Leicestershire County Council

CORPORATE GOVERNANCE COMMITTEE – 22ND SEPTEMBER 2016

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

QUARTERLY TREASURY MANAGEMENT REPORT

Purpose of the Report

1. To update the Corporate Governance Committee about the actions taken in respect of treasury management in the quarter ended 30th June 2016.

Background

2. 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".

3. A quarterly report is produced for the Corporate Governance Committee to provide an update on any significant events in the area of treasury management.

Economic Background

4. The June quarter was dominated by the lead up to the UK EU Referendum, and the volatility within investment markets in the immediate aftermath of the unexpected 'Leave' vote. Provisional figures show GDP growth of 0.6% during the quarter, with the figure for the year to June 2016 registering 2.2%. In a global context these growth numbers were solid, but the path towards actually leaving the EU will be prolonged and include many potential pitfalls so the future is very uncertain.

5. It is too early to be able to form any definitive judgement on how leaving the EU will impact in the long-term, but there is anecdotal evidence that companies and households may put major purchases on hold until greater clarity emerges. Inflation remains subdued and even the threat of imported inflation, caused by the fall in sterling that followed the outcome of the Referendum, looks unlikely to give any immediate problems that would cause the Bank of England any concerns relative to its 2% Consumer Price Inflation target.

6. On 4th August UK base rates were cut to 0.25%, with the Bank of England taking a pro-active role in attempting to guide the UK economy through the potential problems. Further quantitative easing of £60bn was also announced, with the intention being that bonds are purchased and the sellers utilise the cash in a way that is beneficial to economic growth. There is a distinct possibility of a further base rate cut and more quantitative easing, but the Governor of the Bank of England seems to be guiding markets that base rates will not be taken into negative territory.

7. US economic growth remains robust and employment there continues to rise, whilst the Eurozone showed slower growth than the previous quarter. The Eurozone faces almost as much uncertainty over Brexit as the UK economy, but has been weaker for a number of years and looks unlikely to gain any significant amount of traction in the near future.

Action Taken during June Quarter

8. The balance of the investment portfolio increased from £171.9m to £180.0m over the quarter. The increase in cash balance in the first quarter is normal, as there are a number of ‘front-loaded’ grants received early in the financial year.

9. Activity during the quarter related almost entirely to attempting to maintain as long a maturity profile as possible, subject to the availability of acceptable counterparties that were paying attractive rates of interest. Even before the outcome of the Referendum was known it seemed unlikely that there would be increases in base rates for quite some time, so the rates available looked attractive.

10. During the quarter £85m of loans that were originally for periods of 3 months-plus matured, and £110m of longer-term loans were placed (£40m for 1 year, £50m for 6 months and £20m for 3 months). The action taken saw the average rate increase marginally from 0.86% to 0.87%, but the average rate is likely to fall sharply in the coming quarters. Whilst the portfolio has been protected from lower interest rates as far as was possible, there is little else that can be done to combat lower base rates.

11. The loan portfolio at the end of June was invested with the counterparties shown in the list below.

	£m
Lloyds Banking Group/Bank of Scotland	20.0
Royal Bank of Scotland	30.0
Santander UK	20.0
Nationwide	20.0
Toronto Dominion Bank	15.0
Landesbank Hessen Thuringen	15.0
Norddeutsche Landesbank	10.0
Goldman Sachs International	20.0
Commonwealth Bank of Australia	15.0
Money Market Funds	15.0
	180.0

12. There are also five further loans with Lloyds Banking Group which are classified as ‘service investments’ for the Local Authority Mortgage Scheme (LAMS), and all of these loans had original maturities of five years. These do not form part of the treasury management portfolio, but are listed below for completeness:

5 year loan for £2m, commenced 5th September 2012 at 2.72%
5 year loan for £1.4m, commenced 27th November 2012 at 2.19%
5 year loan for £2m, commenced 12th February 2013 at 2.24%
5 year loan for £2m, commenced 1st August 2013 at 2.31%
5 year loan for £1m, commenced 31st December 2013 at 3.08%

13. The Leicestershire Local Enterprise Fund (LLEF) has been making financing available to small and medium sized Leicestershire companies, via an association

with Funding Circle, since December 2013. There are a number of hurdles that companies must clear before being able to access this funding, and any loans made will be classed as ‘service investments’. As such, these loans are not covered within the Treasury Management Policy but at the end of June 2016 there had been 50 loans made totalling £492,400 and the average interest rate on these loans was 8.5%. There were no new loans made during the quarter, and the average interest rate was also static.

14. Since November 2015, Funding Circle have been able to match private loan investors to financing requirements of Leicestershire’s small and medium enterprises without the need for support from LLEF. This is a strong indication that LLEF has met its primary, short term objective to help ensure that Leicestershire businesses have access to loan funding. As a result the County Council will start to disinvest from the scheme and the released funding will be targeted at priority schemes to increase economic growth in Leicestershire.

<u>Loans to counterparties that breached authorised lending list</u>

15. Following discussions surrounding the Annual Treasury Management Report 2015/16 that was presented to the last Corporate Governance Committee, it was agreed that any loans that breached the authorised lending list would be reported on a quarterly basis. There are a number of circumstances where a breach might occur:

(i) A loan is made to a counterparty that is not on the authorised list;
(ii) A loan is made to a counterparty that is on the list, but the loan period is longer than the maximum allowed period for that counterparty;
(iii) A loan is made to a counterparty that takes the total sum on loan to that counterparty to above the maximum limit;
(iv) A loan is within the acceptable limits when it is made, but changed circumstances mean that it breaches limits ‘after-the-event’.

16. The first three items from the list above will occur only as a result of human error. The fourth item is outside the control of Officers, and there will be very limited options open to the Authority in terms of how to deal with the matter – there is no automatic right to demand repayment of a loan, so it would take the counterparty to agree to a premature repayment and this is unlikely to occur without a significant penalty. In all but extreme circumstances it is probable that the preferable course of action will be to simply allow the loan(s) to mature.

17. ‘After-the-event’ breaches can occur for two main reasons. The first is that the credit rating of the counterparty is downgraded, and this means that the counterparty falls off the authorised list altogether or that it falls into a category (maximum amount on loan/maximum maturity period) that is lower than the existing loan position. The second relates to changes in the cost of Credit Default Swaps (CDS) for a counterparty.

18. CDS prices effectively reflect the market’s opinion on the likelihood of a default by a particular counterparty, and the method of compiling the authorised lending list is such that when CDS prices breach certain limits (either in absolute terms, or relative to the CDS prices of other banks) the counterparty is ‘knocked down’ by one ‘notch’, or possibly more in extreme circumstances. In effect a counterparty whose credit ratings, on a stand-alone basis, would see it fit into the 1 year period

would be reduced to a maximum 6 months if the CDS price warranted this; likewise other counterparties could move from 6 months to 3 months or from 3 months to not being on the list that Capita Asset Services compiles for its clients.

19. CDS prices can be volatile, and this is sometimes as a result of general market concerns (i.e. CDS prices for all banks increase) and occasionally as a result of a specific concern about an individual bank. It is not unusual for CDS prices to spike higher for a short period, and then return to more normal levels. Whilst any new loans will only be made if the terms of the loan are in-line with the up-to-date position (i.e. will take account of the CDS overlay), it is not unusual for some banks to move on-and-off the lending list (or to move up and down the categories) fairly regularly as a result of the CDS position.

20. As a result of the CDS issue, it is difficult (although not impossible) to provide a list of all breaches of the authorised lending list. As an example, a loan to Lloyds Banking Group may flit in-and-out of being in line with the authorised lending list and being in breach on a number of occasions during a six month loan due to the changing position of the CDS price. It is therefore proposed that a practical and appropriate way forward would be for breaches where they are due to items (i) – (iii) of the list in paragraph 15, or where the breach is as a result of a credit rating downgrade, be reported to the Committee and that breaches causes by changes to CDS prices will not be reported except in extreme circumstances and where it is considered by the Director of Finance appropriate to do so.

21. Durning the quarter there was one breach of the authorised lending list, other than where caused by CDS prices. On 13th May 2016 a loan of £10m was placed with Norddeutsche Landesbank for a period of 6 months. On 2nd June 2016 one of the credit rating agencies changed the outlook on the Long Term and Short Term Ratings for the counterparty to 'Negative Watch', which moved them from a 6 month maximum period on the standard counterparty list of Capita Asset Services to a 100 day month maximum period. As the Leicestershire policy is to exclude all counterparties that fall within the Capita 100 day period, Norddeutsche were removed from our counterparty list but the loan will remain outstanding (and, therefore, in breach of the list) until its maturity in the middle of November unless there is a positive re-rating in the interim period. At the date of writing this report the credit rating of Norddeutsche remains on 'Negative Watch' and no actual downgrading has occurred.

Resource Implications

22. The interest earned on revenue balances and the interest paid on external debt will impact directly onto the resources available to the Council.

Equal Opportunities Implications

23. There are no discernable equal opportunity implications.

Recommendation

24. The Committee is asked:

(a) To note this report;

(b) To agree that only loans which breach the authorised lending list as set out in paragraph 20 to this report, be reported to the Committee on a quarterly basis.

Background Papers

None

Circulation under the Local Issues Alert Procedure

None

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