Leicestershire County Council

CORPORATE GOVERNANCE COMMITTEE
12TH MAY 2014

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

ANNUAL TREASURY MANAGEMENT REPORT 2013/2014

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 2013/14.

Policy Framework and Previous Decisions

2. Under the CIPFA Code of Practice it is necessary to report on treasury management activities undertaken in 2013/2014 by the end of September 2014. This report will be considered by the Cabinet before the end of September.

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 2013/2014

5. There were no departures from the Treasury Management Policy Statement which was agreed by full Council on 20th February 2013 in relation to the sources and methods of borrowing and approved organisations for lending temporarily surplus funds.

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. The ratings required to become an acceptable counterparty for the authority are very high and as a result there are very few acceptable counterparties. During the year the sale of part of the Government's stake in Lloyds Banking Group (to below the 1/3rd level previously required) meant that they were removed from the list on 17th September 2013. A revised policy in respect of the required level of state ownership (to 20%)

was approved by the Cabinet on 13th December 2013 and Lloyds Banking Group was reinstated following this decision.

7. The action taken in respect of lending during 2013/14 was relatively subdued, mainly as a result of the low number of acceptable counterparties. Market rates of interest remained low as a result of the benign outlook for any increase in the base rate and the plentiful supply of cheap liquidity that has been injected into the financial system, as a result of the Government's Funding for Lending Scheme.

8. On the debt portfolio, no new loans were taken and one loan of £12m matured in June 2013. It continues to be considerably more advantageous to finance some of the historic capital expenditure by using internal cash resources, at a cost of the loss of interest that would be earned (c. 0.5%), than it is to 'externalise' this debt by taking further borrowing.

Position at 31st March 2014

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

	31st March 2014			31st March 2013		
	Principal	Average Rate	Average Life	Principal	Average Rate	Average Life
Fixed Rate Funding						
- PWLB	£188.1m	6.17%	31 yrs	£200.6m	5.96%	28 yrs
-Market	£ 2.0m	8.12%	3 yrs	£ 2.0m	8.12%	4 yrs
Variable Rate Funding:						
- Market (1)	£103.5 m	4.37%	1 yr	£103.5 m	4.37%	1 yr
Total Debt	£293.6m	5.55%	20 yrs	£306.1m	5.44%	19 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 £141m and £247m and averaged £192m.

Debt transactions in 2013/2014

11. The Council began the year with approximately £33.5m 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. During the year, debt of £12.5m matured and was not replaced. 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 - of £13.6m was charged to the revenue account, which left £32.4m of internal debt at the year end. There is a possibility that a further, voluntary, amount of MRP will be charged to the revenue account before the closure of the 2013/14 financial year, so the final level of internal debt may be lower than the current level of £32.4m.

12. Internal debt remained a very attractive option, as it was funded at the loss of interest that would otherwise be earned on lending the extra cash if it had been available – this 'cost' averaged around 0.45% in 2013/14. Most of the internal debt

comes as a result of previous premature repayments of loans, where the average rate of debt being paid was 4.44%.

13. Holding internal debt will become less attractive as the interest rates available for lending cash in the money markets rise. The current medium-term outlook for the bank base rate, in comparison to the interest rates payable on raising new loans, does not make external borrowing an attractive option at present, although a pro-active stance in managing this position will continue. If it is considered attractive to borrow externally – either from a cost or a risk management perspective – then the internal debt position will be reduced.

14. 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. It is entirely possible that this will not happen for a number of years, as opportunities will be taken to raise external debt only if it is felt to be appropriate. Bank base rates (and hence the interest lost by not having the cash available to lend) will not remain at ultra-low levels for ever, although it currently looks as if they will be lower than would have previously been considered 'normal' for a further extended period, and the debt portfolio will be managed on a medium/long term view and not with the aim of maximising short-term savings.

15. 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 were 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 internal debt position. Approximately £15.2m in interest had been saved in the period between the 2009 repayments and the end of the 2013/14 financial year.

Investment Undertaken in 2013/14

16. Bank base rates reached 0.50% in March 2009 and have stayed at this level since. The global economic outlook has improved in the last year, but an increase in UK base rates is not generally expected for at least another 12 months. 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.

17. The future outlook for base rates, combined with the extra cash injected into the financial system by the Funding for Lending Scheme, has impacted negatively on the rates available when lending. By the end of the financial year there was only one acceptable counterparty (Bank of Scotland – part of the Lloyds Banking Group) to whom it was possible to lend at rates that were higher than the historically low base rate.

18. The loan portfolio produced an average return of 0.67% in 2013/14, 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 0.35%. This level of out performance is mainly the result of a single counterparty – Bank of Scotland – who offer above-average rates of interest for longer term (i.e. 1 year) loans, but use of money market funds and loans to local authorities at rates that became attractive for a short period (due to a demand/supply imbalance of available funds) also added a modest degree of value.

Longer Term Performance of Portfolios

19. 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 19 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 19 years is 4.68%, which compares to an average base rate of 3.95% and an average LIBID index return of 3.94%.

20. The variability of balances makes it difficult to calculate the excess interest that the out performance has achieved over the whole of the 19 year period for which performance records are available, but it is estimated to be at least £24.0m. Over 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 the period in which a number of loans placed during the financial crisis were earning interest that (relative to base rates) were extraordinary.

21. 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 (2.80%) than the portfolio average. In reality the maturity of this loan was actually positive to the Authority, as instead of paying 2.80% in external debt, it was effectively refinanced at 0.45% (the cost of not having the cash available for lending).

Summary

22. 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, but there are risks associated with having internal debt and these need to be rigorously assessed and action taken if deemed appropriate. Short term gains might, on occasions, be sacrificed for longer term certainty and stability.

23. The loan portfolio has produced an exceptional level of out performance in the period since performance figures were calculated. At present it is difficult to 'add value' to any great extent as a result of the combination of the lack of acceptable counterparties, a financial system that has lots of cheap liquidity and the fact that there is a very broad consensus about what the immediate outlook for base rates is.

Recommendation

24. The Committee is asked to note this report.

Resource Implications

25. Treasury management is an integral part of the County Council's finances. Interest generated by treasury management activities of approximately £1.3m was earned in 2013/14 and the interest paid on external debt was c. £16.3m.

Equal Opportunities Implications

26. None.

Background Papers

Report to County Council on 20th February 2013 – 'Medium Term Financial Plan': Appendix L 'Treasury Management Strategy Statement and Annual Investment Strategy 2013/14'.

Report to the Cabinet on 13 December 2013 – Sale of part of Lloyds Banking Group Shareholding by UK Government – Impact on List of Acceptable Counterparties.

Circulation under local issues alert procedure

None.

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