

Treasury Management Activity - Second Report 2016-17

1. Background

The County Council's Treasury Management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year including year-end.

The activity to 31st July has already been reported to the Committee therefore this report considers treasury management activity between 1st August 2016 and 30th November 2016.

2. Economic Context in the period

The economic situation between August and November was dominated by the uncertainty about the short and medium term implications of the decision to leave the EU. In response to the risk of reduced economic growth the Bank of England Monetary Policy Committee initiated substantial monetary policy easing at its August meeting. This included a cut in the Bank Rate to 0.25%, further gilt and corporate bond purchases (QE) and cheap funding for banks (Term Funding Scheme) to maintain the supply of credit to the economy. To date, the economy is still showing growth with the Office of National Statistics (ONS) estimate of Q3 GDP showing that the UK economy expanded by 0.6% over the quarter and 2.2% year-on-year.

Another key economic feature of the period was the expectation for an increase in inflation. With the currency falling in value, import prices are rising. The August Quarterly Inflation Report from the Bank of England forecasted a rise in CPI to 0.9% by the end of calendar 2016 and thereafter a rise closer to the Bank's 2% target over the coming year. The expectation of increased inflation was borne out with the Consumer Price Index (CPI) rising to 1.2% in November 2016 which represents the highest CPI rate since October 2014.

2.1 Interest Rate Environment

Short term interest rates continue to be at historically very low levels. As referred to above in response to a potential reduction in economic growth the Bank of England reduced the base rate from 0.5% to 0.25% in August 2016; a level it remained at throughout the period. The expectation is that interest rates will remain low for the rest of the financial year and beyond.

2.2 Implications for Lancashire County Council Treasury Strategy

The County Council continued to use short term market borrowing to fund capital expenditure so taking advantage of historically low interest rates. This policy has proved to be very effective in an environment where rates have stayed low throughout the year. Prospects for interest rate increases are continuously monitored, however it is not anticipated that the interest rates will rise even though they are at very low levels.

This includes the rates for long term borrowing. Therefore the opportunity of fixing some of the debt for a longer period will be kept under consideration.

3. Current Treasury Management Policy

Full Council approved the 2016/17 treasury management strategy in February 2016. The County Council's stated Treasury Management objectives are:

- a) To ensure the security of the principal sums invested which represent the County Council's various reserves and balances;
- b) To ensure that the County Council has access to cash resources as and when required;
- c) To minimise the cost of the borrowing required to finance the County Council's capital investment programme; and
- d) To maximise investment returns commensurate with the County Council's policy of minimising risks to the security of capital and its liquidity position.

3.1 Investment Activity

Investments at the 30th November are £572.41m consisting of £91.82m in bank and Local Authority deposits and £480.59m in bonds. In total investments have decreased by £42.14m over the period. The table below shows the investment activity between 1st August 2016 and 30th November 2016.

| Bank and Local Authority Deposits | Call/MMF £m | Fixed £m | Structured £m | Total £m |
|--|------------------------|---------------------|--------------------------|---------------------|
| Balance 1 August 2016 | 71.81 | 56.50 | 0.00 | 128.31 |
| Maturities | -101.85 | -10.00 | 0.00 | -111.85 |
| New Investments | 75.37 | 0.00 | 0.00 | 75.37 |
| Balance 30 November 2016 | 45.32 | 46.50 | 0.00 | 91.82 |
| | | | | |
| Bonds | LA Bonds £m | Gilts £m | Others £m | Total £m |
| Balance 1 August 2016 | 35.83 | 82.71 | 367.70 | 486.24 |
| Maturities | -0.34 | -1,268.80 | -575.98 | -1,845.12 |
| New Investments | 0.27 | 1,462.30 | 376.90 | 1,839.46 |
| Balance 30 November 2016 | 35.76 | 276.22 | 168.61 | 480.59 |

Within the period, there has been an increase of £194m in the amount of Gilts. This reflects the re-balancing of the portfolio as the previous period saw a significant reduction in the level of Gilts held as a consequence of the volatility in the market at the time. To compensate for this there has been a decrease in Bank and Local Authority deposits of £36m and other bonds of £199m.

The current rate of return on the investment portfolio measured by Arlingclose Ltd is 1.04% which compares favourably with the benchmark 7 day LIBID which averages 0.45% over the same period.

3.2 Borrowing Activity

Current market conditions continue to enable the County Council to take advantage of short term market borrowing. The table below shows the borrowing activity which has taken place between 1st August 2016 and 30th November 2016.

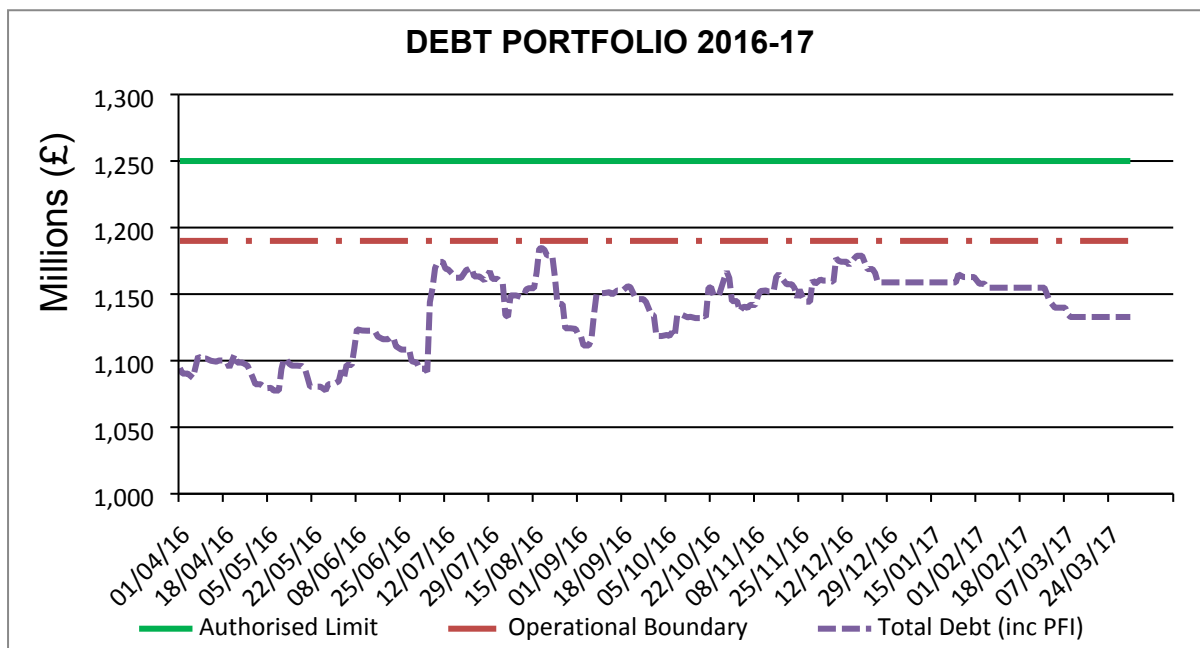
| <u>Borrowing</u> | PWLB Fixed £m | PWLB Variable £m | Long Term Market Loan £m | Other Local Authorities (incl PCC*) £m | Lancashire Call Accounts £m | Total £m |
|--|------------------------------|---------------------------------|---|---|--|---------------------|
| Balance 1 August 2016 | 213.10 | 125.75 | 51.78 | 552.00 | 99.81 | 1,042.45 |
| New Borrowing | 0.00 | 0.00 | 0.00 | 219.00 | 170.85 | 389.85 |
| Maturities | 0.00 | 0.00 | 0.00 | -201.00 | -192.46 | -393.46 |
| Balance 30 November 2016 | 213.10 | 125.75 | 51.78 | 570.00 | 78.20 | 1,038.84 |
| Public Finance Initiative (PFI) Liability | - | - | - | - | - | 167.00 |
| Total Borrowing & PFI | | | | | | 1,205.84 |

* Police & Crime Commissioners

The outstanding borrowing has reduced slightly by £4m in the period. This reduction is due to the decrease in shared investment scheme balances, offset largely by the increase in borrowing with other local authorities. Most of the new borrowing has been to replace short term loans which matured in the period and in line with the current policy have been short term in nature.

Total borrowing now stands at £1.206bn including the financing of £167m of assets through remaining PFI schemes.

The graph below shows the level of debt for the current financial year compared with the prudential indicator operational and authorised boundaries. The debt shown from 1st December 2016 represents the debt position if no maturing debt was replaced rather than an estimate of the expected position.



The Authorised Limit is a prudent estimate of debt which reflects the Authority's capital expenditure plans and allows sufficient headroom for unusual cash movements.

The Operational Boundary is a prudent estimate of debt but no provision for unusual cash movements. It represents the estimated external debt arising as a consequence of the County Council's current plans and as such it is expected that the boundary could be breached but not on a regular basis. Total debt for the period has remained below the Operational Boundary.

The current interest rate payable on debt as measured by Arlingclose Ltd is 1.78%. The most recent benchmarking figure available of the average rate for all Arlingclose clients (as measured on 31st March 2016) is 3.94%.

4. Budget Monitoring Position

The net financing charges budget for 2016/17 is forecasted to be £26.756m lower than the full year budget. The main reasons for this are:

- Sale of bonds due to market movements during recent months. This enabled some core Gilt bonds and other traded bonds to be sold resulting in a gain of £25m offset by a small reduction in interest receivable.
- There is a reduction of £1.954m in interest payable as a result of lower than anticipated borrowing.

This position is kept under regular review taking account both of ongoing performance and also market movements. The forecast is provided to the Director of Financial Resources on a monthly basis.

5. Prudential Indicators 2016/17

The Local Government Act 2003 and supporting regulations require the County Council to have regard to the prudential code and to set prudential indicators to ensure the County Council's capital investment plans are affordable, prudent and sustainable.

The County Council is within these Prudential Indicators as detailed in Annex 1.

6. Economic Outlook

The economic uncertainty is set to continue. With this outlook the County Council's treasury management advisers Arlingclose Ltd are predicting that in the short-term the economic and political uncertainty will likely dampen investment intentions and tighten credit availability, prompting lower activity levels and potentially a rise in unemployment. Their central forecast for the base rate is that it is to remain at 0.25% for not only the rest of the year but up to March 2020. However if there is to be any movement they predict that it will be a further reduction.

Consequently, the current Treasury Management Strategy is still considered to be appropriate for the current market conditions. The level of borrowing and investments are in line with this strategy and within the indicator limits.

Prudential Indicators

| | |
|--|---------|
| 1. Adoption of CIPFA Treasury Management Code of Practice | Adopted |
|--|---------|

| | | |
|--|----------------|------------------------|
| 2. Authorised limit for external debt | | |
| The Authorised Limit is a prudent estimate of debt which reflects the Authority's capital expenditure plans and allows sufficient headroom for unusual cash movements. | 2016/17 | 30th Nov Actual |
| | £m | £m |
| Borrowing | 1,250 | 1,037 |
| Other long term liabilities (PFI schemes) | 200 | 167 |
| TOTAL | 1,450 | 1,204 |

| | | |
|---|----------------|------------------------|
| 3. Operational boundary for external debt | | |
| The Operational Boundary is a prudent estimate of debt but has no provision for unusual cash movements. It represents the estimated maximum external debt arising as a consequence of the County Council's current plans. | 2016/17 | 30th Nov Actual |
| | £m | £m |
| Borrowing | 1,190 | 1,037 |
| Other long term liabilities (PFI schemes) | 180 | 167 |
| TOTAL | 1,370 | 1,204 |

| | | |
|---|----------------|------------------------|
| 4. Capital Financing Requirement to Gross Debt | | |
| The Capital Financing requirement is the underlying need to borrow for capital purposes. This is the cumulative effect of past borrowing decisions and future plans. This is not the same as the actual borrowing on any one day, as day to day borrowing requirements incorporate the effect of cash flow movements relating to both capital and revenue expenditure and income. | 2016/17 | 30th Nov Actual |
| | £m | £m |
| Capital Financing Requirement | 871 | 871 |
| Estimated gross debt | 1,010 | 1,037 |
| Debt to Capital Financing Requirements | 117% | 119% |

Gross borrowing is higher than the capital financing requirement because the shared investment scheme is accounted for as borrowing but it does not form part of the capital financial requirement calculation.

The County Council confirms that it has complied with its Prudential Indicators for 2016/17 for the reported period. The Prudential Indicators were approved in February 2016 as part of the County Council's Treasury Management Strategy Statement.

Treasury Management Indicators

| 1. Interest Rate exposure | | |
|--|--------------------|---------------|
| The limit measures the County Council's exposure to the risk of interest rate movements. The one year impact indicator calculates the theoretical impact on the revenue account of an immediate 1% rise in all interest rates over the course of one financial year. | Upper Limit | Actual |
| | £m | £m |
| Net Interest Payable – Fixed Rate | 50.40 | 9.00 |
| Net Interest Payable – Variable Rate | 5.00 | 3.50 |
| 1 year impact of a 1% rise | 10.00 | 1.40 |

| 2. Maturity structure of debt | | |
|---|----------------------|-----------------|
| The limit on the maturity structure of debt helps control refinancing risk. | Upper Limit % | Actual % |
| Under 12 months | 75 | 13 |
| 12 months and within 2 years | 75 | 35 |
| 2 years and within 5 years | 75 | 26 |
| 5 years and within 10 years | 75 | 6 |
| 10 years and above | 100 | 20 |

| 3. Investments over 364 days | | |
|---|--------------------|---------------|
| The limit on the level of long term investments helps to control liquidity, although the majority of these investments are held in available for sale securities. | Upper Limit | Actual |
| | £m | £m |
| Authorised Limit | 900 | 496 |
| Operating Limit | 600 | 496 |

| 4. Minimum Average Credit Rating | | |
|--|------------------|---------------|
| To control credit risk the County Council requires a very high credit rating from its treasury counterparties. | Benchmark | Actual |
| Average counterparty credit rating | A+ | AA+ |