Lincolnshire COUNTY COUNCIL
Working for a better future

Policy and Scrutiny

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

Report to:	**Value for Money Scrutiny Committee**
Date:	**23 February 2015**
Subject:	**Treasury Management Update 2014/15 - Quarter 3 Report to 31 December 2014**

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 2014/15 to 31 December 2014, comparing this activity to the Treasury Management Strategy for 2014/15, approved by the Executive Councillor for Finance on 25 March 2014. 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.

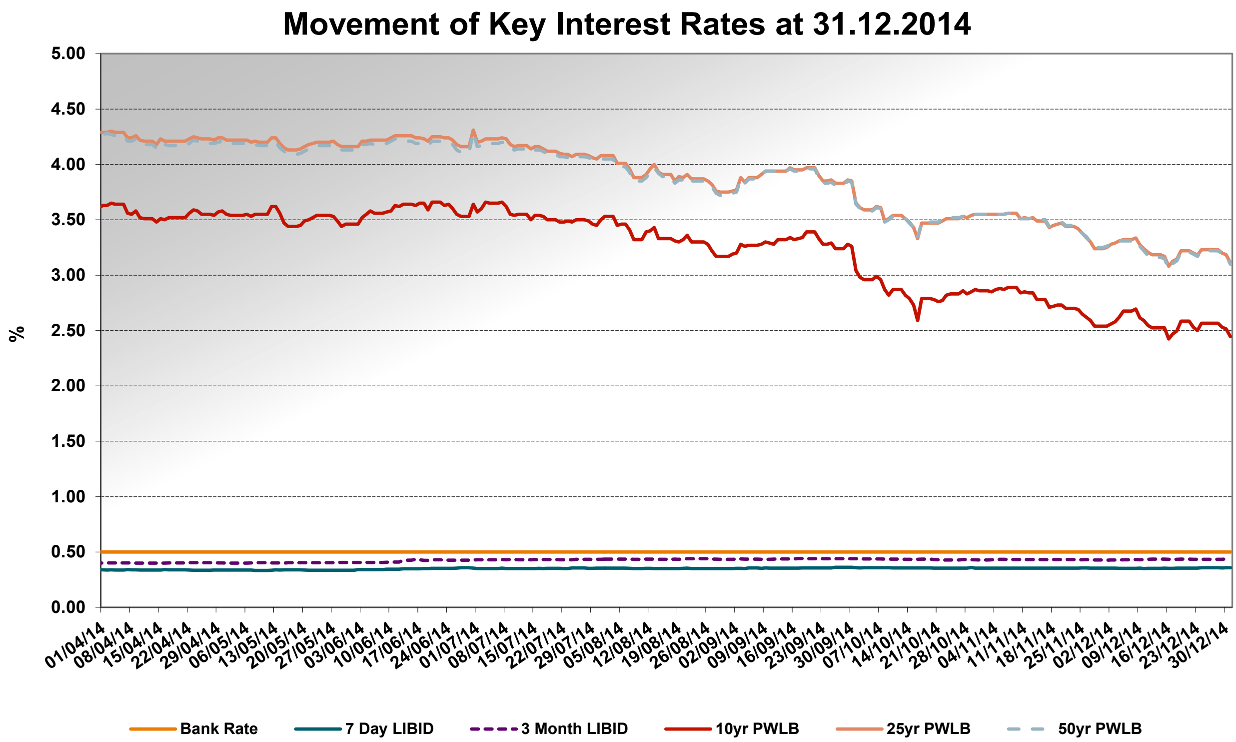
1.2. This Treasury Report will cover the following positions to 31st December 2014:
- Interest rate review, economic overview and revised interest rate forecast.
- Annual investment strategy/ authorised lending list changes during the quarter.
- Investment position and comparison with strategy.
- Borrowing & debt rescheduling position and comparison with strategy.

2. Interest Rate Review, Economic Overview and Revised Interest Rate Forecast to 31st December 2014

2.1. At the time of setting the Strategy in February 2014, the markets were forecasting short-term Bank Rate to remain at 0.50% throughout 2014/15, with an increase not expected until June 2016, later brought forward to March 2015.

2.2. Long term rates were forecast to rise gradually in 2014/15 by only 0.10% or so, remaining at relatively low levels, but remaining volatile and difficult to predict due to external market influences.

2.3. The graph below shows the actual movement of both UK long term and short term interest rates over 2014/15 to 31st December 2014.



2.4. The graph shows that short term rates have remained flat over the period as anticipated. Long term rates however started to fall in August and have continued to fall quite significantly over recent weeks, plunging to phenomenally low levels. Long term rates are currently around 1.00% lower than at the start of the year. This fall has been due to a number of factors, namely concerns over economic and political events worldwide in general and more recently the plunge in oil prices leading to market concerns. These factors have led to a 'flight to quality' by investors, (investors moving into safe haven bonds and out of equities) which in turn increases bond prices and reduces bond yields and hence borrowing rates.

2.5. Economic Background - The quarter ended 31st December 2014 saw the following:

- GDP growth falling back to 0.7%/ 2.6% annual rate during the quarter. Revisions of growth forecasts for 2015 and 2016 reduced (2.6% and 2.4% respectively, although growth still remains strong by UK Standards - fastest growth since 2007). To be sustainable the economy needs to move away from dependence on consumer spending and housing to exporting, particularly manufactured goods;
- Strong growth resulting in unemployment falling much faster than expected with the focus now being on reducing the slack in the economy and increasing labour productivity. Real wage growth now exceeding inflation which should lead to more robust consumer recovery;
- CPI inflation continued to fall reaching 0.50% in December, the lowest rate since May 2000. Recent falls have been linked to cheaper fuel and lower energy prices. Expectation is that the rate remains at this low level for some time;
- No signs of further interest rate hikes from the MPC –citing risks to recovery, weak inflation and slack in the Labour market:
- Government borrowing likely to miss target of being 6% lower this year than last;
- House price growth continued to slow down due to weaker demand;
- US showing strong growth around 5% level since ceasing their QE programme in October 2014, hence first increase in Fed rate predicted to be the middle of 2015.
- Eurozone posted a deflationary -0.2% inflation rate in December 2014 as a result of falls in energy prices. ECB to commence a QE programme of €60bn per month in March 2015 until at least September 2016 to curb this.

2.6. Capita Asset Services Ltd reviewed its interest rate forecast in early January 2015 and have reduced their forecast of rates across the board by around 0.20% to 0.50%, as follows:

	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
5yr PWLB rate	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
10yr PWLB rate	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
50yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%

The decrease in rate predictions reflect numerous factors such as the plunge in the price of oil, fears that Greece will exit the Eurozone after their General Election, the ECB starting a full blown QE programme and the possibility of the US increasing their interest rates by mid-2015. All these factors have led to market fears and a flight to quality, which in turn have led to bond yields plunging to phenomenally low levels. Quite how sustainable these low levels will be is difficult to predict. Other factors which may impact are the UK election in May and other World political events.

Increase in Bank Rate has been pushed further forward in this latest estimate to December 2015 due to the fall in inflation. Capita have also revised their target levels for new borrowing to 2.20% (5 year), 2.80% (10 year) and 3.40% (25y to 50yr), from 2.50%, 3.60% and 4.40% respectively, as recorded in the Strategy in March.

It can be seen from the impact to the interest rate forecast above, that there is huge volatility in rates from market reactions, making rates difficult to predict with any certainty going forward. Capita feels that the overall balance of risks to the economic recovery in the UK and interest rate levels is now balanced, listing the following factors:

Downside Risk Factors of Rates falling:

- The Ukraine situation poses a major threat to Eurozone and world growth if it was to deteriorate into economic warfare between the West and Russia, where Russia resorted to using its control over gas supplies to Europe.
- Fears generated by the potential impact of Ebola around the world.
- Boost from consumer spending and housing market booms fading beyond 2014, depressing UK growth.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK's main trading partner –the Eurozone, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.

- Recapitalisation of European banks requiring more government financial support.

- Lack of support by the people in Eurozone countries for austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.

- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity and reform programmes required.

- France: has a €50bn programme of austerity cuts over the next three years but have major obstacles in implementing this programme such as its employment practices and lack of competitiveness.

- Monetary policy action failing to stimulate growth in western economies, especially in the Eurozone and Japan.

- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.

- Concern over reluctance of western central banks to raise interest rates significantly for some years and the huge QE measures in place has created a lot of liquidity in the markets, all chasing yield in a low yield environment. The potential for taking increased risks is therefore heightened and is similar to the environment in 2008 which led to the financial crisis.

Upside risks that will increase interest rates:

- An adverse reaction by financial markets to the result of the UK general election in May 2015 and the policies adopted by the new government.

- A sudden reversal of Russian policy on military intervention in eastern Ukraine caused by continued depression in oil prices and sanctions.

- The US commencement of increases in their central rate in 2015 leading to flight from bonds to equities.

- A surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds into equities.

- UK inflation returning to significantly higher levels than in the wider EU and US causing an increase in the inflation premium inherent to gilts yields.

3. Annual Investment Strategy/ Authorised Lending List Changes to 31st December 2014

3.1. The Council's Annual Investment Strategy was approved, along with the Treasury Strategy, by the Executive Councillor for Finance on 25th March 2014 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 AA- Long Term Rating (Fitch) and AAA Sovereign Rating (Fitch) minimum limit for all its Counterparties excluding the UK and part-nationalised UK banks. 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. The support element of credit ratings from its scoring has been removed by Capita to concentrate solely on Short Term and Long Term ratings. This is in line with the Credit Rating Agencies who, due to changes in regulatory banking requirements, have indicated that they are starting to remove the uplift in ratings they give to institutions from implied levels of sovereign support, which they feel will no longer be there going forward. The timing of these changes by the Credit Rating Agencies is still subject to discussion. The impact on the Council's Lending List once they have commenced their changes to ratings may require the Council to re-examine its Lending List policy. A review of this policy is therefore being undertaken with Capita and results will be presented to the Executive Councillor for Finance and this Committee in conjunction with the Annual Investment Strategy for 2015/16.

3.4. The table below details changes to the Authorised Lending List during the 3rd quarter to 31st December 2014.

Counterparty	Action	Reason
Nordea Bank (Finland)	Removal from Lending List	Finland Sovereign Rating reduced to AA+ from AAA by S & P

3.5. No investments were outstanding with counterparties that were removed from the Council's Approved List and no loans were invested for longer than the duration limits in place, due to the lending list changes during the quarter.

3.6. A full list of the investments held at 31st December 2014, compared to Capita's creditworthiness list, and changes to credit rating of counterparties during December 2014 are shown in Appendix B.

4. Investment Position to 31st December 2014 – Comparison With Strategy

4.1. The Council's investment position and cumulative annualised return at 31st December 2014 are detailed in the table below:

Investment Position At 31.12.14	Return (Annualised %)	Weighted Benchmark (Annualised %)	Outperformance
£226.135m	**0.65%**	**0.40%**	**0.25%**

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 3 weeks 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 0.65%. Several 6 month and 1 year investments were made during the quarter to take advantage of the enhanced yields offered. The investment portfolio weighted average maturity (WAM) was 76 days at 31st December 2014 from 109 days at 31st March 2014. (As highlighted in Appendix B). The outperformance of the benchmark in the 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 3rd quarter are detailed below, which shows that the Council's return was on a par with that of the comparators for both yield and WAM. The Council's return is also within Capita's risk banding achievable for the level of risk being taken on its investments.

Capita Benchmarking – Position at 31/12/2014			
	LCC	**Benchmark Group(8)**	**English Counties (14)**
30 December Return %	0.66%	0.64%	0.68%
Risk Banding	0.61% -0.74%	0.61% - 0.74%	0.63% -0.76%
WAM (days)	76	77	78

5. Borrowing & Debt Rescheduling Position to 31st December 2014 – Comparison with Strategy

5.1. The Council's external borrowing position at 31st December 2014 is detailed in the table below and shows that £20m of new borrowing was undertaken during the quarter leaving the cost of the Council's debt at 4.137% at this time. No further borrowing is due in this financial year leaving a projected borrowing position at 31st March 2015 of £461.453m at a cost of 4.147%.

Borrowing Position at 31.12.2014	**Maturing Debt £m**	**Debt To Fund CapEX £m**	**Total £m**	**% Cost**
Balance at 1.4.2014	0.0	452.807	452.807	4.141%
New Borrowing to 31.12.2014	0.0	20.000	20.000	4.000%
Borrowing Repaid to 31.12.2014	(5.0)	(1.354)	(6.354)	
Debt Rescheduling to 30.9.2014				
-Borrowing Repaid	0.0	0.0	0.0	
-Borrowing Replaced	0.0	0.0	0.0	
Balance at 31.12.2014	**(5.0)**	**471.453**	**466.453**	**4.137%**
Projected Further Borrowing Required in 2014/15 (net of internal borrowing CF)	0.0	10.404	10.404	
Projected Further Borrowing Repayments – Actual	(5.000)	(0.000)	(5.000)	
- Voluntary	(0.0)	(10.404)	(10.404)	
Projected Borrowing Position at 31.03.2015	**(10.000)**	**471.453**	**461.453**	4.147%
Authorised Limit For External Debt 2014/15			594.125	

5.2. The table below shows the Council's Capital Expenditure plans and Borrowing Requirement at 31st December 2014, from that originally agreed by Full Council at its meeting on 21st February 2014.

	Original Budget at 01/04/2014 £m	Position at 31/12/2014 £m
Net Capital Expenditure Programme 2014/15	87.315	75.144
Borrowing Requirement 2014/15	80.815	37.200

5.3. The Strategy for 2014/15 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.

5.4. 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 £97.973m at 31st March 2014. A further £7.031m of internal borrowing will be made in 2014/15 to cover the 2013/14 carry forward of capital expenditure but it is thought that scope for further internal borrowing after this would be limited due to current levels of cash balance.

5.5. To overcome the cost of carry on any new borrowing (paying interest on borrowing at 4% levels and investing it out at levels of 0.60% until utilised), external LOBO (Lenders Option Borrowers Option) borrowing was arranged on 16th June 2014 for a start date of 31st December 2014. This type of borrowing gives the Lender the option to change the rate at various call intervals and the Borrower the option to either accept or repay. This borrowing maintains an even maturity profile and keeps the cost of borrowing around the existing level of 4.14% in accordance with the strategy. Details of the borrowing taken is detailed in the following table:

Lender	**Amount £**	**Start Date**	**Maturity Date**	**Length**	**Rate %**	**Call Option**
BAE Systems Pension Fund	£10m	31/12/2014	31/12/2061	47 years	4.00%	Every 5 years on/after 31/12/2026
BAE Systems Pension Fund	£10m	31/12/2014	31/12/2057	43 years	4.00%	Every 3 years on/after 31/12/2027

5.6. Total LOBO debt the Council has secured now stands 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.

5.7. No debt rescheduling activity of existing debt has taken place to 31st December 2014, 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).

5.8. A further £3m temporary borrowing was taken during the quarter for a 4 month period at a cost of 0.40% to cover a shortfall in liquidity forecast in January 2015, bringing the total temporary borrowing to £12m at an average cost of 0.399% . In terms of interest this is cost neutral, as surplus funds generated have been invested in Money Market Funds earning on average 0.43%. This is in line with strategy and is an alternative to drawing on higher yielding Notice Accounts when needed. All temporary borrowing is due to be repaid before the end of the financial year.

5.9. Full Council, at its meeting on 21st February 2014, approved the Council's Prudential Indicators for 2014/15, 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 2014/15 to 31st December 2014.

6. Conclusion

Short term Interest rates have remained flat over the period but long term rates have fallen by around 1.00%, reacting to a combination of worldwide concerns affecting markets, including the plunge in oil prices. Forecasts for future direction of rates are very hard to predict due to these external factors, but Capita now believe downside risks are balanced with upside risks for any movement in rates. The Council's investment return is outperforming the market benchmark still by 0.25% and the WAM is 76 days. The cost of the Council's borrowing is 4.137% predicted to be 4.14% by the year end. A sum of £20m LOBO borrowing was taken on 31st December 2014 at 4% to avoid cost of carry and internal borrowing will be restricted to covering the 2013/14 carry forward only this year. No more long term borrowing is required in 2014/15. Temporary borrowing of £12m has been undertaken to cover predicted liquidity issues later on in the year, which is due to be replaced by the end of the financial year.

7. 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.

8. 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 2014 - Capita Asset Services Ltd

9. 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 2014/15 25/3/2014	Lincolnshire County Council, Finance and Public Protection
County Council Report - Council Budget 2014/15 21/02/2014	Lincolnshire County Council, Finance & 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