Decision No 2014/43

REPORT TO:	**POLICE AND CRIME COMMISSIONER FOR LANCASHIRE**
REPORT BY:	**LISA KITTO, CHIEF FINANCE OFFICER**
DATE:	**20 NOVEMBER 2014**
TITLE:	**TREASURY MANAGEMENT MID YEAR REPORT 2014/15**

Appendix A refers

EXECUTIVE SUMMARY

In accordance with the updated CIPFA Treasury Management code of practice (2011) and to strengthen members' oversight of the PCC's treasury management activities, the PCC will receive updates on treasury management issues including a mid-year report. This report provides information on treasury management activity that has been undertaken in the current financial year and reports on the overall performance against the agreed strategy and prudential indicators.

RECOMMENDATION

The Police and Crime Commissioner is asked to note the report.

Decision taken by the Police and Crime Commissioner for Lancashire:

Original decision, as set out in the attached report, approved without amendment (please delete as appropriate)	**YES**	**NO**

Original decision required to be amended and decision as detailed below:

The reasons for the amended decision are as detailed below:

Police and Crime Commissioner: Comments

DECLARATIONS OF INTEREST

The PCC is asked to consider any personal / prejudicial interests he may have to disclose in relation to the matter under consideration in accordance with the law, the Nolan Principles and the Code of Conduct.

STATEMENT OF COMPLIANCE

The recommendations are made further to legal advice from the Monitoring Officer and the Section 151 Officer has confirmed that they do not incur unlawful expenditure. They are also compliant with equality legislation.

Signed: **Police and Crime Commissioner** **Date:**	**Signed:** **Chief Officer:** **Date:**

Signed: **Chief Constable** **Date:**	**Signed:** **Chief Finance Officer:** **Date:**

Appendix A

POLICE & CRIME COMMISSIONER FOR LANCASHIRE

REVIEW OF TREASURY MANAGEMENT 2014/15 Mid Year Report

Issue for Consideration

In accordance with the updated CIPFA Treasury Management code of practice (2011) and to strengthen members' oversight of the Commissioner's treasury management activities, the Police Commissioner receives regular updates on treasury management issues including a mid-year report. Reports on treasury activity are discussed on a quarterly basis with the Chief Finance Officer for PCC and the content of these reports is used as a basis for this report to the Commissioner.

Economic Overview

UK Monetary Policy: The MPC has made no change to the Bank Rate of 0.5% and maintained asset purchases at £375bn during this period. 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 Governor Mark Carney warned that interest rates might rise sooner than financial markets were expecting. The minutes of the MPC's June meeting outlined the Bank's central view that whilst wage growth and inflation had been weak, economic activity had been stronger than expected and the policy decision had therefore become more 'balanced' for some members on the Committee than earlier in the year.

Growth: The recent strong performance of the UK economy continued with GDP growing at an average rate of 0.8% per quarter since the middle of 2013. Whilst still largely driven by household consumption, business investment is recovering, albeit from a very low base, and should support the continued expansion of GDP throughout the year.

Unemployment: The labour market continued to improve, with job growth strong and the headline unemployment rate falling to 6.6%. However, earnings growth continues to deteriorate with an annual decline of -0.2% in June. Employment growth is masking extensive spare capacity with self- employment and a large number on zero-hour contracts and working part-time involuntarily, underemployment is still a significant factor within the workforce.

Inflation: CPI inflation for May fell to 1.5% year-on-year from 1.8% which was lower than market expectations. Even though inflation was expected to tick marginally higher in coming months, it was still expected to remain just below the Bank's 2% target.

The Bank's Financial Policy Committee also announced a range of measures to cool the UK's housing market to avert the potential of spiralling house prices derailing a sustainable economic recovery. Key recommendations included lenders stress-testing 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

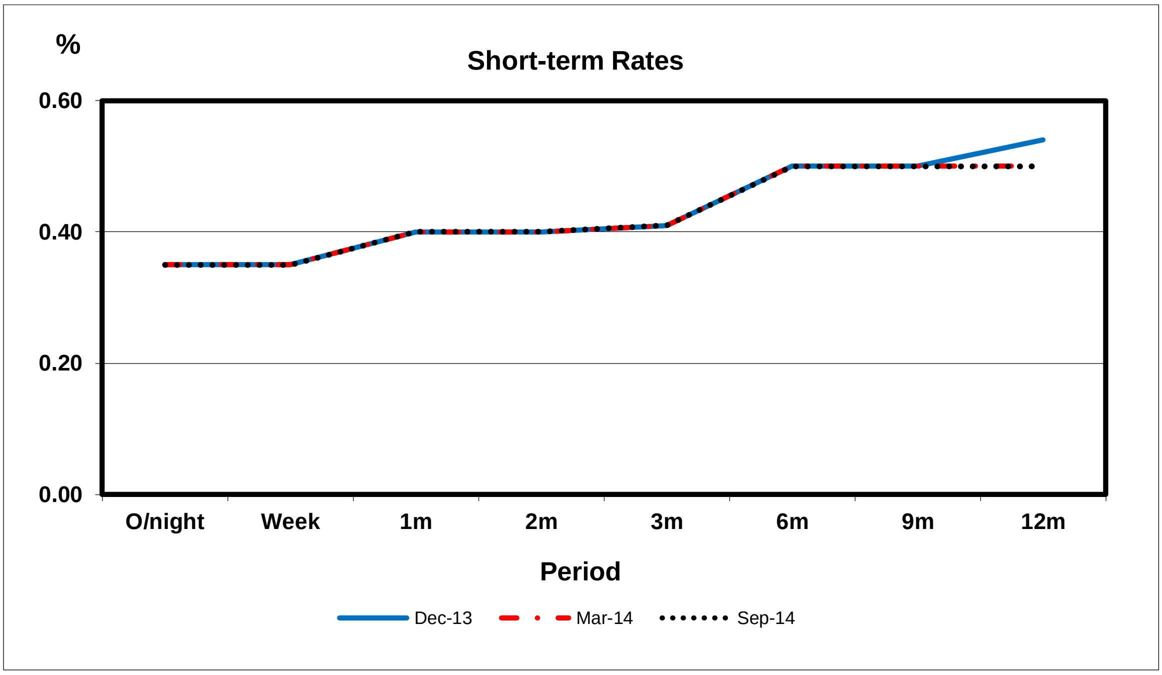
4.5 times their income. The Prudential Regulation Authority also announced that it intends to consult on capital requirements for mortgages.

Against a darkening economic background in Europe in June and again in September the European Central Bank announced interest rate cuts along with a raft of non-conventional measures to head off the growing threat of deflation in the Eurozone. The ECB cut main policy rates (refinancing rate) from 0.25%in May to 0.05% by the beginning of September to encourage banks to lend to businesses and generate economic growth, it also cut the deposit rate to -0.20% which in effect means that commercial banks must pay for the privilege of depositing their funds at the central bank.

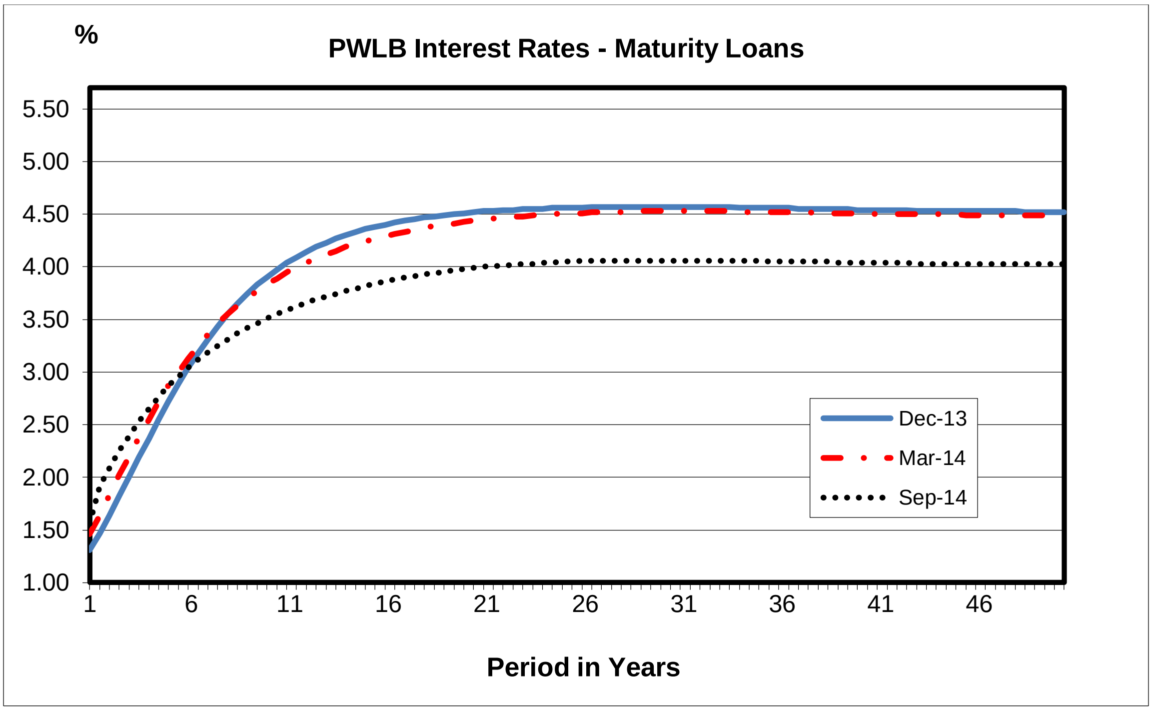
There was no change from the US Federal Reserve as the central bank kept policy on its current track with a reduction in asset purchases by $10 billion to $35 billion per month. The sharp downward revision to US GDP in Q1 to -2.9% annualised was strongly influenced by severe weather deterring consumers from going out and spending. GDP in Q2 of 2014 is expected to rebound, taking the annual average rate of growth over the last four quarters ending in Q2 to a more sustainable level of 2%.

Interest Rate Environment

Short term interest rates continue at the very low levels since the Bank of England reduced base rate to 0.5% in March 2009. The chart below shows that there has been very little movement in short term interest rates over the first three quarters of the calendar year.



Current longer term PWLB rates are shown below.



Following a period where central bank liquidity injections, the abatement of the euro crisis and the economic recovery has seen a reduction in demand for safe haven assets including UK Government gilts, towards the end of the period geopolitical factors weighed heavily on gilt yields and consequently in Public Works Loan Board interest rates, with a noticeable flattening of the curve in the medium term.

Outlook for Interest Rates

Treasury Consultants Arlingclose Ltd forecast the first rise in official interest rates in Q3 2015, which is earlier than general market sentiment. There is clear momentum in the economy, but inflation is benign and currently sits below target. This situation is expected to persist for some time, reducing the need for immediate monetary tightening.

Arlingclose project Gilt yields to climb on an upward path through the medium term as the recovery takes hold, notwithstanding temporary volatility due to the UK General Election and other geo-political events.

Period	Bank Rate	3 month LIBID	12 month LIBID	20-year Gilt Rate
Q3 2014	0.50	0.50	0.90	3.00
Q4 2014	0.50	0.55	0.95	3.20

Q1 2015	0.50	0.60	1.00	3.40
Q2 2015	0.50	0.65	1.05	3.55
Q3 2015	0.75	0.85	1.20	3.65
Q4 2015	0.75	1.00	1.35	3.70
Q1 2016	1.00	1.15	1.45	3.75
Q2 2016	1.00	1.25	1.55	3.80
Q3 2016	1.25	1.40	1.65	3.85
Q4 2016	1.25	1.50	1.70	3.90
Q1 2017	1.50	1.65	1.80	3.95
Q2 2017	1.50	1.70	1.90	3.95

Borrowing

Since 2008-09 the Police & Crime Commissioner for Lancashire cash investments have been in excess of the borrowing requirement and so to avoid excess borrowing and in order to reduce credit rate risk, balances have been used to fund capital programme expenditure and no borrowing has been taken over this period.

	2013-14	**2014-15**	**2015-16**
	Actual	**Estimate**	**Estimate**
	£m	**£m**	**£m**
Capital Programme Borrowing	0	0.600	12.325
Borrowing requirement b/fwd from previous year	20.639	20.273	20.562
Maturing Debt	1.000	1.000	0.500
Less Statutory MRP (PWLB only @ 4%)	-1.366	-1.311	-1.283
Total Borrowing Requirement	**20.273**	**20.562**	**32.104**

The borrowing requirement represents capital expenditure which has not yet been financed by from any external source. It is currently financed internally to the organisation by borrowing from balances. At present the Commissioner's balances are sufficient to cover this internal borrowing and as investment interest rates are at historically low levels internal borrowing is more cost effective than traditional external borrowing from the Public Works Loan Board (PWLB).

All of PCC's borrowing is currently from the Public Works Loan Board. Following a scheduled debt repayment in 2014 the current long term debt outstanding is £20.154m. The next scheduled repayment is in March 2015 when outstanding debt will fall to £19.154m.

	2013-14	**2014-15**	**2015-16**
	Actual	**Estimate**	**Estimate**
	£m	**£m**	**£m**
Total Debt Outstanding	**21.154**	**20.154**	**19.154**
In year debt repayment	-1.000	-1.000	-0.500

New Borrowing	-	-	-
Total Debt Outstanding	**20.154**	**19.154**	**18.654**

It is possible to repay debt early, but the PWLB will charge a premium for early repayment loss of interest.

The Chief Finance Officer reviews debt restructuring opportunities on a regular basis. A review conducted in October 2014 found that given the relatively favourable interest rates at which these have been taken out (below 5%) and the penalties associated with any early repayment it is not considered financially viable to do so at the present time. The Chief Finance Officer will continue to monitor the internal borrowing strategy in the light of economic and interest rate forecasts.

Investments

For a number of years following the financial crisis of 2008, in order to reduce credit risk to the Authority, Lancashire County Council (credit rating by Moodys AA2) was the counterparty for all of the Authority's investments. However this counterparty list was expanded for in the 2014/15 treasury management strategy to include other high quality counterparties.

Both the CIPFA Code and the CLG Guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Authority’s objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk receiving unsuitably low investment income.

The re-addition of the other counterparties into the investment policy is intended to improve investment returns whilst retaining the very high credit quality of the portfolio.
Until recently investment rates for shorter than one year were below the PCC current call account rate of 0.7% and therefore the full amount of the PCC balances were held within the call account.

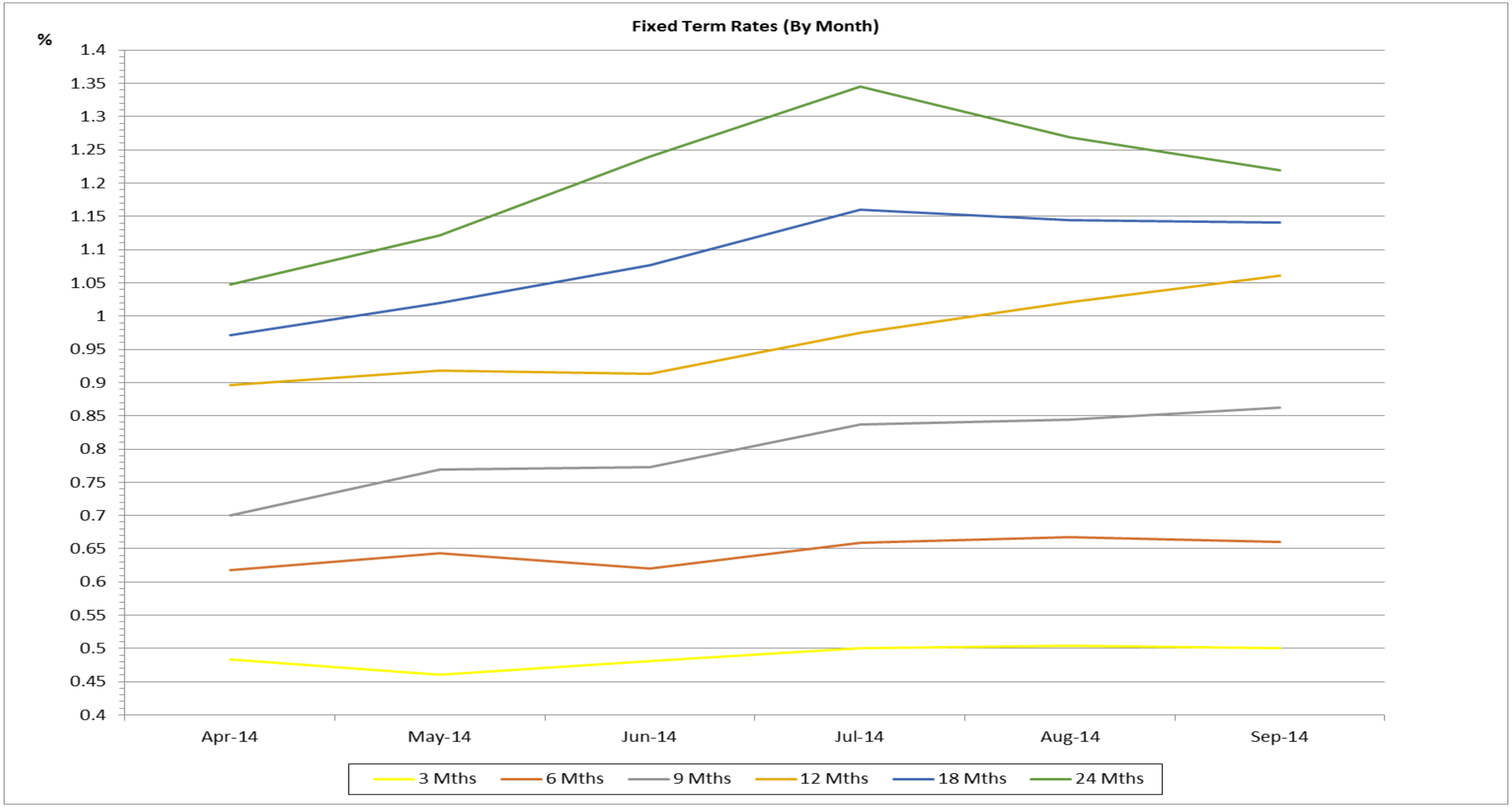
However given the current level of balances and capital forecast expenditure profiles it is considered that a proportion of balances could be invested for a longer period and so increase the amount of interest which will accrue to the Commissioner's revenue account.

Therefore the following fixed deposit has been placed with another UK local authority:

Start Date	End Date	Principal	Rate	Annual Interest	Interest 2014/15
22/10/14	23/10/17	£5,000,000	1.50%	£75,000	£32,877

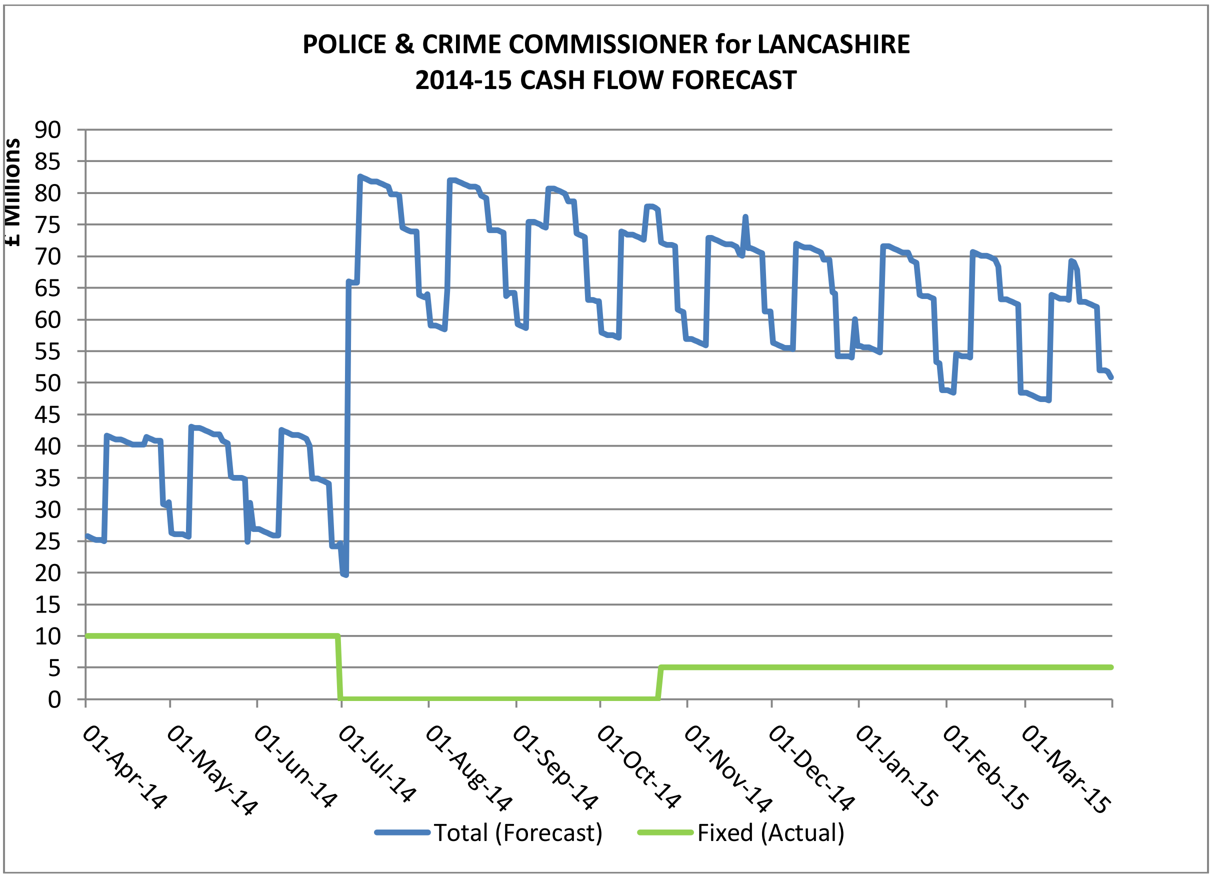
The overall combined amount of interest earned on fixed and call balances as at 31st October 2014 is £209k on an average balance of £51m at an average rate of 0.71%. The current interest rate is 0.70% but this still compares favourably with the benchmark 7 day notice index which averages 0.43% over the same period.

The chart below shows the current interest rates for investment maturities with tenors between 3 months and 2 years. Until recently all rates from 12 months and shorter were below PCC for Lancashire's call rate, currently 0.70%.



Cash Flow

The estimated cash flow totals are as follows:



This graph shows the total cash level held by the Authority. There is a regular pattern as cash is bolstered by precept receipts each month followed by falls as expenditure is incurred. The large cash injection from the low point at the beginning of July is the pensions top up grant. The green line shows how much of the Authority's cash is placed on fixed deposit to earn additional interest. At present opportunities are being sought to place a further £5m deposit to bring the total fixed balance up to £10m.

Prudential Indicators

In order to control and monitor PCC's treasury management functions, a number of prudential indicators are determined against which performance may be measured. The indicators for 2014/15 are shown in the table below alongside the current actual and none of the indicators have been breached over the period.

	2014-15 PIs	**Actual to Date**
Adoption of the CIPFA Code of Practice for Treasury Management	Adopted	Adopted
Authorised limit for external debt	£000	£000
A prudent estimate of total external debt, which does not reflect the worst case scenario, but allows sufficient headroom for unusual cash movements		
Borrowing	46.000	20.154
Other long-term liabilities	1.000	-
Total	47.000	20.154
Operational boundary for external debt		
A prudent estimate of debt, but no provision for unusual cash movements. It represents the estimated maximum external debt arising as a consequence of the Authority's current plans		
Borrowing	43.000	20.154
Other long-term liabilities	1.000	-
Total	44.000	20.154

	2014-15 PIs	**Actual to Date**
Upper limit for fixed interest rate exposure		
Borrowing	100%	100%
Investments	100%	10%
Upper limit for variable rate exposure		
Borrowing	75%	0%
Investments	100%	90%
Upper limit for total principal sums invested for over 364 days (per maturity date)	75%	Nil
Maturity structure of debt	**Upper/ Lower Limits**	**Actual**
Under 12 months	50% / nil	4.96%
12 months and within 24 months	50% / nil	2.48%
24 months and within 5 years	50% / nil	13.40%
5 years and within 10 years	80% / nil	21.11%
10 years and above	90% / 25%	58.05%

Icelandic Banks

At the time the Icelandic banks collapsed in October 2008, the County Council had an investment of £10.0m with Landsbanki. Under the treasury management strategy in operation at that time, the Police Authority's share of the deposit with Landsbanki was £0.668m.

Since then 4 distributions have been received, the most recent on 12th September 2013. These distributions total £355,441 and whilst the reminder of the balance is expected at some point in the future, the timing and amounts of future distributions is not known at this stage.

The PCC Chief Financial Officer closely monitors developments in the bank's winding up activities and the progression of the Commissioner's priority creditor claim through the administration process, although it has not always possible to report immediately on all aspects of the process, because often information is held under legal privilege. At the present time however, the legal representatives which have acted for all the UK local authorities throughout the winding up process are recommending that the Authorities should consider selling their claims at current market price estimated to be between 91.5 and 92.5 pence in the pound which would generate between £286k and £290k against the current outstanding liability of £313k

The reasons for this are:

- The Winding Up Board (WUB) is currently unable to make distributions to priority creditors without the approval of the Central Bank of Iceland (**CBI**). The CBI has not approved any exemption requests filed by the WUB since the first (of three) exemption requests were filed in May 2013. The prospect of this position changing remains weak.

- The extent and timing of future recoveries depends to a significant degree on the revised bond terms agreed between LBI and Landsbankinn (**LB**, the "new" bank) coming into effect. That agreement is conditional on the CBI approving certain exemptions from the capital controls filed by the WUB so that distributions can be made to priority creditors. Those exemptions have not yet been approved and, although LBI and LB have recently agreed an extension to 30 September 2014 for the CBI to approve those exemptions, approval cannot be guaranteed.

- The CBI has publicly stated that it intends to find a "holistic" solution which will resolve the current issues relating to the winding-up of LBI (specifically LBI's inability to meet its obligations under the current bond terms) and the proposed compositions in Glitnir and Kaupthing, whilst not disrupting Iceland's financial stability or the CBI's plans to relax the capital controls.
  Various commentators in Iceland have suggested that this is likely to involve one or more of: (a) a tax on the assets of the LBI estate (or an exit tax on those selling claims); (b) a forced reduction in the value of LBI's assets; and (c) bankruptcy of LBI (and possible "fire sale" of its assets) – all of which are very likely to reduce recoveries for priority creditors. The fact that the CBI is

stalling on the capital control exemption approvals may ultimately result in LBI being dragged into that holistic solution.

- If other priority creditors of LBI sold their claims this would reduce the influence that the remaining (original) priority creditors have over the WUB (and the CBI). Further, the interests of those entities that purchase priority claims are unlikely to align with the interests of the original authorities.

- Although the governor of the CBI has been re-appointed for a further five year term, he may only remain in the role until the end of the year. This would create further uncertainty around the CBI's objectives and its intended "holistic" solution. The governor's impartibility is also questionable as his role in resolving the economic issues facing Iceland is inevitably linked to the political will of the governing party.

- The approach among Iceland politicians to foreign creditors has hardened in recent months with some calling for measures that would have a detrimental effect on recoveries to priority creditors.

Negotiations are ongoing to facilitate the sale of the claim but at this stage further information is held under legal privilege for commercial reasons. Further information will be provided as and when it becomes available and recommendations will be made to the Commissioner for consideration.

Human Resource Implications
None

Financial Implications
The financial implications are set out in the report.

Business Risk Implications

The Treasury Management strategy is designed to minimise the PCC for Lancashire's financial risk associated with investment decisions, whilst maximising the return on any investments made. As such the adoption of the CIPFA’s Code of Practice on Treasury Management and the monitoring arrangements in place ensure that any risks faced by PCC are managed.

However, it must be acknowledged that there will always be a balance between risk and return and hence the strategy does not completely eliminate the risk of any further default on investments in the future.

Decision Required
The Police and Crime commissioner is asked to note the report

Background Papers

I. CIPFA Treasury Management Code of Practice (2011)
II. PCC for Lancashire Treasury Management Strategy 2014/15

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