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:	**28 February 2017**
Subject:	**Treasury Management Update 2016/17 - Quarter 3 to 31 December 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 2016/17 to 31 December 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 31st December 2016:

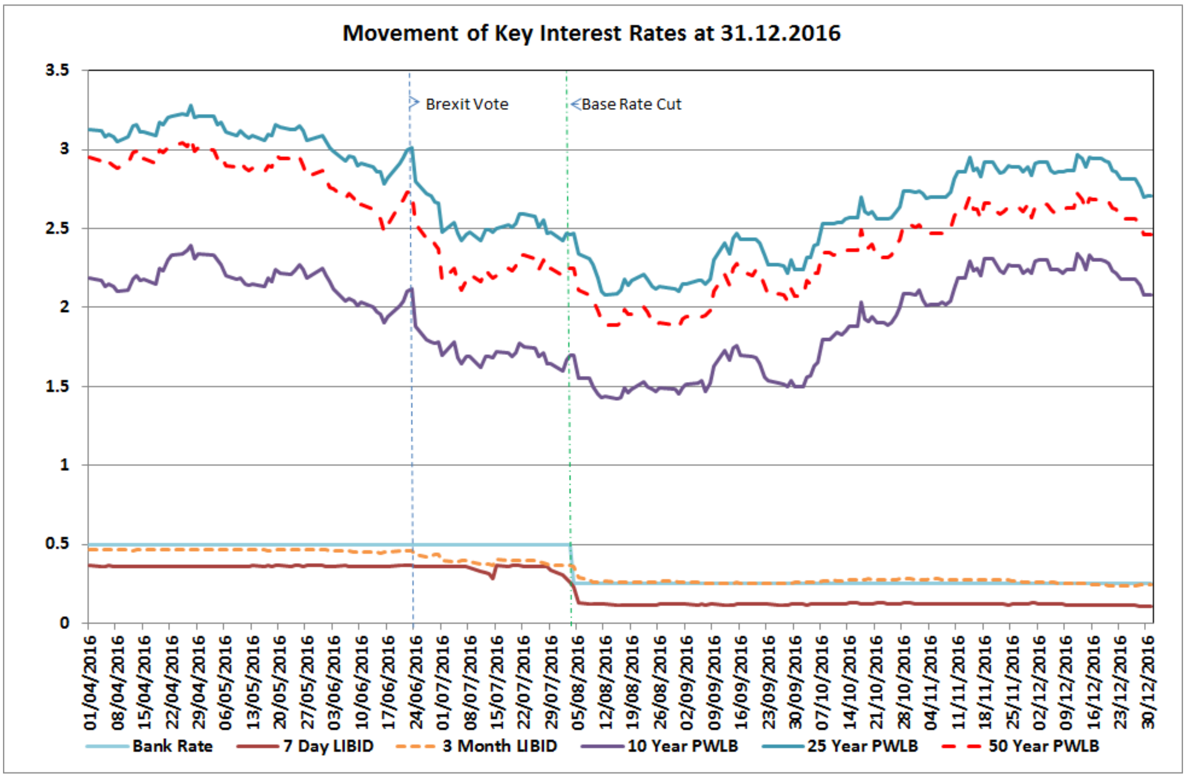
- Interest rate review, economic overview and revised interest rate forecast.
- Annual investment strategy/ authorised lending list changes during the quarter.
- Investment position and comparison with strategy.
- Borrowing & debt rescheduling position and comparison with strategy.
- Other Treasury Management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

2. <u>Interest Rate Review, Economic Overview and Revised Interest Rate Forecast to 31st December 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 2016/17 to 31st December 2016.



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 have rallied since September 2016, as news on Economic Growth was not as bad as feared and Consumer confidence remains robust.

2.5. Economic Background -The quarter ended 31st December 2016 saw the following:

- The economy maintained its momentum, despite Brexit, as economic growth appears to have barely lost pace and was up by 0.6% during the quarter. The Bank of England has recently forecast Growth for 2017 to be back to 2%. (This forecast was cut to 0.8% following the Brexit Vote).
- Consumer spending continues to be the key driver of this growth with retail sales rising by 2.00% from October to November 2016 alone. Although it is unlikely that this will be sustainable going forward as Household incomes fall and inflation starts to rise.
- The labour market showed some signs of weakening as employment actually fell in the three months to October 2016.
- CPI inflation rose above 1% for the first time in two years. Components such as petrol and food that react to exchange rate movements are having an upward effect on CPI. Higher prices on the high street are expected over the course of 2017. CPI is expected to peak at around 3% by Spring 2018. The Bank of England is content with leaving interest rates on hold however, given uncertainty over the economic outlook and Brexit negotiations.
- The US voted for Trump in their election on November 8th 2016. He has promised expansion of infrastructure expenditure in the US at the same time as promising to cut taxes. Stock markets in the US reached record highs since the election. The Fed raised interest rates by 0.25% in December 2016 to 0.75%.
- The ECB announced its commitment to extend QE by another 9 months to December 2017 in an attempt to boost the European economy.
- The UK Government announced its plans to trigger Article 50 to begin Brexit negotiations by the end of March 2017 and has promised to lay out its plans before it does so.

2.6. Capita Asset Services Ltd, the Councils treasury advisors, provided its latest forecast for interest rates on 15 November 2016, as follows:

	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB rate	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%

This forecast removes the expected further cut to Base Rate by the Bank of England of 0.10%, as this no longer looks likely given the strong economic data in the UK. The first increase in Base Rate has been pencilled in for June 2019 after the Brexit negotiations have been concluded. Long term rates have been adjusted to reflect existing levels of 2.3% to 2.7% and are forecast to gradually rise by a further 0.50% by March 2020. Capita have also increased their target levels for new borrowing to **1.60% (5 year), 2.30% (10 year), 2.90% (25 year) and 2.70% (50 year)**, compared to 2.00%, 2.60%, 3.40% and 3.20% respectively, as recorded in the Strategy in March.

The usual caveats apply to this forecast as Capita point out the volatility of rates and the difficulty to predict their movement due to all the uncertainties that prevail. Capita predict that the US Fed rate is likely to go up more quickly and more strongly than the UK Base Rate. They view the overall balance of risks to economic recovery in the UK to remain on the downside, particularly with the current uncertainty over the final terms and impact of Brexit.

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3. Annual Investment Strategy/ Authorised Lending List Changes to 31st December 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. There have been no significant changes to the Authorised Lending List during the quarter up to 31st December 2016 other than the following name changes, reflecting restructuring of the Counterparties:

Pohjola Bank Finland Changed to OP Corporate Bank Finland
SWIP MMF changed to Aberdeen MMF
IGNIS MMF changed to Standard Life MMF

3.6. At the 31st December 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 31st December 2016, compared to Capita's creditworthiness list, and changes to credit rating of counterparties during December 2016 are shown in Appendix B.

4. Investment Position to 31st December 2016 – Comparison With Strategy

4.1. The Council's investment position and cumulative annualised return at 31st December 2016 are detailed in the table below:

Investment Position At 31.12.16	Return (Annualised %)	Weighted Benchmark (Annualised %)	Outperformance
£284.882m	**0.68%**	**0.33%**	**0.35%**

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 0.24% to 0.46%. 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) has remained constant and stood at 125 days on 31st December 2016 from 123 days on 30th September 2016. (Highlighted in Appendix B). The outperformance of the benchmark 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 at this time.

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 3rd 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 31/12/2016			
	LCC	**Benchmark Group(8)**	**English Counties (13)**
31 December Return %	0.60%	0.51%	0.54%
Risk Banding	0.54% -0.66%	0.42% - 0.55%	0.45% -0.57%
WAM (days)	125	81	94

5. Borrowing & Debt Rescheduling Position to 31st December 2016 – Comparison with Strategy

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 31st December 2016 is detailed in the table below and shows £12m of external borrowing from the PWLB was undertaken to the end of December 2016 bringing the cost of the Council's debt down to 4.068% 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 31.12.2016	**Maturing Debt £m**	**Debt To Fund CapEX £m**	**Total £m**	**% Cost**
Balance at 1.4.2016	0.0	480.099	480.099	4.077%
New Borrowing to 31.12.2016	0.0	12.000	12.000	2.393%
Borrowing Repaid to 31.12.2016	(14.000)	(1.354)	(15.354)	
Debt Rescheduling to 31.2.2016				
-Borrowing Repaid	0.0	0.0	0.0	
-Borrowing Replaced	0.0	0.0	0.0	
Balance at 31.12.2016	**(14.000)**	**490.745**	**476.745**	**4.068%**
Projected Further Borrowing Required in 2016/17 (net of internal borrowing CF)	0.0	0.644	0.644	
Projected Further Borrowing Repayments – Actual	(0.000)	(0.000)	(0.000)	
- Voluntary	(0.0)	(0.644)	(0.644)	
Projected Borrowing Position at 31.03.2017	**(14.000)**	**490.745**	**476.745**	**4.068%**
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 31st December 2016, from that originally agreed by Full Council at its meeting on 19th February 2016.

	Original Budget at 1/4/2016 £m	Position at 31/12/2016 after Carry Forwards and Target Changes £m
Net Capital Expenditure Programme 2016/17	86.408	55.793
Borrowing Requirement 2016/17	78.794	50.353

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 and any slippage of the capital programme.

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 £47.7m). 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 31st December 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 2016/17 to 31 December 2016.

6. Other Treasury Management Issues

6.1. Possible Discounted PWLB Rate for High Value Infrastructure Projects:

The government announced in the Autumn Statement 2016, that it would consult on lending local authorities up to £1billion at discounted rates to support infrastructure projects that are high value for money. This rate would be based on gilt rates + 0.60%, a reduction of current available PWLB rates by 0.20%. Loans could be taken up to a period of 50 years. This offer would be available for 3 years. The consultation period closed on 27th January 2017.

The details of this proposal are not yet clear, but it will be based on authorities having to undertake some Net Present Value (NPV) calculations in line with Government Guidance. The inference is that borrowing at the low rate will only be available to those with the best NPV's. Schemes delivering or facilitating new housing would be the most welcome. It is not clear whether applications can only be made for brand new schemes or whether those in the pipeline but not started would qualify.

2. Conclusion

Short Term Interest Rates are now set to remain flat until at least June 2019. Long Term rates have rallied back to near start of the year levels as The UK Economy and Consumer Spending remains strong despite expected fears over Brexit. The Council's investment return to 31st December 2016 of 0.68% is still outperforming the benchmark given the lengthy WAM. This lengthy WAM ensured that its return beat that of its benchmarking comparators. £12m PWLB debt was taken in June/July 2016 at an average rate of 2.39%, bringing the cost of the Council's debt down to 4.068% in line with the Strategy. This level was close to the low point of the year at just below 2%, available in August 2016. It is not expected to take any more debt now as the Capital Programme Borrowing Requirement has slipped. There may be a possibility of taking cheaper PWLB borrowing for infrastructure projects next year but details have to be finalised by the Government.

3. Consultation

a) Have Risks and Impact Analysis been carried out??

Yes

b) Risks and Impact Analysis

Risk & Impact Analysis for Treasury Management forms TMP1 of the Treasury Management Practices, as required by the CIPFA Code of Practice 2011. A Risk Register which details the main risks for Treasury Management has been completed and is reviewed annually. Both the TMPs and the Risk Register are held in the Treasury Files held on IMP at County Offices.

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 2016 - Capita Asset Services Ltd.

5. Background Papers

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 - 19/2/2016	Lincolnshire County Council, Finance and Public Protection

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