Policy and Scrutiny

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

Report to:	**Overview and Scrutiny Management Board**
Date:	**28 September 2017**
Subject:	**Treasury Management Update 2017/18 - Quarter 1 Update Report to 30 June 2017**

Summary:

This report has been prepared in accordance with the reporting recommendations of the CIPFA Code of Practice 2011 and details the results of the Council's treasury management activities for the first quarter of 2017/18 to 30 June 2017, comparing this activity to the Treasury Management Strategy for 2017/18, approved by the Executive Councillor for Finance on 20th March 2017. It will also detail any issues arising in treasury management during this period.

Actions Required:

That the report be noted.

1. Background

1. Introduction and Background

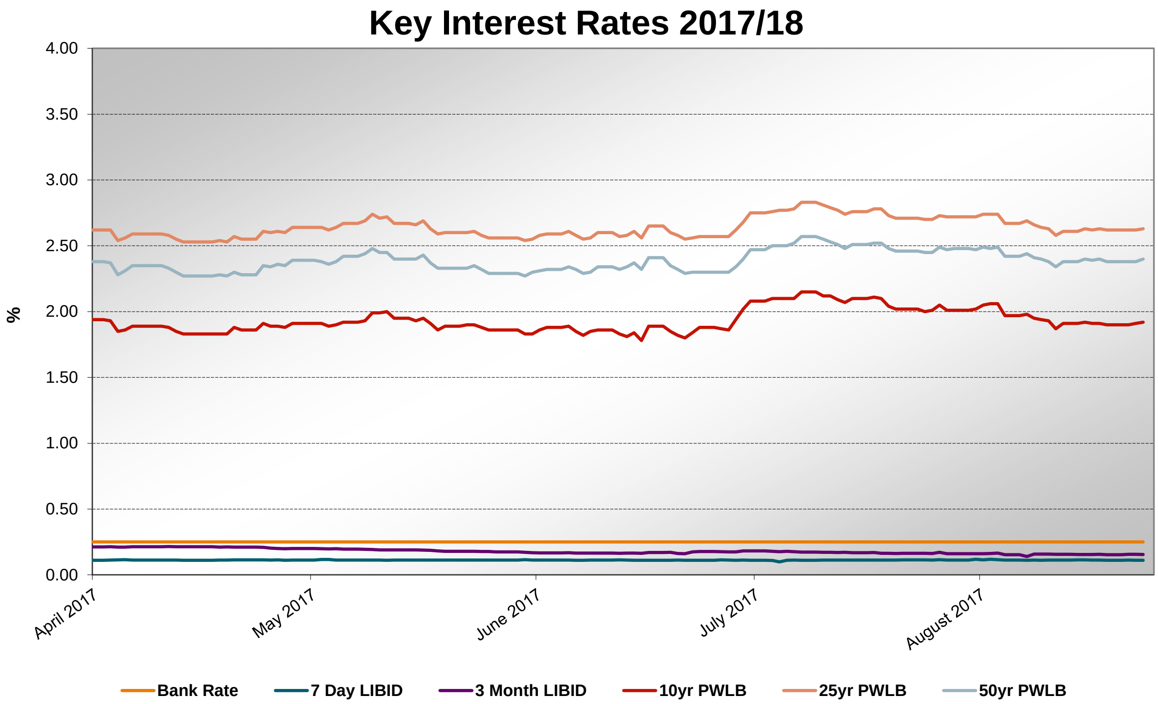
1.1. Treasury Management relates to the policies, strategies and processes associated with managing the cash and debt of the Council through appropriate borrowing and lending activity. It includes the effective control of the risks associated with the lending and borrowing activity and the pursuit of optimum performance consistent with the risks.

1.2. This Treasury Report will cover the following positions to 30th June 2017:
- 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 June 2017

2.1. At the time of setting the Strategy in March 2017, short term bank rate was expected to remain at 0.25% for the year and long term rates were forecast to rise no more than 0.10% by the end of the year.

2.2. Actual rates have indeed remained relatively flat since the start of the year as shown in the graph below:



2.3. Economic Background - The quarter ended 30th June 2017 saw the following:

- The economy showed signs of re-accelerating, but forecasts for GDP have since been pulled back to 1.7% from 1.9%;
- Little change to inflation forecasts –inflation to peak around 3% in October 2017 (currently 2.6%), then fall back to about 2.2% at the end of the three year time horizon.
- Higher inflation has led to an intensifying squeeze on households' real earnings as wage inflation struggles to keep pace;
- The MPC took a more hawkish turn, with 3 members voting to raise interest rates;
- A snap General Election (8th June 2017) delivered a hung Parliament, a huge backfire for the Government position;
- Face to Face negotiations with the EU began, with Brexit still the main cause of uncertainty.

2.4. The latest interest rate from Capita is shown below which has not altered since setting the Strategy in March 2017:

	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%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%

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 with Brexit. 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. But the balance of risks to increases in Bank Rate and shorter term PWLB rates are to the upside and are dependent on how quickly inflation pressures rise. Their forecast also assumes there will be no breakup of the Eurozone, other than the UK departure, and no major escalation of international relations between the US and China/North Korea.

Downside Risks (Rates falling for UK gilts/PWLB rates)

- Geopolitical risks in Europe, the Middle East and Asia, which could lead to 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 to get inflation up consistently to around monetary policy target levels.

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. <u>Annual Investment Strategy/ Authorised Lending List Changes to 30th June 2017</u>

3.1. The Council's Annual Investment Strategy for 2017/18 was approved, along with the Treasury Strategy, by the Executive Councillor for Finance on 20th March 2017, after being scrutinised by the Value For Money Scrutiny Committee on 28th February 2017. The Strategy 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 Short and Long Term Ratings, Sovereign Credit Ratings and Credit Default Swap overlay information provided by Capita.

3.3. 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 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 Authorised Lending List at 30 June 2017, based on this creditworthiness approach, together with a key explaining the credit rating scores.

3.4. The table below details changes to the Authorised Lending List during the first quarter of 2017/18:

Counterparty	**Action**	**Reason**
Union Bank of Switzerland (UBS)-Swiss	Addition: Limit £20m 364 Day	In line with Credit Policy
Nationwide Building Society UK	Addition: Limit £15m 6 Months	In line with Credit Policy

3.5. There were no breaches of Lending Limit over the quarter to 30th June 2017 due to limit changes or error.

3.6. A full list of the investments held at 30th June 2017, compared to Capita's creditworthiness list, and changes to credit rating of counterparties during June 2017 are shown in Appendix B.

4. Investment Position to 30th June 2017- Comparison with Strategy

4.1. The Council's investment position and cumulative annualised return at 30th June 2017 are detailed in the table below:

Investment Position At 30.06.17	Return (Annualised %)	Weighted Benchmark (Annualised %)	Outperformance
£301.285m	**0.54%**	**0.18%**	**0.36%**

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. All investments have been placed in line with the Strategy. Where possible lending has been done in the one year period during the first quarter which has increased the investment portfolio weighted average maturity (WAM) slightly from 153 days at 31st March 2017 to 168 days at 30th June 2017.

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 15 English Counties. The results of this benchmarking for the 1st 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 30/6/2017			
	LCC	**Benchmark Group (9)**	**English Counties (15)**
30 June Return %	0.52%	0.41%	0.45%
Risk Banding	0.48% to 0.59%	0.34% to 0.46%	0.35% to 0.47%
WAM (days)	168	75	83

4.6. Temporary borrowing of £10m was outstanding at 30th June 2017, taken to support identified cashflow requirements forecast in 2017/18. This was at an interest rate of 0.28% and is cash neutral being offset with Investment returns in excess of this amount.

5. Borrowing & Debt Rescheduling Position to 30th June 2017 - Comparison with Strategy

5.1. The Strategy for 2017/18 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. To date, no external debt has been taken or debt rescheduling undertaken and the Council's borrowing position at 30th June 2017 is as follows:

Borrowing Activity 2017/18	**Maturing Debt £m**	**Debt To Fund Capital Expenditure £m**	**Total £m**	**% Cost**
Opening Balance at 1.4.2017 New Borrowing to 30.6.2017 Borrowing Repaid to 30.6.2017	0.000 0.000 (10.000)	476.745 0.000 (0.677)	476.745 0.000 (10.677)	4.068%
Debt Rescheduling to 30.6.2017 -Borrowing Repaid -Borrowing Replaced	0.000 0.000	0.000 0.000	0.000 0.000	
Balance at 30.6.2017	**(10.000)**	**476.068**	**466.068**	**4.077%**
Projected Further Borrowing Required in 2017/18 (net of internal borrowing CF) Projected Further Borrowing Repayments –Actual -Voluntary	0.000 (4.000)	48.844 (0.677) (1.794)	48.844 (4.677) (1.794)	
Projected Borrowing Position at 31.03.2018	**(14.000)**	**522.441**	**508.441**	
Authorised Limit For External Debt			583.007	

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 £69.343m at 31st March 2017. A further £34.579m of internal borrowing will be made in 2017/18 to cover the 2016/17 carry forward of capital expenditure, making the total predicted internal borrowing balance for 2017/18 of £103.922m.

5.4. The Council's Capital Expenditure plans and Borrowing Requirement at 30th June 2017, from that originally agreed by full Council at its meeting on 24th February 2017 is shown below:

	Original Budget at 1/4/2017 £m	Position at 30/6/2017 after Carry Forwards
Net Capital Expenditure Programme 2017/18	49.444	94.017
Borrowing Requirement 2017/18	48.844	83.423

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 £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 3.93%.

5.6. No debt rescheduling activity of existing debt has taken place to 30th June 2017, 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 24th February 2017, approved the Council's Prudential Indicators for 2017/18, 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 2017.

6. Other Treasury Management Issues

6.1. MiFID II (Markets in Financial Instruments Directive)

The Financial Conduct Authority (FCA) has issued the above Directive which comes into force on 3rd January 2018. It relates to the rules governing the relationship between investors and who they invest with and applies to regulated products such as Certificates of Deposit, Bonds and Money Market Funds.

The Council will have to opt up to Professional Status to deal in these products by passing certain Qualitative and Quantitative tests, which it will do.

This will involve a certain amount of administration to achieve and it is hoped that this can be streamlined to cut down on the work required.

6.2. Consultation on Proposed Changes to CIPFA Treasury Management Code and Prudential Code –Closes 30th September

Views are being sought to proposed changes to the above CIPFA Codes that govern Treasury Management, which were last updated in 2011. It is intended to bring the Codes more up to date with the current Treasury environment.

7. Conclusion

Interest Rates have remained flat over the quarter in line with forecasts. The Council continues to outperform the investment by lengthening the Weighted Average Maturity of the Fund. No external borrowing has been undertaken to date. The cost of the Council's borrowing at 30th June 2017 was 4.077%. The Council's internal borrowing level stood at £69.343m at 31st March 2017 with £34.579m of internal borrowing being carried forward in 2017/18 along with capital expenditure and borrowing requirement underspends. Temporary borrowing of £10m was outstanding at 30th June 2017 taken to cover predicted liquidity shortfalls at a cost neutral level. The Council will have to opt to Professional Status under MiFID II requirements which come into force on 3rd January 2018. Changes to the CIPFA Treasury Management Code and Prudential Code are planned to bring it more up to date with the current treasury environment.

8. 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.

9. 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 2017 -Capita Asset Services Ltd.

10. Background Papers

Document title	Where the document can be viewed
Treasury Management Strategy Statement and Annual Investment Strategy 2017/18 -20/3/2017	Lincolnshire County Council, Finance and Public Protection
Council Budget 2017/18 - 24/2/2017	Lincolnshire County Council, Finance and Public Protection

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