising by 0.40% then dropping back again to historically low starting levels. 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 0.27% and also the Capita benchmarking comparators. The WAM of the investment portfolio has dropped to 104 days but remains above that of its comparators. No external borrowing has been taken to date and hence the cost of the Council's borrowing is still 4.138%. Temporary borrowing of £19m has been undertaken to cover predicted liquidity issues later on in the year.

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 September 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	Lincolnshire County Council, Finance & Public Protection

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