

Treasury Management Activity Report 1 April – 31 August 2014-15

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.

This report considers treasury management activity between 1st April and 31st August 2014.

2. Economic Overview

UK Monetary Policy: The MPC has made no change to the Bank Rate of 0.5% and maintained asset purchases at £375bn during this period. However, there was a marked shift in tone from the Bank of England's Governor and other MPC members. In his Mansion House speech in June, Governor Mark Carney warned that interest rates might rise sooner than financial markets were expecting. The minutes of the MPC's June meeting outlined the Bank's central view that whilst wage growth and inflation had been weak, economic activity had been stronger than expected and the policy decision had therefore become more 'balanced' for some members on the Committee than earlier in the year.

Growth: The recent strong performance of the UK economy continued with GDP growing at an average rate of 0.8% per quarter since the middle of 2013. Whilst still largely driven by household consumption, business investment is recovering, albeit from a very low base, and should support the continued expansion of GDP throughout the year.

Unemployment: The labour market continued to improve, with job growth strong and the headline unemployment rate falling to 6.6%. However, earnings growth continues to deteriorate with an annual decline of -0.2% in June. Employment growth is masking extensive spare capacity with self-employment and a large number on zero-hour contracts and working part-time involuntarily, underemployment is still a significant factor within the workforce.

Inflation: CPI inflation for May fell to 1.5% year-on-year from 1.8% which was lower than market expectations. Even though inflation was expected to tick marginally higher in coming months, it was still expected to remain just below the Bank's 2% target.

The Bank's Financial Policy Committee also announced a range of measures to cool the UK's housing market to avert the potential of spiralling house prices derailing a sustainable economic recovery. Key recommendations included lenders stress-testing mortgage applicants can cope with a 3% rise in interest rates; putting a 15% cap on the number of mortgages at more than 4.5 times the borrower's income; and a separate Treasury pledge banning anyone applying for a loan through the Help to Buy scheme borrowing more than 4.5 times their income. The Prudential Regulation

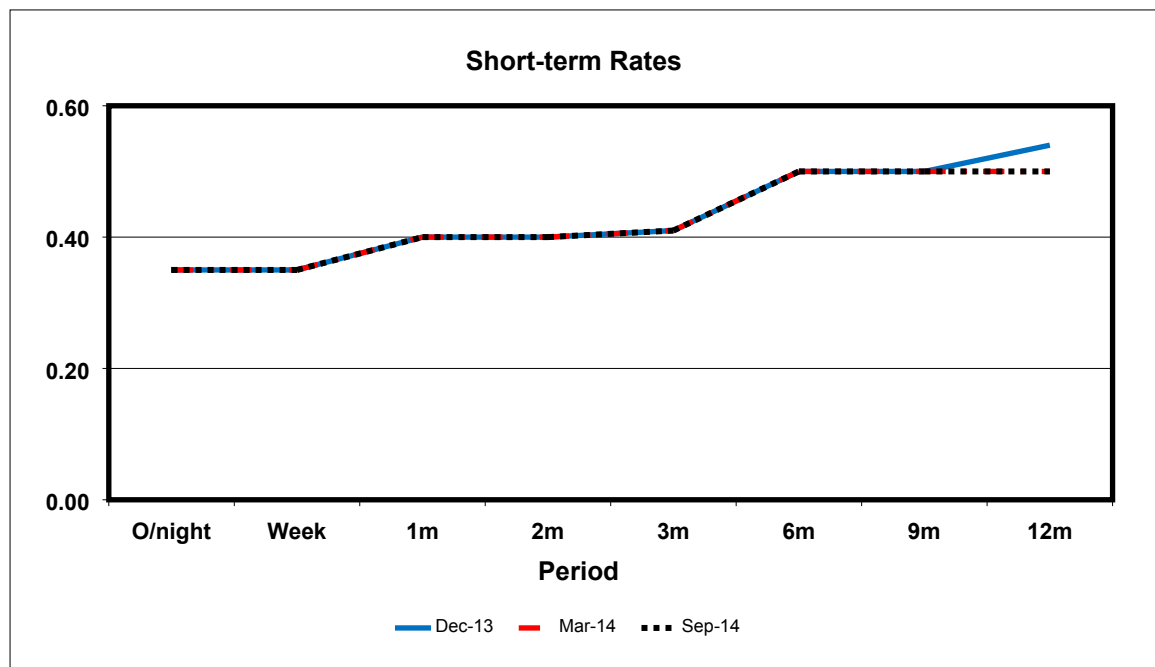
Authority also announced that it intends to consult on capital requirements for mortgages.

Against a darkening economic background in Europe in June and again in September the European Central Bank announced interest rate cuts along with a raft of non-conventional measures to head off the growing threat of deflation in the Eurozone. The ECB cut main policy rates (refinancing rate) from 0.25% in May to 0.05% by the beginning of September to encourage banks to lend to businesses and generate economic growth, it also cut the deposit rate to -0.20% which in effect means that commercial banks must pay to deposit funds at the central bank.

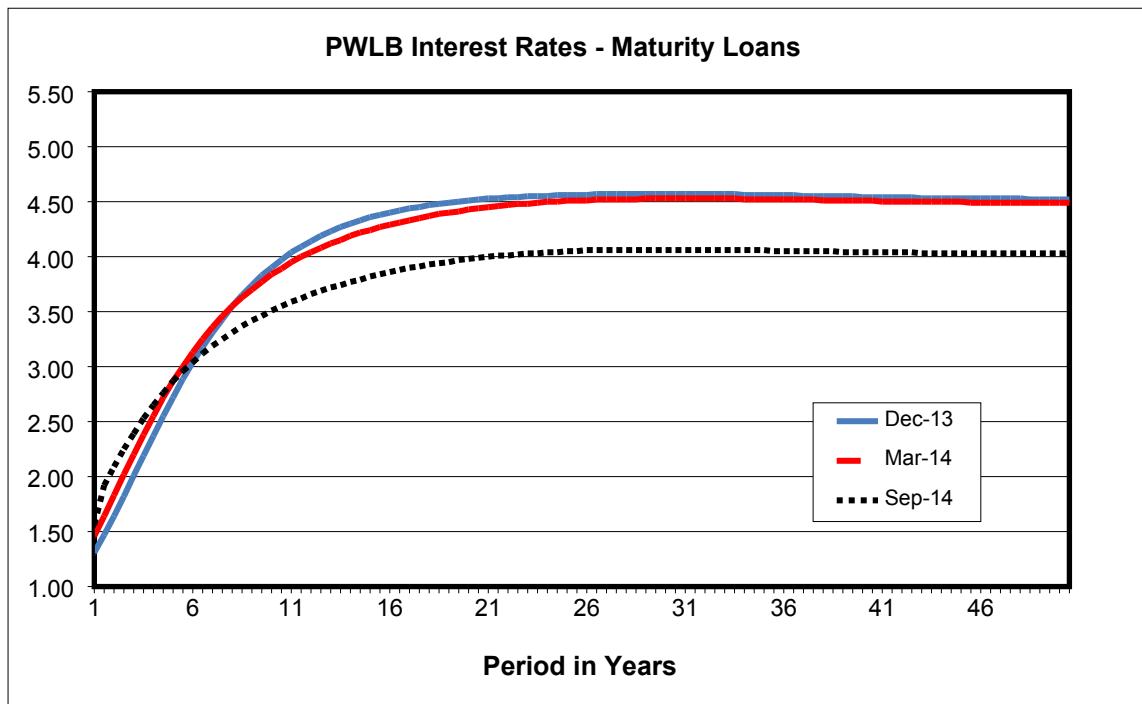
There was no change from the US Federal Reserve as the central bank kept policy on its current track with a reduction in asset purchases by \$10 billion to \$35 billion per month. The sharp downward revision to US GDP in Q1 to -2.9% annualised was strongly influenced by severe weather deterring consumers from going out and spending. GDP in Q2 of 2014 is expected to rebound, taking the annual average rate of growth over the last four quarters ending in Q2 to a more sustainable level of 2%.

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 calendar year.



Current longer term PWLB rates are shown below.



Following a period where central bank liquidity injections, the abatement of the euro crisis and the economic recovery has seen a reduction in demand for safe haven assets including UK Government gilts, towards the end of the period geopolitical factors weighed heavily on gilt yields and consequently in Public Works Loan Board interest rates, with a noticeable flattening of the curve in the medium term.

2.2 Outlook for Interest Rates

Treasury Consultants Arlingclose Ltd forecast the first rise in official interest rates in Q3 2015, which is earlier than general market sentiment. There is clear momentum in the economy, but inflation is benign and currently sits below target. This situation is expected to persist for some time, reducing the need for immediate monetary tightening

Arlingclose project Gilt yields to climb on an upward path through the medium term as the recovery takes hold, notwithstanding temporary volatility due to the UK General Election and other geo-political events.

Period	Bank Rate	3 month LIBID	12 month LIBID	20-year Gilt Rate
Q3 2014	0.50	0.50	0.90	3.00
Q4 2014	0.50	0.55	0.95	3.20
Q1 2015	0.50	0.60	1.00	3.40
Q2 2015	0.50	0.65	1.05	3.55

Q3 2015	0.75	0.85	1.20	3.65
Q4 2015	0.75	1.00	1.35	3.70
Q1 2016	1.00	1.15	1.45	3.75
Q2 2016	1.00	1.25	1.55	3.80
Q3 2016	1.25	1.40	1.65	3.85
Q4 2016	1.25	1.50	1.70	3.90
Q1 2017	1.50	1.65	1.80	3.95
Q2 2017	1.50	1.70	1.90	3.95

2.3 Implications for Lancashire County Council Treasury Strategy

Whilst LCC continue to fund a substantial portion of its financing needs through short term borrowing taking advantage of the extremely low interest rates, we are always mindful of the potential for some form of rate normalization and how that would alter our funding strategy.

Having enacted this strategy in 2010, with an original expectation that base rate would remain lower for longer than generally assumed by markets, we had expected that full economic recovery would be a 10yr process.

The current recovery in the UK is earlier and slightly stronger than our base case, and in the normal course of events we would now be looking to see slowly rising interest rates, but external risks are forcing the Bank of England to remain cautious;

- Slow/zero European recovery plus potential for Quantitative Easing
- Growth risks in China and emerging markets
- Potential for UK economic destabilization as a result of Scottish independence vote
- Low and falling G7 inflation
- Falling wholesale energy prices

In light of all of these factors we continue with our cautious funding approach, whilst retaining sufficient flexibility to make necessary changes should the path of interest rates change.

3. Current Issues

PFI

In July the County Council refinanced the Waste Private Finance Initiative contract. In order to facilitate this operation within the treasury policy the limit on borrowing was increased and the limit on long term liabilities was reduced. This change to the Prudential Indicator limits was agreed by the County Treasurer under her delegated powers and reported to cabinet on 15th July.

Bond Issuance

Whilst the County Treasurer expects the current low rate environment to continue for a further period, the MPC is setting the scene for a slow rise in short term rates to a point somewhat lower than historic average, and therefore it is prudent for the Treasury team to prepare for a further change in capital financing strategy.

As a part of active treasury management, a series of funding options are regularly examined by the Treasurer with regards the medium to long term financing of the Council's capital programme. The aims of this are two fold – to ensure the Council has a secure route to finance its debt and that it achieves value for money.

On 15 July cabinet approved the establishment of two additional channels of long term funding for future capital requirements and responding to a rising interest rate environment by fixing short term borrowing for a longer period:

- A discrete Lancashire County Council EMTN programme
- Participation in the proposed Local Government Association Bond Agency

Either of these routes will access the same pool of medium/long term debt capital available for investment in "high quality" bonds, or a combination of both may be used. The major benefit of this method of financing is the financial certainty it can provide in terms of both cost and liquidity.

In order to facilitate these programs a temporary increase in the borrowing and long term investment limits is required to replace the rolling short term debt to longer term debt financing. An increase of both these limits by £300m for a nine month period in 2014/15 was agreed by Cabinet and approved by Full Council.

4. Current Treasury Management Policy

The Full Council approved the 2014/15 treasury management strategy at its meeting on 27th February 2014. The Council's stated investment priorities were:

- (a) Security of capital and
- (b) Liquidity of its investments.

The Council also aimed to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments.

The Council's stated borrowing strategy was to take advantage of historically low short term interest rates by borrowing short term in the money markets rather than financing capital expenditure through long term Public Works Loan Board (PWLB) loans.

The County Treasurer can report that all treasury management activity undertaken during the financial year complied with the *CIPFA Code of Practice* and the relevant legislative provisions.

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 are expected to rise.

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.

4.1 Investment Activity

The table below shows investment activity between 1st April and 31 August 2014

	Bank and Local Authority Deposits			
	Call/MMF £m	Fixed £m	Structured £m	Total £m
Balance 1 April 2014	57.74	66.50	73.68	197.92
Maturities	-106.57	-20.00	0.00	-126.57
New Investments	138.10	10.00	0.13	148.23
Balance 31 August 2014	89.28	56.50	73.81	219.59

	Bonds			
	LA Bonds £m	Gilts £m	Others £m	Total £m
Balance 1 April 2014	20.31	227.59	141.24	389.14
Maturities	-0.22	-1,315.03	-207.91	-1,523.15
New Investments	0.00	1,131.10	256.81	1,387.91
Balance 31 August 2014	20.09	43.66	190.15	253.90

Overall the level of investments have decreased in the period by £113.57m. This is partly due to sales of the liquidity asset to refinance the long term liabilities associated with the Waste PFI project. These Liquidity assets will be rebought over the following months to cash back the council's reserves.

Significant sales have also been made from the Council's core bond holdings as a rebalancing exercise by the Chief Investment officer in response to market movements.

The current rate of return on the investment portfolio measured by Arlingclose Ltd treasury consultants is 2.044% which compares favourably with the benchmark 7 day LIBID which averages 0.35% over the same period.

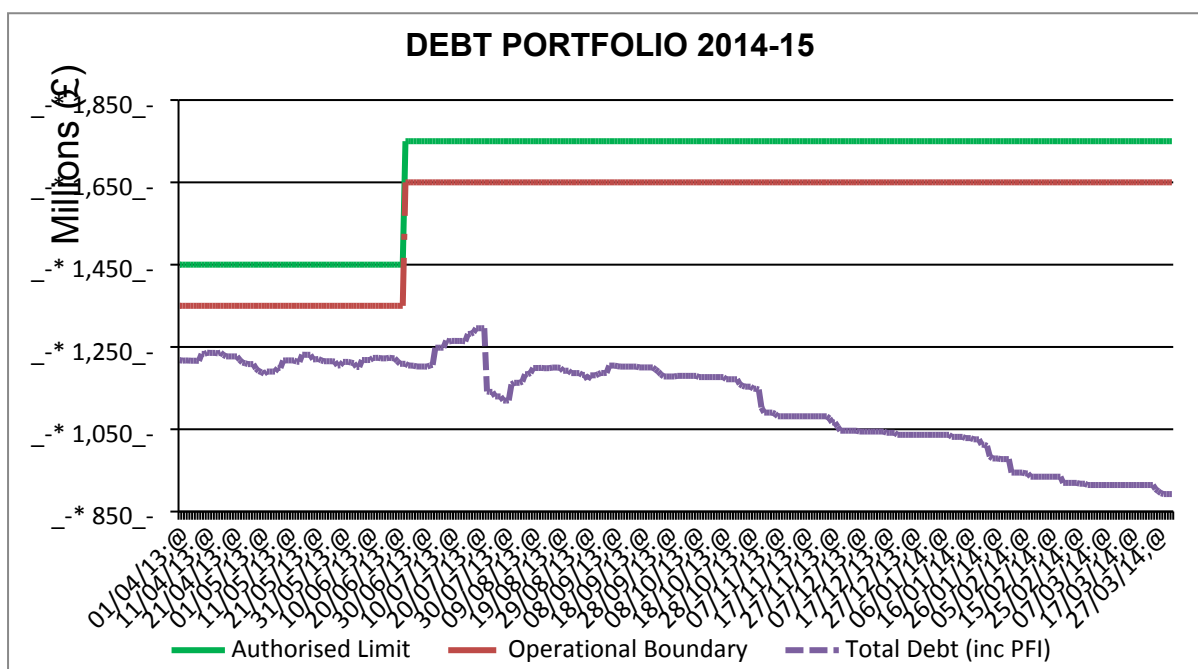
4.2 Borrowing Activity

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 April and 31 August 2014

	PWLB Fixed £m	PWLB Variable £m	Long Term Market Loan £m	Other Locals £m	Police, Fire & Lancashire District Councils £m	Total £m
Balance 1st April 2014	213.10	125.75	52.27	330.97	92.77	814.86
New Borrowing	0.00	0.00	0.00	269.30	278.04	547.34
Maturities	0.00	0.00	0.00	-93.00	-266.15	-359.15
Balance 31 August 2014	213.10	125.75	52.27	507.27	104.66	1,003.05

Treasury borrowing has increased over the period, due to the refinancing of the Waste PFI project. Total borrowing now stands at £1.181bn.

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. The prudential indicator boundaries include headroom to enable a bond issue should the optimum conditions arise. The graph shows there have been no breaches of the prudential indicator boundary to date and the reducing balance of debt going forward should maturing debt not be replaced.



The current interest rate payable on debt measured by Arlingclose Ltd treasury consultants is 1.679%. On 31st March the rate for the year was 2.04%, which compares favourably with the average rate for all Arlingclose clients of 4.14%.

5. Budget Monitoring Position

The financing charges budget is forecasted to be on budget at the end of the financial year.

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.

6. Prudential Indicators 2014/15

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 prudential indicators were revised in July, these changes were approved by Full Council on 17 July 2014.

A comparison of the actual position at 31 August 2014 compared to these revised indicators, is set out below.

Treasury Management Prudential Indicators

	2014/15 £M	31 st Aug 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	1,544	1,003
Other long-term liabilities(PFI schemes)	206	119
TOTAL	1,750	1,122
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	1,494	1,003
Other long-term liabilities	156	119
TOTAL	1,650	1,122

4. Capital financing requirement to gross debt

	Estimate	Actual
Capital financing requirement (excl PFI)	645	871
Estimated gross debt	815	1,003
Debt to CFR	126%	115%

The actual capital financing and gross debt figures are higher than the estimate as a result of refinancing the waste PFI. The estimated gross debt figure will be revised in the 2015/16 Strategy to take into account this refinancing.

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 financing requirement calculation.

7. Treasury Management Indicators

The following indicators are set as part of adopting the treasury management code.

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 31 August 2014 is set out below.

1. Interest rate exposure

	Upper limit	Actual
	£m	£m
Net Interest Payable Fixed rate	37.6	5.5
Net Interest Payable Variable rate	5.0	1.6
1yr impact of 1% rise	25.0	1.7

2. Maturity structure of debt

	Lower Limit %	Upper Limit %	Actual %
Under 12 months		75	43
12 months and within 2 years		75	18
2 years and within 5 years		75	7
5 years and within 10 years		75	6
10 years and above	25	100	24

3. Investments over 365 days

	Upper limit	Actual
	£m	£m
Total invested over 364 days	900	383

4. Minimum Average Credit Rating

	Benchmark	Actual
Average counterparty credit rating	A+	AA

5. Daily Liquidity

	Minimum Requirement	Actual
	£m	£m
Cash maintained on call	20	89

This report on the latest Treasury management activity shows that the Treasury Management Strategy set in February, and updated at Full Council on 17 July 2014, 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 revised indicator limits

The Council confirms that it has complied with its Prudential Indicators for 2014/15, which were approved on 27th February 2014, as part of the Council's Treasury Management Strategy Statement, and updated at Full Council on 17 July 2014.

8. Investment in Landsbanki is.

Under the previous Treasury Management Strategy, Lancashire County Council made a £6.4m deposit with the Icelandic Bank Landsbanki Is (LBI) which was still on deposit when the bank collapsed in October 2008. Following four distributions made by the bank winding up board, 48% of the claim currently remains outstanding.

The County Treasurer closely monitors developments in the bank's winding up process and the progression of the County Council's priority creditor claim through the administration process.

Based on a number of factors the County Council's legal representatives have suggested that the risk of recovering the rest of the claim from the winding up board have increased and they have recommend that the County Council should consider selling the claim at the current market price.

The Deputy Leader has approved the sale of claim at his decision making session on 10th Sept with a set reserve price. The price is subject to legal privilege and cannot be disclosed in this report for legal reasons.

Selling the claim at the reserve price will lead to a loss of approximately £196k based on current balance sheet values. This loss will be shared between the County Council, Pension Fund, Police and Crime Commissioner and the Combined Fire Authority. The Council's estimated share of this loss is £191k. This loss will not lead to an overspend in the Council's finance charges budget as it can be covered by other investment income.

Negotiations are ongoing to facilitate the sale but at this stage further information is held under legal privilege for commercial reasons.