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:	**Overview and Scrutiny Management Board**
Date:	**28 June 2018**
Subject:	**Treasury Management Annual Report 2017/18**

Summary:

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

Actions Required:

The Overview and Scrutiny Management Board is invited to support the content of the Treasury Management Annual Report 2017/18 and agree any comments to be passed onto the Executive Councillor for Resources and Communications.

1. Background

1. Introduction and Background

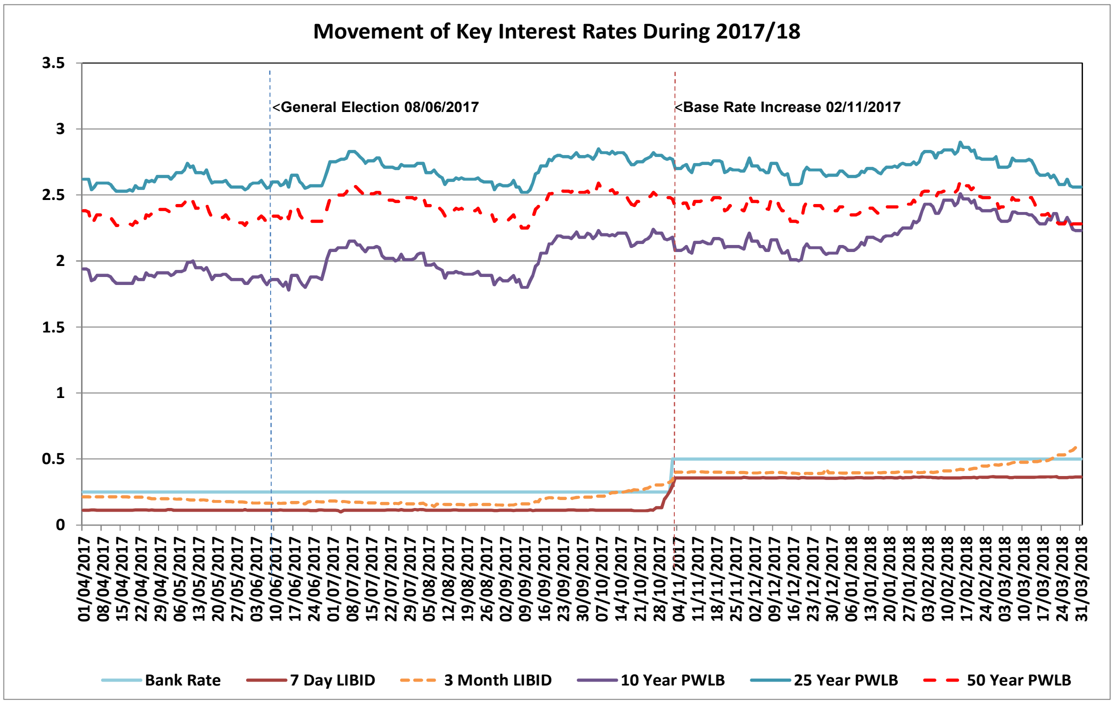
1.1. Treasury Management relates to the policies, strategies and processes associated with managing the cash and debt of the Council through appropriate borrowing and lending activity. It includes the effective control of the risks associated with the lending and borrowing activity and the pursuit of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

1.2. This Annual Treasury Report will cover the following matters for the year 2017/18:
- An economic overview and interest rate review.
- Investment outturn and comparison with strategy.
- Annual investment strategy/ authorised lending list changes during the year.
- Borrowing outturn and debt rescheduling activity and comparison with strategy.
- Other treasury issues during 2017/18.

2. <u>Economic Overview and Interest Rate Forecast 2017/18</u>

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. The graph below shows that Base Rate was increased for the first time in a decade on 2 November 2017 to 0.50% leading to short term rates rising from this point as market expectations for further increases in Bank Rate took hold. Long term rates ended the year around 0.10% lower than they started at the longer end, with many fluctuations in between.



2.3. The General Election result in June 2018, resulting in a hung parliament and a considerably weakened Conservative Government, had little impact on financial markets.

2.4. During the year Base Rate expectations were driven by the pattern of growth in the UK economy and the Monetary Policy Committee's (MPC) comments on this over the year. Growth in the first half of 2017 was disappointingly weak (the slowest rate since 2012). This was due to the sharp increase in inflation caused by the devaluation of sterling after the EU Brexit referendum in June 2016. Cost of imports increased as a result which led to a reduction in consumer spending. Growth started to pick up in the second half of the year leading the MPC to hint at an imminent Base Rate rise in September 2017. This rise to 0.50% came on 2 November 2017 and short term rates followed to around this level. The minutes of the February MPC meeting revealed another sharp warning of more imminent and faster pace of increases in Base Rate due than was previously expected. This fuelled market expectations leading to sharp increases in investment rates from 3 to 12 months by the close of the year. Growth for 2017 ended at 1.7% (up from forecast of 1.5%). Estimates of growth in 2018, 2019 and 2020 were 1.5%, 1.3% and 1.3% respectively. Base Rate was not increased again and remained at 0.50% at the end of the year. Due to the weak growth forecasts, the expected rate rises in May 2018 did not materialise and expectations for rate rises have been pegged back again.

2.5. Inflation was not a significant factor during the year. The MPC forecast that CPI would peak at about 3.1% as a result of the devaluation of sterling caused by the result of the Brexit referendum. This was viewed as a one off impact, for which the MPC was not duly concerned. CPI inflation ended the year at 2.7%, falling to 2.4% in April 2018.

2.6. The US Fed has been the first major western central bank to start raising rates. Starting in December 2015, the Central Rate has been increased 6 times to 1.75% in March 2018. They are also the first to start unwinding quantitative easing by a gradual reduction in reinvesting maturing debt. US growth for 2017 was 2.3%, from 1.6% in 2016. Unemployment fell to its lowest in 17 years reaching 4.1%. Wage and general inflationary pressures are rising in the US as the economy is operating at near full capacity. Further increases in rate are expected in 2018.

2.7. Economic Growth in the EU continued to gather momentum with overall GDP at 2.3% in 2017. Nevertheless despite providing massive monetary stimulus by extending QE, the ECB is struggling to get inflation up to its 2% target and in March, inflation was still only 1.4%. Any rate increases are therefore unlikely until at least the end of 2019.

3. <u>Investment Outturn 2017/18 and Comparison with Strategy</u>

3.1. The Council's investment activity, position and return as at 31 March 2018 are detailed in the table below:

Investment Activity 2017/18	**£m**		
Opening Balance at 01.4.2017	255.69		
Investments Made In 2017/18	929.86		
Investments Repaid In 2017/18	927.85		
Closing Balance at 31.3.2018	**257.70**		
Investment Return 2017/18	**Return Annualised**	**Weighted Benchmark Annualised**	**Outperformance**
Year to 31.03.2018	0.54%	0.28%	0.26%

3.2. The investment balance at 31 March 2018 comprised general and earmarked reserves, Pension Fund Cash (£15.2m), income received but not yet used/spent and general movement of working capital. The average value of investments during 2017/18 was £295.3m, although the investment balance at year end has remained relatively static compared to the previous year.

3.3. In line with the strategy, investments were made in periods of 4 months to 2 years to lock into rates above benchmark rate level, and use of bank call accounts and money market funds were made for liquidity that offered returns ranging from 0.20% to 0.75%. The majority of investments have been in the 364 day area and a couple of two year investments were taken during the year. This was to take advantage of the enhanced yields available in these periods. Investments included fixed deposits, bonds and certificates of deposit. As a result of the strategy, the weighted average maturity of the investment portfolio lengthened slightly over the year, starting at 153 days and ending at 167 days on 31 March 2018.

3.4. The benchmark target return for investments used is a weighted benchmark that uses both the 7 day LIBID and 3 month LIBID market rates, weighted to 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 movement. Market rates have fallen over the year. The cumulative benchmark rate for 2017/18 was 0.28% compared to 0.31% in 2016/17. The Council outperformed this benchmark by 0.26% in 2017/18 with a return of 0.54%, compared to 0.65% in 2016/17, and produced an investment return of £1.390m, (£1.390m in 2016/17), compared to a forecast of £1.0m. This outperformance was achieved by investing in longer term investments at average rates of 0.68% for most of the year.

3.5. The investment return was also benchmarked against the Link Benchmarking analysis, comprising a mixture of 9 other authorities in the East Midlands area and 14 English Counties. The results are detailed below as at 31 March 2018.

Link Benchmarking – Position at 31/3/2018			
	LCC	**Benchmark Group(9)**	**English Counties (14)**
March Return %	0.66%	0.57%	0.60%
Risk Banding	0.62% -0.74%	0.50% - 0.61%	0.52% -0.64%
WAM (days)	167	77	85

3.6. The benchmarking results show that the Council is above par with the investment returns achieved by its Link comparators in 2017/18. This is due to a longer Weighted Average Maturity (WAM) position taken by the Council. This is a good result given the conservative nature of the Counterparties allowed on the Authorities Lending List (restricted to a Long Term minimum rating of A+) for which these comparators were not restricted to. Link calculates a risk banding return that should be achievable for the level of risk being taken on investments and the Council is in line with this banding.

3.7. Temporary borrowing totalling £51m was taken throughout the year to cover a shortfall in liquidity predicted at certain times. The average cost of this temporary borrowing was 0.31%, which was cost neutral as surplus borrowing was invested in money market funds at an average of 0.30%. This was in line with strategy and as an alternative to drawing on higher yielding Notice Accounts when necessary. No temporary borrowing remained outstanding at 31 March 2018.

4. Annual Investment Strategy/ Authorised Lending List Changes During 2017/18

4.1. The Council's Annual Investment Strategy for 2017/18 was approved, along with the Treasury Strategy, by the Executive Councillor with responsibilities for Finance on 20 March 2017, after being scrutinised by the then Value for Money Scrutiny Committee on 28 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.

4.2. As such investments are only placed with highly credit rated financial institutions, using Link's suggested creditworthiness approach, including Short and Long Term Ratings, Sovereign Credit Ratings and Credit Default Swap overlay information provided by Link Asset Services.

4.3. In addition to Link'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 31 March 2018, based on this creditworthiness approach, together with a key explaining the credit rating scores.

4.4. The table below shows the changes to the Authorised Lending List over 2017/18, predominantly resulting from positive changes to credit ratings over the year.

Counterparty	Action	Reason
Lloyds Group (UK) (Lloyds and BOS)	Change: Limit increased to £20m / 364 Day.	Improved Credit Rating & Loss of Part Nationalised Status.
Nordea Bank (Finland)	Removal from List.	Banking Restructure Leading to Exit from Market.
ING Bank (Netherlands)	Change: Limit increased to £20m / 364 Day.	Improved Credit Rating.
UBS Ltd (UK)	Change: Limit increased to £20m / 364 Day.	Improved Credit Rating.
Bank of America (USA)	Change: Limit increased to £20m / 364 Day.	Improved Credit Rating.
Aberdeen Global Liquidity MMF/ Standard Life Liquidity MMF	Group Limit of £20m / 24 Months applied.	Merger of both MMFs to form Aberdeen Standard Group.

4.5. At the 31 March 2018 no investments to Counterparties on the list were in breach of limit due to limit changes.

4.6. A full list of the investments held at 31 March 2018, compared to Link's creditworthiness list, and changes to credit rating of counterparties during March 2018 are shown in Appendix B.

5. <u>Borrowing Outturn & Debt Rescheduling Activity 2017/18 and Comparison with Strategy</u>

5.1. The Capital Programme expenditure plans were revised during 2017/18 from that agreed by Full Council at its meeting on 24 February 2017 and actual spending was under budget. The result on the corresponding Borrowing Requirement for the year is shown in the table below:

	Original Budget at 1/4/2017 £m	Final Budget at 31/3/2018 £m	Actual at 31/3/2018 £m	Underspend £m
Net Capital Expenditure Programme 2017/18	49.444	79.838	53.088	26.750
Borrowing Requirement 2017/18	48.844	36.548	14.602	21.946

5.2. 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.

5.3. The Council's actual borrowing and debt rescheduling position as at 31 March 2018 and activity during 2017/18, is detailed in the table below:

Borrowing Activity 2017/18	Maturing Debt £m	Debt To Fund Capital Expenditure £m	Total £m	% Cost
Opening Balance at 1.4.2017	0.0	476.745	476.745	4.068%
New Borrowing in 2017/18	0.0	0.000	0.000	
Borrowing Matured/Repaid in 2017/18	(14.000)	(1.354)	(15.354)	
Debt Rescheduling:-				
Borrowing Repaid in 2017/18	0.0	0.0	0.0	
Borrowing Replaced in 2017/18	0.0	0.0	0.0	
Closing Balance at 31.3.2018	**(14.000)**	**475.391**	**461.391**	**4.088%**
Authorised Limit For External Debt 2017/18			583.007	

5.4. The table above shows that no external borrowing was taken during the year, the borrowing requirement being met in full by internal borrowing in 2017/18.

5.5. Total Lenders Option Borrowers Option (LOBO) debt the Council has still stands at £30m, well within the limit set in the strategy of 10% of total external debt (equating to £46.1m). A limit is set on this type of borrowing to limit the amount of variability within the debt portfolio for debt repayment.

5.6. Appendix C shows the maturity profile of the Council's long term debt as at 31 March 2018, including the variability effect of the £30m LOBO debt held. (LOBO debt allows the Lender the opportunity to change the rate on the Loan at specified intervals and the Borrower the option to accept this change or repay the loan.) The graph shows a fairly even maturity profile with no debt maturing in any one year exceeding 10.38% of the total debt portfolio.

5.7. Internal Borrowing is using internal balances to finance capital spend, instead of external borrowing. 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. The balance of internal borrowing at 31 March 2018 stood at £82.152m from £69.343m the previous year and is broken down as follows:

2011/12	£15.459m
2012/13	£56.486m
2013/14	£26.028m
2014/15	(£13.417m)
2015/16	(£18.343m)
2016/17	£3.130m
2017/18	£12.808m
Total	£82.152m

A further £21.946m of internal borrowing will be carried forward to 2018/19 along with the Capital Programme and Borrowing Requirement underspends, which will bring total internal borrowing to £104.097m. (16.0% of the 2018/19 authorised borrowing limit). Scope for further internal borrowing after this will be limited as cash balances are run down going forward.

5.8. It is worth pointing out that the internal borrowing balance detailed above can be taken externally at any time if investment interest rate yield curves reverse and move higher than long term borrowing rates in the future.

5.9. The table below shows how the final borrowing requirement for 2017/18 was utilised.

	£m
Final Borrowing Requirement 2017/18	14.602
Made Up Of:	
Voluntary Repayment Debt 2017/18	1.794
Actual Borrowing Undertaken in 2017/18	0.000
Internal Borrowing BF from 2016/17	34.579
Internal Borrowing 2017/18	0.175
Internal Borrowing Underspend CF to 2018/19	-21.946
Total	**14.602**

5.10. No debt rescheduling activity took place during the year 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).

5.11. Interest paid on long term borrowing in 2017/18 was £19.000m some £0.966m under budget due to the underspend of the capital programme borrowing requirement and internal borrowing taken.

5.12. Full Council, at its meeting on 24 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 were breached during 2017/18. Appendix D compares actual key treasury Prudential Indicators with those estimated for 2017/18.

6. Other Treasury Management Issues

6.1. MIFID II (Markets in Financial Instruments Directive)

The Financial Conduct Authority (FCA) issued the above Directive which came into force on 3 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 has met certain Qualitative and Quantitative tests to opt up to professional status where necessary with all its market participants to enable it to continue to invest in accordance with its Investments Strategy.

6.2. Revised CIPFA Treasury Management and Prudential Codes 2017

CIPFA issued revised codes that govern Treasury Management in December 2017, following a consultation. The Codes were last updated in 2011. The new Codes revisions apply to and from Council's 2018/19 budgets. The prime reason of these revisions was to highlight the increased emergence of **non-treasury investments** held in other financial assets and property, primarily held for return by Councils. Such activity includes loans supporting service outcomes, investments in subsidiaries and investment property portfolios. CIPFA has emphasised that these investments, although not part of general treasury management activity, are the responsibility of the S151 Officer and should therefore be managed and subject to the same risk / return considerations as for treasury. Within the Codes, CIPFA recommend that details of these non-treasury investments should be included in an annual **Capital Strategy**, which will also set out the Council's risk appetite and specific policies and governance arrangements for these non-treasury investments. This Capital Strategy will be completed in 2018/19 and will follow the same approval and scrutiny path as the Treasury Strategy.

The new codes also propose some minor changes to the Prudential and Treasury Indicators that have already been adhered to in the Treasury Management Strategy for 2018/19.

6.3. MHCLG Investment & MRP Guidance

New MHCLG Investment & MRP Guidance was issued in February 2018. This too focuses particularly on non-treasury asset investments and their classification and to make sure that the increasingly complex business models for non-treasury related activities being adopted are highlighted and that risk exposure on these investment decisions is being highlighted and understood.

The definition of a long term investment has also been confirmed as over 365 days (change from within 12 months). There are also changes to guidance on retrospective changes to MRP policy.

As with the CIPFA Codes, this Guidance was last updated in 2010 and 2012 and the new Guidance will be adopted from 2018/19 going forward.

2. Conclusion

Base Rate was increased for the first time in a decade to 0.50% in November 2017, whilst longer terms rates remained relatively flat throughout the year ending the year just around 0.10% lower than where they started. In light of this backdrop the Council still outperformed its investment benchmark during the year by 0.26%, achieving an annualised return of 0.54% and also beat benchmarking comparators from Link. This was achieved by lengthening the Weighted Average Maturity of investments, which stood at 167 days at 31 March 2018. The level of Council treasury investments at 31 March 2018 stood at £257.7m. The cost of the Council's borrowing remained at just above 4%. No external borrowing was taken during the year, its borrowing requirement being met from internal cash resources or internal borrowing hence the level of external borrowing fell to £461.4m at 31 March 2018. The Council's internal borrowing level stood at £82.152m at 31 March 2018. A total of £21.946m of internal borrowing will be carried forward to 2018/19 along with capital expenditure and borrowing requirement underspends. Temporary borrowing of £51m was undertaken in 2017/18 to cover predicted liquidity issues during the year at a cost neutral level. This sum was repaid before 31 March 2018. The Council opted up to professional status with its market participants during the year, in line with MIFID II requirements. Both CIPFA and MHCLG issued revised Codes and Guidance during the year primarily to accommodate the rising trend of non-treasury related investments in Councils. The new requirements from these new documents will be adhered to in 2018/19.

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 2017. 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 at 31 March 2018 and Credit Rating Key
Appendix B	Investment Analysis Review at 31 March 2018 - Link Asset Services Ltd
Appendix C	LCC Long Term Maturity Profile as at 31 March 2018
Appendix D	Prudential Indicators -Actuals Compared to Estimates 2017/18

5. 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

This report was written by Karen Tonge, who can be contacted on 01522 553639 or karen.tonge@lincolnshire.gov.uk.

This page is intentionally left blank