Agenda Item 9

Leicestershire County Council

CORPORATE GOVERNANCE COMMITTEE – 17TH FEBRUARY 2017

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 31st December 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. Following the decision by the UK electorate to support leaving the European Union (EU), which came at the end of the June 2016 quarter, there had been an expectation that UK growth would slow quite severely due to the uncertainties that the vote brought. In the event growth was 0.5% in the September quarter, which was very robust. At the time of writing this report GDP figures for the December quarter are not available, but the consensus expectation was for growth to remain at similar levels. There are few signs yet that the vote for Brexit has had a detrimental effect on the UK economy, although Article 50 has not yet been triggered and until negotiations start on the mechanics of leaving the EU it is difficult to say with any certainty what the long term impact of the vote might be.

5. Given the uncertainties surrounding the Brexit vote, the Bank of England cut UK base rates in August from 0.5% (where they had been since March 2009) to 0.25% in a pre-emptive move against a likely economic slowdown, and a further round of quantitative easing was announced. Given the unexpected stability of the UK economy a further rate cut looks unlikely – as does the possibility of rate rises for the foreseeable future.

6. The major external event of the December quarter was the election of Donald Trump as President. The new President's policies can generally be described as pro-US growth and there is an expectation that his Presidency will see a significant increase in public spending, tax cuts and a 'protectionist' approach to global trade. The US economy was already growing at a faster pace than much of the rest of the World, and Trump's policies could be sufficient to ensure that this growth advantage

continues. US interest rates were raised soon after the Trump victory, although in reality this was as much to do with the rate rise being held off during the election period as it was about who won the election, and there is a high expectation that there will be a series of further small rate increases during 2017 and into 2018; the path towards ‘normalisation’ of interest rates seems to have commenced, albeit only in the US.

7. Europe continues to show modest but inconsistent economic growth, and doubt hangs over much of the continent as a result of the UK Brexit vote. The EU is a significant net exporter to the UK and its short term economic position could well be adversely affected if a ‘Hard Brexit’ occurs. The European Central Bank is already pursuing a policy of negative interest rates and quantitative easing, and appears willing to extend these further if this proves necessary. There are a number of important elections across Europe in 2017 – most notably in Germany, France and the Netherlands – and these will be crucial in shaping the future economic and political outlook.

European Banking System/Italian Banks

8. At the November 2016 meeting of this Committee, a request was made that the next quarterly treasury management report (i.e. this one) include information on the instability of the European banking system and the potential impact on the treasury management activities of the Council. The major area of concern was the Italian Banks.

9. One of the key factors included within the criteria that produces a list of acceptable counterparties for loans is that the country of domicile of any bank must be at least AA-; the underlying rationale for this is that the lender of last resort is likely to be the national government and they have to be financially strong enough to be able to offer the necessary support. Continental European countries which meet this minimum requirement, and that also have banks that meet the minimum requirements in terms of the rating of individual financial institutions, are Belgium, Denmark, Finland, France, Germany, Netherlands, Sweden and Switzerland.

10. Money Market Funds, which are used as part of the Council’s normal treasury management activities, also have certain minimum criteria that they must adhere to in order to maintain their AAA-rating. As a result they cannot invest in deposits or any form of instrument issued by an Italian institution, for example.

11. While the Council has no direct linkage to institutions domiciled in countries without a very high sovereign rating, the potential for a wholesale issue affecting (in particular) the Italian banking system has remained a key market consideration for some time. However, the widespread evolution of regulations as a result of the Global Financial Crisis has been focussed on limiting the contagion impact of the failure of one, or a number of, institutions from the remainder of the market.

12. In Europe, the introduction of bail-in regulations has been a key driver behind the regulatory overhaul. In this instance, creditors of a failed or failing institution are bailed-in (i.e. they are liable to significant losses) to limit the threat of the contagion that amplified failure at the height of the Global Financial Crisis. While this process has been used in Cyprus, it has yet to be tested at a far more material level as could be the case with a major Italian banking failure. Nevertheless, unlike the failure of a number of entities at the height of the Global Financial Crisis, the

concerns surrounding Italian banks have been evident for some considerable while. Across various jurisdictions, central banks and regulators have introduced a range of annual stress tests aimed at creating scenarios to see how their banks would fare against a range of hypothetical (and quite extreme) outcomes. In instances where banks have fallen short of minimum capital requirements, remedial action has been proposed to address deficiencies. This process has occurred alongside general requirements for far higher levels of good quality capital held on bank balance sheets, as well as other regulatory changes which are all aimed at materially increasing the robustness of financial markets and the operators therein. They do not negate the potential for failure, but make it less likely and aim to limit any contagion impact.

13. This limit to contagion can also be reflected through other market metrics, such as the Credit Default Swap level of institutions. This price reflects a risk premium attached to investing with an individual entity, and while those for Italian institutions have either remained at very high levels or have risen back there in more recent times, those for other major financial entities (such as those used by the Council) have not moved in a similar vein. The use of CDS prices is an integral part of the acceptable counterparty methodology.

14. There is no suggestion that the risk of contagion is limited to problems within the Italian Banks; they are merely the largest and most obvious risk at present. The broad principles of how the list of acceptable counterparties is produced give a high level of protection against capital loss, regardless of which country the issues occur in. Whilst it is impossible to categorically state that the Council’s cash deposits would be immune from any indirect impact of a banking crisis within a country that does not meet the minimum sovereign rating required, the combination of country ratings, individual institution ratings and other factors that are taken into account (such as Credit Default Swap prices) would suggest that any effect would be very limited.

15. The recent ‘no’ vote in Italy against Constitutional reform had been widely anticipated but it throws further doubt onto a country that was already challenged from a political and financial perspective. There will undoubtedly be a period of higher uncertainty and this is unlikely to be positive for the economy or the banks, although it is widely accepted that every effort will be made to avert a banking crisis and the approval of a €20bn (£17bn) rescue fund for Italy’s banking sector in December 2016 acts as support for this view.

16. In general European banks are not suffering from a lack of capital, and their major issue is how to restore profitability within their operations. This lack of acceptable margins does not pose an immediate and identifiable threat to individual banks, or the banking system as a whole.

17. The methods employed to arrive at a list of acceptable counterparties are multi-dimensional and are assessed in real-time. This combination gives strong assurance that the Council’s treasury management activities remain very low risk.

Action Taken during December Quarter

18. The balance of the investment portfolio decreased from £187.6m to £164.5m over the quarter. The extent of this fall in balances is unusual, but is almost entirely linked to the timing of precepts – a precept of just over £25m was received on 3rd January 2017.

19. Activity during the quarter related 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. There remained a meaningful premium for being willing to lend for longer periods even though there appeared no realistic possibility of base rate rises in the near term.

20. During the quarter £70m of loans that were originally for periods of 6 months or more matured. All except two of these loans, and a total amount of £50m, were rolled-over with the same counterparties at lower interest rates. A new loan of £10m was placed with Royal Bank of Scotland for 1 year, and the impact of all of this activity was the maturity of £70m of loans at an average rate of 0.85% and the lending of £60m of loans at an average rate of 0.65%.

21. The decision to lend as much money as possible for as long as possible to acceptable counterparties has the impact of minimising the amount of money that has to be placed in Money Market Funds, where rates available are currently around 0.30%. At the end of December there was a higher outflow of 'normal' expenditure than was expected and as a result there was a need to borrow £10.5m on the last working day of the year (December 30th) in order to 'balance the books'. The ability to borrow is included within the Treasury Management Policy and although it will never be used in an attempt to 'gear' the portfolio (i.e. to borrow cheaply for short periods simply to lend at a higher level for longer periods), it is occasionally necessary.

22. The required loan was borrowed from the Council's Pension Fund on an 'arms-length' basis, with the Pension Fund receiving the rate of interest that it would have earned if the cash had remained where it otherwise would have been (i.e. in its own Money Market Fund account). The loan was repaid the next working day.

23. In effect the borrowing has the impact of improving the rate of return of the Council's loan portfolio; £10.5m was borrowed at 0.30% and this allowed the loan portfolio (earning an average of 0.75%) to be £10.5m larger than it would otherwise have been. The external loan portfolio at the end of December had £175m of loans at an average of 0.75% on a gross basis, but totalled £164.5m at an average rate of 0.78% when the borrowing is netted off.

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

	£m
Lloyds Banking Group/Bank of Scotland	20.0
Royal Bank of Scotland	50.0
Santander UK	20.0
Nationwide	20.0
Toronto Dominion Bank	5.0
Landesbank Hessen Thuringen	15.0
Credit Industriel et Commercial	10.0
Goldman Sachs International	20.0
Commonwealth Bank of Australia	15.0
Borrowing	(10.5)
	164.5

25. 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%

Loans to counterparties that breached authorised lending list

26. 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 Outlook', 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, this meant that Norddeutsche were removed from our list. Norddeutche have not actually been downgraded and the loan was repaid in November 2016, but this breach is being reported for completeness.

Resource Implications

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

Equality and Human Rights Implications

28. There are no discernible equality and Human Rights implications.

Recommendation

29. The Committee is asked to note this report;

Background Papers

None

Circulation under the Local Issues Alert Procedure

None

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