Leicestershire County Council

CORPORATE GOVERNANCE COMMITTEE
26TH MAY 2017

ANNUAL TREASURY MANAGEMENT REPORT 2016/2017

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 2016/17.

Policy Framework and Previous Decisions

2. Under the CIPFA Code of Practice it is necessary to report on treasury management activities undertaken in 2016/2017 by the end of September 2017. This report will be referred to Cabinet prior to the end of September 2017.

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 2016/2017

5. The Treasury Management Policy Statement for 2016/17 was agreed by the full Council on 17th February 2016, in relation to the sources and methods of borrowing and approved organisations for lending temporarily surplus funds. During the year there were no divergences from the agreed Policy, although it was subsequently agreed that any counterparty that was downgraded whilst a loan was active, and where the unexpired period of the loan or the amount on loan would have breached the limit at which a new loan could be made to that counterparty would be included in the quarterly treasury management report to this Committee.

   As a result it is considered sensible to include these occasions in the Annual Treasury Management Report. .For the sake of completeness the agreed policy in these circumstances is as follows:

   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.

6. 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 were not actually downgraded within the period that the loan was active and the loan was repaid in November 2016.

7. At the commencement of the 2016/17 financial year the consensus economic forecast was that there was a high probability of a base rate increase before the end of the 2016 calendar year, from the historic low of 0.5%. It was also considered that this would be the start of a slow and gradual increase in base rates to more ‘normal’ levels. Whilst this possibility could not have been discounted, interest rates available on longer-term (i.e. 6 – 12 month) loans seemed more than sufficient to cover this scenario, so the broad policy was to lend money to acceptable counterparties that were paying attractive rates for the maximum period allowed by the counterparty list. Following the unexpected Brexit vote, and a reduction in base rate to 0.25%, this policy proved advantageous.

8. Even after the reduction in base rate that occurred in August 2016, there was still a premium available for longer-term lending over short-term. The policy was, therefore, continued and although the rates achieved dropped in the second half of the year they remained very attractive in relation to base rate.

9. On the debt portfolio, no new loans were taken. 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 2017

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

	31st March 2016			31st March 2017		
	Principal	Average Rate	Average Life	Principal	Average Rate	Average Life
Fixed Rate Funding						
- PWLB	£169.6m	6.60%	34 yrs	£169.1m	6.61%	33 yrs
-Market	£ 2.0m	8.12%	1 yr	£ 2.0m	8.12%	<1 yr
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	£274.6m	5..78%	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.

11. 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 £232m, and averaged £202m.

Debt transactions in 2016/2017

12. The Council began the year with approximately £8.5m 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 and 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 – the current internal debt was fully 'paid off' during the year, and the Council had £6.9m more of external debt than is required to fund historic capital expenditure. The Council is, therefore, 'overborrowed'.

13. It is currently expected that, unless premature repayment of existing debt takes place, this overborrowed position will increase in the years ahead. The major reason for this is that the requirement to borrow, to fund the capital programme, will generally be below the annual MRP amount. This has been the case since the government started awarding grants to fund the capital programme rather than the previous approach of supporting borrowing. Given the large penalties that would currently be incurred by prematurely repaying existing debt, there is little that can be done to reduce the likelihood of an increasingly overborrowed position unless long-term interest rates rise significantly

14. The savings made by the proactive management of the debt portfolio in recent years have been substantial, and these savings were achieved by repaying a large amount of long-term debt in 2009 and 2010 (at a time when interest rates made premature repayments cost-effective) and either replacing it with short-term debt at much lower rates, or by not replacing it and 'funding' the costs via the interest lost on revenue balances. It is estimated that the cumulative savings between 2008/09 and 2016/17 were approximately £17m.

Investment Undertaken in 2016/17

15. Bank base rates reached 0.50% in March 2009 and at the commencement of the 2016/17 financial year the consensus forecast was that gradual increases in base rate would commence late in 2016 or early in 2017. The surprise outcome of the European Union Referendum forced a reassessment of this opinion, and in August 2016 base rates were actually reduced to 0.25%.

16. Even prior to the change in sentiment caused by the Brexit vote, it was considered that the interest rates available from certain high-quality counterparties more than compensated for the risk of a rising base rate. As a result the general policy has been to lend for as long a period as possible to these counterparties, which gave protection against the unexpected reduction in base rate. The market continues to overcompensate investors for being willing to commit to longer-term loans and the general approach of ‘lending long’ continued after the base rate reduction, although the absolute level of rates available has fallen.

17. The loan portfolio produced an average return of 0.75% in 2016/17, compared to an average base rate of 0.34% and the average 7 day LIBID (London Interbank Bid Rate) index (representative of what could be achieved if only short-term loans within the money market were made) of 0.23%.

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 22 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 22 years is 4.13%, and this compares to an average base rate and the average LIBID index which have both produced a return of 3.46%.

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 £27m. 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 activity, marginally increased the average rate of external debt over the course of the year as the small amount of maturing loans were at a lower rate (4.54%) than the portfolio average.

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. 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. Adding significant value in a period of extremely low interest rates is very difficult. Ironically a period in which there begins to be differentiation in expectations for both the pace and extent of future base rate rises will make the cash sums that can be gained larger, whilst also giving a higher level of risk that the decisions taken might be wrong. Such a period has intermittently seemed to get closer in recent years, only to be consistently put back.

Equality and Human Rights Implications

23. None.

Background Papers

Report to County Council on 17th February 2016 – ‘Medium Term Financial Plan’: Appendix K ‘Treasury Management Strategy Statement and Annual Investment Strategy 2016/17’.

Circulation under local issues alert procedure

None.

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