

CORPORATE GOVERNANCE COMMITTEE – 12TH JUNE 2015

ANNUAL TREASURY MANAGEMENT REPORT 2014/2015

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

Purpose of Report

1. To report on the action taken and the performance achieved in respect of the treasury management activities of the Council in 2014/15.

Policy Framework and Previous Decisions

2. Under the CIPFA Code of Practice it is necessary to report on treasury management activities undertaken in 2014/2015 by the end of September 2015. This report will be referred to Cabinet prior to the end of September 2015.

Background

3. The term treasury management is defined as:-

“The management of the organisation’s investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks”.
4. The Director of Corporate Resources is responsible for carrying out treasury management on behalf of the County Council, under guidelines agreed annually by the County Council.

Treasury Management 2014/2015

5. There were no departures from the Treasury Management Policy Statement which was agreed by the full Council on 19th February 2014 in relation to the sources and methods of borrowing and approved organisations for lending temporarily surplus funds.
6. The list of available counterparties to whom surplus funds can be lent is based on credit ratings assigned to each institution by independent agencies. The ratings required to become an acceptable counterparty for the authority are very high, and as a result there were very few acceptable counterparties during 2014/15. A revised policy in respect of acceptable counterparties was agreed towards the end of the financial year, and became effective on 1st April 2015. The new policy will increase the number of acceptable counterparties without any meaningful increase in risk, and will give much greater flexibility in the management of surplus funds which will assist in improving the interest earned.

7. The action taken in respect of lending during 2014/15 was relatively subdued, mainly as a result of the low number of acceptable counterparties. Market rates of interest remained low as a result of the benign outlook for any increase in the base rate and the plentiful supply of cheap liquidity that has been injected into the financial system as a result of action taken by the Bank of England.
8. On the debt portfolio, no new loans were taken and one loan of £7.5m matured in April 2014. A total of £0.5m was also repaid in respect of three Equal Instalments of Principal loans. It continues to be considerably more advantageous to finance some of the historic capital expenditure by using internal cash resources – at a cost of the loss of interest that would be earned (c. 0.5%) – than it is to ‘externalise’ this debt by further borrowing.

Position at 31st March 2015

9. The Council’s external debt position at the beginning and end of the year was as follows:-

	Principal	31 st March 2015 Average Rate	Average Life	Principal	31 st March 2014 Average Rate	Average Life
Fixed Rate Funding						
- PWLB	£180.1m	6.33%	33 yrs	£188.1m	6.17%	31 yrs
-Market	£ 2.0m	8.12%	2 yrs	£ 2.0m	8.12%	3 yrs
Variable Rate Funding:						
- Market (1)	£103.5 m	4.37%	1 yr	£103.5 m	4.37%	1 yr
Total Debt	£285.6m	5.63%	21 yrs	£293.6m	5.55%	20 yrs

- (1) The lenders all have an option to increase the rates payable on these loans on certain pre-set dates, and if they exercise this option we can either repay or accept the higher rate. The average life is based on the next option date.

10. The position in respect of investments varies throughout the year as it depends on large inflows and outflows of cash. Over the course of the year the loan portfolio (which includes cash managed on behalf of a large number of schools with devolved banking arrangements) varied between £160m and £226m, and averaged £196m.

Debt transactions in 2014/2015

11. The Council began the year with approximately £22.9m of internal debt – in other words, money that would otherwise have been available to lend on the money markets was being used to fund the historic capital programme. During the year debt of £8.0m matured and was not replaced. After adjusting for Minimum Revenue Provision (MRP) - a charge that is intended to ensure that loans raised to finance capital expenditure is paid off over the longer term – internal debt of £11.8m remained at 31st March 2015. There is a strong possibility that the internal debt will have been entirely repaid within the next two financial years, and that an ‘overborrowed’ position will replace it. Given the large penalties that would currently be incurred by prematurely repaying existing debt (the most practical way of avoiding becoming overborrowed), there is little that can be done to reduce this possibility.
12. Internal debt remained a very attractive option, as it was funded at the loss of interest that would otherwise be earned on lending the extra cash if it had been available – this ‘cost’ averaged around 0.45% in 2014/15. Most of the internal debt

comes as a result of previous premature repayments of loans, where the average rate of debt being paid was 4.44%.

13. Holding internal debt will become less attractive as the interest rates available for lending cash in the money markets rise, but given the possibility of the internal debt being replaced with an overborrowed position in the near future there is no reason to currently consider further external borrowing. Early repayment of existing debt is a more likely option, if it becomes a cost-effective.
14. The savings made by the proactive management of the debt portfolio in recent years have been substantial but will only be able to be fully quantified when the internal debt position has been fully closed out. On current projections this will happen within the next two financial years. The debt portfolio will continue to be managed on a medium/long term view and not with the aim of maximising short-term savings.
15. Although proactive management of the debt portfolio had been carried out for many years (and had generated significant on-going savings) prior to 2009, the transactions had always involved the replacement of debt that matured in a specific period with new debt of a different maturity and the repayment and replacement was generally simultaneous or within a relatively short period of time. In early 2009 there were two separate repayments, for a total of £99.2m, where some of the loans were not replaced with new debt and some were replaced with debt with a relatively short maturity (between 2 and 8 years) period and a much lower interest rate; it is the non-replacement of some of the loans (and the fact that some of the replacement loans have now matured) that has created the current internal debt position. Approximately £16.0m in interest had been saved in the period between the 2009 repayments and the end of the 2014/15 financial year.

Investment Undertaken in 2014/15

16. Bank base rates reached 0.50% in March 2009 and have stayed at this level since. The global economic outlook has improved in the last year, but an increase in UK base rates is not generally expected until at least the end of 2015 and some economists believe that an increase will not happen until well into 2016. Even when base rates do start to rise, the market considers it probable that the increases will be relatively modest and that the increases will be gradual over a protracted period of a number of years.
17. The future outlook for base rates, combined with the extra cash injected into the financial system by Bank of England, has impacted negatively onto the rates available when lending.
18. The loan portfolio produced an average return of 0.59% in 2014/15, compared to an average base rate of 0.50% and the average 7 day LIBID index (representative of what could be achieved if only short-term loans within the money market were made) of 0.35%. This level of out performance is mainly the result of a single counterparty – Bank of Scotland – who offer above-average rates of interest for longer term (i.e. 1 year) loans, but use of money market funds and loans to local authorities at rates that became attractive for a short period (due to a demand/supply imbalance of available funds) also added a modest degree of value.

Longer Term Performance of Portfolios

19. The loan portfolio has achieved out performance of both the average base rate and the local authority 7 day deposit rate in every one of the last 20 years, which is when the figures started to be produced. The level of the out performance is flattered somewhat by the significant out performance achieved both during and in the immediate aftermath of the credit crunch, but even without this the record is impressive. The average rate of interest earned in the last 20 years is 4.47%, which compares to an average base rate and the average LIBID index which have both produced a return of 3.77%.
20. The variability of balances makes it difficult to calculate the excess interest that the out performance has achieved over the whole of the 20 year period for which performance records are available, but it is estimated to be at least £25m. Half of this added value came in the five financial years from 2008/09 to 2012/13, which can be categorised as the start of the financial crisis and the period in which a number of loans placed during the financial crisis were earning interest that (relative to base rates) were extraordinary.
21. The action taken on the debt portfolio, or rather the lack of action, increased the average rate of external debt over the course of the year as the maturing loan was at a lower rate (2.38%) than the portfolio average. In reality the maturity of this loan was actually positive to the authority as instead of paying 2.38% in external debt, it was effectively refinanced at 0.45% (the cost of not having the cash available for lending).

Summary

22. Treasury Management is an integral part of the Council's overall finances and the performance of this area is very important. Whilst individual years obviously matter, performance is best viewed on a medium/long term basis. The action taken in respect of the debt portfolio in recent years has been extremely beneficial and has resulted in significant savings, and the significantly decreased amount of internal debt in recent years has reduced the risks associated with the possibility of rising short-term interest rates. Short term gains might, on occasions, be sacrificed for longer term certainty and stability.
23. The loan portfolio has produced an exceptional level of out performance in the period in which performance figures have been calculated. At present it is difficult to add significant 'value' as a result of the cheap liquidity that has been injected into the financial system, although the revision of the list of acceptable counterparties (effective from 1st April 2015) will assist in providing extra flexibility and enhanced returns for negligible extra risk. A period in which there begins to be differentiation in the expectations of the pace and extent of future base rate rises, which looks to be almost upon us, will also give greater scope to enhance returns.

Recommendation

24. The Committee is asked to note this report.

Resource Implications

25. Treasury management is an integral part of the County Council's finances. Interest generated by treasury management activities of approximately £1.5m was earned in 2014/15 and the interest paid on external debt was c. £15.8m.

Equalities and Human Rights Implications

26. None.

Background Papers

Report to County Council on 20th February 2013 – 'Medium Term Financial Plan': Appendix L 'Treasury Management Strategy Statement and Annual Investment Strategy 2013/14'.

Circulation under local issues alert procedure

None.

Officers to Contact

Chris Tambini, Assistant Director, Strategic Finance and Property, Corporate Resources Department, tel (0116) 3056199. Email chris.tambini@leics.gov.uk