# CABINET – 25 NOVEMBER 2014

# TREASURY MANAGEMENT MID-TERM REVIEW 2014/15

**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 2014/15 |
| Annex 3 | PWLB Debt Maturing |
| Annex 4 | Prudential Indicator Monitoring |
| Annex 5 | Arlingclose Quarter 1 Benchmarking |

## Strategy 2014/15

3. The approved Treasury Management Strategy for 2014/15 was based on an average base rate forecast of 0.50%.

4. The Strategy for Long Term Borrowing was to use internal balances up the value of 25% of the investment portfolio.

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

## Economic Background

6. The recent relatively strong performance of the UK economy continued with output growing at 0.8% in Q1 2014 and at 0.9% in Q2. The services sector being the main contributor. On the back of strong consumption growth, business investment appeared to be recovering quickly, albeit from a low base. The annual CPI inflation rate fell to 1.2% year-on-year in September.

7. The labour market continued to improve, with headline unemployment falling to 6.2%. However, earnings growth remained very weak, rising just 0.6% for the three months May-July 2014 compared to the same period a year earlier. The growth in employment was masked by a large number of zero-hour contracts and involuntary part-time working.

8. The MPC made no change to the Bank Rate of 0.5% and maintained asset purchases at £375bn. However, there was a marked shift in tone from the Bank of England's Governor and other MPC members. In his Mansion House speech in June 2014 Governor Mark Carney warned that interest rates might rise sooner than financial markets were expecting. Following some mixed messages from Governor Carney later in the summer, the minutes of the August and September MPC meetings revealed a split vote with regards to the Bank

Rate. Ian McCafferty and Martin Weale voted to increase Bank Rate by 0.25%, arguing economic circumstances were sufficient to justify an immediate rise. The MPC emphasised that when Bank Rate did begin to rise, it was expected to do so only gradually and would likely remain below average historical levels for some time to come.

9. In the Bank of England's August Inflation Report the Bank forecast growth to be around 3½% in 2014, easing back thereafter to around its pre-crisis historical average rate. Inflation was forecast to remain at, or slightly below, 2% before reaching the target at the end of the 2-year forecast period.

10. The Bank's Financial Policy Committee also announced a range of measures to abate the UK's housing market in order to avert the potential of spiralling house prices derailing a sustainable economic recovery. Key recommendations included lenders stress-testing that mortgage applicants can cope with a 3% rise in interest rates; putting a 15% cap on the number of mortgages at more than 4.5 times the borrower's income; and a separate Treasury pledge banning anyone applying for a loan through the Help to Buy scheme borrowing more than 4.5 times their income. The Prudential Regulation Authority also announced that it intends to consult on capital requirements for mortgages.

11. The result of the Scottish referendum in the end was close, but not as close as many believed it might be. However, the political upheaval set in motion (the Prime Minister's linking of a more devolved Scotland to giving greater powers to English MPs over English-only legislation, the prospect of Scotland's potential freedom to raise taxes not being replicated elsewhere in the UK) is arguably likely to be just as problematic in the run-up to and beyond next year's general election.

12. Eurozone inflation continued to fall towards zero (HICP inflation registered just 0.3% in September), and there was mounting evidence that the already feeble recovery was losing pace. The unemployment rate remained very high at 11.5%. The European Central Bank lowered its official benchmark interest rate from 0.15% to 0.05%. The rate it pays on commercial bank balances held with it was also cut further into negative territory from -0.1% to -0.2% and the Marginal Lending Facility rate cut further to 0.3%. The ECB also announced a programme of acquiring Asset Backed Securities (ABS) from banks in an effort to encourage lending which was viewed as being one step away from full blown Quantitative Easing (QE) adopted by the US, UK and Japanese central banks. The minutes of the Bank of England's MPC meeting in September noted that "weakness in the euro area had been the most significant development during the month" and that, if it led once again to uncertainty about the sustainability of euro-area public and external debt, it could damage confidence and disrupt financial markets.

13. There was no change in the US Federal Reserve as the central bank kept policy on its current track with a reduction in asset purchases by $10 billion per month. Asset purchases are expected to end by October 2014, expectations therefore turned towards the timing of rate increases. The US economy rebounded strongly in Q2 with annualised growth of 4.6%.

14. Gilt yields have continued to decline and hit a financial year low at the end of August, before moving upwards in the run up to the Scottish referendum. What has driven yields lower is a combination of factors but the primary drivers have been the escalation of geo-political risk within the Middle East and Ukraine alongside the slide towards deflation within the Eurozone (EZ).

## Treasury Management Activity

## Debt Financing

15. Oxfordshire County Council's debt financing to date for 2014/15 is analysed in Annex 2.

16. The 2014/15 borrowing strategy is to use internal balances to fund new or replacement borrowing up to the value of 25% of the portfolio. This is intended to reduce the cost of carry (the difference between borrowing rates and investment returns) in the low interest rate environment and reduce counterparty risk by minimising the level of cash balances.

17. There has been no change to this strategy.

18. The Council's cumulative total external debt has decreased from £401.38m on 1 April 2014 to £400.38m by 30 September 2014, a net decrease of £1m. No new debt financing has been arranged during the year. The total forecast external debt as at 31 March 2015, after repayment of loans maturing during the year, is £399.38m. The forecast debt financing position for 31 March 2015 is shown in Annex 2.

19. At 30 September 2014, the authority had 66 PWLB[1] loans totalling £350.38m and 10 LOBO[2] loans totalling £50m. The combined weighted average interest rate for external debt as at 30 September 2014 was 4.53%.

## Maturing Debt

20. The Council repaid £1m of maturing PWLB loans during the first half of the year. The details are set out in Annex 3.

## Debt Restructuring

21. There has been no restructuring of Long Term Debt during the year to date.

## Investment Strategy

22. The security and liquidity of cash was prioritised above the requirement to maximise returns. The Council continued to adopt a cautious approach to lending to financial institutions and continuously monitored credit quality information relating to counterparties.

23. During the first half of the financial year short term fixed deposits of up to 12 months have been placed with banks, building societies and local authorities. All deposits with banks & building societies have been restricted to a maximum duration of twelve months. No deposits over twelve months have been made with other local authorities. This was due to fewer local authorities in the market than experienced in previous years, possibly due to front loading of grants. Where local authorities were in the market for deposits over 12

[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.

months it was determined that rates quoted did not reflect the wider market and the potential for increases in the base rate of interest over the period.

24. In January 2015 the UK will implement the “bail-in” provisions of the EU Bank Recovery and Resolution Directive, a year earlier than most other countries. Bail-in involves shareholders of a failing institution being divested of their shares, and creditors of the institution having their claims cancelled or reduced to the extent necessary to restore the institution to financial viability. Through the use of term deposits with banks and building societies the Council will be classified as an unsecured creditor, subsequently any term deposits would fall within the scope of a bail-in. In the event of a bail-in public authorities’ term deposits would begin to take a loss at the point at which shareholders had been fully divested and junior bond holders have been bailed-in in full.

25. In the event of a bail-in there are numerous factors which would determine whether a public authority term deposit would be subject to loss and the extent of a given loss. These include the size of the loss incurred by the counterparty, the value of equity capital and junior bonds available to absorb any loss first, and the proportion of unsecured creditors eligible for compensation. Those eligible for compensation include all non-financial private sector organisations. The effect of a greater proportion of creditors eligible for compensation is to reduce the pool of unsecured creditors to share any loss, thus increasing the losses of the remaining creditors.

26. Reforms will signal a move away from government support for failing banks and building societies. This introduces a risk that UK banks and building societies may be subject to credit rating downgrades by the three major ratings agencies when next reviewed, to reflect the removal of government support. This could result in some counterparties on our existing lending list falling below our current minimum credit rating criteria, including the Council’s own bank Lloyds.

27. In response to concerns surrounding bail-in, as well as tensions and negativity in the wider European economy the Treasury Management Strategy Team (TMST), in line with advice from treasury advisors Arlingclose, agreed to reduce the durations of all new unsecured investments with counterparties likely to be affected (see below). The TMST will continue to monitor the situation, as well as seeking to move towards the use of secured investments.

28. The Treasury Management Strategy Statement and Annual Investment Strategy for 2014/15 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 original strategy permitted up to 20% of the total portfolio to be invested with external fund managers and pooled funds (excluding Money Market Funds).

29. Current investments in pooled funds are held with a long-term basis and reflect the higher level of volatility they may display when viewed on a short-term basis. As such the TMST aim to avoid withdrawals from pooled fund investments for cashflow purposes, in order to ensure any negative effects of short term volatility are not realised. For 2014/15 the total portfolio size is expected to fluctuate by approximately £170m, with cash balances reducing temporarily towards the end of the year. The reduced portfolio size towards year end has the effect of constraining investment in pooled funds throughout the year to 20% of the minimum forecast portfolio size. As pooled fund investments are held with a long term view

there is no appetite to make withdrawals when balances temporarily decrease for a short period, as this could result in losses of principal. Subsequently, investments in pooled funds are not made if it is forecast that the limit will be breached at any point later in the current year.

30. Due to the practical implications discussed above, as well as the need for greater diversification, and to move away from unsecured bank and building society term deposits, it is recommended that the limit be increased to no more than 30% of the total portfolio. The limit and levels of diversification should be monitored monthly by the TMST. In order to ensure appropriate diversification within externally managed and pooled funds these should be diversified between a minimum of two asset classes.

31. The performance of the pooled funds will continue to be monitored by the TMST throughout the year against the funds benchmarks and the in-house portfolio. The TMST will keep pooled funds under review, including ensuring appropriate diversification and the consideration of alternative investment and fund structures, to manage overall portfolio risk.

32. It is recommended that the authority to withdraw, or advance additional funds to/from pooled fund and external fund managers, continue to be delegated to the TMST.

## The Council’s Lending List

33. The Council’s in-house cash balances were deposited with institutions that meet the Council’s approved credit rating criteria. The approved Lending List was updated during the period to incorporate additional counterparties. Changes were reported to Cabinet on a bi-monthly basis. Annex 1 shows the amendments incorporated into the Lending List during the first half of 2014/15, in accordance with the approved credit rating criteria. Additionally the reductions in duration previously discussed, applied beyond the reporting period have been included for information.

34. In the six months to 30 September 2014 there were no instances of breaches in policy. Any breaches in policy will be reported to Cabinet as part of the bi-monthly financial monitoring.

## Investment Performance

35. 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 for 2014/15.

36. The average daily balance of temporary surplus cash invested in-house in the six months to 30 September was £359.3m. The Council achieved an average in-house return for that period of 0.77%, falling below the target rate of 0.80% set in the strategy. This has produced gross interest receivable of £1.38m.

37. Temporary surplus cash includes; Government grants received in advance, developer contributions, maintained school balances, council reserves and balances, working capital, trust fund balances, and various other funds to which the Council pays interest at each financial year end, based on the average rate earned on all balances.

38. 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 2014/15 the average three month inter-bank sterling rate was 0.42%. The Council's average in-house return of 0.77% exceeded the benchmark by 0.35%. 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 £41.8million or 11.6% of the total in house portfolio.

## External Fund Managers and Pooled Funds

39. The Council continued to use pooled funds with variable net asset value operated by Scottish Widows Investment Partnership, Federated, Threadneedle and Payden & Rygel. The annualised returns over the period to 30 September 2014 for these funds were 0.72%, 0.66%, 3.89% and 1.05% respectively. Weighted by value this represents an overall annualised return of 2.15% on pooled fund investments for the period. These investments are held with a long-term view and performance is assessed accordingly.

## Prudential Indicators for Treasury Management

40. The position as at 30 September 2014 for the Prudential Indicators is shown in Annex 4.

## External Performance Indicators and Statistics

41. 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 2013/14 showed that Oxfordshire County Council had achieved an average return of 0.86% compared with an average of 0.85% for their comparative group of 50 members

42. The average interest rate paid for all debt during 2013/14 was 4.57%, with an average of 4.34% for the comparative group of 50 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 had a higher than average proportion of its debt portfolio in PWLB loans at 88% compared to 73% for the all member group. Oxfordshire County Council had 12% of its debt in LOBO loans at 31 March 2014 compared with an average of 18% for the comparative group.

43. 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 2014 are not yet available. Quarter 1 results to 30 June 2014 are included in annex 5.

44. The benchmarking results show that the Council has achieved higher than average interest on deposits at 30 June 2014. This has been achieved by placing deposits over a longer than average duration with institutions that are of better than average credit quality.

## Training

45. 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

46. Interest payable and receivable in relation to Treasury Management activities are only two parts of the overall Strategic Measures budget.

47. The 2014/15 budget for interest receivable is £2.4m. The forecast outturn for interest receivable is £2.5m giving net forecast excess income of £0.1m. The increased forecast in interest receivable is due to higher average cash balances due in part to the timings of capital and revenue expenditure.

48. Interest payable is currently forecast to be in line with the budgeted figure of £18.2m.

## RECOMMENDATION

49. **The Cabinet is RECOMMENDED to note the report, and to RECOMMEND Council to note the Council's Mid-Term Treasury Management Review 2014/15 and to approve the revision to the Treasury Management Strategy Statement & Annual Investment Strategy 2014/15.**

LORNA BAXTER
Chief Finance Officer

Contact officer: Lewis Gosling – Financial Manager (Treasury Management)
Contact number: 01865 323988

November 2014

**Annex 1**

## Lending List Changes during 2014/15

### Counterparties added/reinstated

| Counterparty | Lending Limit | Maximum Maturity |
|---|---|---|
| Rabobank Group | £25m | 364 days |
| Goldman Sachs International Bank | £15m | 100 days |
| Landesbank Hessen-Thuringen (Helaba) | £20m | 100 days |

### Counterparties removed

No Counterparties have been removed from the Lending List between 1 April 2014 and 30 September 2014.

### Lending limits & Maturity limits increased

No Counterparty limits have been increased between 1 April 2014 and 30 September 2014.

### Lending limits & Maturity limits decreased

No Counterparty limits have been decreased between 1 April 2014 and 30 September 2014.

### Lending limits & Maturity limits decreased after the reporting period

| Counterparty | New Lending limit | New Maximum Maturity |
|---|---|---|
| HSBC Bank | no change | 6 months |
| Standard Chartered | no change | 6 months |
| Lloyds Bank | no change | 6 months |
| Rabobank | no change | 6 months |
| Svenska Handelsbanken | no change | 6 months |
| Development Bank of Singapore (DBS) | no change | 6 months |
| Overseas-Chinese Banking Corp | no change | 6 months |
| United Overseas bank | no change | 6 months |
| National Australia Bank | no change | 6 months |
| Commonwealth Bank of Australia | no change | 6 months |
| Bank of Montreal | no change | 6 months |
| Bank of Nova Scotia | no change | 6 months |
| Canadian Imperial Bank of Commerce | no change | 6 months |
| Toronto-Dominion Bank | no change | 6 months |
| National Bank of Canada | no change | 100 days |
| Barclays Bank | no change | 100 days |

**Annex 2**

## OXFORDSHIRE COUNTY COUNCIL DEBT FINANCING 2014/15

| Debt Profile | | £m |
|---|---|---|
| 1. PWLB | 88% | 351.38 |
| 2. Money Market LOBO loans | 12% | 50.00 |
| 3. Sub-total External Debt | | 401.38 |
| 4. Internal Balances | 0% | -13.52 |
| **5. Actual Debt at 31 March 2014** | **100%** | **387.86** |
| 6. Government Supported Borrowing | | 0.00 |
| 7. Unsupported Borrowing | | 12.48 |
| 8. Borrowing in Advance | | 0.00 |
| 9. Minimum Revenue Provision | | -16.16 |
| **10. Forecast Debt at 31 March 2015** | | **384.18** |
| | | *Maturing Debt* |
| 11. PWLB loans maturing during the year | | -2.00 |
| 12. PWLB loans repaid prematurely in the course of debt restructuring | | 0.00 |
| **13. Total Maturing Debt** | | **-2.00** |
| | | *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% | 349.38 |
| 19. Money Market LOBO loans | 13% | 50.00 |
| 20. Sub-total External Debt | | 399.38 |
| 21. Internal Balances | 0% | -15.20 |
| **22. Forecast Debt at 31 March 2015** | **100%** | **384.18** |

## Line

1 – 5 This is a breakdown of the Council's debt at the beginning of the financial year (1 April 2014). 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 2014/15.

15 New PWLB loans to replace debt repaid early.

16 The Money Market borrowing undertaken by the Council during 2014/15.

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 2014/15**

**Public Works Loan Board: Loans Matured during first half of 2014/15**

| Date | Amount £m | Rate % |
|---|---|---|
| 13/07/2014 | 0.500 | 2.35% |
| 31/07/2014 | 0.500 | 2.35% |
| **Total** | **1.000** | |

**Public Works Loan Board: Loans Due to Mature during second half of 2014/15**

| Date | Amount £m | Rate % |
|---|---|---|
| 13/01/2015 | 0.500 | 2.35% |
| 31/01/2015 | 0.500 | 2.35% |
| **Total** | **1.000** | |

**Annex 4**

## Prudential Indicators Monitoring at 30 September 2014

### Authorised and Operational Limit for External Debt

| | |
|---|---|
| Authorised limit for External Debt | £484,000,000 |
| Operational Limit for External Debt | £474,000,000 |
| Capital Financing Requirement for year | £420,249,000 |

| | Actual 30/09/2014 | Forecast 31/03/2015 |
|---|---|---|
| Borrowing | £400,382,618 | £399,382,618 |
| Other Long-Term Liabilities | £40,000,000 | £40,000,000 |
| **Total** | **£440,382,618** | **£439,382,618** |

### Fixed Interest Rate Exposure

| | |
|---|---|
| Fixed Interest Net Borrowing limit | 150.00% |
| Actual at 30 September 2014 | 100.41% |

### Variable Interest Rate Exposure

| | |
|---|---|
| Variable Interest Net Borrowing limit | 25.00% |
| Actual at 30 September 2014 | -0.41% |

### Sums Invested over 365 days

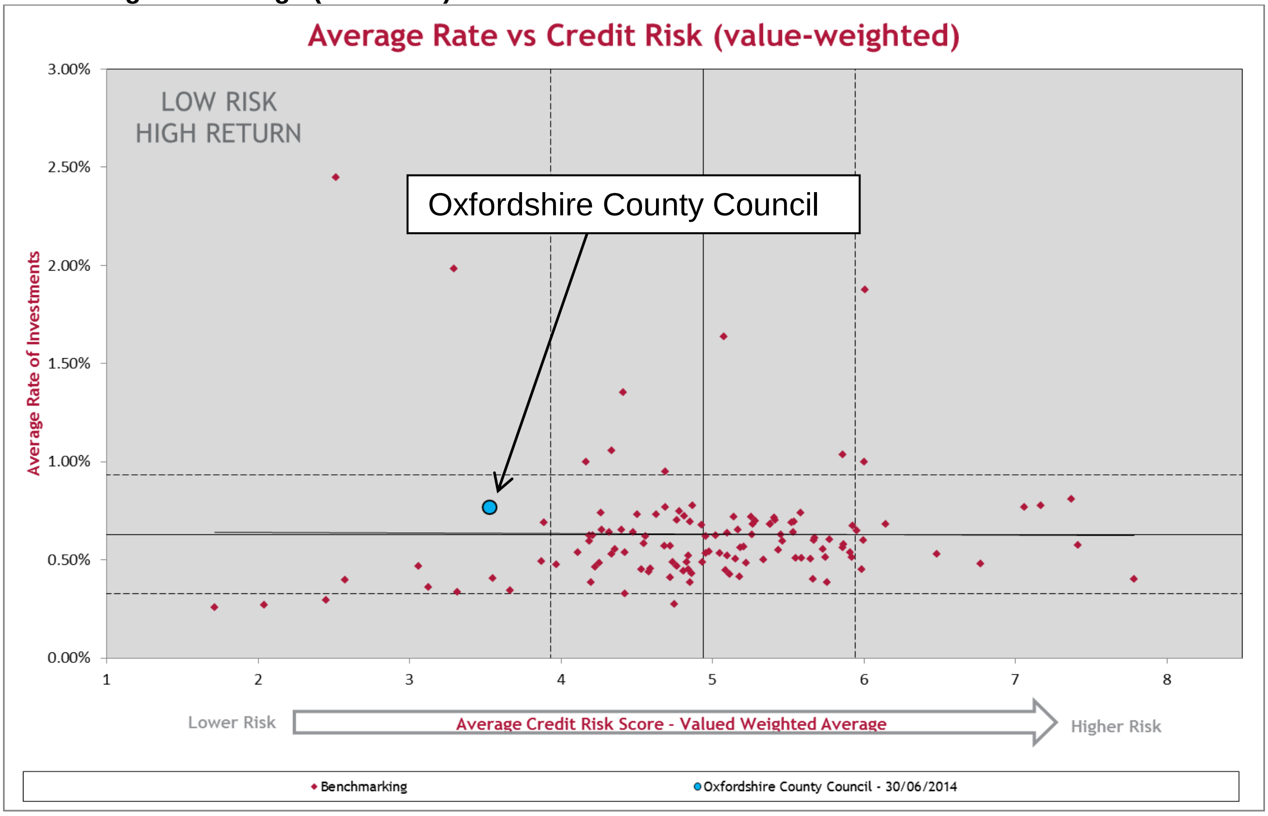
| | |
|---|---|
| Total sums invested for more than 364 days limit | £150,000,000 |
| Actual sums invested for more than 364 days | £ 50,000,000 |

### Maturity Structure of Borrowing

| | Limit % | Actual % |
|---|---|---|
| Under 12 months | 0 - 20 | 4.00 |
| 12 – 24 months | 0 - 25 | 4.00 |
| 24 months – 5 years | 0 - 35 | 17.48 |
| 5 years to 10 years | 5 - 40 | 13.48 |
| 10 years + | 50 - 95 | 61.04 |

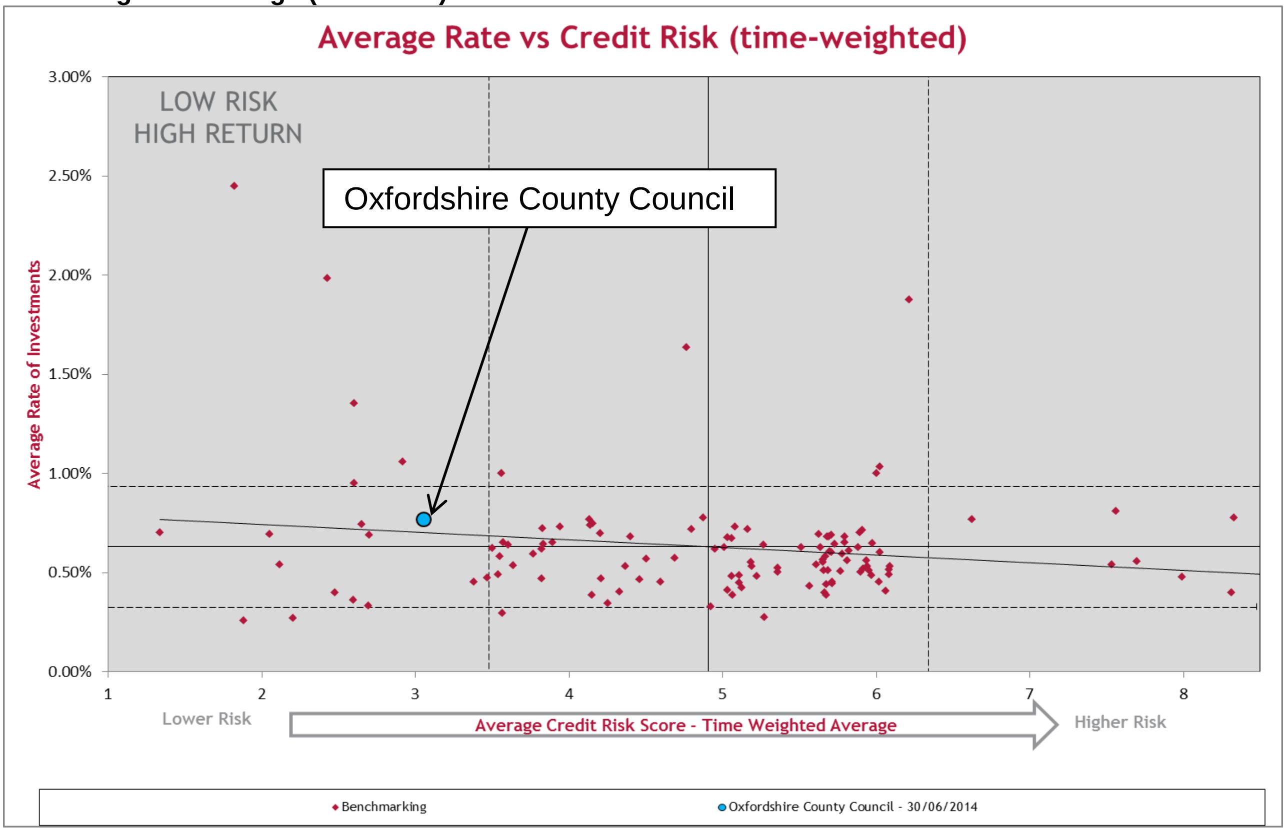
**Annex 5**

**Value weighted average (all clients)**



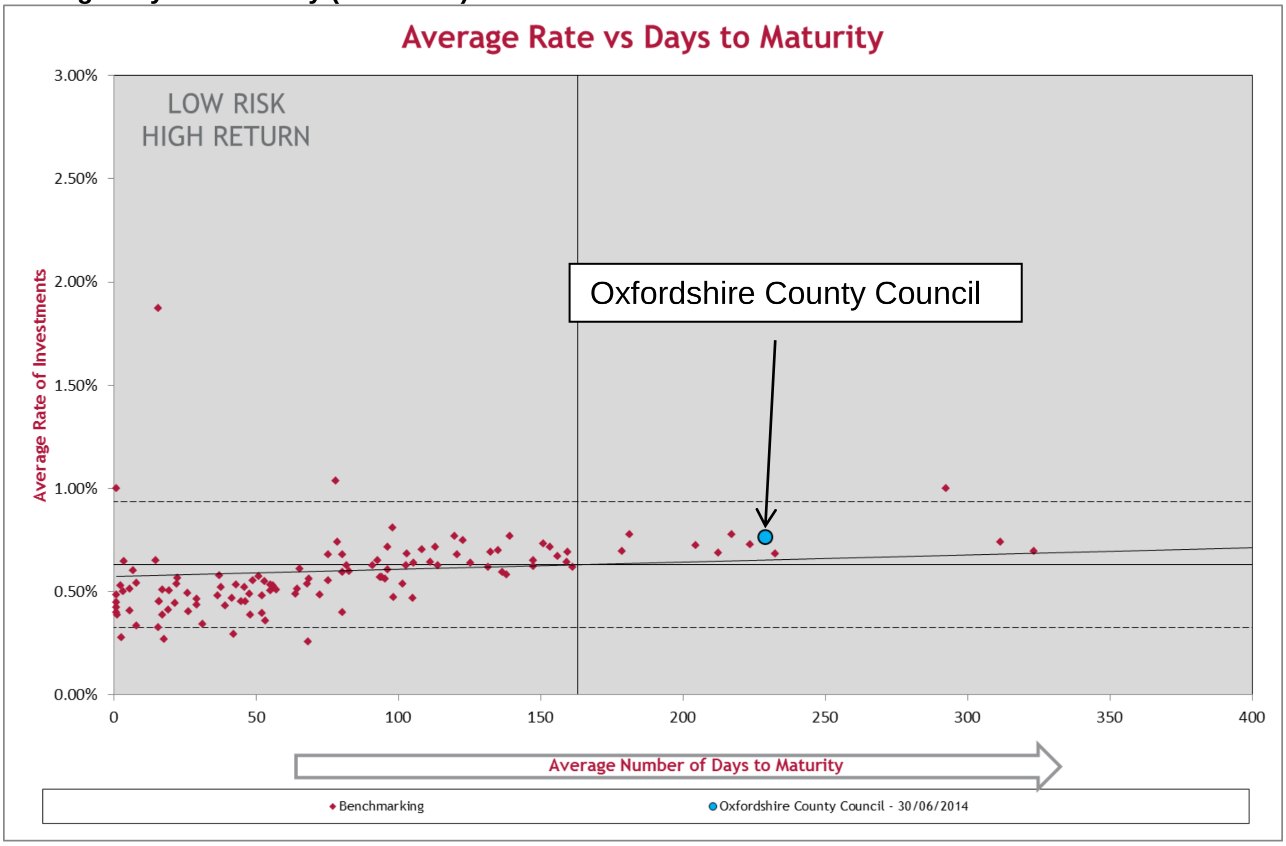

This graph shows that, at 30 June 2014, Oxfordshire achieved a higher than average return for lower than average credit risk, weighted by deposit size.

**Time weighted Average (all clients)**




This graph shows that, at 30 June 2014, Oxfordshire achieved higher than average return for lower than average credit risk, weighted by duration.

**Average Days to Maturity (all clients)**




This graph shows that, at 30 June 2014, Oxfordshire achieved a higher than average return by placing deposits for longer than average duration.