TREASURY MANAGEMENT MID-YEAR UPDATE 2016/17

Finance Advisory Committee – 15 November 2016

Report of the: Chief Finance Officer

Status: For Consideration

Also considered by: Cabinet – 1 December 2016

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. An update on the Municipal Bonds Agency is also provided.

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:

(a) That Cabinet be asked to approve the Treasury Management Mid-Year Update for 2016/17; and

(b) That Members' views are sought on signing up to the Municipal Bonds Agency's Framework Agreement.

Recommendation to Cabinet:

(a) It be RESOLVED that the Treasury Management Mid-Year Update for 2016/17 be approved; and

(b) Members' decision is sought on signing up to the Municipal Bonds Agency's Framework Agreement and ,if approved, delegated authority is given to the Section 151 Officer and the Monitoring Officer to sign these documents, as appropriate, on behalf of the Council.

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 2016/17 the minimum reporting requirements are that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 16/2/2016).
- 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) an economic update for the 2016/17 financial year to 30 September 2016;

(b) interest rate forecasts;

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

(d) a review of the Council's investment portfolio for 2016/17.

Economic Update

8 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. 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.

9 The Bank of England meeting on 4 August 2016 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%. 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 23 November 2016.

10 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 Bank of England's Monetary Policy Committee (MPC) is expected to look through 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.

11 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 US Federal Reserve (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.

12 In the Eurozone, the European Central Bank (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 Eurozone 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.

13 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

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

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.25%	0.25%	0.25%	0.25%	0.50%
5yr PWLB rate	1.00%	1.00%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.20%	1.30%
10yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%
25yr PWLB rate	2.30%	2.30%	2.40%	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.60%
50yr PWLB rate	2.10%	2.10%	2.20%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%

15 Capita Asset Services undertook a quarterly review of its interest rate forecasts after the MPC meeting of 4 August 2016 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.

16 The overall longer run trend is for gilt yields and Public Works Loan Board (PWLB) rates to rise, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities. However, we have been experiencing exceptional levels of volatility in financial markets which have caused significant swings in PWLB rates. Capita Asset Services' PWLB rate forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1 November 2012.

17 The overall balance of risks to economic recovery in the UK remains to the downside. Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Monetary policy action reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some major developed economies, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
- Weak capitalisation of some European banks.
- A resurgence of the Eurozone sovereign debt crisis.
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and/or Fed rate increases, causing a further flight to safe havens (bonds).
- UK economic growth and increases in inflation are weaker than currently anticipated.
- Weak growth or recession in the UK's main trading partners, the EU and US.

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

- The pace and timing 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

19 The Treasury Management Strategy Statement (TMSS) and Prudential Indicators for 2016/17 were approved by the Council on 16 February 2016. 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.

Investment Portfolio 2016/17

20 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 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis together with other risks which could impact on the creditworthiness of banks, prompts a low risk strategy. Given this risk environment, investment returns are likely to remain low.

21 The Council held £43.331m of investments as at 30 September 2016 (£34.420m at 31 March 2016) and the investment portfolio yield for the first six months of the year is 0.62% against 7 Day and 3 Month LIBID benchmarks of 0.35% and 0.44% respectively. A full list of investments held as at 30 September 2016 appears in Appendix A.

22 The approved limits within the Annual Investment Strategy have been breached just once during the first six months of 2016/17. At the close of business on 15 August 2016, the balance held in the Business Premium Account at Barclays reached £7.2m, which, together with £2m of fixed deposits, exceeded the £7m limit we had set. The breach occurred on the Principal Accountant's first day back from annual leave and was corrected on the following day. Following two similar breaches in 2015/16, as reported to the previous meeting of the Finance Advisory Committee, further measures have been introduced to minimise the risk of this happening in the future.

23 The Council's budgeted investment return for 2016/17 is £277k and performance for the year to date is less than £1k below budget. At this stage, the year-end forecast is expected to remain at, or very slightly below, the budgeted level of £277k.

24 The current investment counterparty criteria approved in the Treasury Management Strategy Statement is currently meeting the requirements of the treasury management function.

Update on the Municipal Bonds Agency (MBA)

25 Members were updated on the latest developments at the last meeting of the Finance Advisory Committee. The relevant paragraphs have been reproduced in Appendix B.

26 At that time Members raised concerns about the joint and several liability clauses in the framework agreement. These concerns have been echoed by our Legal team and also by other authorities looking to sign up to the framework agreement. Whilst the likelihood of a borrowing authority defaulting on its loan is extremely unlikely, the risk is still there. The MBA has produced a draft report for authorities' use when seeking to approve for the framework agreement which appears in Appendix C.

27 The question now seems to be around the wisdom rather than the legality of signing up to the MBA's framework agreement. There is an attraction to signing up to the agreement now, in that access to borrowing could go ahead at short notice without seeking further approval. Additionally, the Council would only be called upon to meet the liabilities of a defaulting authority if it was a borrower at that time. If the Council does not intend to borrow from the MBA in the near future, the joint and several liability clauses would not be an issue until it does so.

28 Members' views on the next steps would be welcomed.

Key Implications

Financial

29 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

30 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.

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

32 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.

33 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

34 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

35 The overall return on the Council's investments up to the end of September 2016 is at budget and is forecast to remain at, or marginally below, that level by the end of the financial year.

36 The percentage yield on the portfolio is 0.62%, which exceeds the recognised benchmarks.

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

Appendices:	Appendix A - Investment Portfolio at 30 September 2016 Appendix B – Extract from Item 5, Finance Advisory Committee 15 September 2016 Appendix C - Municipal Bonds Agency draft framework agreement
Background Papers:	Treasury Management Strategy for 2016/17 - Council 16 February 2016

Adrian Rowbotham
Chief Finance Officer