Lincolnshire COUNTY COUNCIL
*Working for a better future*

**Policy and Scrutiny**

| **Open Report on behalf of Pete Moore, Executive Director Finance and Public Protection** |
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| Report to: | **Value for Money Scrutiny Committee** |
| Date: | **27 September 2016** |
| Subject: | **Treasury Management Update 2016/17**<br>**Quarter 1 Update Report to 30 June 2016** |


**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 2016/17 to 30 June 2016, comparing this activity to the Treasury Management Strategy for 2016/17, approved by the Executive Councillor for Finance on 21st March 2016. 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. <u>Introduction and Background</u>

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.

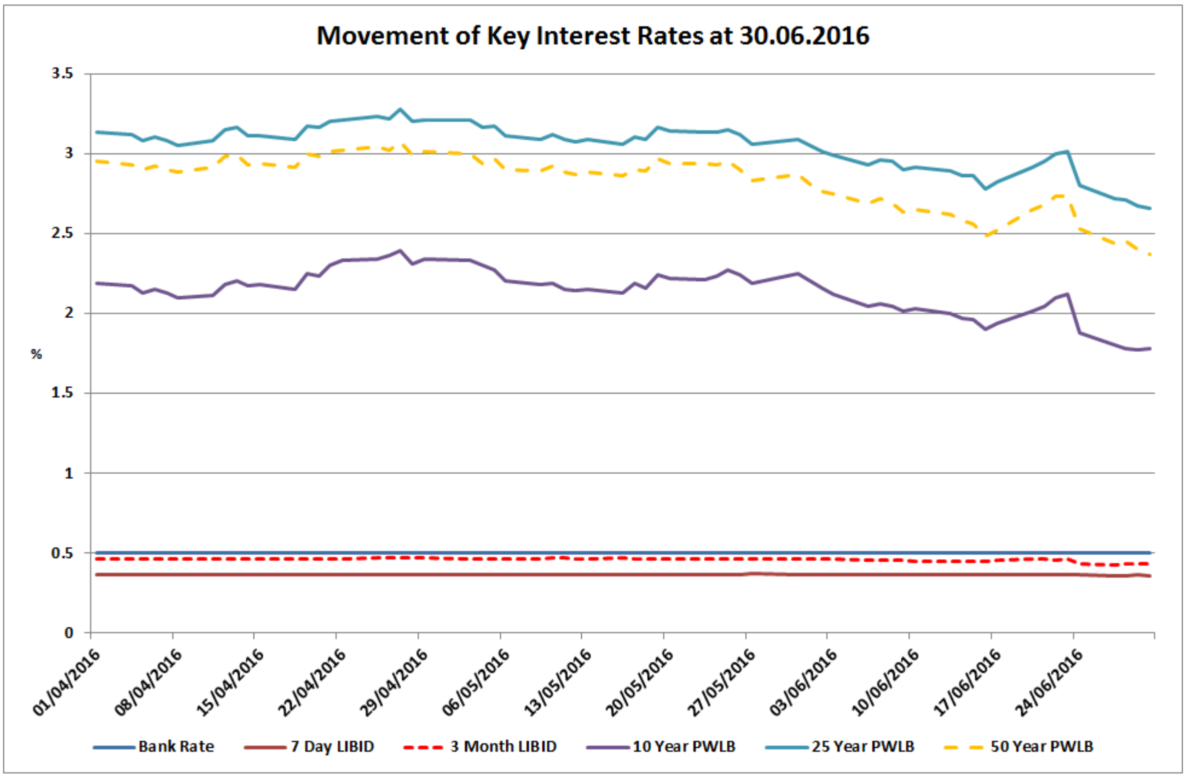
1.2. This Treasury Report will cover the following positions to 30th June 2016:
- Interest rate review, economic overview and revised interest rate forecast.
- Annual investment strategy/ authorised lending list changes during the quarter.
- Investment position and comparison with strategy.
- Borrowing & debt rescheduling position and comparison with strategy.
- Other Treasury Management issues arising during period.

2. <u>Interest Rate Review, Economic Overview and Revised Interest Rate Forecast to 30th June 2016</u>

2.1. At the time of setting the Strategy in February 2016, the markets were forecasting short-term Bank Rate to increase to 0.75% from 0.50% by December 2016 for the first time since 2008 in response to the low inflation strong growth environment in the UK. This first increase was pushed further into the future following the Bank of England Inflation Report in May 2016, which pegged back its growth forecast and factored in concerns over a Brexit vote to leave.

2.2. Long term rates were forecast to rise moderately over 2016/17 by around 0.30%, 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 2016/17.




2.4. The UK voted to leave the European Union in the 24th June 2016 Referendum. The graph shows the impact of this result on interest rates over the first quarter. Short term rates remained flat over the quarter as expected with a small fall post the Brexit vote. Long term rates remained relatively level until June, then fell progressively in the first 3 weeks of June as confidence rose for an 'IN' vote in the polls developed. This was followed by a sharp rise in rates in the run up to referendum day as polls swung to an 'OUT' vote. Rates fell sharply after the resultant OUT vote over concerns as to the impact of leaving the EU on economic growth grew. Rates have continued to fall to date. The Bank of England cut their forecast for growth for 2017 significantly in August 2016 to 0.8% from 2.3% and went on to cut the Base Rate to 0.25% and increase Quantitative Easing by £60bn to £435bn on 4th August 2016, in an attempt to stabilise the economy. This is the first movement in Base Rate since 2009. Long term rates have fallen as a result and stand at around only 1.95% (for 40 to 50 years) at the time of writing. Long term rates are now the lowest they have ever been.

2.5. <u>Economic Background</u> -The quarter ended 30th June 2016 saw the following:

- The UK voted to leave the EU at the end of June 2016.
- The economic recovery lost some momentum ahead of the vote.
- Growth remained highly dependent on consumer spending.
- The jobs recovery slowed, but wage growth picked up.
- Inflation remained stuck at very low levels.
- A sharp fall in sterling following the referendum result.
- Post referendum uncertainty brought the prospect of a near-term rate cut onto the agenda.
- Both the ECB and the US Federal Reserve kept policy unchanged.

2.6. The Bank of England in its Inflation Report on 4th August 2016 lowered growth forecasts for 2017/ 2018 sharply and revised its forecast for inflation up sharply to 2% in 2017 and 2.4% in 2018/2019, as a result of a big drop in Sterling following the Brexit vote. In an attempt to calm market sentiment and support the Economy the BOE acted by cutting Base Rate to 0.25% and increasing QE by £60bn.

2.7. The Brexit vote to leave and the BOE action have obviously had a major impact on reducing interest rate forecasts. Capita Asset Services Ltd, the Councils treasury advisors, provided its latest forecast for interest rates on 9 August 2016, as follows:

| | NOW | Sep-16 | Dec-16 | Mar-17 | Jun-17 | Sep-17 | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 | Jun-19 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| BANK RATE | 0.25 | 0.25 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 |
| 3 month LIBID | 0.50 | 0.30 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.30 | 0.30 | 0.30 | 0.40 | 0.50 | 0.60 |
| 6 month LIBID | 0.55 | 0.40 | 0.30 | 0.30 | 0.30 | 0.40 | 0.40 | 0.50 | 0.50 | 0.50 | 0.60 | 0.60 | 0.70 |
| 12 month LIBID | 0.75 | 0.60 | 0.50 | 0.50 | 0.60 | 0.60 | 0.70 | 0.70 | 0.70 | 0.80 | 0.80 | 0.80 | 0.90 |
| 5 yr PWLB | 1.00 | 1.00 | 1.00 | 1.00 | 1.10 | 1.10 | 1.10 | 1.10 | 1.20 | 1.20 | 1.20 | 1.20 | 1.30 |
| 10 yr PWLB | 1.60 | 1.50 | 1.50 | 1.50 | 1.60 | 1.60 | 1.60 | 1.60 | 1.70 | 1.70 | 1.70 | 1.70 | 1.80 |
| 25 yr PWLB | 2.30 | 2.30 | 2.30 | 2.30 | 2.40 | 2.40 | 2.40 | 2.40 | 2.50 | 2.50 | 2.50 | 2.50 | 2.60 |
| 50 yr PWLB | 2.10 | 2.10 | 2.10 | 2.10 | 2.20 | 2.20 | 2.20 | 2.20 | 2.30 | 2.30 | 2.30 | 2.30 | 2.40 |

The forecast reflects the Base Rate cut to 0.25% and factors in another cut to 0.10% in November 2016. Increases to Base Rate back to 0.50% are not forecast until June 2019. Long rates have been adjusted to existing levels of 1%-2% and are forecast to rise by only 0.20% to 0.30% by June 2019. Capita have also revised their target levels for new borrowing to **1.00% (5 year), 1.50% (10 year), 2.30% (25 year) and 2.10% (50 year)**, from 2.00%, 2.60%, 3.40% and 3.20% respectively, as recorded in the Strategy in March.

Capita stress that forecasting rates remains difficult with so many external influences weighing on the UK and that their forecasts will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Major volatility in bond yields is likely to endure due to investor fears and market uncertainty. They view the overall balance of risks to economic recovery in the UK to be on the downside. These risks currently include:

**Downside Risks: (Rates Falling)**

- Emerging country economies, currencies and corporates destabilised by falling commodity prices and US Fed Rate increases causing flight to safe havens (bonds).
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth and increases in inflation are 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.
- Weak capitalisation of some European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the Eurozone and Japan.

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include:-

**Upside Risks: (Rates Increasing)**

- The pace and timing of increases in the US Fed. Funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities 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 2016

3.1. The Council's Annual Investment Strategy was approved, along with the Treasury Strategy, by the Executive Councillor for Finance on 21st March 2016, 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 limit of A+ Long Term Rating (two out of three agencies) for all its Counterparties, excluding the UK and part-nationalised UK banks and a minimum limit AA- Sovereign Rating, (two out of three agencies) for any Country in which a Counterparty is based. 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. As part of the Annual Investment Strategy for 2016/17, the Sovereign Rating minimum limit was reduced from AAA to AA- as a result of this lowering of emphasis on Sovereign Ratings by the industry.

3.4. The minimum Long Term Rating requirement of A+ was also relaxed to two out of three agencies to allow more flexibility to the Council's lending list for those Counterparties who consistently rated a notch lower by one agency only.

3.5. The table below details changes to the Authorised Lending List during the first quarter up to 30th June 2016, and include additions to the list from the above Annual Investment Strategy changes.

| Counterparty | Action | Reason |
|---|---|---|
| Lloyds Group (UK) (Lloyds and BOS) | Addition: Limit £15m / 6 Months. | Revised Credit Methodology. |
| UBS Ltd (UK) | Addition: Limit £15m / 6 Months. | Revised Credit Methodology. |
| BNP Paribas (France) | Addition: Limit £15m / 6 Months. | Revised Credit Methodology. |
| BNP Paribas Fortis (Belgium) | Addition: Limit £15m / 6 Months. | Revised Credit Methodology. |
| National Bank of Canada(Canada) | Addition: Limit £15m / 6 Months. | Revised Credit Methodology. |
| Landesbank Hessen-Thueringen Girozentrale (Heleba) (Germany) | Addition: Limit £20m / 364 Day. | Revised Credit Methodology. |
| ING Bank (Netherlands) | Addition: Limit £15m / 6 Months. | Revised Credit Methodology. |
| Bank of America (USA) | Addition: Limit £15m / 6 Months. | Revised Credit Methodology. |
| Standard Chartered Bank (UK) | Increase in Limit from Suspension to £15m/ 3 Months. | Reduced CDS Price. |
| HSBC Bank plc (UK) | Increase in Maturity Limit from 6 Months to 364 Day. | Reduced CDS Price. |
| Australia & New Zealand Banking Group (Australia) | Increase in Maturity Limit from 6 Months to 364 Day. | Reduced CDS Price. |
| Commonwealth Bank of Australia (Australia) | Increase in Maturity Limit from 6 Months to 364 Day. | Reduced CDS Price. |
| National Australia Bank (Australia) | Increase in Maturity Limit from 6 Months to 364 Day. | Reduced CDS Price. |
| Westpac Banking Corporation (Australia) | Increase in Maturity Limit from 6 Months to 364 Day. | Reduced CDS Price. |

3.6. At the 30th June 2016 no investments to Counterparties on the list were in breach of limit due to limit changes.

3.7. A full list of the investments held at 30th June 2016, compared to Capita's creditworthiness list, and changes to credit rating of counterparties during June 2016 are shown in Appendix B.

4. Investment Position to 30th June 2016 – Comparison With Strategy

4.1. The Council's investment position and cumulative annualised return at 30th June 2016 are detailed in the table below:

| Investment Position At 30.06.16 | Return (Annualised %) | Weighted Benchmark (Annualised %) | Outperformance |
|---|---|---|---|
| **£242.179m** | **0.72%** | **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 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 0.69%. Several 364 day investments have been made during the quarter to take advantage of the enhanced yields offered. Including investments in Bonds and Certificates of Deposit. This has increased the investment portfolio weighted average maturity (WAM) slightly to 134 days at 30th June 2016 from 125 days at 31st March 2016. (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 14 English Counties. The results of this benchmarking for the 1st 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 in line with Capita's suggested risk banding achievable for the level of risk being taken on its investments.

| **Capita Benchmarking – Position at 30/6/2016** | | | |
|---|---|---|---|
| | **LCC** | **Benchmark Group(8)** | **English Counties (13)** |
| **30 June Return %** | 0.74% | 0.73% | 0.67% |
| **Risk Banding** | 0.66% -0.76% | 0.60% - 0.70% | 0.62% -0.72% |
| **WAM (days)** | 134 | 87 | 62 |

5. <u>Borrowing & Debt Rescheduling Position to 30th June 2016 – Comparison with Strategy</u>

5.1. The Council's external borrowing position at 30th June 2016 is detailed in the table below and shows £8m of external borrowing from the PWLB was undertaken to the end of June 2016 bringing the cost of the Council's debt down to 4.065%. In line with the Strategy, this was to take advantage of the sharp fall in long term borrowing rates after the Brexit Leave Vote. The borrowing was taken over the 47 to 48 year period at a record low average rate of 2.51% at the time.

| **Borrowing Position at 30.6.2016** | **Maturing Debt £m** | **Debt To Fund CapEX £m** | **Total £m** | **% Cost** |
|---|---|---|---|---|
| Balance at 1.4.2016<br>New Borrowing to 30.6.2016<br>Borrowing Repaid to 30.6.2016 | 0.0<br>0.0<br>(5.000) | 480.099<br>8.000<br>(0.677) | 480.099<br>8.000<br>(5.677) | 4.077%<br>2.088% |
| Debt Rescheduling to 30.6.2016<br>-Borrowing Repaid<br>-Borrowing Replaced | <br>0.0<br>0.0 | <br>0.0<br>0.0 | <br>0.0<br>0.0 | |
| **Balance at 30.6.2016** | **(5.000)** | **487.422** | **482.422** | **4.065%** |
| Projected Further Borrowing Required in 2016/17 (net of internal borrowing CF)<br><br>Projected Further Borrowing Repayments – Actual<br>- Voluntary | 0.0<br><br><br>(9.000)<br>(0.0) | 70.794<br><br><br>(0.677)<br>(8.168) | 70.794<br><br><br>(9.677)<br>(8.168) | |
| **Projected Borrowing Position at 31.03.2017** | **(14.000)** | **549.371** | **535.371** | |
| Authorised Limit For External Debt 2016/17 | | | 584.851 | |

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 £66.213m at 31st March 2016. A further £50.092m of internal borrowing will be made in 2016/17 to cover the 2015/16 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 is still at £30m, well within the limit set in the strategy of 10% of total external debt (equating to £48m). 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 2016, 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 19th February 2016, approved the Council's Prudential Indicators for 2016/17, 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 2016.

6. Other Treasury Management Issues

6.1. Revision to MRP Policy Statement for 2016/17 and future years:

Minimum Revenue Provision (MRP) is a charge to the Council's revenue account to make provision for the repayment of the Council's outstanding capital debt liabilities. The Council is required by law to set aside an amount for this provision which it considers to be prudent. Statutory Guidance which accompanies Regulations provides options for the calculation of MRP and gives Council's significant discretion in determining the level of MRP.

The Council's MRP policy was created and approved in 2009 at the start of the new MRP system and since then only relatively minor changes to the policy have been made to adjust for more appropriate asset lives. Some work has been done over the quarter therefore to look at the method of which the Council calculates its MRP provision in order to revise this to bring it up to date with current circumstances.

A more detailed update of the results of this work and any subsequent revisions made to the MRP Policy will be reported to this Committee in the next Quarter 2 Update Report in November 2016.

**2. Conclusion**

Interest rate forecasts were drastically revised down at the end of the June 2016 following the Brexit Vote to leave the EU on 24th June 2016. The impact of this revision was too late to affect the Investment return for the first quarter which was 0.72%, outperforming the benchmark by 0.28%. Advantage was taken of the sharp fall in long term rates after the Brexit vote by taking £8m PWLB debt at 2.51%, bringing the cost of the Council's debt down to 4.065%.

Base Rate cuts and more QE in August 2016 have brought all rates down further. Whilst this is a good prospect for further long term borrowing, investments returns will suffer with only £1m now expected to be earned for the year.

Work has started to look at the Council's calculation of MRP with the aim to revise this to bring it up to date with current circumstances regarding capital financing.

**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 2016 - 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 2016/17 - 21/3/2016 | Lincolnshire County Council, Finance and Public Protection |
| Council Budget 2016/17 - 19/02/2016 | Lincolnshire County Council, Finance and Public Protection |

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