Report to: AUDIT COMMITTEE

Date of meeting: 7 December 2016

Report of: Sunjiv Seetul – Finance Manager and Loretta Manhertz – Finance Officer

Title: Treasury Management Update

1.0 SUMMARY

1.1 This report gives details of the 2016/17 Mid-Year Review of the Treasury Management function.

2.0 RECOMMENDATION

2.1 That members note the contents of the 2016/17 Mid-Year Review of the Treasury Management function.

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Report approved by: Bob Watson, Head of Finance, Shared Services

3.0 Introduction and Background

3.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management as: "The management of the local authority'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".

3.2 The Council's 2016/17 Treasury Management Strategy (TMS) as approved by Council on 28 January 2015 is designed to ensure that cash flows are adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity before considering optimising investment return.

3.3 This report considers the UK economy and updates members with the progress on whether the Council is meeting the TMS and the policies contained therein for the first 6 months of 2016/17.

4.0 Economic Update

4.1 **UK**. UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were strong but 2015 was disappointing at 1.8%, though it still remained one of the leading rates among the G7 countries. Growth improved in quarter 4 of 2015 from +0.4% to 0.7% but fell back to +0.4% (2.0% y/y) in quarter 1 of 2016 before bouncing back again to +0.7% (2.1% y/y) in quarter 2. During most of 2015, the economy had faced headwinds for exporters from the appreciation during the year of sterling against the Euro, and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme.

4.2 The referendum vote for Brexit in June this year delivered an immediate shock fall in confidence indicators and business surveys, pointing to an impending sharp slowdown in the economy. However, subsequent surveys have shown a sharp recovery in confidence and business surveys, though it is generally expected that although the economy will now avoid flat lining, growth will be weak through the second half of 2016 and in 2017. The Bank of England meeting on August 4th addressed this expected slowdown in growth by a package of measures including a cut in Bank Rate from 0.50% to 0.25%. The Inflation Report included an unchanged forecast for growth for 2016 of 2.0% but cut the forecast for 2017 from 2.3% to just 0.8%.

4.3 The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting and suggested that the Government will need to help growth by increasing investment expenditure and possibly by using fiscal policy tools (taxation). The new Chancellor Phillip Hammond announced after the referendum result, that the target of achieving a budget surplus in 2020 will be eased in the Autumn Statement on November 23.

4.4 The Inflation Report also included a sharp rise in the forecast for inflation to around 2.4% in 2018 and 2019. CPI has started rising during 2016 as the falls in the price of oil and food twelve months ago fall out of the calculation during the year and, in addition, the post referendum 10% fall in the value of sterling on a trade weighted basis is likely to result in a 3% increase in CPI over a time period of 3-4 years. However, the MPC is expected to look thorough a one off upward blip from this devaluation of sterling in order to support economic growth, especially if pay increases continue to remain subdued and therefore pose little danger of stoking core inflationary price pressures within the UK economy.

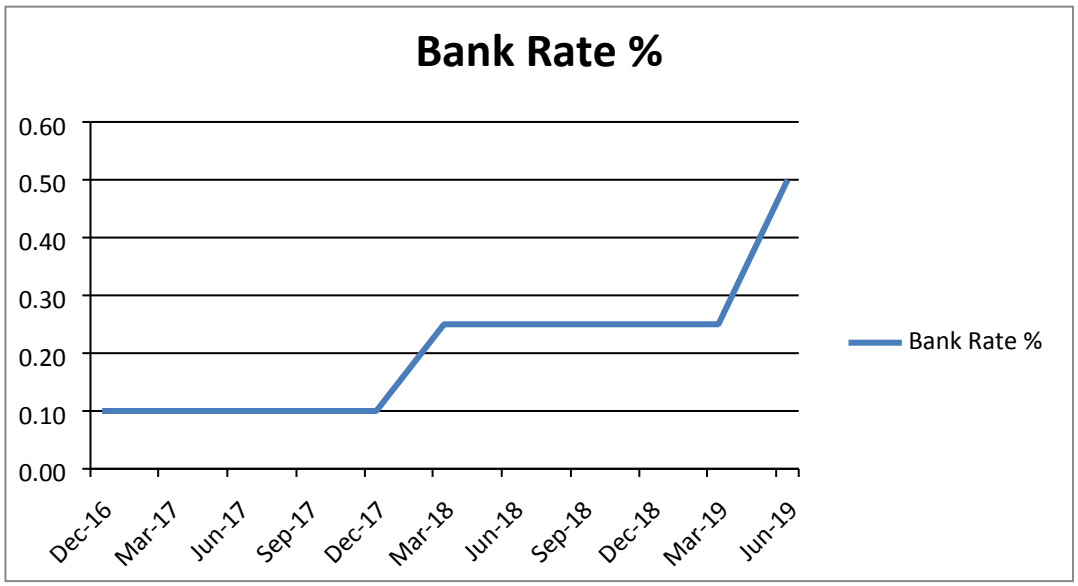
4.5 **USA**. The American economy had a patchy 2015 with sharp swings in the growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 disappointed at +0.8% on an annualised basis while quarter 2 improved, but only to a lacklustre +1.4%. However, forward indicators are pointing towards a pickup in growth in the rest of 2016. The Fed embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December this year.

4.6 **EZ**. In the Eurozone, the ECB commenced in March 2015 its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month; this was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise from around zero towards the target of 2%. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) but slowed to +0.3% (+1.6% y/y) in quarter 2. This has added to comments from many forecasters that central banks around the world are running out of ammunition to stimulate economic growth and to boost inflation. They stress that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand in the their economies and economic growth.

4.7 **Japan**. Japan is still bogged down in anaemic growth and making little progress on fundamental reform of the economy while Chinese economic growth has been weakening and medium term risks have been increasing.

Interest rate forecasts

4.8 The Council's treasury advisor, Capita Asset Services, have provided the following interest rate forecasts and commentary:



4.9 Capita Asset Services undertook a quarterly review of its interest rate forecasts after the MPC meeting of 4th August cut Bank Rate to 0.25% and gave forward guidance that it expected to cut Bank Rate again to near zero before the year end. The above forecast therefore includes a further cut to 0.10% in November this year and a first increase in May 2018, to 0.25%, but no further increase to 0.50% until a year later. Mark Carney has repeatedly stated that increases in Bank Rate will be slow and gradual after they do start. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when the growth in average disposable income is still weak and could well turn negative when inflation rises during the next two years to exceed average pay increases.

5.0 **Property Investment Fund**

5.1 The Council is keen to increase its diversification of its treasury activities by direct property investment overseen by its Property Investment Board (PIB), which oversees all property related investments. Since inception the PIB has made a point of rationalising the Council's property assets and re-invested in less-management intensive and better yielding property assets.

5.2 The Council has no investments in pooled property funds.

6.0 **Investment Portfolio**

6.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. Indeed, the Funding for Lending scheme has reduced market investment rates even further. The potential for a prolonging of the Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

6.2 The Council held £38.99m of investments as at 30 September 2016 (See table below). This information is reported in the monthly Members Information Bulletin.

Institution	Principal (£)
Clydesdale	2,990,000
Lloyds Bank plc	6,000,000
Santander Uk	5,000,000
Total Banks	***13,990,000***
Coventry Building Society	2,000,000
Nationwide Building society	9,000,000
Principality Building Society	8,000,000
Skipton Building Society	6,000,000
Total Building Societies	***25,000,000***
Total	***38,990,000***

6.3 The approved limits within the Annual Investment Strategy were not breached during the first six months of 2016/17.

Clydesdale Bank plc

6.4 The investment with Clydesdale is a long-standing investment made in April 2010. The Council placed funds with Clydesdale to support local businesses. When the Bank's credit rating was downgraded and it no longer met the criteria as outlined within the Treasury Management Strategy, its continuing use as counterparty has been approved by Leadership Team.

Security

6.5 The Council's maximum security risk benchmark for the current portfolio was set as 0.01% risk of default when compared to the whole portfolio.

6.6 The benchmarks are an average risk of default measure, and would not constitute an expectation of loss against a particular investment. The benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members. As this data is collated, trends and analysis will be collected and reported. Where counterparty is not credit rated a proxy rating will be applied.

6.7 In line with the TMS, the Council has managed to invest with those institutions who offered the best rate and the investment portfolio is above the overall benchmark during the year to date.

Liquidity

6.8 The Council set liquidity facilities/benchmarks to maintain:

- A zero bank overdraft
- The benefit of instant access to its funds on the general account with Lloyds.

6.9 The liquidity arrangements were adequate during the year to date.

Yield

6.10 The budget for interest earned on investments for 2016/17 is £220,000; interest received up to the end of September was £176,300.

6.11 The approved benchmark measure of yield is a return of 0.12% above the average bank rate of 0.50%. The returns up to 30 September 2016 averaged 0.67%, against a benchmark rate of 0.58%.

6.12 The average yield return was higher than the benchmark for the year to date.

Table of Monthly Interest Rates to Date:

Month	Rate Achieved
Apr-16	0.67%
May-16	0.66%
Jun-16	0.67%
Jul-16	0.66%
Aug-16	0.68%
Sep-16	0.66%

6.13 The Council keeps all investments short term. There are no sums invested for greater than 364 days. Counterparties have been downgraded over the past few years; most investments have been limited to a 6 months period. This has resulted in lower interest rates being achieved.

6.14 The current investment counterparty criteria selection approved in the TMS is being met.

Credit Ratings

6.15 Fitch and Moody provide the Council with credit ratings for financial institutions.

6.16 The Council keeps all investment short term. There are no sums invested for greater than 364 days. Counterparties have been downgraded over the past few years; most investments have been limited to a 6 month period. This has resulted in lower interest rates being achieved.

6.17 The current investment counterparty criteria selection approved in the Treasury Management Strategy is being met.

7.0 External Borrowing

7.1 The Council's capital financing requirement (CFR) as at 31 March 2017 is estimated to be £2.4 million. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.

7.2 Consistent with the strategy, no new borrowing has been undertaken during the first half of 2016/17. The current borrowing levels and maturity profile are set out in the table and graph below.

Prudential Indicator	2016/17 Original Estimate	Current Borrowing Position	2016/17 Revised Estimate
Capital Financing Requirement	£2.5m	£2.4m	£2.4m
External Debt / the Operational boundary			
Borrowing	£15m	£15m	£15m

Treasury Management Indicators

7.3 The Authorised Limit

This PI, which is required to be set and revised by Members, controls the overall level of borrowing and represents the limit beyond which borrowing is prohibited. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised Limit For External Debt	2016/17 Original Indicator	Current Borrowing Position	2016/17 Revised Indicator
Borrowing	£20m	£7.5m	£20m

7.4 **Actual External Debt**

This is the closing balance for actual gross borrowing obtained directly from the council's Balance Sheet at year end. There has been no change in external borrowing. The council has complied with this prudential indicator at mid-year and does not envisage difficulties for the future.

8.0 **Financial Implications**

8.1 As continued in the body of the report

9.0 **Legal Issues (Monitoring Officer)**

9.1 There is no requirement to make any amendments to the Treasury Management Strategy at this stage

10.0 **Equalities**

10.1 None.

11.0 **Potential Risks.**

11.1 There are no risks associated with the decision members are being asked to make, i.e. to note this report.

Background Papers:

Treasury Management Strategy 2016/17;
UK Economic Forecasts provided by Capita Asset Services;

Data source: Logotech Treasury Management system