Appendix A

Treasury Management Activity - First Report 2016-17

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 2016 and 31st July 2016.

2. Economic Context in the period

The economic situation between April and July was one of great volatility being dominated by concerns about world economic growth and the EU referendum vote. Uncertainty around the level of economic growth arose largely from the slowdown in China and the knock on effect this had on both trading partners and commodity prices. The uncertainty of the outcome of the referendum vote resulted in pronounced volatility in exchange rates, gilts, corporate bonds and equities as the result became increasingly uncertain.

Once the vote was known there was an immediate market reaction. Between 23rd June and 1st July the sterling exchange rate index fell by 9% and short-term volatility of sterling against the dollar increased significantly. Worldwide, markets reacted very negatively with a big initial fall in equity prices. Government bond yields also fell sharply by 20-30 bases points across all maturities (i.e. prices rose) as investors sought safe haven from riskier assets.

As a result of the vote many economists reduced their forecast of economic growth for the UK. Some were even predicting that the economy would go into recession. The Bank of England sought to reassure markets and investors. Governor Mark Carney's speeches on 24th and 30th June in response to the referendum result stressed that the Bank was ready to support money market liquidity and raised the likelihood of a cut in policy rates 'in the summer' as they looked to balance the risk of lower growth with the likelihood of increased inflation as a result of a lower exchange rate.

2.1 Interest Rate Environment

Short term interest rates continue to be at historically very low levels. During the period the Bank of England maintained the base rate at 0.5%. However, as referred to above the prospects of lower economic growth did give the expectation of lower interest rates. The Bank of England did subsequently reduce the base rate to 0.25% in August 2016.

2.2 Implications for Lancashire County Council Treasury Strategy

Since 2010 the County Council have used short term market borrowing to fund capital expenditure so taking advantage of historically low interest rates. This policy has proved to be very effective in an environment where rates have stayed low for much longer than expected and continue to do so and was continued in the first period of the financial year. However, prospects for interest rate increases are continuously monitored. Although it is not anticipated that the interest rates will rise they are at very low levels including those for long term borrowing. Therefore the opportunity of fixing some of the debt for a longer period will be kept under consideration.

3. Current Treasury Management Policy

Full Council approved the 2016/17 treasury management strategy in February 2016. The County Council's stated Treasury Management objectives are:

a) To ensure the security of the principal sums invested which represent the County Council's various reserves and balances,
b) To ensure that the County Council has access to cash resources as and when required,
c) To minimise the cost of the borrowing required to finance the County Council's capital investment programme, and
d) To maximise investment returns commensurate with the County Council's policy of minimising risks to the security of capital and its liquidity position.

3.1 Investment Activity

Investments at the 31st July are £614.55m consisting of £128.31m in bank and Local Authority deposits and £486.24m in bonds. In total investments have increased by £37.15m over the period which is partly the result of receiving grants in the period in advance of need. The table below shows the investment activity between 1st April 2016 and 31st July 2016.

Bank and Local Authority Deposits	**Call/MMF £m**	**Fixed £m**	**Structured £m**	**Total £m**
Balance 1 April 2016	**10.71**	**56.50**	**0.00**	**67.21**
Maturities	-29.11	0.00	0.00	-29.11
New Investments	90.21	0.00	0.00	90.21
Balance 31 July 2016	**71.81**	**56.50**	**0.00**	**128.31**
Bonds	**LA Bonds £m**	**Gilts £m**	**Others £m**	**Total £m**
Balance 1 April 2016	**36.29**	**234.20**	**239.70**	**510.19**
Maturities	-0.65	-1,550.76	-368.27	-1,919.68
New Investments	0.20	1,399.27	496.26	1,895.73
Balance 31 July 2016	**35.83**	**82.71**	**367.70**	**486.24**

Within the period, there has been a reduction of £151m in the amount of Gilts being held as a consequence of the volatility in the market. To compensate for this there has been an increase in Bank and Local Authority deposits of £61m and other bonds of £128m.

The current rate of return on the investment portfolio measured by Arlingclose Ltd treasury consultants is 1.01% which compares favourably with the benchmark 7 day LIBID which averages 0.45% 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 1st April 2016 and 31st July 2016.

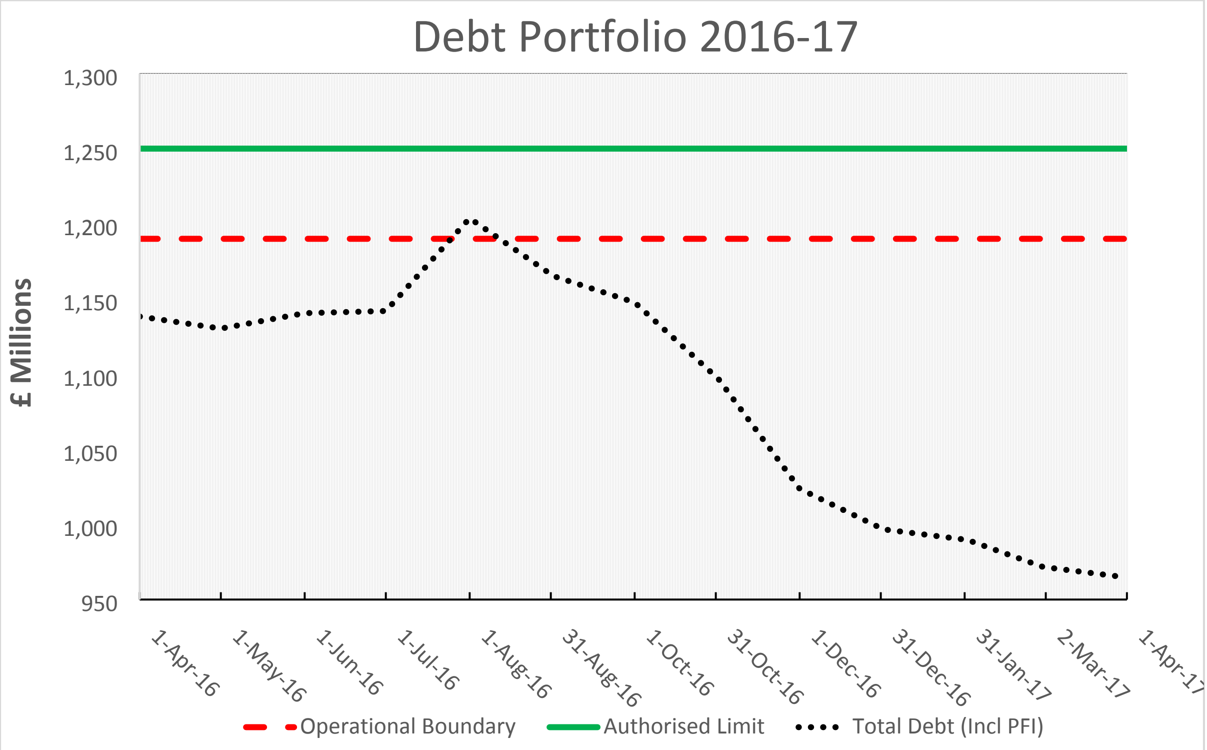
Borrowing	**PWLB Fixed £m**	**PWLB Variable £m**	**Long Term Market Loan £m**	**Other Local Authorities (incl PCC*) £m**	**Lancashire Call Accounts £m**	**Total £m**
Balance 1 April 2016	**213.10**	**125.75**	**51.78**	**522.40**	**62.38**	**975.42**
New Borrowing	0.00	0.00	0.00	207.50	180.78	388.28
Maturities	0.00	0.00	0.00	-177.90	-143.35	-321.25
Balance 31 July 2016	**213.10**	**125.75**	**51.78**	**552.00**	**99.81**	**1,042.45**
Public Finance Initiative (PFI) Liability	-	-	-	-	-	167.00
Total Borrowing & PFI						**1,209.45**

* Police & Crime Commissioners

The outstanding borrowing has increased by £67.03m in the period. This increase is partly due to the increase in shared investment scheme balances. There has also been an increase in borrowing with other local authorities principally to cover short term loans which will be due to mature.

Total borrowing now stands at £1.209bn including the financing of £167m of assets through remaining PFI schemes.

The graph below shows the level of debt for the current financial year compared with the prudential indicator operational and authorised boundaries. The debt shown from 1st August 2016 represents the debt position if no maturing debt was replaced rather than an estimate of the expected position.



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.

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 and as such it is expected that the boundary could be breached but not on a regular basis.

Apart from a few days in late July, total debt during the year has remained below the Operational Boundary. The reason for this breach was due to an increase in shared investment scheme balances held on their behalf, however this has now been remedied.

The current interest rate payable on debt measured by Arlingclose Ltd treasury consultants is 1.83%. The most recent benchmarking figure available of the average rate for all Arlingclose clients (as measured on 31st March 2016) is 3.94%.

4. Budget Monitoring Position

The net financing charges budget for 2016/17 is forecasted to be £3.5m lower than budget at the end of the financial year. The main reasons for this are:

- Sale of bonds due to market movements during recent months. This enabled some core Gilt bonds and other traded bonds to be sold resulting in a net gain of £10m.
- This net gain has been offset by the lost interest receivable, as a result of selling these Core and Traded bonds

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

5. Prudential Indicators 2016/17

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 County Council are within the Prudential Indicators as detailed in Annex 1.

6. Credit Rating issued by Moody's

The County Council's credit rating is reviewed by Moody's on a yearly basis. This review was completed in the period and the rating currently remains unchanged at Aa2, which is a high credit rating. The rating is in place for the Council to issue its own bonds at an appropriate time.

7. Economic Outlook

The economic uncertainty is set to continue. The Bank of England Monetary Policy Committee voted unanimously to reduce the base rate from 0.5% to 0.25% in August. They did this anticipating that the UK is facing a period of heightened uncertainty and an expected weakening in the housing market. The best collective judgement of the Committee was that the economy was likely to see little growth in the second half of this year.

The County Council's treasury management consultants Arlingclose Ltd are predicting that in the short-term the economic and political uncertainty will likely dampen investment intentions and tighten credit availability, prompting lower activity levels and potentially a rise in unemployment. The downward trend in growth apparent on the run up to the referendum will continue through the second half of 2016. Their central forecast for the base rate is that it is to remain at 0.25% for the rest of the year. However if there is to be any movement they predict that it will be a further reduction with the rate moving to zero.

Consequently, the Treasury Management Strategy set in February 2016 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.

Annex 1

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.	**2016/17**	**31st July Actual**
	£m	**£m**
Borrowing	1,250	1,042
Other long term liabilities (PFI schemes)	200	167
TOTAL	**1,450**	**1,209**

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.	**2016/17**	**31st July Actual**
	£m	**£m**
Borrowing	1,190	1042
Other long term liabilities (PFI schemes)	180	167
TOTAL	**1,370**	**1,209**

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.	**2016/17**	**31st July Actual**
	£m	**£m**
Capital Financing Requirement	871	871
Estimated gross debt	1,010	1,042
Debt to Capital Financing Requirements	117%	120%

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 financial requirement calculation.

The County Council confirms that it has complied with its Prudential Indicators for 2016/17 for the reported period. The Prudential Indicators were approved in February 2016 as part of the County Council's Treasury Management Strategy Statement.

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	10.3
Net Interest Payable – Variable Rate	5.00	2.5
1 year impact of a 1% rise	10.00	0.5

2. Maturity structure of debt The limit on the maturity structure of debt helps control refinancing risk.	**Upper Limit %**	**Actual %**
Under 12 months	75	31
12 months and within 2 years	75	22
2 years and within 5 years	75	20
5 years and within 10 years	75	7
10 years and above	100	20

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**
Authorised Limit	900	493
Operating Limit	600	493

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+