Appendix A

Treasury Management Activity 3rd Quarter Report 2013-14

1. Background

As part of the County Council's governance arrangements for its treasury management activities, the Audit and Governance Committee is charged with oversight of the County Council's treasury management activities. To enable the Committee to fulfil this role, the Committee receives regular reports on treasury management issues and activities. Reports on treasury activity are discussed on a monthly basis with the County Treasurer and the content of these reports is used as a basis for this report to the Committee.

This report considers treasury management activity between August and November 2013.

2. Economic Overview

There has been no change to UK monetary policy with official interest rates and asset purchases maintained at 0.5% and £375bn respectively. The Bank of England's Monetary Policy Committee (MPC) through its recent forward guidance is committed to keeping policy rates low for an extended period using the Labour Force Survey unemployment rate of 7% as a threshold for when it would consider whether or not to raise interest rates. Unemployment was 7.6% in the three months to September 2013. On the probability of unemployment reaching the 7% threshold, the MPC attaches only a two-in-five chance to the rate having reached the 7% level by the end of 2014. The corresponding figures for the end of 2015 and 2016 are around three-in-five and two-in-three respectively. These forecasts were revealed in the November Inflation Report and brought forward market expectations of a bank rate rise.

The flow of credit to households and businesses is slowly improving but is still below pre-crisis levels. The fall in consumer price inflation from the high of 5.2% in September 2011 to 2.2% in October 2013 will allow real wage increases (i.e. after inflation) to slowly turn positive and aid consumer spending.

Stronger growth data in 2013 (0.4% in Q1, 0.7% in Q2 and an second estimate of 0.8% in Q3) alongside a pick-up in property prices mainly stoked by government initiatives to boost mortgage lending have led markets to price in an earlier rise in rates than warranted under Forward Guidance and the broader economic backdrop. However, with jobs growth picking up slowly, many employees working shorter hours than they would like and benefit cuts set to gather pace, growth is likely to only be gradual. Arlingclose forecasts the MPC will maintain its resolve to keep interest rates low until the recovery is convincing and sustainable.

On the inflation side CPI for October fell more than expected from 2.7% to 2.2% but it is expected that regulated and administered prices are likely to keep CPI above target in the near term. In the medium term Inflation is set to fall back to around the 2% target over the next year or so as the impetus from past increases in import

prices fades and a gradual revival in productivity growth, together with a persistent margin of spare capacity, curbs domestic price pressures.

House price inflation is likely to rise due to the government's help to buy scheme, where it will guarantee up to 15% of purchasers' 95% mortgages. This could lead to a housing bubble, which in turn could come under pressure if rates were to rise quickly. The Funding for Lending scheme was curtailed to only cover business lending and not mortgages, due to concerns around the housing market overheating.

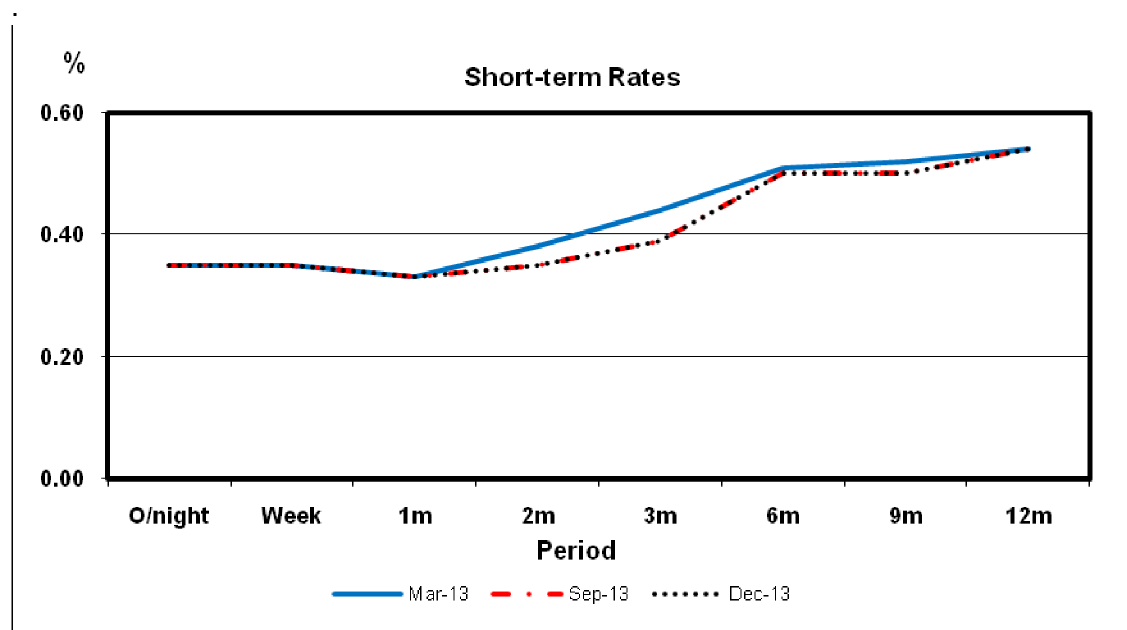
In the US expectations for the slowing in the pace of asset purchases ('tapering') by the Federal Reserve and the end of further asset purchases will remain predominant drivers of the financial markets. The Fed did not taper in September as had been originally expected and has talked down potential tapering in the near term. It now looks more likely to occur in early 2014 which will be supportive of bond and equity markets in the interim. US GDP grew by more than expected in the third quarter and the unemployment rate fell to 7.0%, further towards the 6.5% the Federal Reserve looks for under US forward guidance. The US government shutdown and political deadlock over the debt ceiling could return in 2014 as the solutions to the situation were only temporary.

In Europe the situation seems to have calmed. The European backstop mechanisms have lowered the risks of catastrophic meltdown. The slightly more stable economic environment at the aggregate Eurozone level could be undone by political risks and uncertainty in Italy, Spain and Portugal (doubts over longevity of their coalitions). The ECB has discussed a third long term refinancing operation, as credit conditions remain challenging for European banks.

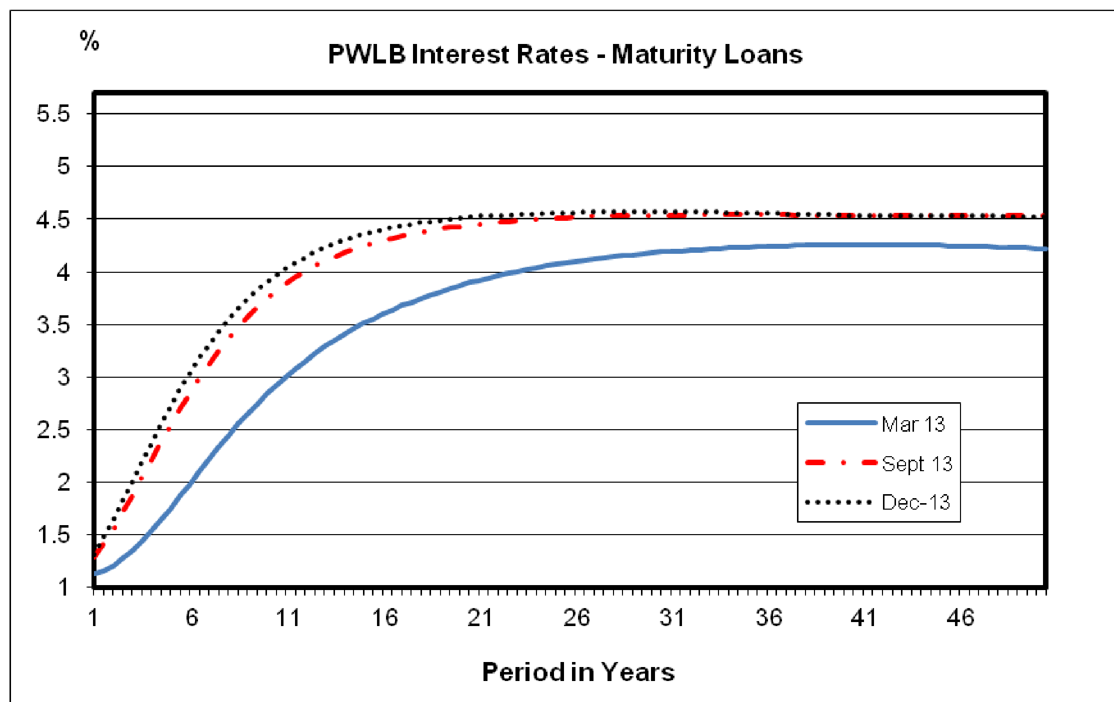
2.1 Interest Rate Environment

Short term interest rates continue at the very low levels since the Bank of England reduced base rate to 0.5% in March 2009. The chart below shows that there has been very little movement in short term interest rates over the first three quarters of the current financial year.

.



Current longer term PWLB rates are shown below.



Central bank liquidity injections, the abatement of the euro crisis and the fragile economic recovery has seen a reduction in demand for safe haven assets including UK Government gilts. This resulted in an increase in gilt yields during the summer and consequently in Public Works Loan Board interest rates, with a noticeable steepening of the curve in the medium term. Rates have hardly changed in the 3rd quarter of the year.

2.2 Outlook for Interest Rates

Treasury Consultants Arlingclose Ltd forecast the path for short term interest rates to remain flat. Markets are still pricing in an earlier rise in rates than warranted under Forward Guidance and the broader economic backdrop, however upside risks now weight more heavily at the end of the forecast horizon.

Gilt yields are projected to climb on an upward path through the medium term. However, the recent climb in yields was overdone given the soft fundamental global outlook and risks surrounding the Eurozone, China and US. Yields are slowly drifting lower now that tapering is less likely to occur in the near-term.

Period	Bank Rate	3 month LIBID	12 month LIBID	20-year Gilt Rate
Q3 2013	0.50	0.45	0.90	3.25
Q4 2013	0.50	0.45	0.95	3.30
Q1 2014	0.50	0.50	0.95	3.35
Q2 2014	0.50	0.55	0.95	3.40
Q3 2014	0.50	0.55	1.00	3.45
Q4 2014	0.50	0.55	1.05	3.50
H1 2015	0.50	0.60	1.15	3.55
H2 2015	0.50	0.65	1.20	3.65
H1 2016	0.50	0.70	1.25	3.75
H2 2016	0.50	0.80	1.30	4.05

3. Current Treasury Management Policy

The current borrowing policy of keeping a higher proportion of borrowing at variable rates or short dated maturities is enabling the County Council to take advantage of the very low rates available on short term borrowing. Rates will be carefully monitored and the proportion of borrowing held on longer term fixed rates will be increased as rates start to rise. The interest rate indicators approved by Full Council on 12 December restrict the rate increase to 5% this is then a trigger point for the Chief investment officer to "lock" the existing borrowing at the lowest possible rates to minimise debt costs.

The current investment policy of accessing high credit quality institutions through bond investments as opposed to placing fixed term deposits directly with banks continues to be appropriate given the continued difficult credit environment.

3.1 Investment Activity

The table below shows investment activity between 1st September and 30th November 2013

Bank Deposits

	Call £m	**Fixed £m**	**Structured £m**	**Total £m**
Balance 31 Aug	**31.31**	**31.50**	**72.64**	**135.45**
Maturities	(398.30)	0	0	(398.30)
New Investments	368.71	10.00	0.59	379.30
Balance 30 Nov	**1.72**	**41.50**	**73.23**	**116.45**

Bonds

	Local Authority Bonds £m	UK Govt Gilts £m	Corporate & Supra-nationals £m	Total £m
Balance 31st Aug	**20.28**	**223.53**	**324.32**	**568.13**
Maturities	(0.05)	0	(109.57)	**(109.62)**
New Investments	0	1.42	0	**1.42**
Balance 30th Nov	**20.23**	**224.95**	**214.75**	**459.93**

Overall the level of investments has decreased by £127.20m mainly through the sale of corporate and supranational bonds. This reduction is in line with cash flow movements and requirements.

The current rate of return on the investment portfolio measured by Arlingclose Ltd treasury consultants is 2.775% which compares favourably with the benchmark 7 day LIBID which averages 0.36% over the same period.

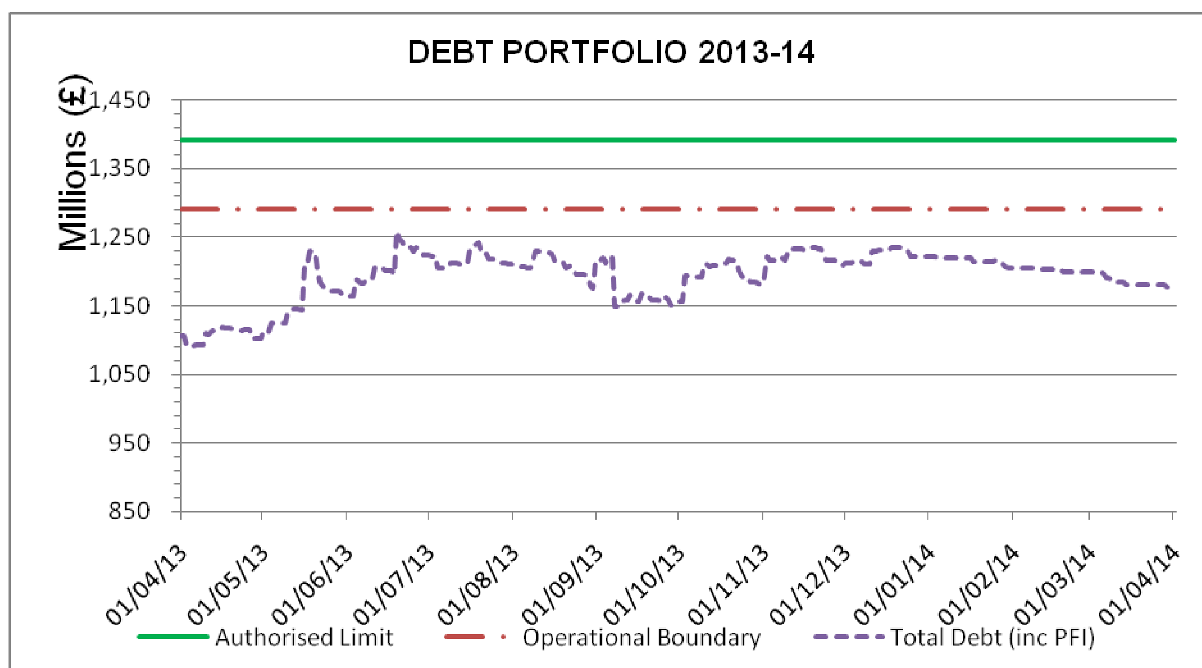
3.2 Borrowing Activity

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 the end of August and the end of November 2013.

	PWLB Fixed Rate £m	PWLB Variable Rate £m	Long Term Market Loan £m	Other Locals £m	Police, Fire and Lancashire District Councils £m	Total £m
Balance 31st August	**170.40**	**125.75**	**51.81**	**342.75**	**115.29**	**806.00**
Maturities	45.70	0.00	0.00	177.02	121.51	**344.23**
New Borrowing	(3.00)	0.00	(0.10)	(194.50)	(142.52)	**(340.11)**
Balance 30thNovember	**213.10**	**125.75**	**51.71**	**325.27**	**94.29**	**810.12**

Borrowing has remained largely constant over the period with total borrowing now standing at £1,213m including the financing of £403m of assets through Private Finance Initiative schemes.

The graph below shows the level of debt for each day of the current financial year compared with the prudential indicator operational and authorised boundaries. There have been no breaches of the prudential indicator boundary although the graph clearly shows the peaks in borrowing, which occur at the end of each month as salaries are paid.



The current interest rate payable on debt measured by Arlingclose Ltd treasury consultants is 1.921%, which compares favourably with the average rate for all English County Councils of 4.78%.

4. Budget Monitoring Position

The financing charges budget is forecasted to be on budget at the end of the financial year. This differs to the £1.27m underspend reported to Cabinet on 7 November. The increased spend is a result of the reduction in the market value of traded investments.

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

5. Prudential Indicators

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.

A comparison of the actual position at 30 November 2013 compared to the prudential indicators set in the treasury management strategy for 2013/14 is set out

below. The information below shows that the Council complied with its Treasury Management Prudential Indicators for 2013/14,

Treasury Management Prudential Indicators	2013/14 £M	30st Nov Actual £M
1. Adoption of CIPFA TM Code of Practice	ADOPTED	
2. Authorised limit for external debt - A prudent estimate of debt, which reflects the Authority's capital expenditure plans and allows sufficient headroom for unusual cash movements.		
Borrowing	891	810
Other long-term liabilities(PFI schemes)	500	403
TOTAL	1,391	1,213
3. Operational boundary for external debt - A prudent estimate of debt, but no provision for unusual cash movements. It represents the estimated maximum external debt arising as a consequence of the County Council's current plans.		
Borrowing	841	810
Other long-term liabilities	450	403
TOTAL	1,291	1,213

4. Capital financing requirement to gross debt

	Estimate	Actual
Capital financing requirement (excl PFI)	618.273	618.273
Estimated gross debt	768.000	810.120
Debt to CFR	124%	131%

Gross borrowing appears 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 financing requirement calculation.

Actual debt to CFR is currently 7% higher than the target. This is only a short term situation (as is consistent with the code of practice), due to the shared investment scheme holding more cash than estimated at the beginning of the year and the need to borrow short term for salaries at month end.

6. Treasury Management Indicators

The following indicators are set as part of adopting the treasury management code. As proposed in the mid year report Interest rate exposure indicators have been revised and the new indicators were approved by Full Council at its meeting on 12

December 2013.

The code states that local authorities should have regard to the following treasury indicators.

A comparison of the agreed indicators and the actual position at 30th November 2013 is set out below.

1. Interest rate exposure

	Upper limit £m	**Actual £m**
Net Interest Payable Fixed rate	37.6	-1.8
Net Interest Payable Var rate	5.0	1.4
1yr impact of 1% rise	25.0	4.7

The above is a measure of the revised interest rate indicator as approved by Full Council on 12 December.

2. Maturity structure of debt

	Lower Limit %	Upper Limit %	Actual %
Under 12 months		75	14
12 months and within 2 years		75	39
2 years and within 5 years		75	5
5 years and within 10 years		75	8
10 years and above	25	100	34

3. Investments over 365 days

	Upper limit £m	**Actual £m**
Total invested over 364 days	550	572

The level of these investments reflects the portfolio structure adopted by the County Council to reduce credit risk by holding a proportion of the portfolio in government and supranational securities, which although highly liquid have maturities in excess of 364 days.

In practice these investments can be liquidated at one day's notice to meet any short term cash flow requirements.

4. Minimum Average Credit Rating

	Benchmark	**Actual**
Average counterparty credit rating	A+	AA

5. Minimum cash available within 3 months

Minimum cash available within 3 months:	Requirement £m	Actual £m
Without borrowing	100	100
With borrowing	500	500

This report on the latest Treasury management activity shows that the Treasury Management Strategy set in February is still appropriate for the current market conditions and that the level of borrowing and investments are in line with this strategy and within the indicator limits.