Agenda Item 7

# CORPORATE GOVERNANCE COMMITTEE – 13TH MAY 2016

# ANNUAL TREASURY MANAGEMENT REPORT 2015/2016

# 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 2015/16.

Policy Framework and Previous Decisions

2. Under the CIPFA Code of Practice it is necessary to report on treasury management activities undertaken in 2015/2016 by the end of September 2016. This report will be referred to Cabinet prior to the end of September 2016.

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 2015/2016

5. The Treasury Management Policy Statement for 2015/16 was agreed by the full Council on 18th February 2015 in relation to the sources and methods of borrowing and approved organisations for lending temporarily surplus funds. During the year there were two accidental divergences from the agreed Policy, which are outlined below:

   *Lending above maximum permitted amount to a counterparty*

   Following continuing government sales of shares in Lloyds Banking Group, public ownership dipped below a level at which the Council's treasury management advisors considered them to be a 'special case'. As a result they moved from a maximum outstanding loan amount of £50m and a maximum maturity period of 1 year to a maximum period of 6 months and amount of £20m.

   This was correctly identified and the lending list updated accordingly. At the time of the reclassification there was £50m on loan to Lloyds, and this meant that no further

loans could be placed until the outstanding amount had dropped below £20m – in effect, maturing loans could not be renewed until this happened. Unfortunately when the next maturity occurred (in early July 2015) an error was made by the dealer, who renewed the loan for £5m for a 6 month period.

This was a purely human error and was not due to poor systems or processes. For a number of years Lloyds Banking Group had been almost the only attractive counterparty on the lending list, and hence it had become routine to renew all loans as soon as they matured; instinct simply took over, and the error was recognised soon after.

Given the low risk associated with this error, it was not included in the quarterly treasury management report but it is being included in the Annual Report for completeness. The loan in question has subsequently matured and been repaid by Lloyds.

*Failure to report downgrading of counterparty to Corporate Governance Committee and Cabinet*

Part of the Treasury Management Policy Statement for 2015/16 that was agreed by the full Council on 18th February 2015 is an Annex titled 'Policy on approved organisations for lending'. This annex lays out the broad criteria that help to create the authorised counterparty list.

The last part of this annex was as follows:

*If the credit rating of an individual financial institution decreases to a level which no longer makes them an acceptable counterparty the Assistant Director, Strategic Finance & Property will make a decision on what action to take and report it subsequently to the Cabinet and/or Corporate Governance Committee. It should be noted that there will be no legal right to cancel a loan early, and any premature repayment can only be made with the approval of the counterparty and may include financial penalties. Similar actions will be taken if a counterparty is downgraded to a level which allows them to remain on the list of acceptable counterparties, but where the unexpired term of any loan is longer than the maximum period for which a new loan could be placed with them.*

This wording was introduced during the Credit Crunch, when there were a large number of credit downgradings that affected financial institutions with whom the Council had loans. Its inclusion allowed flexibility in dealing with downgradings, with subsequent reporting to members of the action taken.

In recent years the wording has remained but has become less relevant, in part due to the small number of banks that were on the counterparty list and their relative stability. The lower risk nature of financial institutions and the tighter regulation of them has meant that systemic and individual counterparty risk is much lower than it was during the Credit Crunch, and the inclusion of this wording had almost been forgotten.

An annual internal audit into the treasury management function highlighted the fact that the policy had been breached, due to the non-reporting of the reduction in Lloyds Banking Group's' maximum loan period. On 14th May 2015 their maximum maturity period was reduced to six months and at that time there were eight

different loans (totalling £45m) that had more than six months until their maturity date. Failure to report this was an error, although the risks were considered low and there was never any intention of doing anything other than allowing the existing loans to run until their natural maturity.

The Treasury Management Policy Statement for 2016/17 that was agreed by the full Council on 17th February 2016 replaced the wording shown in italics above with the following:

*If the credit rating of an individual financial institution decreases to a level which no longer makes them an acceptable counterparty the Director of Finance will make a decision on what action to take. Similar actions will be taken if a counterparty is downgraded to a level which allows them to remain on the list of acceptable counterparties, but where the unexpired term of any loan is longer than the maximum period for which a new loan could be placed with them.*

*In the event that the circumstances highlighted in the above paragraph occur, the Director of Finance will report his decision to the Cabinet and/or Corporate Governance Committee when it is deemed significant enough to do so. If there is considered to be no meaningful risk involved, relative to agreeing a new loan of the outstanding maturity period to the same counterparty, the decision will not be reported.*

*It should be noted that there will be no legal right to cancel a loan early, and any premature repayment can only be made with the approval of the counterparty and may include financial penalties.*

This new wording effectively removes the need to report this kind of breach to Corporate Governance Committee and Cabinet, unless there is considered to be a meaningful financial risk.

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. A revised policy in respect of acceptable counterparties was agreed towards the end of the 2014/15 financial year, and became effective on 1st April 2015. The new policy increased the number of acceptable counterparties without any meaningful increase in risk, and gives much greater flexibility in the management of surplus funds which will assist in improving the interest earned.

7. There was more activity in respect of lending during 2015/16 than there had been in previous years, mainly as a result of having a larger counterparty list. At the beginning of the year there was a flurry of activity that could be described as ‘catch up’, in that it involved lending to counterparties that were previously not included on the list but were offering attractive interest rates. This also coincided with a period in which the market was beginning to factor in bases rate increases before the end of 2015, which seemed an unlikely scenario given the low level of inflation and sluggish global economic growth. A strategic decision was taken to lend for as long a period as possible (at rates that reflected the market’s view that rates would rise) to the counterparties that were offering attractive rates, and this proved a good decision given that base rates did not increase and are now considered unlikely to for some time to come.

8. On the debt portfolio, no new loans were taken and one loan of £10m matured in July 2015. A total of £0.5m was also repaid in respect of three Equal Instalments of Principal loans. The authority has not raised any external loans since August 2010 and external debt is over £115m lower than it was at its peak in November 2006. There are no current plans to raise any further external debt, and opportunities to reduce it will be considered if they are cost effective.

Position at 31st March 2016

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

| | 31st March 2015 | | | 31st March 2015 | | |
|---|---|---|---|---|---|---|
| | Principal | Average Rate | Average Life | Principal | Average Rate | Average Life |
| **Fixed Rate Funding** | | | | | | |
| - PWLB | £169.6m | 6.60% | 34 yrs | £180.1m | 6.33% | 33 yrs |
| -Market | £ 2.0m | 8.12% | 1 yr | £ 2.0m | 8.12% | 2 yrs |
| **Variable Rate Funding:** | | | | | | |
| - Market (1) | £103.5 m | 4.37% | 1 yr | £103.5 m | 4.37% | 1 yr |
| **Total Debt** | £275.1m | 5.77% | 21 yrs | £285.6m | 5.63% | 21 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 £164m and £228m, and averaged £194m.

Debt transactions in 2015/2016

11. The Council began the year with approximately £11.8m 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. After adjusting for debt repayments, statutory 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 – and voluntary MRP, the current internal debt is considered to be £6.5m. There is a possibility that an additional voluntary MRP amount will be applied as part of the accounts closedown process, so the final figure for internal debt may ultimately be lower than this figure.

12. There is a very strong probability that the internal debt will be entirely repaid during 2016/17, 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 unless long-term interest rates rise significantly.

13. 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 in 2016/17. The debt portfolio will continue to be managed on a medium/long term view and not with the aim of maximising short-term savings.

14. 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 was 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 £16.5m in interest had been saved in the period between the 2009 repayments and the end of the 2015/16 financial year.

Investment Undertaken in 2015/16

15. Bank base rates reached 0.50% in March 2009 and have stayed at this level since. The global economic outlook has been relatively stable but lacklustre in recent years, with a slowdown in china being the latest Concern. UK economic growth has been stronger than that of most other countries, but an increase in UK base rates in not generally expected until at least the end of 2016 and some economists believe that an increase will not happen until well into 2017. 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.

16. Central banks continue to pursue accommodative monetary policies, but there has been a withdrawal of some liquidity from markets. As a result, and despite the benign outlook for base rate increases, the rates available from lending for six months or a year have generally moved upward from the rates of recent years. This, when combined with the increase in available counterparties, has meant that a higher average interest rate was earned on the investment portfolio than the previous two years.

17. The loan portfolio produced an average return of 0.80% in 2015/16, 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 0.36%.

Longer Term Performance of Portfolios

18. 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 21 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 21 years is 4.29%, which compares to an average base rate and the average LIBID index which have both produced a return of 3.61%.

19. 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 £26m. Almost 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 a period in which a

number of loans placed during the financial crisis were earning interest that (relative to base rates) were extraordinary.

20. 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 (1.84%) than the portfolio average. In reality the maturity of this loan was actually positive to the authority as instead of paying 1.84% in external debt, it was effectively refinanced at 0.50% (the cost of not having the cash available for lending, as it would have been held in Money Market Funds).

Summary

21. 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.

22. The loan portfolio has produced an exceptional level of outperformance in the period in which performance figures have been calculated. The revision to the list of acceptable counterparties which was effective from 1st April 2015 will assist in providing extra flexibility and enhanced returns for negligible extra risk, but adding significant value in a period of extremely low interest rates very difficult. A period in which there begins to be differentiation in the expectations of the pace and extent of future base rate rises, which seems to get closer every year but then gets put back, will also give greater scope to enhance returns.

Recommendation

23. The Committee is asked to note this report.

Resource Implications

24. Treasury management is an integral part of the County Council's finances. Interest generated by treasury management activities of approximately £1.7m was earned in 2015/16 and the interest paid on external debt was c. £15.8m.

Equal Opportunities Implications

25. None.

Background Papers

Report to County Council on 18th February 2015 – 'Medium Term Financial Plan': Appendix L 'Treasury Management Strategy Statement and Annual Investment Strategy 2013/14'.

http://cexmodgov1/Published/C00000134/M00004176/AI00043041/$AppendixLTreasuryManagementStrategyStatementandAnnualInvestmentStrategy.docA.ps.pdf

Circulation under local issues alert procedure

None.

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