TREASURY MANAGEMENT MID-YEAR UPDATE

Cabinet – 3 December 2015

Report of the:	Chief Finance Officer
Status:	For Consideration
Also considered by:	Finance Advisory Committee – 17 November 2015
Key Decision:	No

Executive Summary: This report gives details of treasury activity in the first half of the current financial year, recent developments in the financial markets and fulfils the reporting requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management.

This report supports the Key Aim of Effective Management of Council Resources.

Portfolio Holder Cllr. Searles

Contact Officer Roy Parsons, Principal Accountant - Ext 7204

Recommendation to Finance Advisory Committee: That Cabinet be asked to approve the Treasury Management Mid-Year Update for 2015/16, including the changes to the credit methodology whereby viability, financial strength and support ratings will not be considered as key criteria in the choice of creditworthy investment counterparties.

Recommendation to Cabinet: That the Treasury Management Mid-Year Update for 2015/16 be approved, including the changes to the credit methodology whereby viability, financial strength and support ratings will not be considered as key criteria in the choice of creditworthy investment counterparties.

Reason for recommendation: As required by both the Council's Financial Procedure Rules and the CIPFA Code, a mid-year report of treasury management activity is to be presented to Members for approval.

Background

1 The Council is required through regulations issued under the Local Government Act 2003 to produce an annual Treasury Management Strategy Statement, which includes the Annual Investment Strategy and Minimum Revenue Provision Policy, for the year ahead, a mid-year review report and an annual report covering activities during the previous year.

2 During 2015/16 the minimum reporting requirements are that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 17/2/2015).
- a mid year treasury update report (this report).
- an annual report following the year describing the activity compared to the strategy.

3 In addition, monthly reports from our treasury management advisors, Capita Asset Services, are emailed to Members of the Finance Advisory Committee.

Introduction

4 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

5 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

6 Accordingly, treasury management is defined 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."

7 This mid-year update report, prepared in compliance with CIPFA's Code of Practice on Treasury Management, covers:

(a) Changes in credit rating methodology;

(b) an economic update for the 2015/16 financial year to 30 September 2015;

(c) interest rate forecasts;

(d) a review of the Treasury Management Strategy Statement and Annual Investment Strategy; and

(e) a review of the Council's investment portfolio for 2015/16.

Changes in credit rating methodology

8 The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis that occurred in 2008, provided some institutions with

a ratings "uplift" due to implied levels of sovereign support. Commencing in 2015, in response to the evolving regulatory regime, all three agencies have begun removing these "uplifts" with the timing of the process determined by regulatory progress at the national level. The process has been part of a wider reassessment of methodologies by each of the rating agencies. In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A consequence of these new methodologies is that they have also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

9 In keeping with the agencies' new methodologies, the credit element of our treasury advisor's credit assessment process now focuses solely on the Short and Long Term ratings of an institution. Whilst this is the same process that has always been used by Standard & Poor's, this has been a change to the use of Fitch and Moody's ratings. It is important to stress that the other key elements to their process, namely the assessment of Rating Watch and Outlook information as well as the Credit Default Swap (CDS) overlay have not been changed.

10 The evolving regulatory environment, in tandem with the rating agencies' new methodologies also means that sovereign ratings are now of lesser importance in the assessment process. Whereas through the crisis, councils typically assigned the highest sovereign rating to their criteria, the new regulatory environment is attempting to break the link between sovereign support and domestic financial institutions. Whilst this authority understands the changes that have taken place, it will continue to specify a minimum sovereign rating of AA-. This is in relation to the fact that the underlying domestic and where appropriate, international, economic and wider political and social background will still have an influence on the ratings of a financial institution.

11 It is important to stress that these rating agency changes do not reflect any changes in the underlying status or credit quality of the institution, merely a reassessment of their methodologies in light of enacted and future expected changes to the regulatory environment in which financial institutions operate. While some banks have received lower credit ratings as a result of these changes, this does not mean that they are suddenly less credit worthy than they were formerly. Rather, in the majority of cases, this mainly reflects the fact that implied sovereign government support has effectively been withdrawn from banks. They are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In fact, in many cases, the balance sheets of banks are now much more robust than they were before the 2008 financial crisis when they had higher ratings than now. However, this is not universally applicable, leaving some entities with modestly lower ratings than they had through much of the "support" phase of the financial crisis.

Economic Update

United Kingdom

12 UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y). Growth is expected to weaken to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation 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, although the pace of reductions was eased in the May Budget.

13 Despite these headwinds, the Bank of England August Inflation Report had included a forecast for growth to remain around 2.4 – 2.8% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth. However, since the report was issued, the Purchasing Manager's Index, (PMI), for services on 5 October would indicate a further decline in the growth rate to only +0.3% in Q4, which would be the lowest rate since the end of 2012. In addition, worldwide economic statistics and UK consumer and business confidence have distinctly weakened so it would therefore not be a surprise if the next Inflation Report in November were to cut those forecasts in August.

14 The August Bank of England Inflation Report forecast was notably subdued in respect of inflation which was forecast to barely get back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction and Iran expected to soon rejoin the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

15 Therefore, there are considerable risks around whether inflation will rise in the near future as strongly as had previously been expected. This will make it more difficult for the central banks of both the US and the UK to raise rates as soon as was being forecast until recently. This is especially so given the recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets in 2015 so far, which could potentially spill over to impact the real economies rather than just financial markets.

United States

16 The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Federal Reserve could start increasing rates at its meeting on 17 September, or if not by

the end of 2015, the recent downbeat news about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Federal Reserve's decision to pull back from making that start. The non-farm payrolls figures for September and revised August, issued on 2 October, were disappointingly weak and confirmed concerns that US growth is likely to weaken. This has pushed back expectations of a first rate increase from 2015 into 2016.

Eurozone

17 In the Eurozone, the European Central Bank (ECB) fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing (QE) to buy up high credit quality government and other debt of selected Eurozone (EZ) countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

Interest Rate Forecasts

18 The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
5yr PWLB rate	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
50yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%

19 Capita Asset Services undertook its last review of interest rate forecasts on 11 August shortly after the quarterly Bank of England Inflation Report. Later in August, fears around the slowdown in China and Japan caused major volatility in equities and bonds and sparked a flight from equities into safe havens like gilts and so caused Public Works Loan Board (PWLB) rates to fall below the above forecasts for quarter 4 2015. However, there is much volatility in rates as news ebbs and flows in negative or positive ways and news in September in respect of Volkswagen, and other corporates, has compounded downward pressure on equity

prices. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.

20 Despite market turbulence since late August causing a sharp downturn in PWLB rates, the overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

21 The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

22 The disappointing US non-farm payrolls figures and UK PMI services figures at the beginning of October have served to reinforce a trend of increasing concerns that growth is likely to be significantly weaker than had previously been expected. This, therefore, has markedly increased concerns, both in the US and UK, that growth is only being achieved by monetary policy being highly aggressive with central rates at near zero and huge QE in place. In turn, this is also causing an increasing debate as to how realistic it will be for central banks to start on reversing such aggressive monetary policy until such time as strong growth rates are more firmly established and confidence increases that inflation is going to get back to around 2% within a 2-3 year time horizon. Market expectations in October for the first Bank Rate increase have therefore shifted back sharply into the second half of 2016.

23 Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:-

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth turns significantly weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the EZ sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Federal Reserve rate increases, causing a flight to safe havens

24 The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- Uncertainty around the risk of a UK exit from the EU.

- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.

- The commencement by the US Federal Reserve of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.

- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Treasury Management Strategy and Annual Investment Strategy update

25 The Treasury Management Strategy Statement (TMSS) and Prudential Indicators for 2015/16 were approved by the Council on 17 February 2015. There are no policy changes to the TMSS thus far and the details in this report merely update the position in the light of updated economic data.

26 As far as the Council's Prudential Indicators are concerned, three indicators relating to borrowing were reviewed by Cabinet on 16 July 2015 and approved by the Council on 21 July 2015 as a consequence of expanding the Property Investment Strategy. The indicators relating to the Operational Boundary and the Authorised Limit For External Debt were amended, whilst the indicator relating to Treasury Management Limits On Activity was left unchanged for the time being. Other indicators relating to the Council's borrowing need (the Capital Financing Requirement or 'CFR') and the Council's minimum revenue provision (MRP) strategy were highlighted for potential changes once a requirement to borrow had been identified.

Investment Portfolio 2015/16

27 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 described above, 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. The continuing potential for a re-emergence of a 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.

28 The Council held £40.719m of investments as at 30 September 2015 (£37.801m at 31 March 2015) and the investment portfolio yield for the first six months of the year is 0.66% against 7 Day and 3 Month LIBID benchmarks of 0.35% and 0.43% respectively. A full list of investments held as at 30 September 2015 appears in the Appendix.

29 The approved limits within the Annual Investment Strategy were breached twice during the first six months of 2015/16. At the close of business on 8 May 2015, the balance held in the Business Premium Account at Barclays reached £5.3m,

which, together with £2m of fixed deposits, exceeded the £7m limit we had set. At the close of business on 15 September 2015, the balance held in Business Premium Account at Barclays reached £6.1m, which, together with £3m of fixed deposits, again exceeded the £7m limit. Both breaches occurred when treasury management staff were absent and both were corrected on the following day.

30 The Council's budgeted investment return for 2015/16 is £328k and performance for the year to date is £20k below budget. At this stage, the year-end forecast is expected to remain in the region of £20k below budget.

Key Implications

Financial

31 The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority. The security of its capital and liquidity of its investments is of paramount importance.

Legal Implications and Risk Assessment Statement

32 Under Section 151 of the Local Government Act 1972, the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority, including securing effective arrangements for treasury management.

33 This annual review report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009.

34 Treasury management has two main risks :

- Fluctuations in interest rates can result in a reduction in income from investments; and

- A counterparty to which the Council has lent money fails to repay the loan at the required time.

35 Consideration of risk is integral in our approach to treasury management. However, this particular report has no specific risk implications as it is not proposing any new actions, but merely reporting performance over the last six months.

Equality Assessment

36 The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act. There is no perceived impact on end users.

Conclusions

37 The overall return on the Council's investments up to the end of September 2015 is £20k below budget and is forecast to remain at that level by the end of the financial year.

38 The percentage yield on the portfolio is 0.66%, which exceeds the recognised benchmarks.

39 The economic situation both globally and within the Eurozone remains volatile, and this will have consequences for the UK economy. Treasury management in the current and recent financial years has been conducted against this background and with a cautious investment approach.

Appendices:	Investment Portfolio at 30 September 2015
Background Papers:	Treasury Management Strategy for 2015/16 - Council 17 February 2015 Property Investment Strategy – Council 21 July 2015

Adrian Rowbotham
Chief Finance Officer