Division(s): N/A

CABINET – 22 NOVEMBER 2016

TREASURY MANAGEMENT MID-TERM REVIEW 2016/17

Report by Chief Finance Officer

Introduction

1. The Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice on Treasury Management (Revised) 2011 recommends that members are informed of Treasury Management activities at least twice a year. This report ensures this authority is embracing Best Practice in accordance with CIPFA's recommendations.

2. The following annexes are attached

Annex 1	Lending List Changes
Annex 2	Debt Financing 2016/17
Annex 3	PWLB Debt Maturing
Annex 4	Prudential Indicator Monitoring
Annex 5	Arlingclose Quarter 2 Benchmarking

Strategy 2016/17

3. The approved Treasury Management Strategy for 2016/17 was based on an average base rate forecast of 0.55%.

4. The Strategy for borrowing provided an option to fund new or replacement borrowing up to the value of 15% of the portfolio through internal borrowing.

5. The Strategy included the continued use of pooled fund vehicles with variable net asset value.

External Context – Provided by Arlingclose

6. The preliminary estimate of Q2 2016 GDP showed reasonably strong growth as the economy grew 0.7% quarter-on-quarter, as compared to 0.4% in Q1 and year/year growth running at a healthy pace of 2.2%. However the UK economic outlook changed significantly on 23rd June 2016. The surprise result of the referendum on EU membership prompted forecasters to rip up previous projections and dust off worst-case scenarios. Growth forecasts had already been downgraded as 2016 progressed, as the very existence of the referendum dampened business investment, but the crystallisation of the risks and the subsequent political turmoil prompted a sharp decline in household, business and investor sentiment.

7. The repercussions of this plunge in sentiment on economic growth were judged by the Bank of England to be severe, prompting the Monetary Policy Committee to initiate substantial monetary policy easing at its August meeting to mitigate the worst of the downside risks.

This included a cut in Bank Rate to 0.25%, further gilt and corporate bond purchases (QE) and cheap funding for banks (Term Funding Scheme) to maintain the supply of credit to the economy. The minutes of the August meeting also suggested that many members of the Committee supported a further cut in Bank Rate to near-zero levels (the Bank, however, does not appear keen to follow peers into negative rate territory) and more QE should the economic outlook worsen.

8. In response to the Bank of England's policy announcement, money market rates and bond yields declined to new record lows. Since the onset of the financial crisis over eight years ago, Arlingclose's rate outlook has progressed from 'lower for longer' to 'even lower for even longer' to, now, 'even lower for the indeterminable future'. The new members of the UK government, particularly the Prime Minister and Chancellor, are likely to follow the example set by the Bank of England. After six years of fiscal consolidation, the Autumn Statement on 23rd November is likely to witness fiscal initiatives to support economic activity and confidence, most likely infrastructure investment.

9. Whilst the economic growth consequences of BREXIT remain speculative, there is uniformity in expectations that uncertainty over the UK's future trade relations with the EU and the rest of the world will weigh on economic activity and business investment, dampen investment intentions and tighten credit availability, prompting lower activity levels and potentially a rise in unemployment. These effects will dampen economic growth through the second half of 2016 and in 2017. Meanwhile, inflation is expected to pick up due to a rise in import prices, dampening real wage growth and real investment returns. The August Quarterly Inflation Report from the Bank of England forecasts a rise in CPI to 0.9% by the end of calendar 2016 and thereafter a rise closer to the Bank's 2% target over the coming year, as previous rises in commodity prices and the sharp depreciation in sterling begin to drive up imported material costs for companies.

10. The rise in inflation is highly unlikely to prompt monetary tightening by the Bank of England, with policymakers looking through import-led CPI spikes, concentrating instead on the negative effects of Brexit on economic activity and, ultimately, inflation.

11. **Market reaction:** Following the referendum result gilt yields fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. The yield on the 10-year gilt fell from 1.37% on 23rd June to a low of 0.52% in August, a quarter of what it was at the start of 2016. The 10-year gilt yield has since risen to 0.69% at the end of September. The yield on 2- and 3-year gilts briefly dipped into negative territory intra-day on 10th August to -0.1% as prices were driven higher by the Bank of England's bond repurchase programme. However both yields have since recovered to 0.07% and 0.08% respectively. The fall in gilt yields was reflected in the fall in PWLB borrowing rates.

12. On the other hand, after an initial sharp drop, equity markets appeared to have shrugged off the result of the referendum and bounced back despite warnings from the IMF on the impact on growth from 'Brexit' as investors counted on QE-generated liquidity to drive risk assets.

13. The most noticeable fall in money market rates was for very short-dated periods (overnight to 1 month) where rates fell to between 0.1% and 0.2%

Treasury Management Activity

Debt Financing

14. Oxfordshire County Council's debt financing to date for 2016/17 is analysed in Annex 2.

15. The Council's cumulative total external debt has decreased from £393.38m on 1 April 2016 to £388.38m by 30 September 2016, a net decrease of £5m. No new debt financing has been arranged during the year. The total forecast external debt as at 31 March 2017, after repayment of loans maturing during the year, is £385.38m. The forecast debt financing position for 31 March 2017 is shown in Annex 2.

16. At 30 September 2016, the authority had 64 PWLB[1] loans totalling £338.38m, 9 LOBO[2] loans totalling £45m and 1 long-term fixed Money Market loan totalling £5m. The combined weighted average interest rate for external debt as at 30 September 2016 was 4.5%.

Maturing Debt

17. The Council repaid £5m of maturing PWLB loans during the first half of the year. The details are set out in Annex 3.

Debt Restructuring

18. The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Authority's portfolio and therefore unattractive for debt restructuring activity. No PWLB debt restructuring activity was undertaken during the first half of the year.

LOBOs

19. At the beginning of the financial year the Authority held £50m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. £20m of these LOBOs had options during 2016/17, none were exercised by the lender. The Authority acknowledges there is an element of refinancing risk associated with LOBOs although in the current interest rate environment lenders are unlikely to exercise their options.

20. In June Barclays Bank informed the Authority of its decision to cancel all the embedded options within standard LOBO loans. This effectively converts £5m of the Authority's LOBO loans to a fixed rate loan removing the uncertainty on both interest cost and maturity date. This waiver has been done by 'deed poll'; it is irreversible and transferable by Barclays to

[1] PWLB (Public Works Loans Board) is a Government agency operating within the United Kingdom Debt Management Office and is responsible for lending money to Local Authorities.

[2] LOBO (Lender's Option/Borrower's Option) Loans are long-term loans which include a re-pricing option for the bank at predetermined intervals.

any new lender. A post balance sheet amendment was made to the disclosure notes in the 2015-16 Statement of Accounts to reflect the change in loan structure.

Investment Strategy

21. The Authority holds deposits and invested funds representing income received in advance of expenditure plus balances and reserves. The guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles. The Council continued to adopt a cautious approach to lending to financial institutions and continuously monitored credit quality information relating to counterparties.

22. During the first half of the financial year short term fixed deposits of up to 12 months have been placed with banks and building societies on the approved lending list and Money Market Funds have been utilised for short-term liquidity. Opportunities to place longer-term deposits have been limited.

23. The Treasury Management Strategy Statement and Annual Investment Strategy for 2016/17 included the use of external fund managers and pooled funds to diversify the investment portfolio through the use of different investment instruments, investment in different markets, and exposure to a range of counterparties. It is expected that these funds should outperform the Council's in-house investment performance over a rolling three year period. The strategy permitted up to 50% of the total portfolio to be invested with external fund managers and pooled funds (excluding Money Market Funds). The performance of the pooled funds will continue to be monitored by the Treasury Management Strategy Team (TMST) throughout the year against respective benchmarks and the in-house portfolio.

The Council's Lending List

24. The Council's in-house cash balances were deposited with institutions that meet the Council's approved credit rating criteria. The approved Lending List is updated to reflect changes in counterparty credit quality with changes reported to Cabinet on a bi-monthly basis. Annex 1 shows the amendments incorporated into the Lending List during the first half of 2016/17, in accordance with the approved credit rating criteria.

25. Various indicators of credit risk reacted negatively to the result of the referendum on the UK's membership of the European Union. UK bank credit default swaps saw a modest rise but bank share prices fell sharply, on average by 20%, with UK-focused banks experiencing the largest falls. Non-UK bank share prices were not immune although the fall in their share prices was less pronounced.

26. Fitch credit rating agency downgraded the UK's sovereign rating by one notch to AA from AA+, and Standard & Poor's (S&P) downgraded its corresponding rating by two notches to AA from AAA. Fitch, S&P and Moody's have a negative outlook on the UK. S&P took similar actions on rail company bonds guaranteed by the UK Government. S&P also downgraded the long-term ratings of the local authorities to which it assigns ratings as well as the long-term rating of the EU from AA+ to AA, the latter on the agency's view that it lowers the union's fiscal flexibility and weakens its political cohesion.

27. Moody's affirmed the ratings of nine UK banks and building societies but revised the outlook to negative for those that it perceived to be exposed to a more challenging operating environment arising from the 'leave' outcome.

28. There was no immediate change to Arlingclose's credit advice on UK banks and building societies as a result of the referendum result. Arlingclose believes there is a risk that the uncertainty over the UK's future trading prospects will bring forward the timing of the next UK recession.

29. In the six months to 30 September 2016 there were no instances of breaches in policy in relation to the Council's Lending List. Any breaches in policy will be reported to Cabinet as part of the bi-monthly Business Strategy and Financial Monitoring report.

Investment Performance

30. Security of capital has remained the Authority's main investment objective. This has been maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement and Annual Investment Strategy for 2016/17.

31. The average daily balance of temporary surplus cash invested in-house in the six months to 30 September was £332m. The Council achieved an average in-house return for that period of 0.84% marginally below the budgeted rate of 0.85% set in the strategy. This has produced gross interest receivable of £1.4m for the period to 30 September.

32. Temporary surplus cash includes; developer contributions; council reserves and balances; trust fund balances; and various other funds to which the Council pays interest at each financial year end, based on the average three month London Interbank Bid (LIBID) rate.

33. The Council uses the three month inter-bank sterling bid rate as its benchmark to measure its own in-house investment performance. During the first half of 2016/17 the average three month inter-bank sterling rate was 0.38%. The Council's average in-house return of 0.84% exceeded the benchmark by 0.46%. The Council operates a number of call accounts and instant access Money Market Funds to deposit short-term cash surpluses. The average balance held on overnight deposit in money market funds or call accounts in the 6 months to 30 September was £59.8m.

34. The UK Bank Rate had been maintained at 0.5% since March 2009 until August 2016, when it was cut to 0.25%. It is now forecast to fall further towards zero but not to go negative. Short-term money market rates have remained at relatively low levels.

External Fund Managers and Pooled Funds

35. The Council continued to use pooled funds with variable net asset value. Weighted by value pooled fund investments produced an overall annualised return of 2.6% for the period. These investments are held with a long-term view and performance is assessed accordingly.

36. Gross distributions from pooled funds have totalled £0.46m in the first six months of the year. This brings total income, including gross interest receivable on in-house deposits to £1.86m for the period.

Prudential Indicators for Treasury Management

37. The Authority confirms compliance with its Prudential Indicators for 2016/17, which were set as part of the Authority's Treasury Management Strategy Statement. The position as at 30 September 2016 for the Prudential Indicators is shown in Annex 4.

External Performance Indicators and Statistics

38. The County Council is a member of the CIPFA Treasury and Debt Management benchmarking club and receives annual reports comparing returns and interest payable against other authorities. The benchmarking results for 2015/16 showed that Oxfordshire County Council had achieved an average investment return of 0.88% compared with an average of 0.87% for their comparative group of members.

39. The average interest rate paid for all debt during 2015/16 was 4.5%, with an average of 4.35% for the comparative benchmarking group members. It should be noted that all of Oxfordshire County Council's debt is long-term, whereas the averages for the comparators include short-term debt which has a lower interest rate and so reduces the averages. Oxfordshire County Council's long-term fixed debt was below the group average rate. Oxfordshire County Council had a higher than average proportion of its debt portfolio in PWLB loans at 87% compared to 78% for the all member group. Oxfordshire County Council had 13% of its debt in LOBO loans at 31 March 2016 compared with an average of 17% for the comparative group.

40. Arlingclose also benchmark the Council's investment performance against its other clients on a quarterly basis. The results of the quarter 2 benchmarking to 30 September 2016 are shown in Annex 5.

41. The benchmarking results show that the Council was achieving higher than average interest on deposits at 30 September 2016, when compared with a group of 138 other local authorities. This has been achieved by placing deposits over a longer than average duration with institutions that are of higher than average credit quality.

42. Oxfordshire had a higher than average allocation to external funds, fixed and local authority deposits when compared with other local authorities in the benchmarking exercise. Oxfordshire also had a notably lower than average exposure to money market funds and call accounts.

Training

43. Individuals within the Treasury Management Team continued to keep up to date with the latest developments and have attended a number of external workshops and conferences.

Financial and Legal Implications

44. Interest payable and receivable in relation to Treasury Management activities are included within the overall Strategic Measures budget. The 2016/17 budget for interest receivable

was £3.2m. The forecast outturn is currently in line with the budget. Interest payable is currently forecast to be in line with the budgeted figure of £17.6m.

45. The economic outlook for the UK has immeasurably altered following the vote to leave the EU. The long-term position of the economy will be largely dependent on the agreements the government is able to secure with the EU, particularly with regard to Single Market access. The short to medium-term outlook has been more downbeat due to the uncertainty generated by the result and forthcoming negotiations.

46. Arlingclose has changed its central case for the path of Bank Rate over the next three years, predicting that Bank Rate will remain at 0.25%, but with a 40% possibility of a drop to close to zero, with a small chance of a reduction below zero. Gilt yields are forecast to be broadly flat from current levels, albeit experiencing short-term volatility.

RECOMMENDATION

47. **The Cabinet is RECOMMENDED to note the report and to RECOMMEND Council to note the Council's Mid-Term Treasury Management Review 2016/17.**

LORNA BAXTER
Chief Finance Officer

Annexes:	Annex 1	Lending List Changes
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Contact officer: Donna Ross – Strategic Finance Manager
Contact number: 01865 323976
November 2016

Annex 1

Lending List Changes from 1 April 2016 to 30 September 2016

Counterparty	Lending Limit	Maximum Maturity
Counterparties added/reinstated		
None		
Counterparties suspended		
None		
Lending limits & Maturity limits increased		
None		
Lending limits & Maturity limits decreased		
None		

Pension Fund Lending list changes

The Oxfordshire Pension Fund cash balances are held separately from County Council cash and are deposited in accordance with the Cash Management Strategy approved by the Pension Fund Committee. The Strategy for 2016/17 is to use a sub-set of the Councils approved counterparties.

The following Pension Fund counterparty limits were updated to £25m in line with the Pension Fund Cash Management Strategy approved by the Pension Fund Committee for 2016/17.

Pension Fund Counterparty limits amended to £25m
Standard Life Sterling Liquidity Fund
Lloyds Bank Plc
Overseas Chinese Banking Corp
Svenska Handelsbanken

Annex 2

OXFORDSHIRE COUNTY COUNCIL DEBT FINANCING 2016/17

Debt Profile		£m
1. PWLB	87%	343.38
2. Money Market loans	13%	50.00
3. Sub-total External Debt		393.38
4. Internal Balances		-15.80
5. Actual Debt at 31 March 2016	**100%**	**377.58**
6. Government Supported Borrowing		0.00
7. Unsupported Borrowing		15.77
8. Borrowing in Advance		0.00
9. Minimum Revenue Provision		-15.53
10. Forecast Debt at 31 March 2017		**377.82**

Maturing Debt	
11. PWLB loans maturing during the year	-8.00
12. PWLB loans repaid prematurely in the course of debt restructuring	0.00
13. Total Maturing Debt	**-8.00**

New External Borrowing	
14. PWLB Normal	0.00
15. PWLB loans raised in the course of debt restructuring	0.00
16. Money Market LOBO loans	0.00
17. Total New External Borrowing	**0.00**

Debt Profile Year End		
18. PWLB	87%	335.38
19. Money Market loans (incl £45m LOBOs)	13%	50.00
20. Sub-total External Debt		385.38
21. Internal Balances		-7.56
22. Forecast Debt at 31 March 2017	**100%**	**377.82**

Line

1 – 5 This is a breakdown of the Council's debt at the beginning of the financial year (1 April 2016). The PWLB is a government agency operating within the Debt Management Office. LOBO (Lender's Option/ Borrower's Option) loans are long-term loans, with a maturity of up to 60 years, which includes a re-pricing option for the bank at predetermined time intervals. Internal balances include provisions, reserves, revenue balances, capital receipts unapplied, and excess of creditors over debtors.

6 'Government Supported Borrowing' is the amount that the Council can borrow in any one year to finance the capital programme. This is determined by Central Government, and in theory supported through the Revenue Support Grant (RSG) system.

7 'Unsupported Borrowing' reflects Prudential Borrowing taken by the authority whereby the associated borrowing costs are met by savings in the revenue budget.

8 'Borrowing in Advance' is the amount the Council borrowed in advance to fund future capital finance costs.

9 The amount of debt to be repaid from revenue. The sum to be repaid annually is laid down in the Local Government and Housing Act 1989, which stipulates that the repayments must equate to at least 4% of the debt outstanding at 1 April each year.

10 The Council's forecast total debt by the end of the financial year, after taking into account new borrowing, debt repayment and movement in funding by internal balances.

11 The Council's normal maturing PWLB debt.

12 PWLB debt repaid early during the year.

13 Total debt repayable during the year.

14 The normal PWLB borrowing undertaken by the Council during 2016/17.

15 New PWLB loans to replace debt repaid early.

16 The Money Market borrowing undertaken by the Council during 2016/17

17 The total external borrowing undertaken.

18-22 The Council's forecast debt profile at the end of the year.

Annex 3

Long-Term Debt Maturing 2016/17

Public Works Loan Board: Loans Matured during first half of 2016/17

Date	Amount £m	Rate %
13/07/2016	0.500	2.35%
31/07/2016	0.500	2.35%
31/08/2016	4.000	5.00%
Total	**5.000**	

Public Works Loan Board: Loans Due to Mature during second half of 2016/17

Date	Amount £m	Rate %
22/11/2016	2.000	7,75%
13/01/2017	0.500	2.35%
31/01/2016	0.500	2.35%
Total	**3.000**	

Annex 4

Prudential Indicators Monitoring at 30 September 2016

The Local Government Act 2003 requires the Authority to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. To demonstrate that the Authority has fulfilled the requirements of the Prudential Code the following indicators must be set and monitored each year.

Authorised and Operational Limit for External Debt

Actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt below. The Operational Boundary is based on the Authority's estimate of most likely, i.e. prudent, but not worst case scenario for external debt. The council confirms that the Operational Boundary has not been breached during 2016/17.

The Authorised Limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum debt that the Authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements. The Authority confirms that the Authorised limit was not breached in the first half of 2016/17.

Authorised limit for External Debt	£465,000,000
Operational Limit for External Debt	£450,000,000
Capital Financing Requirement for year	£407,384,000

	Actual 30/09/2016	Forecast 31/03/2017
Borrowing	£388,382,618	£385,382,618
Other Long-Term Liabilities	£ 30,000,000	£ 30,000,000
Total	**£418,382,618**	**£415,382,618**

Interest Rate Exposures

These indicators are set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest exposures. Fixed rate investments are borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Fixed Interest Rate Exposure

Fixed Interest Net Borrowing limit	£350,000,000
Actual at 30 September 2016	£293,382,618

Variable Interest Rate Exposure

Variable Interest Net Borrowing limit	£0
Actual at 30 September 2016	-£252,219,512

Principal Sums Invested over 365 days

Total sums invested for more than 364 days limit	£100,000,000
Actual sums invested for more than 364 days	£ 80,000,000

Maturity Structure of Borrowing

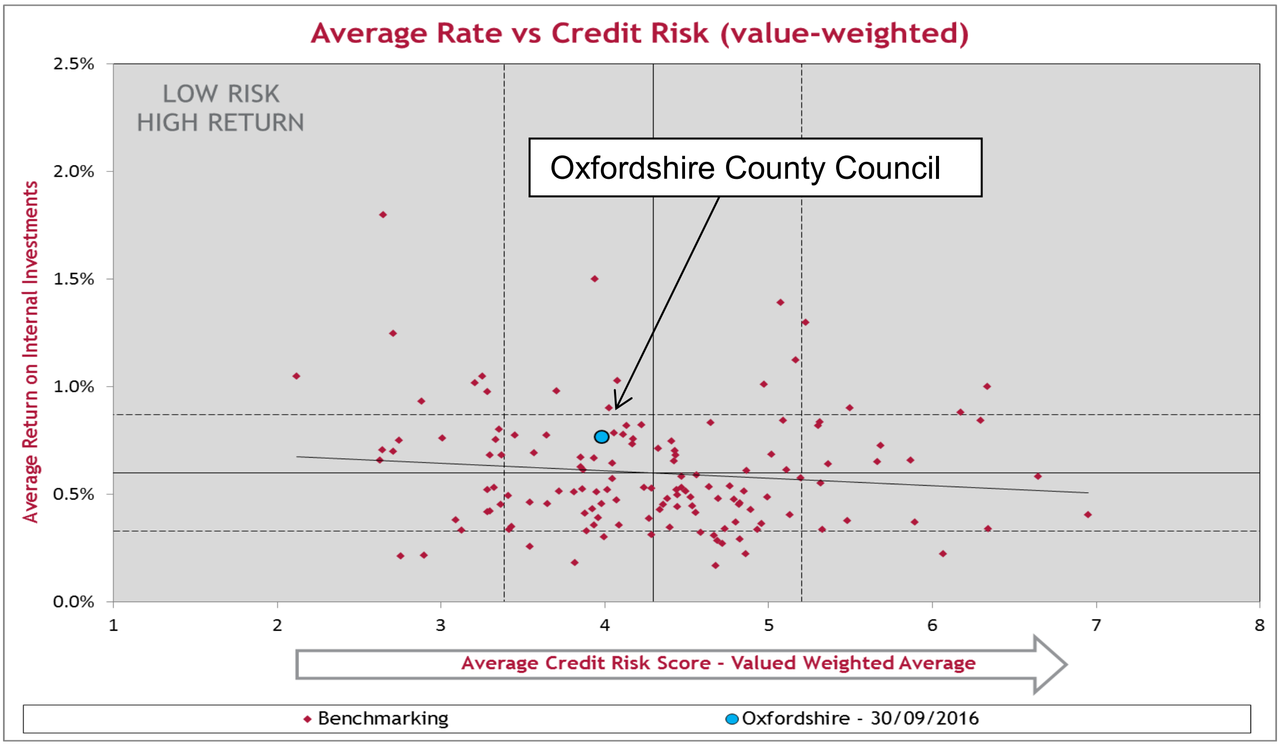
This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing and the actual structure at 30 September 2016, are shown below. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

	Limit %	**Actual %**
Under 12 months	0 - 20	4.63
12 – 24 months	0 - 25	7.21
24 months – 5 years	0 - 35	9.53
5 years to 10 years	5 - 40	15.71
10 years +	50 - 95	62.92

Arlingclose Benchmarking

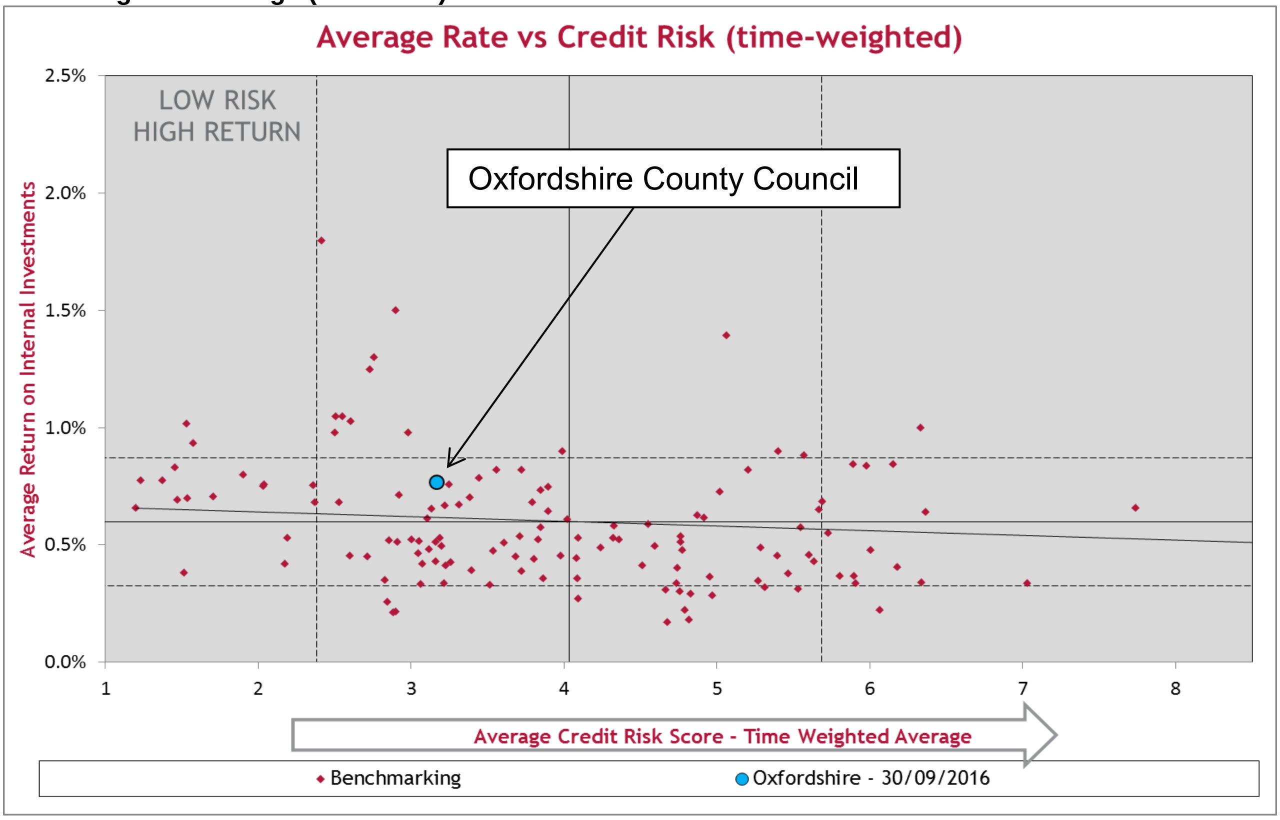
Annex 5

Value weighted average (all clients)



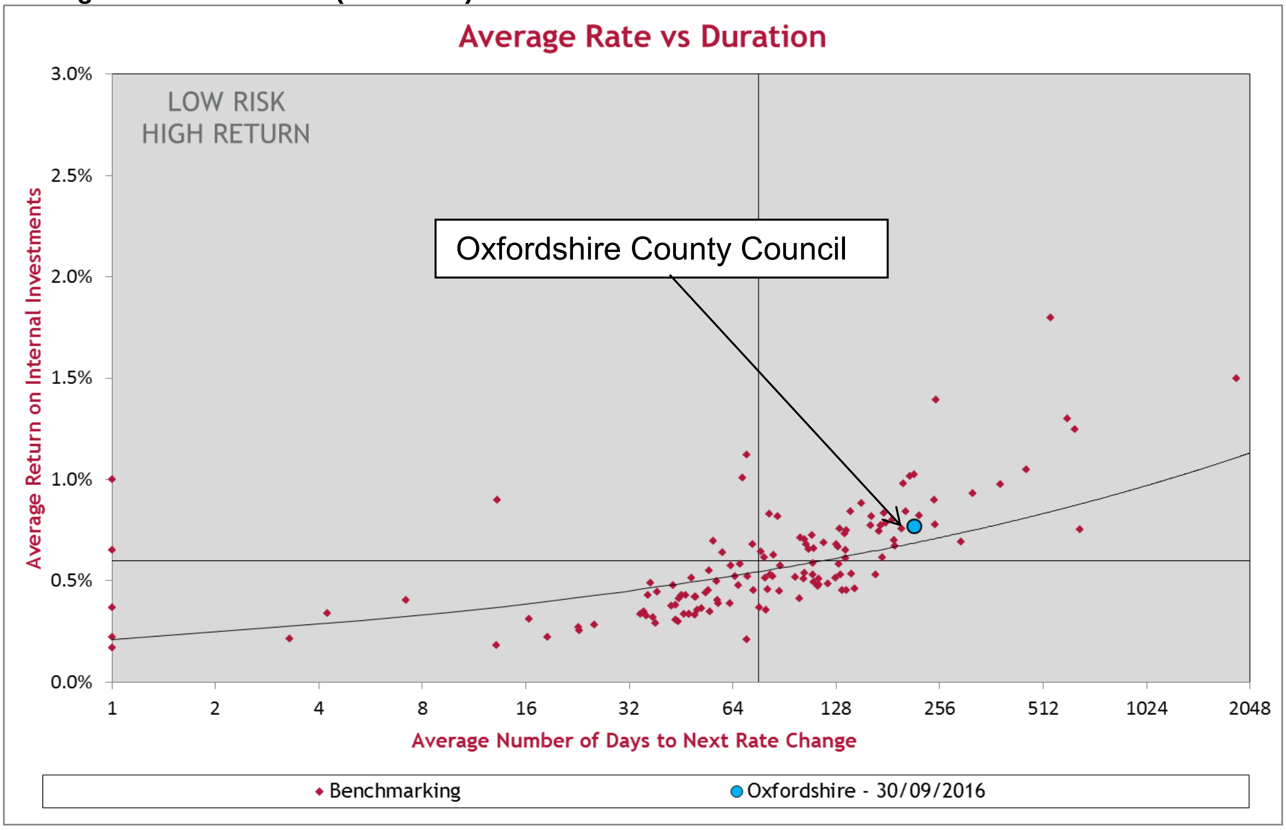
This graph shows that, at 30 September 2016, Oxfordshire achieved a higher than average return for lower than average credit risk, weighted by deposit size.

Time weighted Average (all clients)



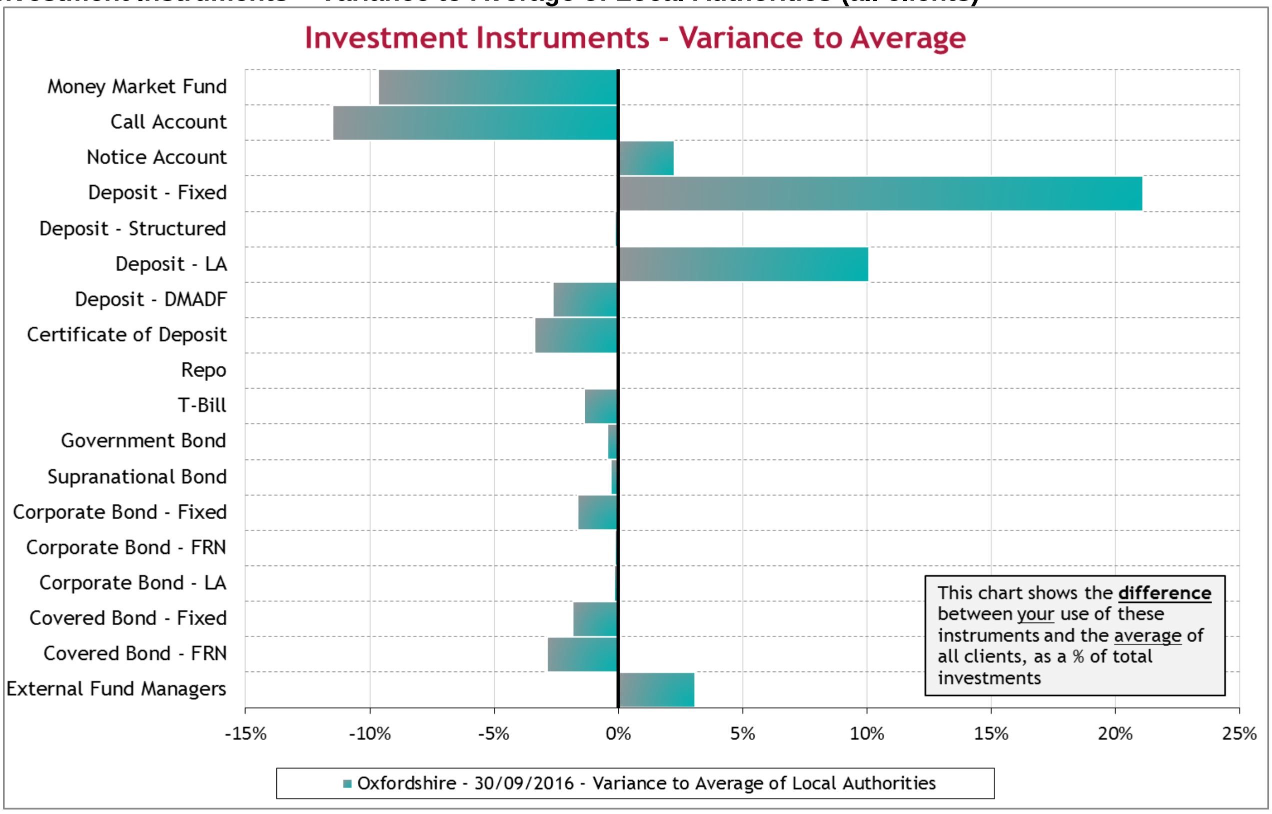
This graph shows that, at 30 September 2016, Oxfordshire achieved higher than average return for lower than average credit risk, weighted by duration.

Average Rate vs Duration (all clients)



This graph shows that, at 30 September 2016, Oxfordshire achieved a higher than average return by placing deposits for longer than average duration.

Investment Instruments – Variance to Average of Local Authorities (all clients)



This graph shows that, at September 2016, Oxfordshire had notably higher than average allocation to external funds, fixed and local authority deposits when compared with other local authorities. Oxfordshire also had notably lower exposures to money market funds and call accounts.