

## **Review of Treasury Management 2014/15**

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### **1. Introduction**

The County Council's treasury management activity is undertaken in accordance with CIPFA's Code of Practice on Treasury Management ("the Code"). This recommends that members are informed of treasury management activities at least twice a year. This report provides a summary of the activities undertaken in 2014/15.

### **2. Executive Summary**

- During 2014/15 the council re-financed £573m of short term borrowing as part of the treasury strategy to take advantage of very low interest rates.
- Total borrowing at 31 March 2015 was £1.036bn, an increase of £220m from the previous year. This was entirely due to the refinancing of the former Waste PFI contract.
- Overall the average interest rate paid on borrowing was 2.05% per annum.
- The total return on the investment portfolios for the 2014/15 financial year was 9.32% on an average investment balance of £864.961m.
- In total, the capital financing charges showed a surplus in-year of £69m.
- Credit risk is controlled through only dealing with very high quality investment counterparties. The average credit rating throughout the year has been AA, well above the target A+ rating.
- Liquidity is a priority for the council to ensure day to day obligations can be met. The council held £107m as cash and cash equivalents on 31 March 2015 along with a further £361m in bonds which are available for sale at current market prices should further liquidity be required.
- All Treasury Management activities in year comply with the CIPFA Code of Practice and none of the Prudential Indicators have been breached during the financial year 2014/15.

### 3. Economic Summary 2014/15

Gross Domestic Product (GDP) growth of 3% in 2014 was indicative of a more positive outlook for the UK economy as a result of a buoyant services sector, supplemented by positive contributions from the production and construction sectors.

Annual Consumer Price Index (CPI) inflation fell to zero for the year to March 2015, down from 1.6% a year earlier. The key driver was the fall in the oil price (which fell to its lowest level since March 2009) and a steep drop in wholesale energy prices; extra momentum came from supermarket competition resulting in lower food prices. Bank of England Governor Mark Carney wrote an open letter to the Chancellor in February, explaining that the Bank expected CPI to temporarily turn negative but to increase around the end of 2015 as the lower prices dropped out of the annual rate calculation. The UK labour market also continued to improve with January 2015 showing the rate of unemployment falling to 5.7% from 7.2% a year earlier.

The Bank of England's Monetary Policy Committee (MPC) maintained interest rates at 0.5% and asset purchases (Quantitative Easing) at £375bn. The minutes of the MPC meetings reiterated the Committee's stance that the economic outlook for the UK economy meant that increases in the Bank Rate would be gradual and limited.

Political uncertainty had a large bearing on market confidence this year. The possibility of Scottish independence was of concern to the financial markets, however this dissipated following the outcome of September's referendum. The risk of upheaval (the pledge to devolve extensive new powers to the Scottish parliament and English MPs in turn demanding separate laws for England) lingers on. A closely contested general election campaign led to the markets bracing for a hung parliament.

On the continent, the European Central Bank (ECB) lowered its official benchmark interest rate from 0.15% to 0.05% in September and the rate paid on commercial bank balances held with it was lowered from -0.10% to -0.20%. The much-anticipated quantitative easing, which will expand the ECB's balance sheet by €1.1 trillion was finally announced by the Central Bank at its January meeting in an effort to steer the euro area away from deflation and stimulate economies. This involves buying €60bn of sovereign bonds, asset-backed securities and covered bonds a month commencing March 2015 through to September 2016. The possibility of a Greek exit from the Eurozone refused to subside given the clear frustrations that remained between its new government and its creditors.

The US economy performed strongly in 2014, employment growth was robust and there were early signs of wage pressures building, albeit from a low level. The Federal Reserve made no change to US policy rates. The central bank however continued with 'tapering', i.e. a reduction in asset purchases by \$10 billion per month, and ended them altogether in October 2014. With the US economy resilient enough to weather the weakness of key trading partners and a strong US dollar, in March 2015 the Fed removed the word "patient" from its statement accompanying its rates decisions, effectively leaving the door open for a rise in rates later in the year.

Against this economic backdrop, from July gilt yields were driven lower by geo-political risks emanating from the Middle East and Ukraine, the slide towards deflation within the Eurozone and the big fall in the price of oil and its transmission through into lower prices globally. 5-, 10- and 20-year gilt yields fell to their lows in January (0.88%,

1.33% and 1.86% respectively) before ending the year higher at 1.19%, 1.57% and 2.14% respectively.

#### **4. Local Context and the Treasury Management Strategy 2014/15**

The Full Council approved the revised 2014/15 treasury management strategy at its meeting on 20th February 2014. The Council's stated investment priorities were:

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

The LCC policy, which has been in place for a number of years, is a deliberate "low credit risk" investment policy, replacing bank deposits with bonds issued by governments, government agencies, government guaranteed bodies, supranational bodies and covered or collateralized corporate bonds. LCCs position is therefore substantially insulated from the effects of an individual or systemic banking crisis.

This strategy worked well during 2014/15. Reforms of banking legislation will leave local authorities as one of the few categories of organisation without any protection from losses. The control of credit risk will become increasingly important from 2015/16 onwards.

Evidence of the low credit risk portfolio compared to the other clients of our investment advisors Arlingclose can be seen in the results of the Arlingclose benchmarking included in the appendices to this report. These graphs show that Lancashire County Council is rated as low risk – high return compared to other county authorities and against other Arlingclose clients.

The Council also aimed to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. During the 2014/15 financial year continued low interest rates and the economic and political uncertainties described in the economic summary above, increased the value of low risk secure assets such as those held by the county council. This led to a better than estimated investment performance during the year and a surplus of income over expenditure on the capital financing budget.

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 (PWL) loans.

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

## 5. Treasury Management Activities in 2014/15

### 5.1 Borrowing Activity 2014/15

The revised 2014/15 borrowing requirement was estimated at £549.109m after taking into account the updated Capital Programme and the refinancing of existing borrowing. The table below shows the 2014/15 revised borrowing requirement along with the actual position as at 31 March 2015.

	<b>2014/15 Revised £m</b>	<b>2014/15 Actual £m</b>
<b>Capital Programme Expenditure</b>	<b>205.903</b>	<b>178.016</b>
<i><b>Financed by:</b></i>		
Capital Receipts	8.171	11.405
Grants and Contributions	187.450	150.797
Revenue Contributions	8.999	15.814
<b>Borrowing</b>	<b>1.283</b>	<b>0</b>
<i><b>Add Maturing Debt to be replaced:</b></i>		
Short Term Market Borrowing	579.950	573.000
Less Transferred Debt	1.967	1.967
Less Statutory Charge to Revenue	30.157	30.157
<b>Total Borrowing Requirement</b>	<b>549.109</b>	<b>540.876</b>

The revised capital programme estimated that £1.283m of new borrowing would be required to finance the capital programme. However lower than anticipated capital expenditure meant this borrowing was not required.

## 5.2 Analysis of Borrowing Outstanding

The following table sets out the structure of the County Council's treasury borrowing as at 31 March 2015:

	Debt as at 31-Mar-14		Borrowing	Repayments	Debt as at 31-Mar-15	
	£m	%	£m	£m	£m	%
<b>Fixed Rate Funding</b>						
Public Works Loan Board	213.10	26.22	-	-	213.10	20.58
*LOBO	50.00	6.15	-	-	52.23	5.04
Local Bonds	0.02	-	-	0.02	0.00	0.00
Market Borrowing	330.95	40.73	703.80	461.75	573.00	55.33
	<b>594.07</b>		<b>703.80</b>	<b>461.77</b>	<b>838.33</b>	<b>80.96</b>
<b>Variable Rate Funding</b>						
Public Works Loan Board	125.75	15.48	-	-	125.75	12.14
Shared Investment Scheme	92.77	11.42	571.73	593.04	71.46	6.09
	<b>218.52</b>		<b>571.73</b>	<b>593.04</b>	<b>197.21</b>	<b>19.04</b>
<b>Loan Debt Administered by the County Council</b>	<b>812.59</b>	<b>100.00</b>	<b>1,259.79</b>	<b>1,184.81</b>	<b>1,035.54</b>	<b>100.00</b>

\*Lender option borrower option

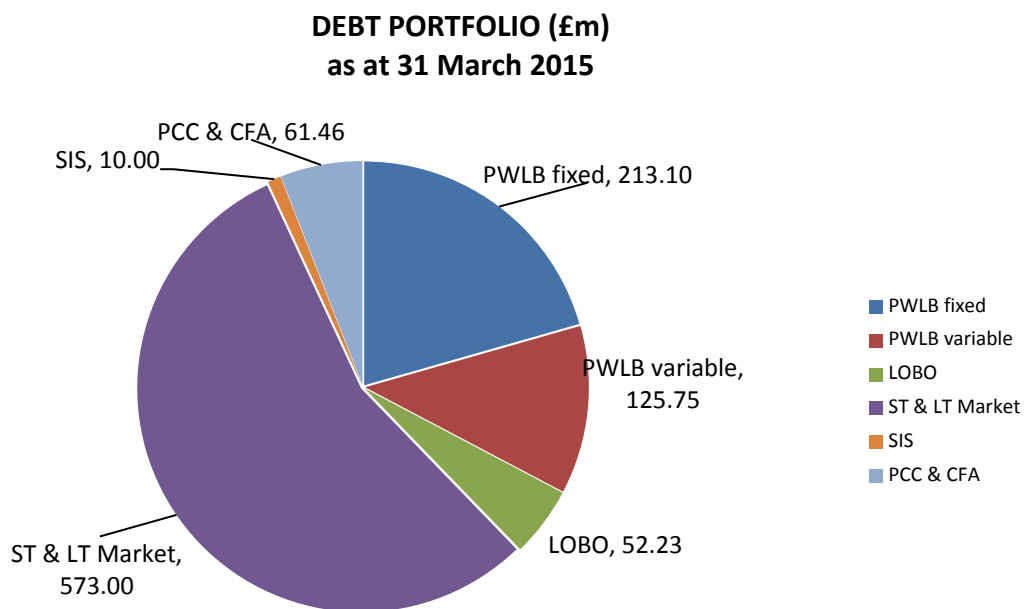
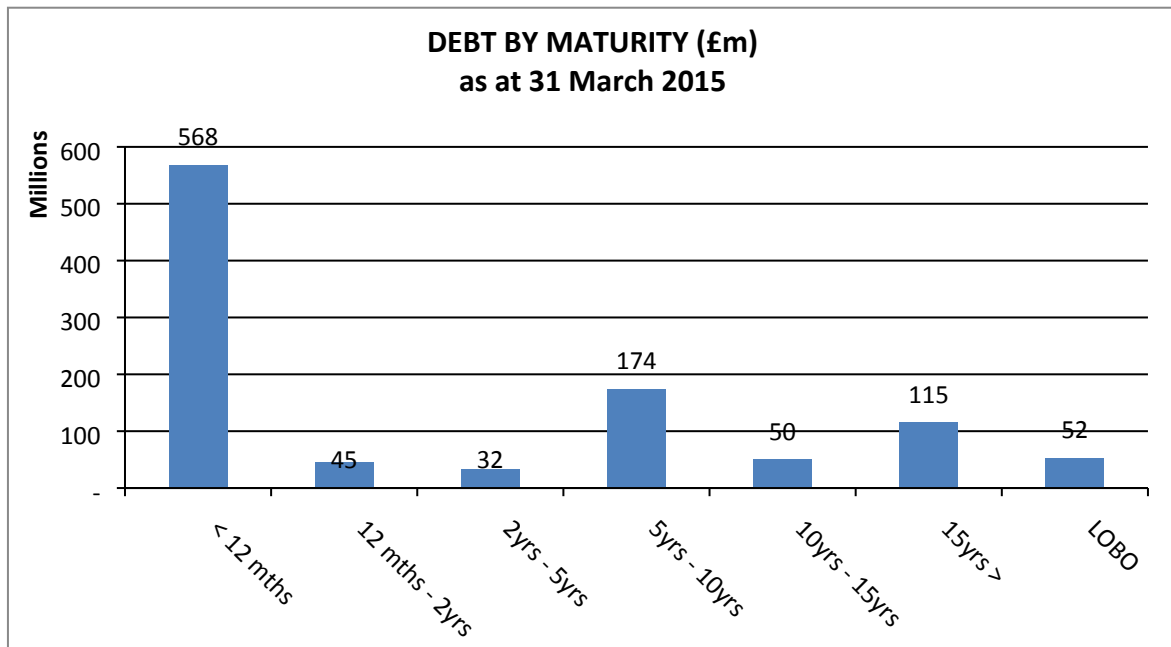
The total loan debt administered by the county council at 31 March 2015 of £1.036bn represents mainly borrowings over the years to finance the acquisition of the county council's fixed assets, which are currently valued at £2.669bn. The total borrowing increase of £220m over the year is entirely due to the refinancing of the former Waste PFI contract in July 2014 and therefore the increased borrowing is offset by a reduction in the council's long term liabilities.

With short-term interest rates having remained much lower than long-term rates, it was more cost effective to borrow short-term loans from the market, mainly from other local authorities. By doing so, the Council was able to keep borrowing costs low and reduce overall treasury risk. Whilst such a strategy is most likely to be beneficial over the next year as official interest rates remain low, it is unlikely to be sustained in the medium-term.

The Interim Director of Financial Resources will, in conjunction with Arlingclose, continue to closely monitor interest rate forecasts in order to establish when long term interest rates might be expected to rise and adapt its strategy accordingly.

Overall the average rate of interest paid in 2014/15 on the debt administered by the County Council was 2.05% per annum compared with an average rate of 2.48% in 2013/14, 2.45% in 2012/13 and 2.11% in 2011/12

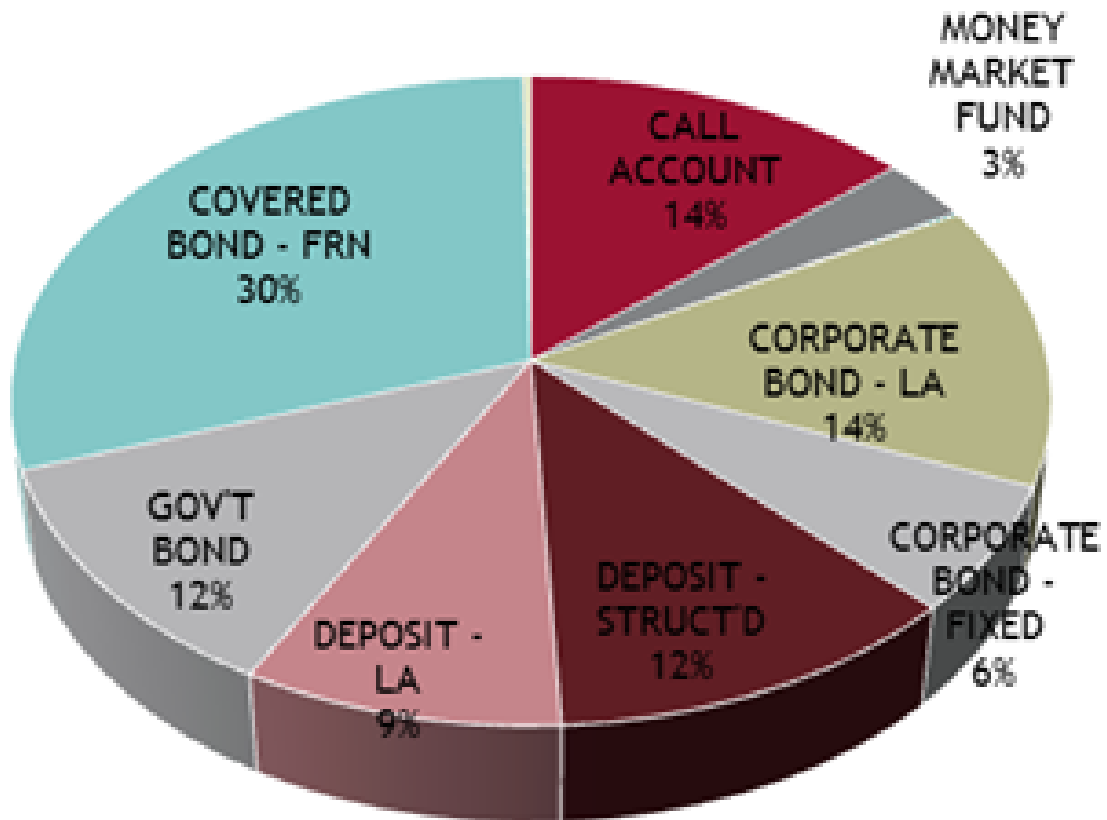
The charts below show the maturity and portfolio profiles of the County Council's debt as at 31 March 2015.



NOTE: PCC & CFA – Lancashire Police & Crime Commissioner and Combined Fire Authority.

### 5.3 Investment Activity

The total amount of investments (excluding fair value adjustment) held by Lancashire County Council at 31 March 2015 is £636.57m including £107.25m of cash and cash equivalents. The chart below shows the asset classes and the proportion of investments held in each class.

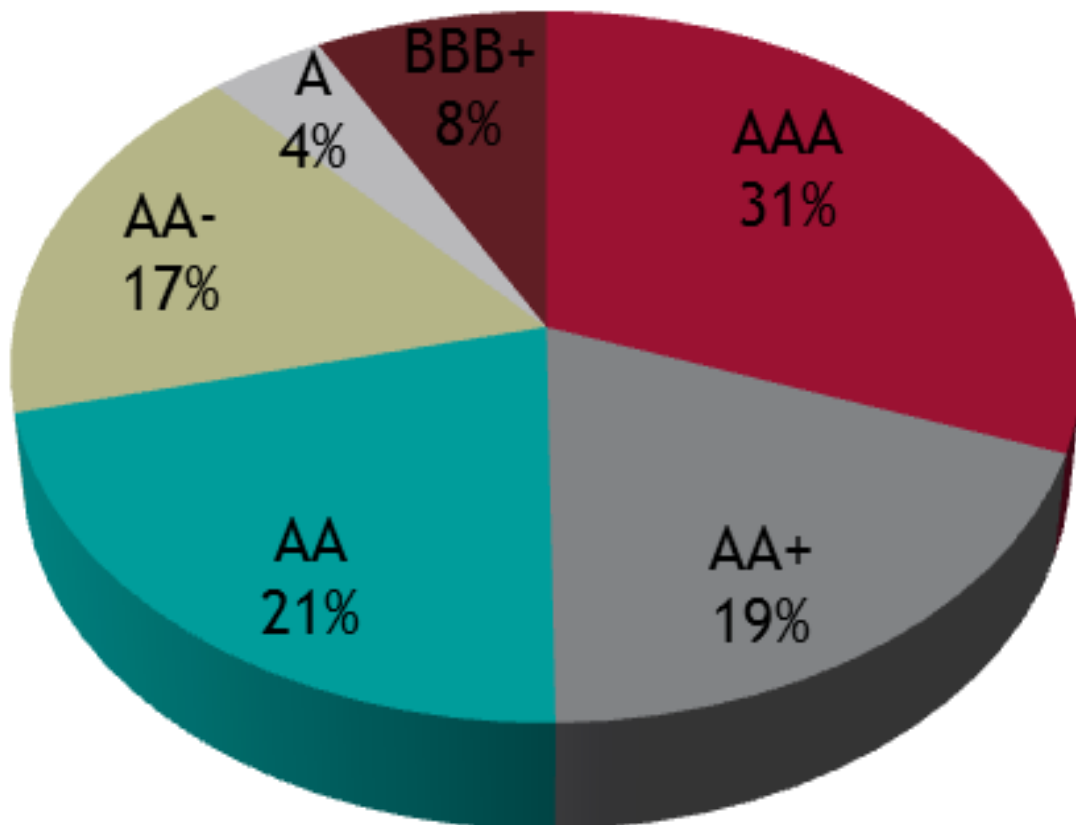


NOTE: FRN – Floating Rate Note.

The portfolio is developed in line with risk management, credit rating and maturity profiles as discussed below.

### 5.3.1 Total Investments analysed by credit rating

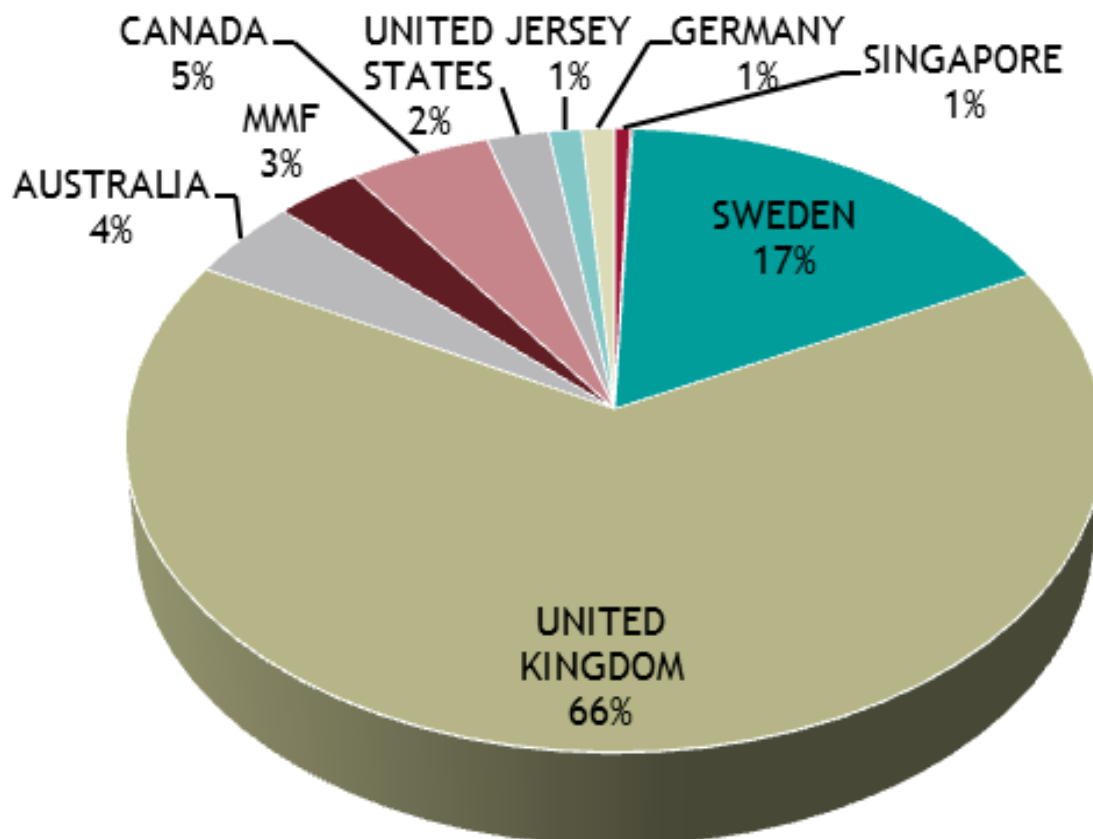
Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2014/15. This defined "high credit quality" organisations as those having a minimum long-term credit rating of A+. In practice the Council continued to monitor the credit quality of its counter parties and the average credit rating in 2014/15 was AA which is higher than the A+. Details are shown in the chart below.





As part of the risk management policy, the Council has been moving away from unsecured bank deposits as an asset class and apart from on call balances they no longer form an allowable investment class under the 2015/16 treasury policy.

Sovereign credit risk is monitored by reference to the country in which investment counterparties are domiciled. The chart below shows the investments analysed by country.



NOTE: MMF – Money Market Fund – which is invested in various countries.

### 5.3.2 Investments by Maturity

The table below shows a maturity analysis of the portfolio as at 31 March 2015, alongside the average interest rate earned over the 2014/15 financial year.

<b>Maturity Range</b>	<b>Amount as at 31 March 2015 £m</b>	<b>Average Rate 2014/15 %</b>
Call, Money Market Funds & Under 1yr	181.71	1.43
Bank Deposit 1-2 Years	10.00	1.00
Bank & Local Authority Deposits 3-5 Years	36.50	1.44
Bank Deposit 5 Years +	10.00	2.95
Local Authority Bonds	36.70	4.05
UK Government and Supranational* Bonds	361.66	12.23
<b>Total</b>	<b>636.57</b>	<b>9.32</b>

\* Supranational – bodies such as the World Bank, European Development Bank.

### 5.4 Liquidity Management

In keeping with the Department of Community & Local Government's Guidance on Investments, the Council maintained a minimum level of primary liquidity of £20m through the use of Money Market Funds and Call Accounts. The Council also has bond portfolios which are available for sale, at current market prices, if needed as "secondary" liquidity. From June 2015 the only assets held by the County Council which would be unprotected if a bank defaulted will be overnight deposits on call.

The Council uses cash flow forecasting to determine the maximum period for which funds may prudently be committed.

### 5.5 Yield

The low rates of return on the Authority's short-dated money market investments reflect prevailing market conditions and the Authority's objective of optimising returns commensurate with the principles of security and liquidity.

Income of £83.931m was earned on investments as a result of continuing low interest rates and concern over deflation and geo-political unrest in the Middle East and Ukraine. Overall the investment portfolios returned an average rate of 9.32% in 2014/15.

## 6. Impact of the Treasury Management Strategy on the County Council's revenue budget

The table below shows that the net position is £69.583m better than the budget. This is a result of additional income being received from realising market value increases in bonds and gains from the UK Treasury redemption of war loan bonds of which the Council was a holder. These gains are considered to be extraordinary and therefore will be a one-off gain.

## Financing Charges 2014/15– End of Year Position

	Budget £m	Year End Position £m	Variance £m
Statutory Charge to Revenue	34.298	30.157	-4.141
Interest paid	22.475	22.033	-0.442
Investment interest received	-18.931	-83.931	-65.000
<b>Total Net Financing charges</b>	<b>37.842</b>	<b>-31.741</b>	<b>-69.583</b>

### 7. Treasury Management and 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.

A comparison of the actual position as at 31 March 2015 compared to the indicators set in the treasury management strategy for 2014/15 is set out below.

<u>Prudential Indicators</u>	2014/15 Revised Limit £m	2014/15 Actual £m
1. <b>Adoption of CIPFA Treasury Management Code of Practice</b>		Adopted
2. <b>Authorised limit for external debt</b> A prudent estimate of debt which reflects the Authority's capital expenditure plans and allows sufficient headroom for unusual cash movements.		
Borrowing	1,544	1,036
Other long term liabilities (PFI schemes)	206	176
<b>TOTAL</b>	<b>1,750</b>	<b>1,212</b>

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	1,036
Other long term liabilities (PFI schemes)	156	176
<b>TOTAL</b>	<b>1,650</b>	<b>1,212</b>

4. **Capital Financing Requirement** 1,007 1,005

**Treasury Management Indicators**

5. **Upper limit for fixed rate debt** 37.6 8.7
6. **Upper limit for variable rate debt** 5.0 -1.8
7. **Upper limit for investments over 364 days** See below

Limits on the level of long term investments helps to control liquidity, although the majority of investments are held in available for sale securities.

	<b>Upper Limit £m</b>	<b>Actual £m</b>
<b>Authorised limit</b>		
Total invested over 364 days	900	514

8. **Maturity structure of debt**

	<b>Lower Limit %</b>	<b>Upper Limit %</b>	<b>Actual %</b>
Under 12 months	-	75	59.9
12 months and within 2 years	-	75	3.1
2 years and within 5 years	-	75	2.8
5 years and within 10 years	-	75	16.3
10 years and above	25	100	11.1

The Council confirms that it has complied with its Prudential Indicators for 2014/15, which were approved on 20th February 2014 as part of the Council's Treasury Management Strategy Statement.

The Council also confirms that during 2014/15 it complied with its Treasury Management Policy Statement and Treasury Management Practices.



# **Appendices**





## Average Rate vs Credit Risk (value-weighted) - Client Type

