Lincolnshire COUNTY COUNCIL
Working for a better future

Policy and Scrutiny

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

Report to:	**Value for Money Scrutiny Committee**
Date:	**22 November 2016**
Subject:	**Treasury Management Update 2016/17 - Quarter 2 Mid Term Update Report to 30 September 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 first half of 2016/17 to 30 September 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. 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.

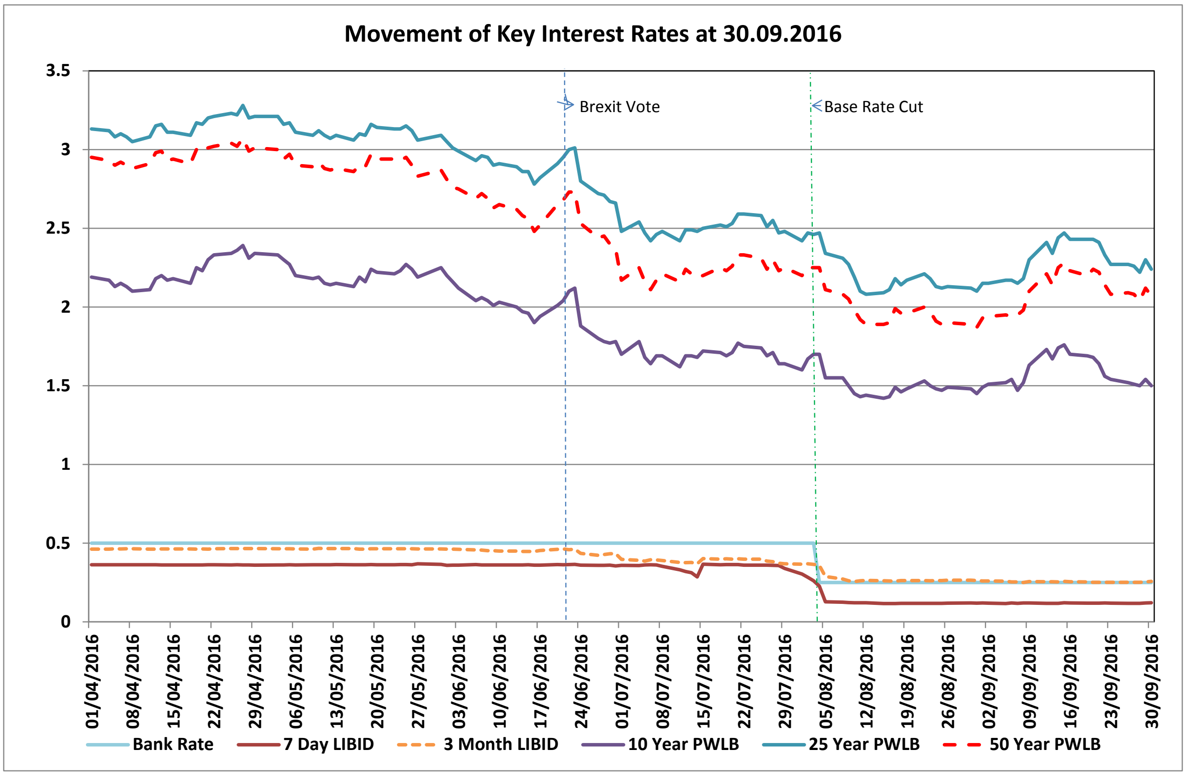
1.2. This Treasury Report will cover the following positions to 30th September 2016:
- Interest rate review, economic overview and revised interest rate forecast.
- Annual investment strategy/ authorised lending list changes during the quarter.
- Investment position and comparison with strategy.
- Borrowing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

2. Interest Rate Review, Economic Overview and Revised Interest Rate Forecast to 30th September 2016

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 half of 2016/17.



2.4. The UK voted to leave the European Union in the 24th June 2016 Referendum. Shocks to the markets subsequent to this result and fears for Economic Growth led to the Bank of England to cut Base Rate on 4th August 2016 to 0.25% from 0.50% for the first time since 2009 and increase Quantitative Easing by £60bn to £435bn. The graph shows the impact on interest rates due to these events. Short term rates dropped to 0.25% levels following the Base Cut and have remained flat since. Long term rates fell significantly after the Brexit vote but rallied in September 2016 as news on Economic Growth was not as bad as feared.

2.5. Economic Background -The quarter ended 30th September 2016 saw the following:

- Economic growth expected to fall on the back of Brexit Vote to leave the EU. BOE Forecast for 2017 cut from 2.3% to just 0.8%.
- The BOE decisions on 4th August 2016 to stabilise the Economy included:
    - Bank Rate Cut from 0.50% to 0.25%.
    - New Gilt Purchases (QE) of £60bn.
    - New Corporate Bond Purchases (QE) £10bn.
    - Term Funding Scheme to provide £100bn of cheap funding to banks.
    - QE programme now standing at £545bn in total.
- BOE hinted at a further cut in Base Rate in November to 0.10% but ruled out negative interest rates.
- Government announced budget surplus target by 2020 will be eased in the Autumn Statement on 23rd November 2016 and hinted that they will do anything necessary to promote growth including fiscal policy or increased Government expenditure on infrastructure.
- Consumer confidence fell very sharply immediately after the Brexit Vote but fully recovered by the end of September.
- The value of Sterling fell sharply following the referendum result and remains at an all-time low, which is feeding through to higher importing costs for businesses.
- There was a sharp rise in inflation expectations by BOE to over 2% target by 2018. This is primarily due to the fall in the value or Sterling since the Brexit vote. A 10% fall in the value of Sterling is likely to result in a 3% increase in CPI over a 3-4 year time period. The BOE is likely to take a long term view on this to support growth as long as pay remained subdued.
- Both the ECB and the US Federal Reserve kept policy unchanged.

2.6. 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:

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.25%	0.25%	0.25%	0.25%	0.50%
5yr PWLB rate	1.00%	1.00%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.20%	1.30%
10yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%
25yr PWLB rate	2.30%	2.30%	2.40%	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.60%
50yr PWLB rate	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 have indicated that they intend to provide a revised forecast to interest rates on 14th November after the BOE Inflation Report on 3rd November 2016 and the US Presidential Election on 8th November which both could have significant implications for market rates.

The recent spike in inflation expectations and better than expected UK GDP figures in Q3 of 0.5% have provided momentum to push gilt yields and hence long term borrowing up. They forecast that there is considerable upside potential to future interest rate forecasts due to these factors.

3. <u>Annual Investment Strategy/ Authorised Lending List Changes to 30th September 2016</u>

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. There have been no changes to the Authorised Lending List during the quarter up to 30th September 2016.

3.6. At the 30th September 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 September 2016, compared to Capita's creditworthiness list, and changes to credit rating of counterparties during September 2016 are shown in Appendix B.

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

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

Investment Position At 30.09.16	Return (Annualised %)	Weighted Benchmark (Annualised %)	Outperformance
£264.776m	**0.70%**	**0.37%**	**0.33%**

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 2 days 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 0.30% to 0.50%. 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. The investment portfolio weighted average maturity (WAM) stood at 123 days on 30th September 2016 from 134 days on 30th June 2016. (Highlighted in Appendix B). The outperformance of the benchmark in the first quarter is a reflection of this strategy, as the weighted benchmark has dropped as a result of the fall in Base Rate but long dated fixed deals have yet to drop out of the Return.

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 2nd 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 in line with Capita's suggested risk banding achievable for the level of risk being taken on its investments.

Capita Benchmarking – Position at 30/9/2016			
	LCC	**Benchmark Group(8)**	**English Counties (14)**
30 September Return %	0.67%	0.59%	0.60%
Risk Banding	0.62% -0.75%	0.52% - 0.65%	0.50% -0.63%
WAM (days)	123	87	80

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

5.1. The Strategy for 2016/17 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

5.2. The Council's external borrowing position at 30th September 2016 is detailed in the table below and shows £12m of external borrowing from the PWLB was undertaken to the end of September 2016 bringing the cost of the Council's debt down to 4.062% 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 45 to 48 year period at a record average low average rate of 2.39% at the time.

Borrowing Position at 30.9.2016	**Maturing Debt £m**	**Debt To Fund CapEX £m**	**Total £m**	**% Cost**
Balance at 1.4.2016 New Borrowing to 30.9.2016 Borrowing Repaid to 30.9.2016	0.0 0.0 (9.000)	480.099 12.000 (0.677)	480.099 12.000 (9.677)	4.077% 2.393%
Debt Rescheduling to 30.9.2016 -Borrowing Repaid -Borrowing Replaced	 0.0 0.0	 0.0 0.0	 0.0 0.0	
Balance at 30.9.2016	**(9.000)**	**491.422**	**482.422**	**4.062%**
Projected Further Borrowing Required in 2016/17 (net of internal borrowing CF) Projected Further Borrowing Repayments – Actual - Voluntary	0.0 (5.000) (0.0)	69.908 (0.677) (5.537)	69.908 (5.677) (5.537)	
Projected Borrowing Position at 31.03.2017	**(14.000)**	**555.116**	**541.116**	
Authorised Limit For External Debt 2016/17			584.851	

5.3. The table below shows the Council's Capital Expenditure plans and Borrowing Requirement at 30th September 2016, from that originally agreed by Full Council at its meeting on 19th February 2016.

	Original Budget at 1/4/2016 £m	Position at 30/9/2015 after Carry Forwards £m
Net Capital Expenditure Programme 2016/17	86.408	138.454
Borrowing Requirement 2016/17	78.794	132.000

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 £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.

5.5. 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%.

5.6. 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).

5.7. 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 half of 2016/17.

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.

The Guidance states that 'the broad aim of prudent provision is to ensure that debt is repaid over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

To achieve these aims the Council's existing MRP policy uses the 'Regulatory Method' for repayment of pre 2008 debt, where borrowing was supported by Government RSG and repaid over a term reasonably commensurate with the period implicit in the determination of that grant. Repayment of this debt was therefore set on a 4% reducing balance. For debt from 2008/09 onwards, the Council chose to calculate MRP on an 'Average Life Method' using an equal instalment of principle calculation. This focuses on the Asset life of all assets financed by borrowing and repays debt on an equal basis over the life of these assets.

Changes to existing policy from 2016/17 onwards:

Pre 2008 Debt

Since the business rates reform in 2013/14, there is no component of grant determining an implicit level of support for debt repayment. For pre 2008 debt therefore, it is proposed to change the MRP approach to a full repayment method and base this on a standard asset life of 50 years which equates to a flat rate of 2% per year until the debt is fully repaid over 50 years. From 2016/17 this would reduce the MRP repayment from £8.8m to £4.4m. Over the next four years the reduction in MRP from this change would be £15.5m, however as this is a full repayment approach the cost in future years will become more expensive than on the current approach.

Average Life Method-Annuity Calculation

As well as applying equal instalments of principal debt repayment over the asset lives of assets financed from borrowing, there is also the opportunity to calculate debt repayment using an annuity calculation for those assets. With an annuity, a fixed repayment consists of primarily all interest in early years and principal repayment increases in later years. This method therefore has the advantage of linking MRP to the flow of benefits from as asset where the benefits of those assets are expected to increase in later years. It is therefore proposed to use the annuity method on those assets/projects financed by borrowing where we can make this link, such as Infrastructure Spending (Lincoln Eastern Bypass, East-West Link, Relief Road Projects etc). From 2016/17 this would reduce the MRP repayment further by up to £2.8m. Over the next four years the reduction in MRP from this change would be up to £13.1m. The cost again in future years will eventually be more expensive than the current approach.

Reviewing the Date of Financing

The guidance allows Councils not to start charging MRP until an asset becomes operational. The Council has four large highway schemes which are due to take a number of years to complete. It is therefore proposed that from 2016/17 these four major schemes will not be financed until they become operational. This represents around £90m of funding by borrowing and in the short term this will reduce the MRP charge by £1m to £2m, but is only a deferral of these costs.

We have approached the Council's external Auditors KPMG with these proposals for changing the MRP calculation and they have confirmed they have no concerns with this strategy.

The revenue budget savings from this revised policy will be reflected both in the next revenue budget monitoring report for the current year due in January 2017 and in the revenue budget proposals for next year presently under development.

2. Conclusion

Interest rate forecasts were drastically revised down in August 2016 following the Brexit Vote to leave the EU on 24^{th} June 2016. The Base Rate was cut on 4^{th} August 2016 to 0.25% from 0.50% in an attempt to stabilise the Economy. Sterling has fallen to an all-time low leading to an increase in inflation expectations as prices are affected by the exchange rate. The Council's investment return for the first quarter remained at pre-cut levels of 0.70% which outperformed the falling benchmark by 0.33% due to the lengthy WAM. The Council's lengthy WAM ensured that its return beat that of its benchmarking comparators. Advantage was taken of the sharp fall in long term rates after the Brexit vote by taking £12m PWLB debt at an average of 2.39%, bringing the cost of the Council's debt down to 4.062%, in line with the Strategy.

A revision to the calculation of MRP is proposed to bring it up to date with current circumstances regarding capital financing and making it better reflect the useful life of assets financed by borrowing. The result will be to re-profile the level of MRP over the next 50 years, leading to significantly lower repayment in the next few years, but higher repayment after 18 years out.

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 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 - 21/03/2016	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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