Leicestershire County Council

CORPORATE GOVERNANCE COMMITTEE
23 APRIL 2018

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 March 2018.

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. In November 2017 the Bank of England raised base rates for the first time in over 10 years (from 0.25% to 0.5%). At the time of the rate rise the market was guided that this was likely to be the first rate rise in a gradual progression towards interest rate 'normalisation' but that the progression would be slow and steady, with only one 0.25% rise in 2018 (late in the year) and a further one in 2019. Guidance has subsequently been revised and there is a high expectation of a 0.25% rate rise in May 2018, with a slightly faster pace of rises thereafter than was previously anticipated. The huge majority of market commentators remain of the opinion that the neutral level of interest rates will be much lower than would have been considered 'normal' prior to the Global Financial Crisis.

5. The UK economy continues to lag growth being produced elsewhere in the world, but growth remains reasonable given the significant uncertainties relating to Brexit. There has been a lack of real (i.e. after adjusting for inflation) wage growth for many years and household budgets remain stretched, with high levels of personal debt. Inflation has remained stubbornly high but much of this is directly correlated to the weakening of sterling, and the impact on the cost of imports, that followed the vote to leave the EU. Recent data has seen a fall in inflation as price increases from over a year ago fall out of the calculation. When combined with signs of slightly higher wage growth across the economy, there is an expectation of a period of real wage growth that should assist in maintaining decent economic growth. Strong economic growth across the rest of the world should also assist in the UK economy continuing

to perform reasonably, although there remains an expectation of underperformance relative to other economies.

6. Europe is currently growing at a very strong pace, and appears to have gained in confidence to the extent that the European Central Bank feels comfortable enough to talk about future interest rate rises. Consumer spending and business investment are simultaneously strong, and the economic upturn appears to be self-sustaining.

7. There is no doubt that US interest rates will continue to be raised at a moderate pace, and at a faster pace than almost anywhere else in the world, but the strength of the economy should mean it is able to withstand the increases. Recent changes to taxation for both corporates and individuals are likely to boost the economy in both the short and long-term. A recent escalation of the threat of import tariffs, and retaliation from elsewhere, increases the general economic risks; fortunately these risks come against a background of synchronised global growth and may not be as damaging as they would otherwise have been.

8. Central Banks are keen to avoid policy mistakes that may disrupt this global growth, so it is likely that increases in interest rates will be carried out in a considered manner that does not surprise markets.

Action Taken during March Quarter

9. At the end of the quarter the loan portfolio stood at £206.3m, which was an increase from the £193.7m balance at the end of December 2017. This increase is within the normal tolerances of cash movements over any quarter, and mainly relates to timing of precepts and grants.

10. During the quarter, £25m of loans that were originally for periods of 6 months or more matured, and the average rate of these loans was 0.54%. The same value of new loans was placed for periods of 6 months or more, and the average rate of 0.87% achieved on these reflects the market’s expectation that there will be a further interest rate rise in the near future.

11. In January 2018 an investment of £7m, from a £20m commitment, was ‘drawn down’ by the private debt fund in which an investment has been made. The remaining £13m will be drawn over the next 4 months. The private debt fund has a variable capital value, and for the purposes of this report the investment will be shown at ‘par’ (i.e. the amount drawn, adjusted for any capital repayments when these occur in the future); if there is any meaningful fall in value to below par this will be stated in the narrative. It also has a variable interest rate and the calculation of the average rate being earned by the loan portfolio will exclude the private debt fund investment and will relate only to the cash portfolio. At the end of March the average rate of interest on the cash portfolio was 0.73%, in comparison to 0.67% at the end of December 2017.

12. The loan portfolio at the end of March was invested with the counterparties shown in the list below:

	£m
Money Market Funds	14.3
Lloyds Banking Group/Bank of Scotland	30.0
Royal Bank of Scotland	40.0
Santander UK	20.0
Goldman Sachs International	20.0
Close Brothers	20.0
Danske Bank	10.0
Toronto Dominion Bank	10.0
Birmingham City Council	10.0
Thurrock Borough Council	10.0
London Borough of Southwark	10.0
Northamptonshire County Council	5.0
Partners Group Private Debt Fund 2018	7.0
	206.3

13. At the end of December there were also two 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. One LAMS loan matured during the quarter (£2.0m at 2.24%). These do not form part of the treasury management portfolio, but are listed below for completeness:

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

14. There were no loans active during the period that breached the authorised counterparty list at the time that the loan was made, and also none that had already been placed to a counterparty that subsequently fell below the threshold that would have been acceptable for the remaining period of the loan following a credit-rating downgrade.

Lending to Local Authorities

15. At the beginning of January a loan of £5m for 1 year at a rate of 0.75% was made to Northamptonshire County Council. At the time of the loan, the expectation was that base rates would not rise to that level until late in 2018 and as a result the rate on offer was very attractive relative to the other options available. The loan was carried out on commercial terms via a broker.

16. The loan has drawn local press coverage and concern from a number of elected members. As a result it is felt worthwhile commenting on the issue within this report.

17. The authorised lending list of Leicestershire County Council is based on a list produced by the Council's treasury management advisors, Link Asset Services. The main factor used in the production of Link's standard list is credit ratings provided by independent rating agencies, although other factors are taken into account. Leicestershire makes a number of adjustments to the standard list, namely to restrict all counterparties to a maximum loan period of one year (Link's standard list has a small number of counterparties with a maximum loan period above one year) and to exclude all counterparties that are on the standard list that have a maximum

loan period of less than 6 months. These changes make the Leicestershire authorised lending list less risky than the standard one produced by Link, which is used in its original form by most of their clients. Maximum loan amounts are also set by Leicestershire County Council, and these depend on the overall financial strength of the counterparty.

18. Local authorities do not generally have credit ratings, so they do not form part of the Link list. The reason for the lack of credit ratings for local authorities is for entirely practical reasons; they generally have no need to raise financing in a form where a credit rating would be necessary, and the cost and resource required to have an external agency produce and maintain a credit rating is significant and difficult to justify.

19. At the time of writing this report there was press coverage of a first bond issue by the Municipal Bonds Agency – owned by 56 local authorities and the Local Government Association – on behalf of 4 local authorities. These four local authorities will have 'joint and several liability' for the debt (in other words a default by one would have to be met by the others), and the bond issue has secured an Aa3 rating by the credit rating agency Moody's. This is the equivalent of an AA- rating by Standard & Poors and Fitch (the two other main credit rating agencies) and is on a par with the likes of Lloyds and HSBC. Moody's were quoted as follows:

"The credit quality is supported by the high level of control and monitoring of local authorities by the central government, strong institutional framework, and statutory codes of practice covering local authority capital expenditure, investments, treasury management and borrowing."

20. Leicestershire has always included the ability to lend to local authorities within its authorised counterparty list, and currently loans can be for a maximum amount of £10m to any single authority and a maximum loan period of one year. There are a number of reasons why it is felt that lending to local authorities is very low risk, and it is considered that these reasons remain valid despite the well-publicised financial difficulties of a small number of authorities. Some of these are as follows:

Legal position

Section 13 (3) of the Local Government Act 2003 states:

"All money borrowed by a local authority (whether before or after the coming into force of this section), together with any interest on the money borrowed, shall be charged indifferently on all the revenues of the authority."

In the context of the above paragraph "indifferently" means before any other expenditure. In other words, the repayment of capital and interest on borrowings is a first call on the available resources of an authority and the only way it will not happen is if the authority has gone bankrupt and is incapable of fulfilling *any* of its functions.

Practical position

All local authorities serve a significant population, including many individuals that are classified as vulnerable. Whilst there is no formal government guarantee for local authorities, there has never been a financial failure of one. Despite a number of local authorities being in a difficult financial situation it is considered very unlikely that one will be allowed to collapse and default on its debt; for authorities that are responsible for services such as education and adult social care central government support is almost inevitable. There are many reasons for this, and some of them are as follows:

(i) In order to finance long-term capital expenditure local authorities borrow from capital markets and a default by any local authority is likely to seriously impact the ability of other councils to access borrowing from this source in the future. This will put greater pressure on central government to provide more borrowing to the sector, which will require higher government borrowing and this is unlikely to be something the government wants;

(ii) A substantial proportion of external debt held by local authorities has been borrowed from the Public Works Loan Board (PWLB), which is effectively an agency of central government. A default will hit the government more substantially than any other financial counterparty;

(iii) There is clearly a necessity to protect the population served by a local authority, and in particular the vulnerable people that the authority serves. Replacing an authority with another provider of services to these people would be incredibly complex and take a number of years to plan and execute; the risks associated with disruption to services is such that central government support in the short to medium term appears an absolute necessity. Even a suspicion of an authority not being able to pay its providers is likely to lead to a withdrawal of these services by third parties, and an uncontrollable situation for vulnerable people;

(iv) Within the Local Government Pension Scheme the deficit of any employer that is unable to meet its liabilities becomes the responsibility of all other employers within that Fund. Within Leicestershire these deficits ranged from £10m for one of the smaller districts to £300m for the County and City Councils at the last actuarial valuation of March 2016, and the Leicestershire Pension Fund is in a similar position to most other Local Government Pension Funds. An authority being declared bankrupt would lead to a multi-million pounds (and possibly multi- hundreds of millions of pounds) deficit becoming the responsibility of employers such as the other local authorities within the Fund, FE Colleges, the Police and Fire Authority, academies, housing associations, charities etc. It is considered highly unlikely that this will be allowed by the government, given the knock-on financial effect it would have on the other employers.

Financial Position

The language used to describe the financial position of Local authorities and companies is very similar. However, the actual position is very different.

(i) Despite Government cuts to grants Local Authorities are in control of the majority of their income, due to their tax-raising powers. To regain a balanced budget service reduction can take place without a corresponding income reduction. Companies do not have this ability and if a service is cut by them, all of the related income stops.

(ii) Historically when public sector re-organisations have taken place, resulting in the cessation of one or more entities, government has nominated successor organisations. These organisations take on all of the historic assets and liabilities of the original entities. If a limited company ceases trading the known liabilities can only be settled out of the assets held by the company at that time.

21. Whilst it may seem more risky to lend money to a local authority that is experiencing difficulties than it is to a financial counterparty such as a bank, the reality is somewhat different. Local authorities remain very low risk counterparties and it is extremely likely that the existing loans will be repaid in full, on time and with full interest. The Council's treasury management advisors are aware of local authorities being on Leicestershire's list of authorised counterparties and are supportive of it, and comfortable that they remain low-risk counterparties. There is evidence that lending between local authorities continues to happen, including to those that have been highlighted as in very difficult financial positions.

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.

Equality and Human Rights Implications

23. There are no discernible equality and human rights implications.

Recommendation

24. The Committee is asked to note this report;

Background Papers

None

Circulation under the Local Issues Alert Procedure

None

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