Lincolnshire COUNTY COUNCIL
Working for a better future

Policy and Scrutiny

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

Report to:	**Value for Money Scrutiny Committee**
Date:	**22 February 2016**
Subject:	**Treasury Management Update 2015/16 - Quarter 3 Report to 31 December 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 2015/16 to 31 December 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.

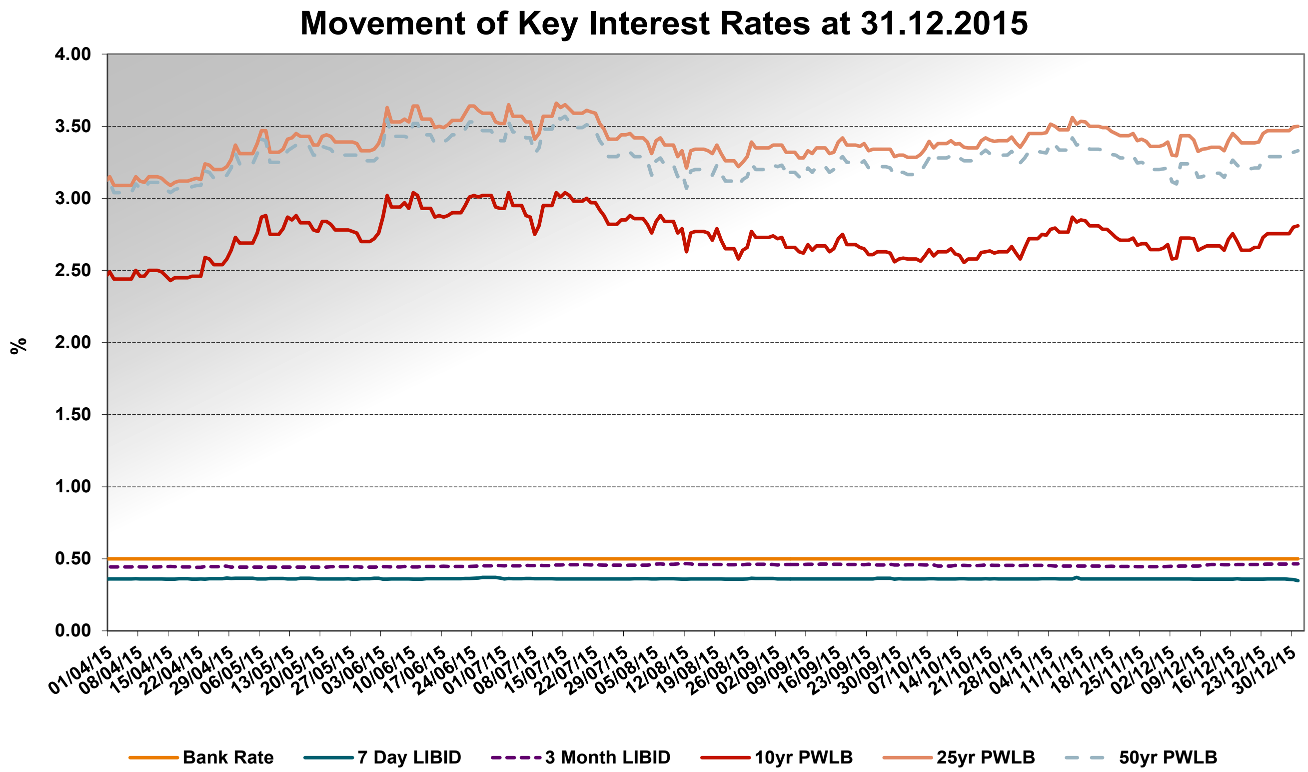
1.2. This Treasury Report will cover the following positions to 31st December 2015:
- Interest rate review, economic overview and revised interest rate forecast.
- Annual investment strategy/ authorised lending list changes during the quarter.
- Investment position and comparison with strategy.
- Borrowing & debt rescheduling position and comparison with strategy.

2. Interest Rate Review, Economic Overview and Revised Interest Rate Forecast to 31st December 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 2015/16 to 31st December 2015.



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, then rising slightly again by the end of December 2015. The volatility in long term rates has been in reaction to market reaction to good or bad news throughout the year leading to market turbulence.

2.5. Economic Background - The quarter ended 31st December 2015 saw the following:

- UK GDP growth for quarters 1 to 3 was revised down to 0.4%, 0.5% (from 0.7%) and 0.4% (from 0.5%) respectively with a yearly forecast of 2.1% (from 2.4%) predicted. The final quarter estimate of growth picked up to around 0.6% which would imply 2.2% GDP growth in 2015 as a whole. This improvement in the last quarter driven mainly by consumer demand;
- Employment rose to record levels and consequently unemployment rate fell during the quarter; however wage growth slowed to1.9% from 2.5%. The employment increase reflected large increases in self-employment, part time or temporary work thus resulting in no pressure to wage inflation.
- Inflation (CPI) nudged back into positive territory at 0.1% in November 2015, but will remain below target for a long while due to weak wage pressures and falls in energy and food prices.
- With the low inflation environment it will be difficult for the MPC to raise rates as soon as predicted in the UK; The UK remains sandwiched between the US who did raise their rates in December and Europe who cot their rates and extended their QE programme during the quarter.
- The Government reversed the 'Tax Credits Cut' policy in November having found £27bn of savings in the Spending Review. The Government is continuing with its Austerity package however and forecast to achieve a £10bn budget surplus in 2019/20;
- 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 latest forecast for interest rates on 20 January 2016, before the February Bank of England’s (BoE's) Quarterly Inflation Report, because of the downbeat UK and world economic news received in recent week, as follows:

	NOW	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	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	1.75
3 month LIBID	0.52	0.50	0.50	0.60	0.80	0.90	1.00	1.10	1.30	1.40	1.50	1.60	1.80	1.90
6 month LIBID	0.66	0.70	0.70	0.80	0.90	1.00	1.20	1.30	1.50	1.60	1.70	1.80	2.00	2.20
12 month LIBID	0.98	1.00	1.00	1.10	1.20	1.30	1.50	1.60	1.80	1.90	2.00	2.10	2.30	2.40
5 yr PWLB	1.92	2.00	2.10	2.20	2.30	2.40	2.50	2.60	2.70	2.80	2.90	3.00	3.10	3.20
10 yr PWLB	2.58	2.60	2.70	2.80	2.90	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.60	3.70
25 yr PWLB	3.36	3.40	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00	4.10	4.10	4.10
50 yr PWLB	3.18	3.20	3.20	3.30	3.40	3.50	3.60	3.70	3.80	3.90	3.90	4.00	4.00	4.00

The forecast shows that the first increase in Bank Rate has been pushed forward yet again to December 2016 from June 2016 and the forecasted increase in longer term PWLB rates interest rate have been pegged back by around 0.40%. Capita have also revised their target levels for new borrowing to 2.00% (5 year), 2.60% (10 year), 3.40% (25year) and 3.20% (50year), from 2.20%, 2.80%, 3.40% and 3.40% respectively, as recorded in the Strategy in March 2015.

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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 and increases in inflation are 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 US rate increases, causing a flight to safe havens.(bonds).

Upside Risks: (Rates Increasing)

- Uncertainty around the risk of a UK exit from the EU.
- The pace and timing of increases in the US rate 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 31st December 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. There have been no changes to the Authorised Lending List during the quarter up to 31st December 2015.

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 31st December 2015 the Council had £37.25m is 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 31st December 2015, compared to Capita's creditworthiness list, and changes to credit rating of counterparties during December 2015 are shown in Appendix B

4. Investment Position to 31st December 2015 – Comparison With Strategy

4.1. The Council's investment position and cumulative annualised return at 31st December 2015 are detailed in the table below:

Investment Position At 31.12.15	Return (Annualised %)	Weighted Benchmark (Annualised %)	Outperformance
£266.359m	**0.71%**	**0.44%**	**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 5 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 0.68%. Several investments greater than 6 months have been made during the quarter to take advantage of the enhanced yields offered. The investment portfolio weighted average maturity (WAM) was 103 days at 31st December 2015 from 104 days at 30th September 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 9 other authorities in the East Midlands area and 13 English Counties. The results of this benchmarking for the 3rd 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 within Capita's suggested risk banding achievable for the level of risk being taken on its investments.

Capita Benchmarking – Position at 31/12/2015			
	LCC	**Benchmark Group(8)**	**English Counties (13)**
31 December Return %	0.75%	0.71%	0.71%
Risk Banding	0.66% -0.78%	0.61% - 0.72%	0.60% -0.72%
WAM (days)	103	72	71

5. Borrowing & Debt Rescheduling Position to 31st December 2015 – Comparison with Strategy

5.1. The Council's external borrowing position at 31st December 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 4.147%.

Borrowing Position at 31.12.2015	**Maturing Debt £m**	**Debt To Fund CapEX £m**	**Total £m**	**% Cost**
Balance at 1.4.2015 New Borrowing to 31.12.2015 Borrowing Repaid to 31.12.2015	0.0 0.0 (5.000)	461.453 0.0 (1.354)	461.453 0.0 (6.354)	4.147%
Debt Rescheduling to 31.12.2015 -Borrowing Repaid -Borrowing Replaced	 0.0 0.0	 0.0 0.0	 0.0 0.0	
Balance at 31.12.2015	**(5.000)**	**460.099**	**455.099**	**4.147%**
Projected Further Borrowing Required in 2015/16 (net of internal borrowing CF) Projected Further Borrowing Repayments – Actual - Voluntary	0.0 (5.000) (0.0)	70.761 (0.000) (9.571)	70.761 (5.000) (9.571)	
Projected Borrowing Position at 31.03.2016	**(10.000)**	**521.289**	**511.289**	
Authorised Limit For External Debt 2015/16			592.052	

5.2. The table below shows the Council's Capital Expenditure plans and Borrowing Requirement at 31st December 2015, from that originally agreed by Full Council at its meeting on 20th February 2015.

	Original Budget at 01/04/2015 £m	Position at 31/12/2015 £m
Net Capital Expenditure Programme 2015/16	80.362	80.200
Borrowing Requirement 2015/16	73.861	70.761

5.3. 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.

5.4. 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 (£9.571m from £10.433m).

5.5. 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.

5.6. Total LOBO debt the Council has secured 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. The average cost of the Council's LOBO debt is 3.99%.

5.7. No debt rescheduling activity of existing debt has taken place to 31st December 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).

5.8. A total of £27m temporary borrowing has been taken at an average cost of 0.40% 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 the temporary borrowing taken matures before 31st March 2016.

5.9. 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 2015/16 to 31st December 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, then rising again. Weakness in growth and inflation have lowered and pushed forward expected increases in rates. The Council's investment return is outperforming the market benchmark by 0.28% and also the Capita benchmarking comparators. The WAM of the investment portfolio has remained level at 103 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 4.147%. Temporary borrowing of £27m 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 December 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 - 20/02/2015	Lincolnshire County Council, Finance & Public Protection

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