

Treasury Management Activity Mid-Year Report 2013/14

1. Background

As part of the County Council's governance arrangements for its treasury management activities, the Audit 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 over the first 5 months of the financial year.

2. Economic Overview

Global central bank monetary activity has continued to reduce the volatility of international market. Specifically the European Central Bank's promise to do whatever was necessary to protect the Euro followed by the US Federal Reserve providing \$85bn per month in asset purchases and the Japanese government seeking to break 25yrs of economic stagnation with a huge quantitative easing programme, have in combination provided the worldwide financial markets with liquidity on a dramatic scale.

The general effect has been to produce on-going buying of "risk assets" such as equities, and some early signs of renewed economic activity in particular in the United States and there is speculation that this will lead to the US tapering the Federal reserves support in the financial markets.. The market, seeing these signs, has already begun to speculate when the need for "Keynesian" support will end, pushing some bond yields higher in advance of the expected return of "normal" interest rates.

Whilst the signs are broadly encouraging, economies do still appear to Central Banks as fragile, indicating that their timetable for rate normalization is still some way off, highlighted by the new Bank of England Governor giving forward guidance on policy rates.

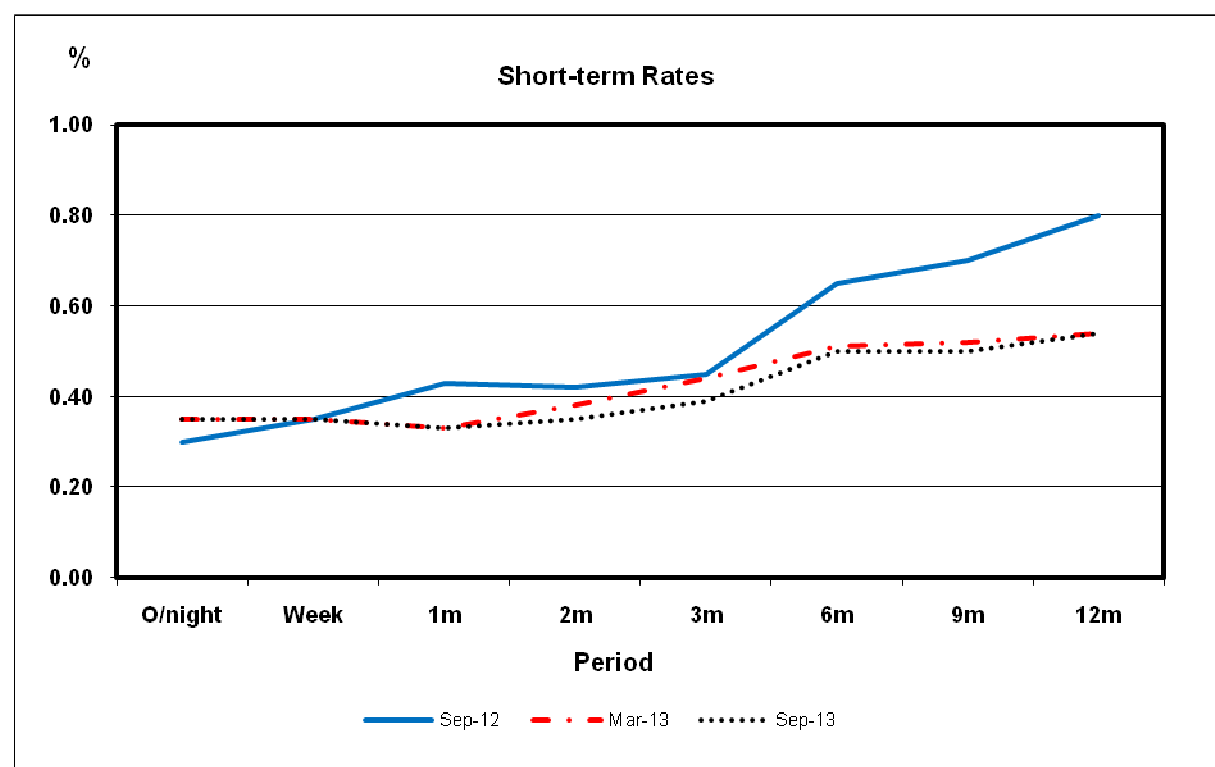
Geo-political factors had, until recently, also shown improvement as day to day crises in Southern Europe abated post bailouts, but the structural issues remain to be dealt with. Elsewhere the expected shift in the balance of the Chinese economy is underway leading to a growth slowdown from the double digit figures of the 1990s and 2000s to an official level of 7.5%. Official statistics are at odds with indicators produced by firms such as HSBC and proxies such as electricity usage, which point to an even sharper GDP slowdown, seemingly borne out by the sharp fall in commodity prices, and the linked fall in some Emerging Markets.

Specifically in the UK non standard monetary policy action such as QE, "Funding for Lending" and government support for the housing market appear to be the corner stones of improving UK statistics. The interbank funding market which had remained very sticky since 2009 has seen substantial falls in funding costs and increases in activity volume and whilst UK banks still have a lot of balance sheet repairing to complete, lending activity has definitely risen. Money supply and velocity is still low but above the contraction levels consistently seen from 2009-2012.

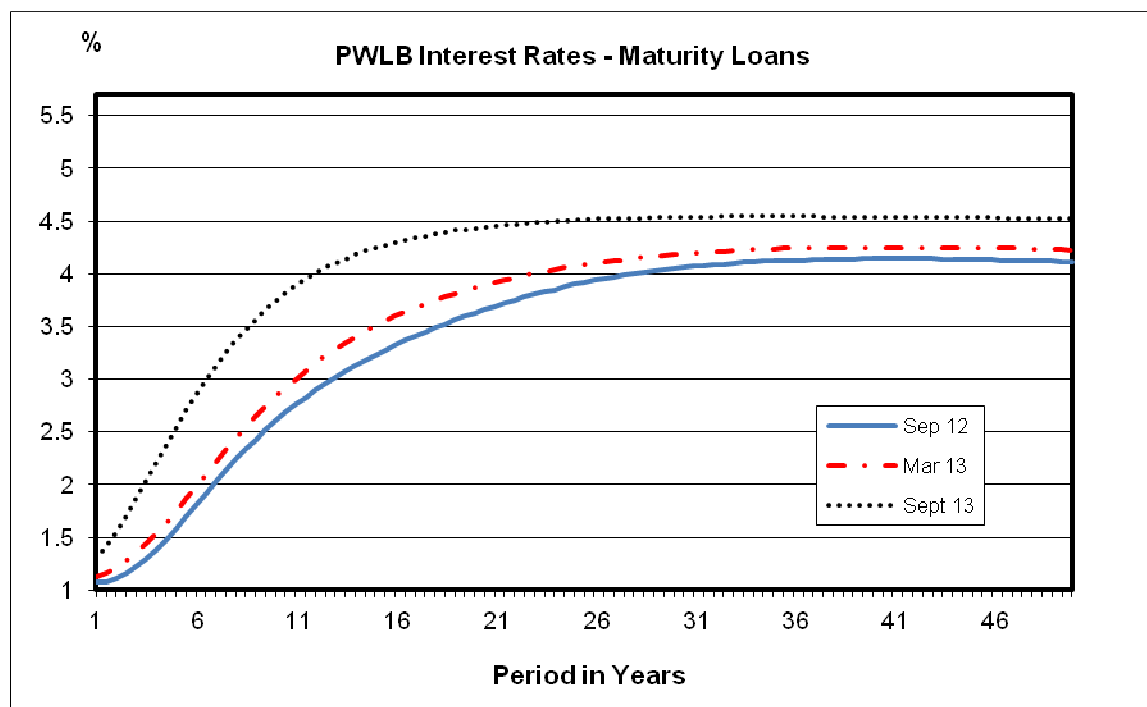
So in conclusion UK economic activity is slowly improving from a very low base. Recovery is fragile and the Bank of England has signalled on-going monetary support at least until 2016 although this is dependent upon the rate of employment growth which has slowed until recently. Personal incomes continue to decline as pay rises fail to track inflation, indicating a very high sensitivity to retail interest rates when the eventual base rate moves do come. International risk factors have reduced but have most definitely not gone away as recent events in the Middle East serve to highlight. All of which still suggested that a very conservative credit risk strategy with some inflation protection is still appropriate.

3. Interest Rate Environment

Short term interest rates continue at the very low levels since the Bank of England reduced the 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 half of the current financial year.



The current longer term PWLB rates shown below indicate that markets expect that policy rates may rise sooner than anticipated effecting rates across the maturity spectrum.



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. The result has been an increase in gilt yields and consequently in PWLB interest rates, with a noticeable steepening of the curve in the medium term.

Outlook for Interest Rates

The table below shows a forecast, provided by the County Council's treasury management advisors Arlingclose Ltd. of interest rates over the next three years.

Short term rates are projected to remain flat over this period. Despite the more optimistic economic background short term growth prospects remain subdued. In addition, in his first speech as Governor of the Bank of England Mark Carney, believing that the uncertainty surrounding interest rate rises in recent years had damaged the UK economic recovery highlighted that policy rates would remain low for some years to come as part of the forward guidance policy framework. However the condition attached to this guidance have created some marked uncertainty with regard to the timing of rate rises given the recent reductions in unemployment

Gilt yields are projected to rise steadily through the medium term although downside risks are still present, arising from political instability in Southern Europe and Germany and a recurrence of the Eurozone sovereign debt crisis, events in the Middle East or concern over a possible liquidity crisis in China.

Period	Bank Rate	3 month LIBID	12 month LIBID	20-year PWLB rate
Q3 2013	0.50	0.45	0.90	3.90
Q4 2013	0.50	0.45	0.95	3.95
Q1 2014	0.50	0.50	0.95	4.00
Q2 2014	0.50	0.55	0.95	4.05
Q3 2014	0.50	0.55	1.00	4.10
Q4 2014	0.50	0.55	1.05	4.15
H1 2015	0.50	0.60	1.15	4.30
H2 2015	0.50	0.70	1.20	4.40
H1 2016	0.50	0.80	1.25	4.50
H2 2016	0.50	0.80	1.30	4.70

4. 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 continue to be carefully monitored and the proportion of longer term fixed rates will be increased as rates start to rise in order to lock in the financial benefit to the County Council.

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 the County Council's preferred strategy given the continued difficult credit environment. This policy explicitly changes the balance and nature of the risks to which the council is exposed away from risks relating to the stability of the counterparty towards the risk of the impact of market prices on the value of investments.

5. Investment Activity

The table below shows investment activity during the period April to August 2013.

Bank Deposits

	Call	Fixed	Structured	Total
	£m	£m	£m	£m
Balance 1st April	49.54	99.60	97.92	247.06
Maturities	(816.29)	(79.60)	(25.00)	(920.89)
New Investments	816.75	1.50	-	818.25
Balance 31st August	50.00	21.50	72.92	144.42

Bonds

	Local Authority Bonds	UK Govt Gilts	Corporate & Supra-nationals	Total
	£m	£m	£m	£m
Balance 1st April	20.53	85.10	213.43	319.06
Maturities	(0.25)	(303.04)	(223.76)	(527.05)
New Investments	-	441.47	335.69	777.16
Balance 31st August	20.28	223.53	325.36	569.17

Overall the level of investments has increased by £182.77m. This increase is as a result of there being strong positive cashflow position at the start of the year as grant income tends to be front loaded. This income is invested for the short term until it is required for expenditure later in the year. Maturing fixed and structured bank deposits of £79.60m have largely been replaced by investments in gilts and corporate bonds continuing the policy of reducing the County Council's credit risk. Bond investments now make up 80.81% of the portfolio.

Bank credit continues to be under pressure and a further round of credit rating cuts has taken place. As a result, the County Council has continued to scale back bank investments replacing them with increased allocations to Government, Supranational, and Government guaranteed bonds.

During the first half of 2013 a number of structured bank deposit investments made in 2010 matured. Originally these investments were made in structured deposit form as at the time the County Council did not have the custodial and other infrastructure established to allow investment in the more liquid investments. The deposits have performed as expected giving strong returns but being fixed deposits they did reduce

overall liquidity. Re-investment of the maturing proceeds at similar rates of return required analysis of available alternatives, and after due consideration of the alternatives, a core investment in undated UK Gilts which yield a premium to dated gilts but are still UK government credit was agreed. The bonds can be cancelled at 3 months notice at 100% of issue value but are currently priced well below par giving a substantial degree of protection whilst providing an appropriate level of return.

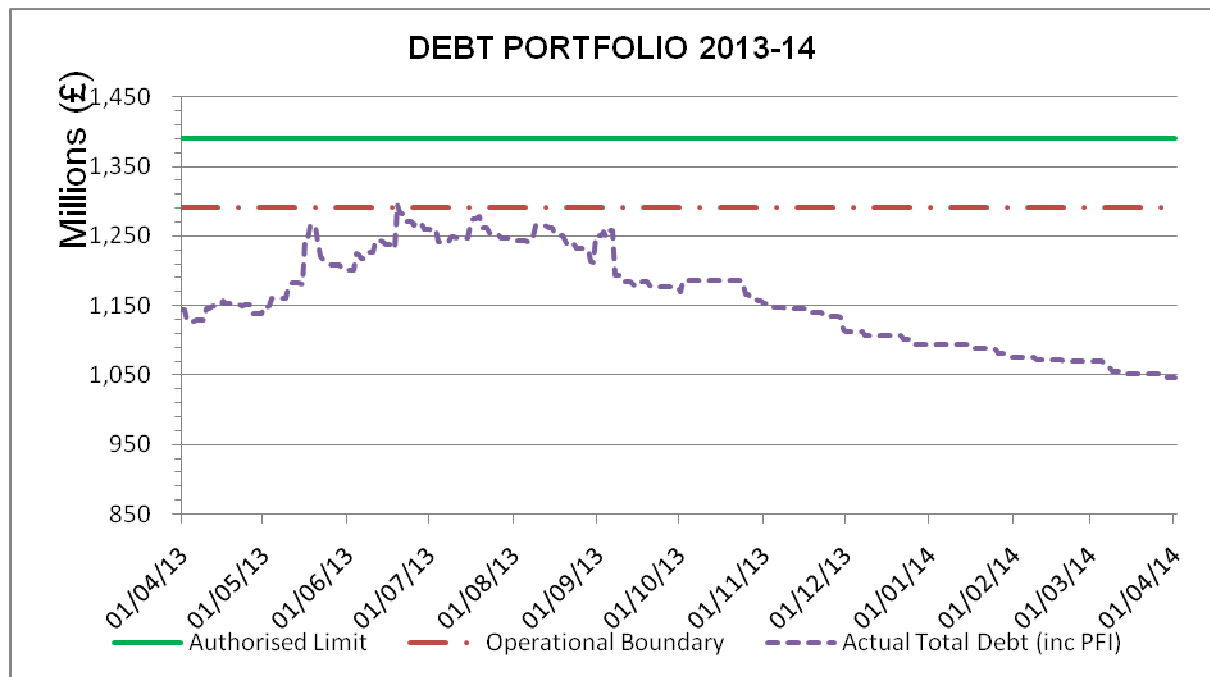
The current rate of return on the investment portfolio measured by Arlingclose Ltd is 2.48% which is 1.69% above the benchmark yield. **Borrowing Activity**

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 April and the end of August 2013. The total is net of transferred debt.

	PWLB Fixed Rate	PWLB Variable Rate	Long Term Market Loan	Other Locals	Police, Fire and Lancashire District Councils	Total
	£m	£m	£m	£m	£m	£m
Balance 1st April	213.10	125.75	52.41	287.25	61.42	739.93
Maturities	-	-	(0.60)	(361.50)	(184.89)	(546.99)
New Borrowing	-	-	-	380.00	253.77	633.77
Balance 31st August	213.10	125.75	51.81	305.75	130.30	826.71

Total borrowing now stands at £1,209m 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, do approach the operational limit. The investment and debt portfolios are currently being adjusted to reduce the size of short term month end borrowing.



The current interest rate payable on debt measured by Arlingclose Ltd is 1.81% which is 2.48% lower than the benchmark.

6. Budget Forecast for 2013/14

At this stage in the year the forecast, as recently reported to the Cabinet, remains that the financing charges budget will 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.

7. 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 31st August 2013 compared to the prudential indicators set in the treasury management strategy for 2013/14 is set out below.

Treasury Management Prudential Indicators	2013/14 £M	31st 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	891	827
Other long-term liabilities(PFI schemes)	500	403
TOTAL	1391	1251
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	827
Other long-term liabilities	450	403
TOTAL	1,291	1,251
4. Capital financing requirement to gross debt		
	Estimate	Actual
Capital financing requirement (excl PFI)	618.273	618.273
Maximum gross debt	768.000	784.014
Debt to CFR	124%	127%

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 3% higher than the target. This is only a short term situation (as is consistent with the code of practice), which has incurred mainly due to the need to borrow for the short term for salaries at month end. This situation has

been addressed and the current position at the middle of September is within the indicator percentage.

8. 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 actual position at 31st August 2013 compared to the Treasury Management indicators set in the treasury management strategy for 2013/14 is set out below.

1. Interest rate exposure

	Upper limit	Actual	Amount under +/- over(-) limit
	£m	£m	£m
Fixed rate	220	212	8
Variable rate	220	360	(140)

2. Maturity structure of debt

	Lower Limit %	Upper Limit %	Actual %
Under 12 months		75	45.59
12 months and within 2 years		75	4.14
2 years and within 5 years		75	1.21
5 years and within 10 years		75	20.48
10 years and above	25	100	28.58

3. Investments over 365 days

	Upper limit £m	Actual £m
Total invested over 364 days	550	669

4. Minimum Average Credit Rating

	Benchmark	Actual
Average counterparty credit rating	A+	AA

5. Minimum cash available within 3 months

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

The above analysis shows that the actual position as at the 31st August the County Council has exceeded some of the Treasury Management indicators set in the initial strategy for 2013/14.

Global market conditions have developed during the year which in conjunction with some UK specific monetary policy actions has caused a substantial change in the overall financial landscape.

The worldwide provision of extraordinary liquidity has over the last three months resulted in markets beginning to discount the withdrawal of this liquidity causing a step change in the structure of global interest rate markets and the price expectations of asset markets, in particular Emerging Markets and commodities, which had been prime recipients of injected liquidity.

The Bank of England, at the direction of the Treasury has also begun to implement a further range of non standard monetary policy measures, such as "Funding for Lending" which have the effect of reducing the net funding costs of banks in the UK interbank market in turn leading to a reduction in general money market rates. The effect of these changes for the County Council has been to improve the cost effectiveness of running the Councils short term funding programme, in conjunction with the maturing of previous medium term financing

International markets are always moveable and therefore we must always expect that strategies will need to be dynamic to efficiently and securely react to landscape changes.

When the current Treasury Management strategy was presented to Cabinet, credit risk and break up risks in the Eurozone were perceived to be the main risks for the Council but during the year as European monetary and political bodies have defused breakup risk and developed economies have begun to show signs of growth. It is vital that the Treasury Management indicators support the effective risk management of the County Council's Treasury Management activities and given the change within the global financial context, it is appropriate they are reviewed.

As a result of this officers have identified that there is a need to review the principal current risks to the Council as compared to those perceived at the beginning of the year and recast the Treasury Management indicators accordingly. Work is currently being undertaken to review and produce recommendations for updated indicators in conjunction with the County Council's external advisors, Arlingclose. It is proposed to present a report on the revised indicators to the Cabinet at its meeting on the 5th December 2013 for consideration by Full Council at its meeting on 12 December 2013.