Appendix 'A'

Review of Treasury Management 2015/16

Introduction

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 Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity annually. The Code also recommends that members are informed of Treasury Management activities at least twice a year.

1. Economic Summary 2015/16

The Treasury Management activity is influenced by the economic situation and the anticipated movement in interest rates. The following is a summary of the economic position in 2015/16.

Growth, Inflation, Employment:

The UK economy slowed in 2015 with GDP growth falling to 2.3% from a robust 3.0% the year before. CPI inflation hovered around 0.0% through 2015 with deflationary spells in April, September and October. This prolonged spell of low inflation was attributed to the continued collapse in the price of oil; the appreciation of sterling since 2013 pushing down import prices and weaker than anticipated wage growth resulting in subdued unit labour costs. CPI picked up to 0.3% year/year in February, but this was still well below the Bank of England's 2% inflation target. The labour market continued to improve through 2015 and in Q1 2016, the latest figures (Jan 2016) showing the employment rate at 74.1% (the highest rate since comparable records began in 1971) and the unemployment rate at a 12 year low of 5.1%. Wage growth has however remained modest at around 2.2% excluding bonuses, but after a long period of negative real wage growth (i.e. after inflation) real earnings were positive and growing at their fastest rate in eight years, boosting consumers' spending power.

Global influences:

The slowdown in the Chinese economy posed a significant threat to global growth as a whole. The effect of the Chinese authorities' intervention in their currency and equity markets was temporary and led to high market volatility. In addition as the global economy entered 2016 there was further uncertainty about growth resulting from the potential outcome of the US presidential election and the consequences of June's referendum on whether the UK is to remain in the EU. Between February and March 2016 sterling had depreciated by around 3%, a significant proportion of the decline reflecting the uncertainty surrounding the referendum result.

Monetary Policy:

The Bank of England's MPC (Monetary Policy Committee) made no change to policy, maintaining the Bank Rate at 0.5% (in March it entered its eighth year at 0.5%) and asset purchases (Quantitative Easing) at £375bn. In its Inflation Reports and monthly monetary policy meeting minutes, the Bank was at pains to stress and reiterate that when interest rates do begin to rise they were expected to do so more gradually and to a lower level than in recent cycles.

Improvement in household spending, business fixed investment, a strong housing sector and solid employment gains in the US allowed the Federal Reserve to raise rates in December 2015 for the first time in nine years to take the new Federal funds range to 0.25%-0.50%. Despite signalling four further rate hikes in 2016, the Fed chose not to increase rates further in Q1 and markets pared back expectations to no more than two further hikes this year.

However central bankers in the Eurozone, Switzerland, Sweden and Japan were forced to take policy rates into negative territory. The European Central Bank also announced a range of measures to inject sustained economic recovery and boost domestic inflation which included an increase in asset purchases (Quantitative Easing).

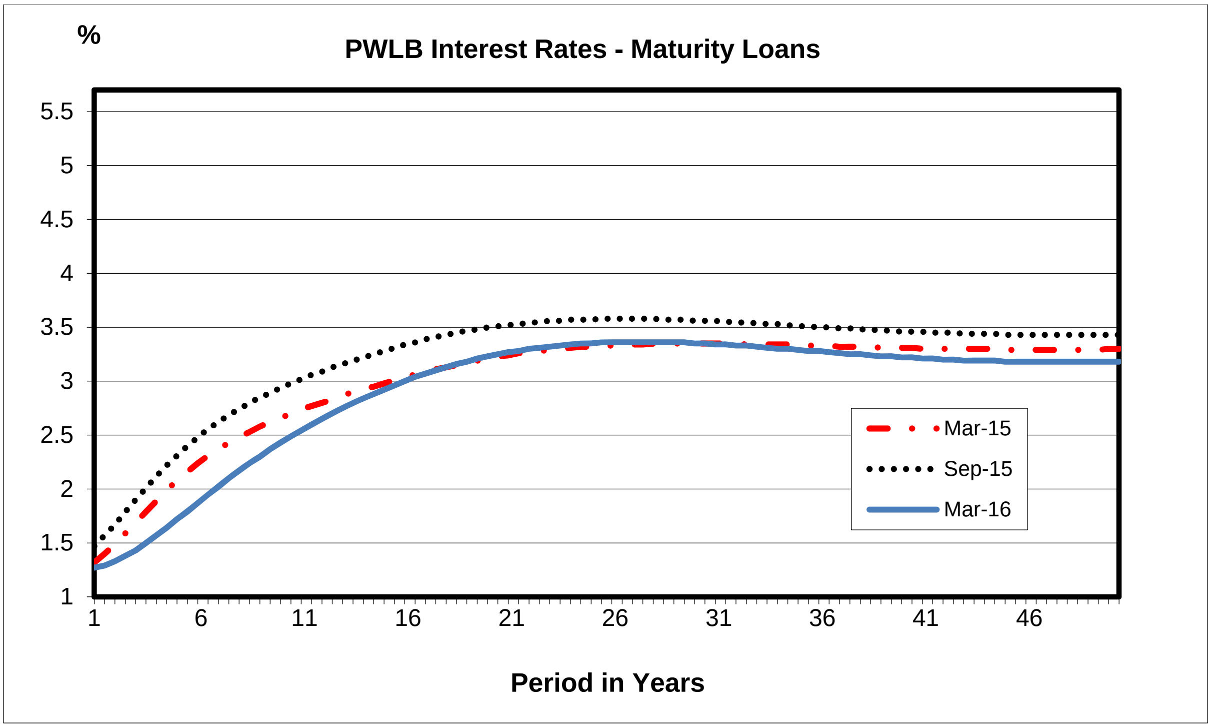
Market reaction:

From June 2015 gilt yields were driven lower by the a weakening in Chinese growth, the knock-on effects of the fall in its stock market, the continuing fall in the price of oil and commodities and acceptance of diminishing effectiveness of central bankers' policy actions. Added to this was the heightened uncertainty surrounding the outcome of the UK referendum on its continued membership of the EU as well as the US presidential elections which culminated in a significant volatility and in equities and corporate bond yields.

10-year gilt yields moved from 1.58% on 31/03/2015 to a high of 2.19% in June before falling back and ending the financial year at 1.42%. The pattern for 20-year gilts was similar, the yield rose from 2.15% in March 2015 to a high of 2.71% in June before falling back to 2.14% in March 2016. The FTSE All Share Index fell 7.3% from 3664 to 3395 and the MSCI World Index fell 5.3% from 1741 to 1648 over the 12 months to 31 March 2016.

Interest Rate Environment:

Short term interest rates continue at very low levels with the Bank of England maintaining the base rate to 0.5% throughout the year. Short term investment levels available in the market remained below 0.6% through the year as illustrated in the chart below.



Due to the continued economic uncertainty and the prospects for economic growth it is anticipated that the low interest rate environment will continue. When rates do increase it is expected that this will be at a gradual rate. Lancashire County Council's Treasury Management advisors, Arlingclose Treasury Consultants, has changed its forecast of interest rates movement. It now considers that the next move in the Bank base rate will be in Q2 2018. Last year it was anticipated that the next increase would have been in Q2 2017. (Note that the Quarter and Half years referred to are calendar years, as opposed to financial years). Their forecast are shown in the table below.

Period	Bank Rate	3 month LIBID	12 month LIBID	20-year guilt Yield
Q2 2016	0.50	0.50	1.00	2.30
Q3 2016	0.50	0.50	1.05	2.35
Q4 2016	0.50	0.55	1.10	2.40
Q1 2017	0.50	0.60	1.10	2.45
Q2 2017	0.50	0.65	1.15	2.50
Q3 2017	0.50	0.70	1.20	2.55
Q4 2017	0.50	0.75	1.25	2.60
Q1 2018	0.50	0.80	1.30	2.65
Q2 2018	0.75	0.85	1.35	2.68
H1 2019	0.75	1.05	1.40	2.75

2. Local Context and the Treasury Management Strategy 2015/16

The Full Council approved the revised 2015/16 Treasury Management Strategy at its meeting on 11th February 2015. The Council's stated investment priorities were:

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

The County Council policy, which has been in place for a number of years, is a deliberate "low credit risk" investment policy, using bonds issued by governments, government agencies, government guaranteed bodies, supranational bodies and covered or collateralized corporate bonds. The County Council's position is not to invest in banks, other than call accounts; and therefore it is substantially insulated from the effects of an individual or systemic banking "credit event". This control of credit risk was a key driver in the Treasury Management activity in 2015/16, and will continue to be so in future years. As outlined later in the report over 75% of investments are rated AA+ or AAA demonstrating that LCC has maintained a low risk portfolio.

The County Council's Treasury Advisor, Arlingclose, compares the credit risk of its clients. This comparison shows that at 31 March 2016 the County Council has one of the lowest credit risk scores of all of its clients. This comparison is shown graphically at the end of this appendix.

The County Council also aimed to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. 2015/16 saw continued low interest rates with significant economic uncertainty in the world economy as described in the economic summary above, increased the value of low risk secure assets such as those held by the County Council.

The County 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. Since this strategy was first implemented in 2010/11 the County Council has taken advantage of low interest rates to reduce the cost of financing current and former years' capital programmes. This strategy continued to be implemented in 2015/16 and will continue to be the most cost effective financing method until there is a significant increase in interest rates.

The Director of Finance can report that all Treasury Management activity undertaken during the financial year complied with the *CIPFA Code of Practice* and the relevant legislative provisions.

3. Treasury Management Activities in 2015/16

Borrowing Activity 2015/16

The estimated borrowing requirement in 2015/16, as agreed in the Treasury Management Strategy, was £619.089m. This took into account the financing of the Capital Programme and the refinancing of existing short term borrowing which has been taken to fund previous capital expenditure. The actual borrowing required was lower than expected (principally due to slippage in capital expenditure). The table below shows the 2015/16 revised borrowing requirement as agreed within the 2016/17 Treasury Management Strategy report, along with the actual position as at 31st March 2016.

	2015/16 Revised £m	2015/16 Actual £m
Capital Programme Expenditure	**250.521**	**186.077**
Financed by:		
Capital Receipts	21.297	26.502
Grants and Contributions	143.350	152.725
Revenue Contributions	24.869	6.850
Borrowing	61.005	0.000
***Add Maturing Debt to be replaced*:**		
Long Term PWLB	0.000	0.000
Long Term Fixed Borrowing	0.000	0.000
Short Term Market Borrowing	579.950	522.400
Less Transferred Debt	1.899	1.761
Less Statutory Charge to Revenue	19.967	19.446
Total Borrowing Requirement	**619.089**	**501.193**

Analysis of Borrowing Outstanding

The total loan debt administered by the County Council at 31 March 2016 was £973.630m which is a reduction of £59.680m in the year. This debt has been incurred over a number of years to finance the acquisition of the County Council's fixed assets, which are currently valued at £2.751bn.

The following table sets out the movement of the County Council's treasury borrowing during the year and the structure of the debt at 31st March 2016.

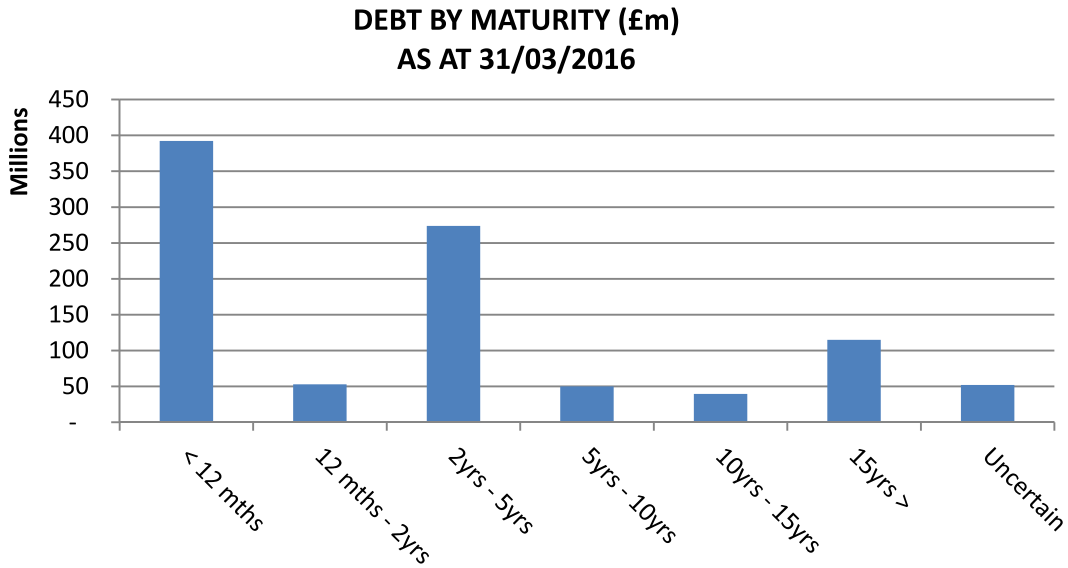
	Debt at 31-Mar-15		Borrowing	Repayments	Debt at 31-Mar-16	
	£m	%	£m	£m	£m	%
Fixed Rate Funding						
Public Works Loan Board	213.10	20.62	-	-	213.10	21.89
*LOBO	50.00	4.84	-	-	50.00	5.14
Market Borrowing	573.00	55.45	622.30	672.90	522.40	53.64
Total Fixed Rate Funding	**836.10**		**622.30**	**672.90**	**785.50**	
Variable Rate Funding						
Public Works Loan Board	125.75	12.17	-	-	125.75	12.92
Shared Investment Scheme	71.46	6.92	481.95	491.03	62.38	6.41
Total Variable Rate Funding	**197.21**		**481.95**	**491.03**	**188.13**	
Loan Debt Administered by the County Council	**1,033.31**	**100.00**	**1,104.25**	**1,163.93**	**973.63**	**100.00**

*Lender option borrower option

With short-term interest rates being lower than long-term rates, it was more cost effective in the short-term to borrow short-term loans from the market, mainly from other local authorities. 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 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 adjust the strategy accordingly.

Overall the average rate of interest paid in 2015/16 on the debt administered by the County Council was 2.03% per annum compared with an average rate of 2.07% in 2014/15, 2.48% in 2013/14 and 2.45% in 2012/13.

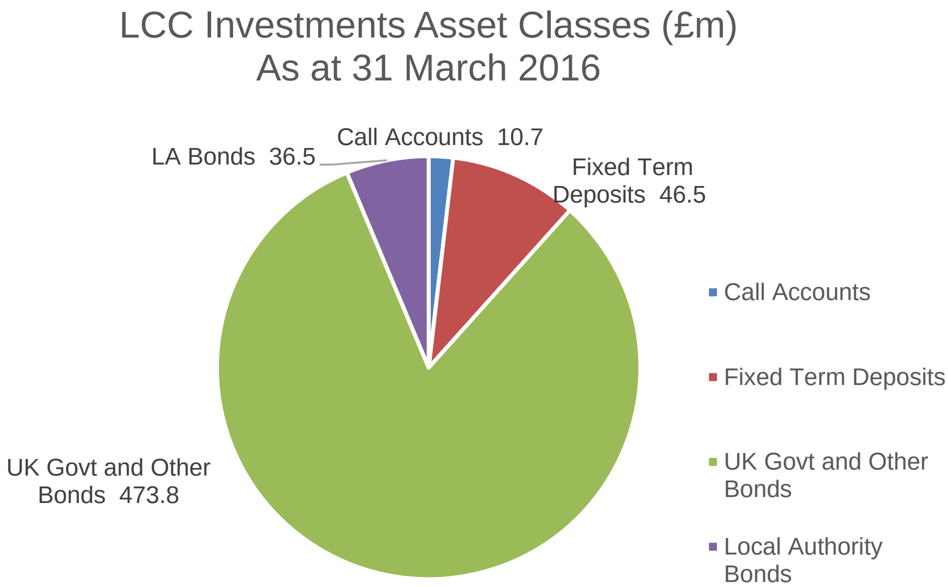
The charts below show the maturity profiles of the County Council's debt as at 31 March 2016 which reflect the strategy of recently taking debt on a short term basis.



Investment Activity

The County Council holds investments as it holds reserves and other cash balances in its Balance Sheet. The total amount of investments (excluding fair value adjustment) held by Lancashire County Council at 31st March 2016 is £577.52m. This is £59m lower than at 31st March 2015. The table below shows the holding of investments:

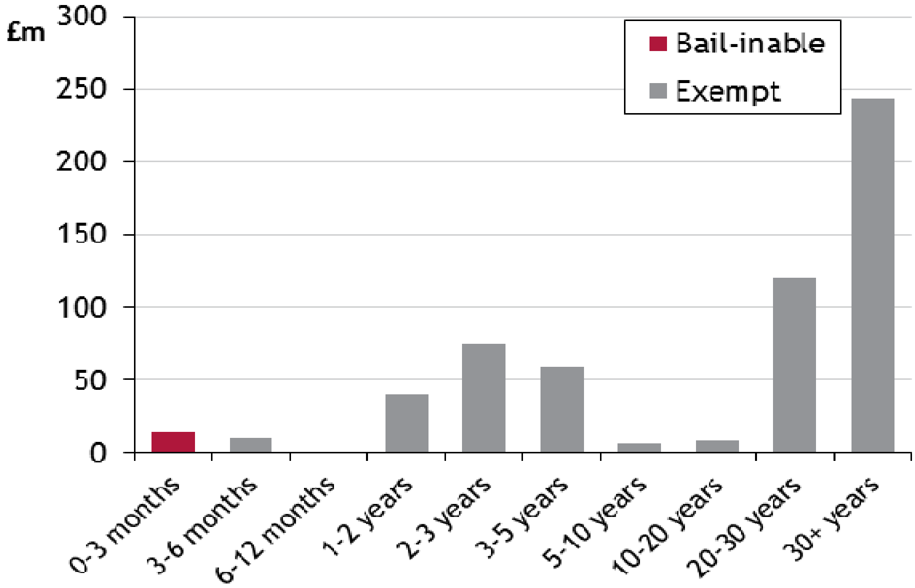
Maturity Range	**Position as at 31/3/15 £m**	**2015/16 Movement £m**	**Position as at 31/3/16 £m**
Call, Money Market Funds & Under 1yr	181.71	-161.00	20.71
Bank Deposit 1-2 Years	10.00	-10.00	0.00
Bank & Local Authority Deposits 2-3 years	36.50	0.00	36.50
Bank & Local Authority Deposits 3-5 Years	10.00	-10.00	0.00
Bank Deposit 5 Years +	0.00	10.00	10.00
Local Authority Bonds	36.70	-0.25	36.45
UK Government and Supranational Bonds	361.66	112.20	473.86
Total	**636.57**	**-59.05**	**577.52**



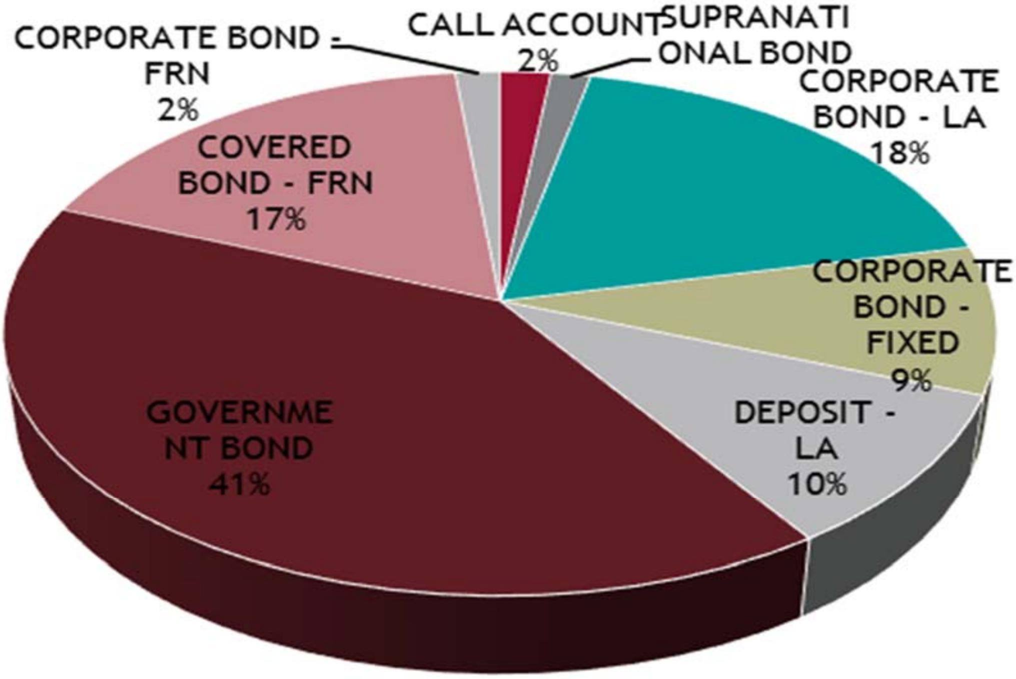
In undertaking investments consideration is taken on the risk and liquidity within the portfolio. Some of the factors considered are the maturity of the investment, the asset type, the country invested in and the credit rating. The position of the investment portfolio on these areas are shown in the graphs below.

Investments by Maturity

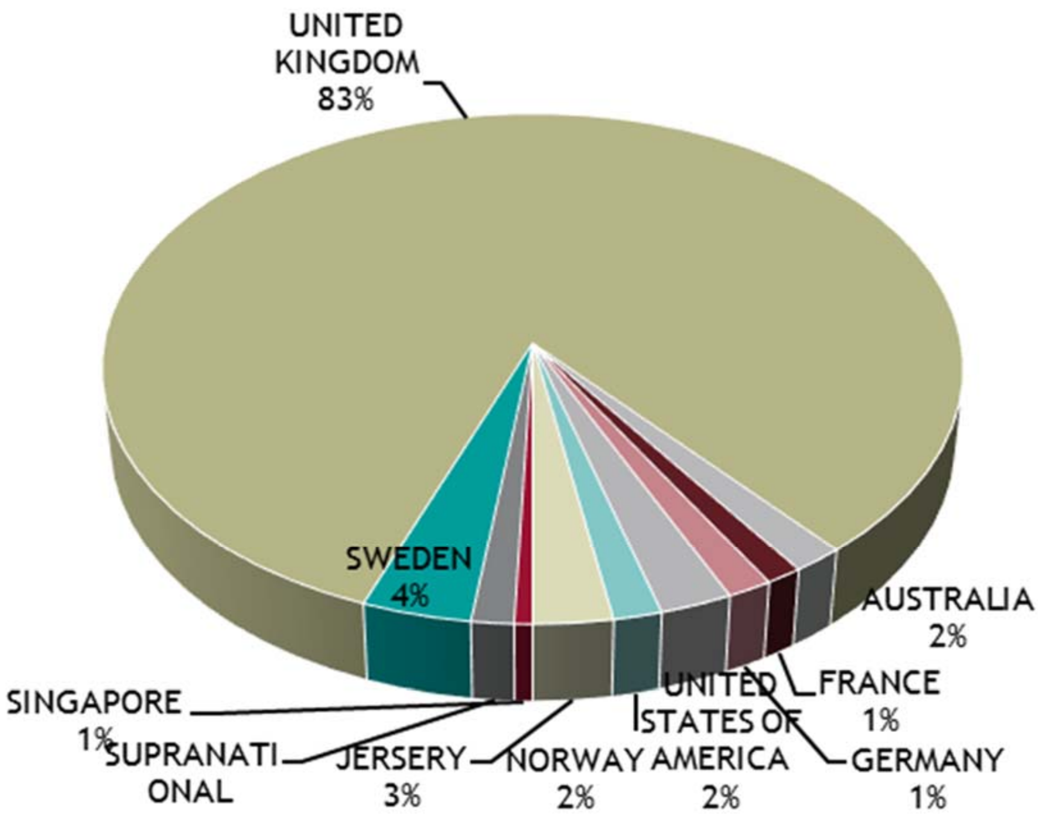
The graph below shows the maturity dates of assets against their exposure to bail-in risk in the event of a bank default (i.e. the risk that the investment may be lost or the principal repaid significantly reduced). The County Council has been moving away from unsecured bank deposits as an asset class and apart from on call balances they no longer form an allowable investment class under the 2015/16 Treasury Management Policy.



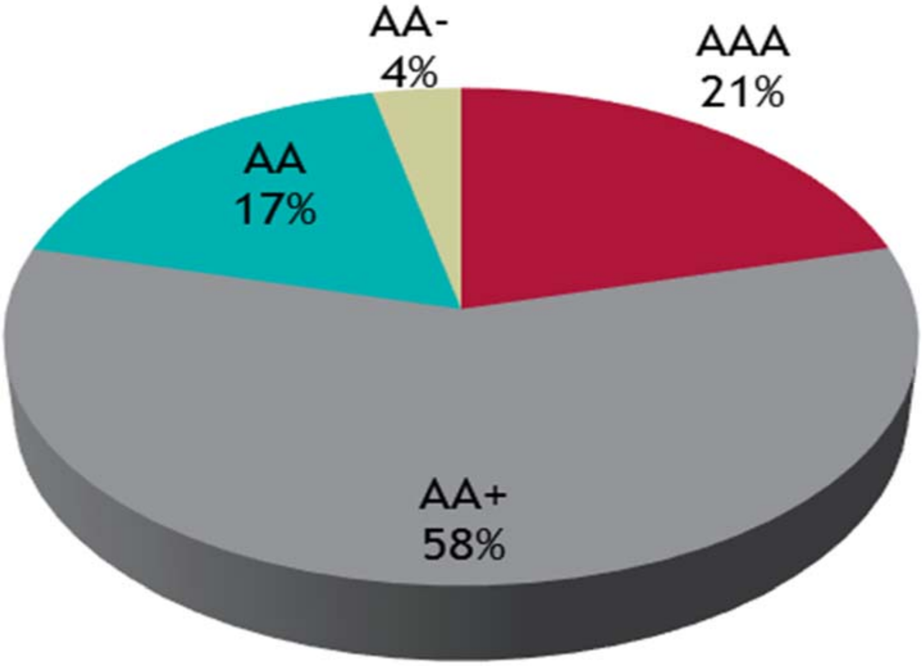
Total investments analysed by asset type



Total Investments analysed by Country



Total Investments analysed by credit rating



Investments are very secure, with over 75% rated AAA or AA+, with the others rated at A or above. The average credit score of 1.88/AA+ is well within the policy limit of 5/A+.

Security of capital remained the County Council's main investment objective. This was maintained by following the County Council's Counterparty Policy, as set out in its Treasury Management Strategy Statement for 2015/16. This defined "high credit quality" organisations as those having a minimum long-term credit rating of A+ In practice the average credit rating in 2015/16 was higher at AA+.

Investments with banks were held in call accounts only. Any longer term deposits have been restricted to other local authorities.

Liquidity Management

In keeping with the CLG's Guidance on Investments, the County Council maintained a minimum level of primary liquidity of £20.00m through the use of Call Accounts. The County Council also has bond portfolios which are available for sale, at current market prices, if needed as "secondary" liquidity.

The County Council uses purpose-built cash flow forecasting spreadsheets to determine the maximum period for which funds may prudently be committed.

Yield

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

Income of £26.579m was earned on longer-dated investments .Overall the investment portfolios returned an average rate of 3.78% in 2015/16 which can be attributed to the categories as follows:

Maturity Range	Amount 31/3/16 £m	Average Rate 15/16
Call, MMF & Under 1 year	20.71	1.47%
Bank & Local Authority Deposits 2-3 years	36.50	1.44%
Bank Deposits 5 years +	10.00	2.95%
Local Authority Bonds	36.45	3.73%
UK Government & Supranational Bonds	473.86	4.44%
Total	**577.52**	**3.78%**

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

The table below shows a net underspend of £30.984m on the financing charges budget. Of this £17.60m has arisen as a result of changes to the Minimum Revenue Provision (MRP) calculation as agreed by the County Council in February 2016. The MRP is an annual charge to the revenue account to pay for capital expenditure that was originally funded by debt. The County Council is required to make a prudent charge each year and the review of the calculation has arisen partly to reflect changes in funding received to support the charge from Central Government Grants.

Income received in the year was £16.60m higher than initially anticipated. The forecast surplus on interest received arose primarily because the County Council's low risk investment portfolios increased in value as a result of market movements during the year. This enabled some core GILT bonds to be sold resulting in a net gain of £9.90m. There have also been net gains of £6.40m resulting from sales on the traded bond portfolio.

Financing Charges 2015/16 – End of Year Position

	Budget 15/16 £m	Year End Position £m	Variance £m
MRP	37.085	19.446	-17.639
Interest Paid	22.308	25.584	3.276
Interest Received	-12.990	-29.611	-16.621
Total	**46.403**	**15.419**	**-30.984**

5. Treasury Management and Prudential Indicators 2015/16

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 31 March 2016 compared to the indicators set in the Treasury Management Strategy for 2015/16 is set out below.

Prudential Indicators

1. Adoption of CIPFA Treasury Management 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** 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.	**2015/16**	**2015/16 Actual**
	£m	**£m**
Borrowing	1,300.00	974.00
Other long term liabilities (PFI schemes)	250.00	168.00
TOTAL	**1,550.00**	**1,144.00**

3. Operational boundary for external debt The Operational Boundary is 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.	**2015/16**	**2015/16 Actual**
	£m	**£m**
Borrowing	1,250.00	974.00
Other long term liabilities (PFI schemes)	200.00	168.00
TOTAL	**1,450.00**	**1,144.00**

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.	**2015/16**	**2015/16 Actual**
	£m	**£m**
Capital Financing Requirement (borrowing)	861.00	811 .00
Estimated gross debt	1,010.00	974.00
Debt to Capital Financing Requirements	117%	120%

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.

5. Council Tax Indicators	**2015/16**	**2015/16 Actual**
Ratio of financing costs to the net revenue stream	5.81%	2.12%
Estimated revenue impact of capital investment on Band D	41.05	19.99

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	7.70
Net Interest Payable – Variable Rate	5.00	2.90
1 year impact of a 1% rise	10.00	2.30

2. Maturity structure of debt The limit on the maturity structure of debt helps control refinancing risk.	Lower Limit %	Upper Limit %	Actual %
Under 12 months	-	75	40
12 months and within 2 years	-	75	5
2 years and within 5 years	-	75	28
5 years and within 10 years	-	75	5
10 years and above	25	100	22

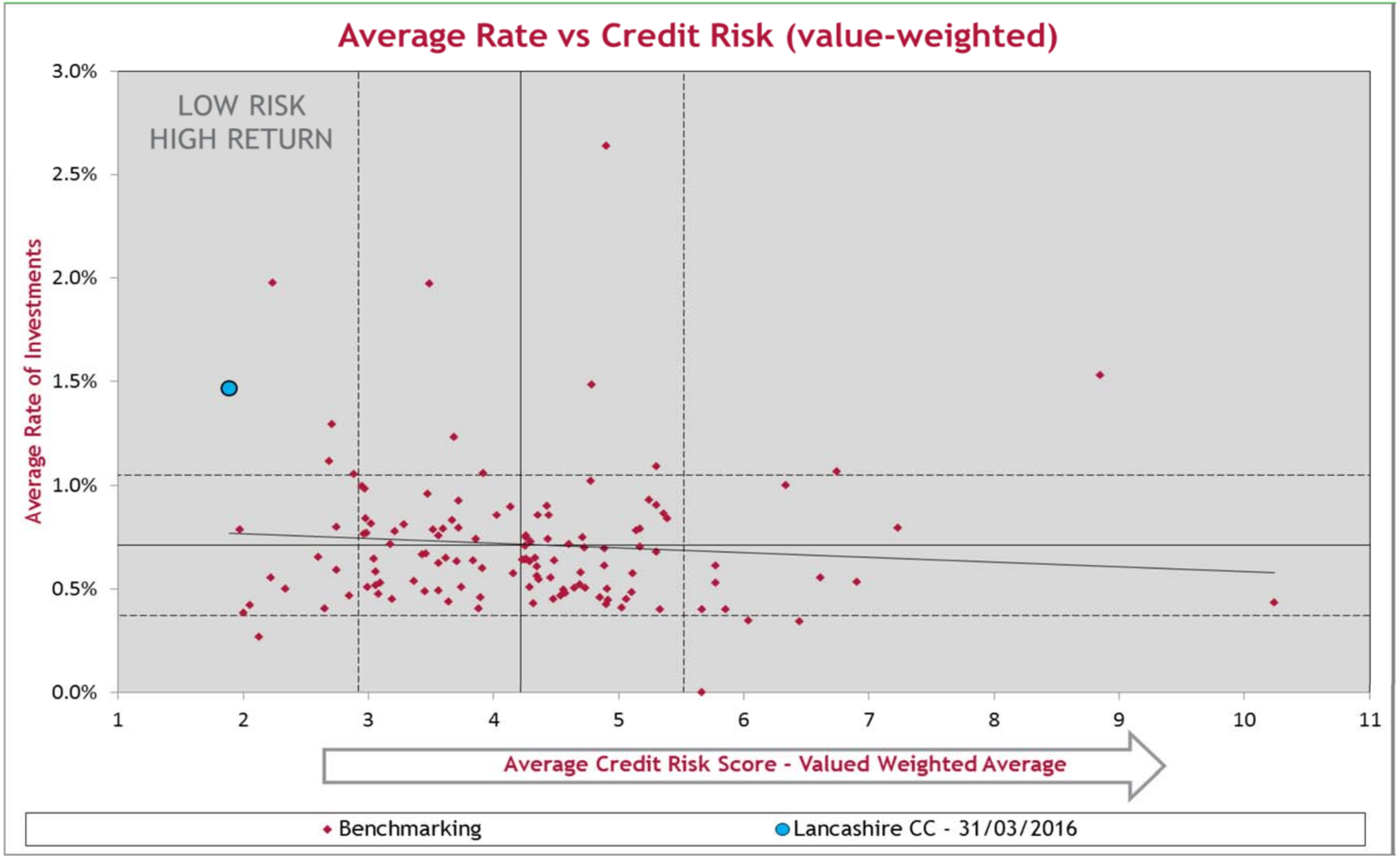
3. Investments over 364 days The limit on the level of long term investments helps to control liquidity, although the majority of these investments are held in available for sale securities.	Upper Limit	Actual
	£m	£m
Total invested over 364 days	900.00	557.00

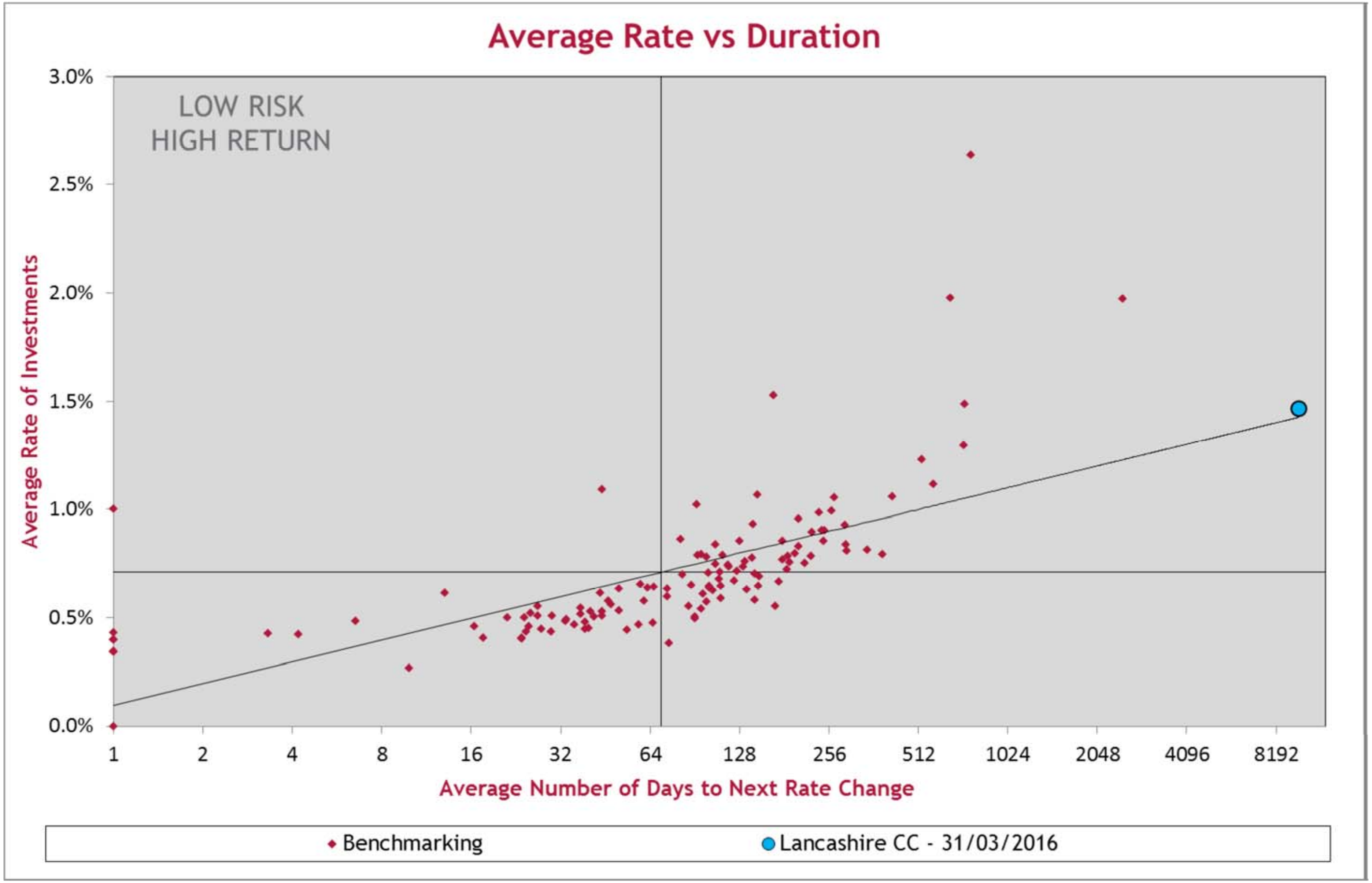
4. Minimum Average Credit Rating To control credit risk the County Council requires a very high credit rating from its treasury counterparties.	**Benchmark**	**Actual**
Average counterparty credit rating	A+	AA+

The County Council confirms that it has complied with its Prudential Indicators for 2015/16, which were approved on as part of the County Council’s Treasury Management Strategy Statement. The County Council also confirms that during 2015/16 it complied with its Treasury Management Policy Statement and Treasury Management Practices.

6. Arlingclose Credit Risk Comparisons

The County Council's Treasury Advisor, Arlingclose, compares the credit risk of its clients. This comparison shows that at 31 March 2016 the County Council has one of the lowest credit risk scores of all of its clients. This comparison is shown graphically overleaf.


Average Rate vs Credit Risk (value-weighted)
LOW RISK
HIGH RETURN
Average Rate of Investments
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
1
2
3
4
5
6
7
8
9
10
11
Average Credit Risk Score - Valued Weighted Average
Benchmarking
Lancashire CC - 31/03/2016



Average Rate vs Duration
LOW RISK
HIGH RETURN
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
Average Rate of Investments
1
2
4
8
16
32
64
128
256
512
1024
2048
4096
8192
Average Number of Days to Next Rate Change
Benchmarking
Lancashire CC - 31/03/2016