Treasury Management Review up to 30 September 2016

1.1 Background

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties, providing adequate liquidity initially before considering investment return.

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. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

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."

1.2 Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by this Council

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council of an annual Treasury Management Strategy Statement - including 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.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Governance and Audit Committee:

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2016/17 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's borrowing strategy for 2016/17;
- A review of any debt rescheduling undertaken during 2016/17;
- A review of the Council's investment portfolio, Treasury and Prudential Limits for 2016/17;
- Treasury Policies /Issues

2 Economics and interest rates

2.1 Economics update

UK Gross Domestic Product (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 European Union, 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 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%. 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.

The Inflation Report also included a sharp rise in the forecast for inflation to around 2.4% in 2018 and 2019. The Consumer Price Index has started rising during 2016 as the falls in the price of oil and food twelve months ago fell 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 Monetary Policy Committee (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.

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 Federal Reserve 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.

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 Euro Zone 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 their economies and economic growth.

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.

2.2 Interest rate forecasts

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%

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.

The overall longer run trend is for gilt yields and Public Work Loan Board (PWLB) rates to rise, albeit gently (please see paragraph 2.7). 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. Our PWLB rate forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

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 we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.

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.
- US election.

2.3 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2016/17 was approved by this Council on 22nd March. There are no policy changes to the

TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

2.4 The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- Limits to Borrowing Activity,
- Borrowing
- Compliance with the limits in place for borrowing activity.

2.4.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure by Service	2016/17 Original Estimate £m	Current Position £m	2016/17 Revised Estimate £m
Total Capital Expenditure	133	23.4	100.8

2.4.2 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of Capital Finance Requirement (CFR) in the preceding year plus the estimates of any additional CFR for 2016/17 and next two financial years. This allows some flexibility for limited early borrowing for future years.

The Director of Finance reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

Below is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by members. 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 Position
Borrowing	£400m	£336m
Other long term liabilities	£240m	£202m
Total	£640m	£538m

Given the current historically low interest rates, the reduction in the Council's cash balance and the need to finance the commitments in the capital investment plan it is expected that the Council will need to consider additional borrowing before the end of this financial year.

2.4.3 Borrowing

The Council's capital financing requirement (CFR) for 2016/17 is expected to be below the original forecast of £719m, due to slippage in a number of capital schemes. . 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. The Council has borrowings of £336m and last year utilised £53m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

It is anticipated that further borrowing be undertaken during this financial year to refinance the loans totally £26m maturing in March 2017.

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates 1 April 2016 to 30 September 2016

	1 Year	5 Year	10 Year	25 Year	50 Year
01/04/16	1.13%	1.62%	2.31%	3.14%	2.95%
30/09/16	0.93%	1.06%	1.58%	2.36%	2.19%
Low	0.78%	0.95%	1.42%	2.08%	1.89%
Date	26.09.2016	10.08.2016	10.08.2016	12.08.2016	12.08.2016
High	1.20%	1.80%	2.51%	3.28%	3.08%
Date	27.04.2016	27.04.2016	27.04.2016	27.04.2016	27.04.2016

2.4.4 Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

2.5 Investment Portfolio, Treasury and Prudential Limits 2016/17

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. 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 current 0.25% 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.

The Council held £41m of investments as at 30th September 2016 (£43m at 31 March 2016) and the investment portfolio yield for the first 6 months of the year is 0.53% against a benchmark of 0.28 %.

The Director of Finance confirms that the approved limits within the Annual Investment Strategy and prudential limits were not breached in 2016/17.Appart from on the cash investments, where school individual balances for both Lloyds and Barclays were over the set limits.

2.6 Treasury Policies /Issues

2.6.1 Following the closure of the cash offices in 2013, the Council put in place arrangements for residents to pay their Council Tax and other bills through a network of high street retailers and post offices. The only bank approved at the time to offer the necessary cash handling service to support the new arrangement was the Co-op Bank.

Arrangement have now been made to change over the running of this service to Barclays Bank with an expected start date of the middle of January. While this will cause the Treasury limits for Barclays to be breached due to the schools balances held with this bank (please see below). Balances will be kept to a minimum and cleared into the Council main account on a daily basis. It should also be noted that Barclays is a significantly better credit rated bank than the Co-op Bank.

2.6.2 In a previous Treasury report the investment limits for the 4 main UK banks were reduced to the same credit criteria as the other banks/building societies within the policy. This resulted in the Lloyds investment limit reducing to £20m and Barclays to £7m.

This raised the following issue

Bradford schools- The schools have their own individual bank balances with the four main UK banks .At 31/03/16 their overall bank balances with Lloyds was £24.7m and Barclays £8.8m, both exceeding the Treasury Policy investment limits.

Schools changing to Academies

In around the next 18 months most of the Primary and Secondary schools are expected to convert to academies (18 have already converted since April).Once converted to academies their bank balances no longer count towards the Council's Treasury limits.

2.6.3 With the above change in status for the schools and the use of Barclays for cash handling the following alteration to the Council Treasury policy are proposed.

i) That school balances have a temporary exception from the Treasury Policy until the main academy conversion process has been finished.

ii) If Barclays credit rating fall in the future resulting in the bank being outside the Treasury policy. The council can continue to use Barclays for the cash handling service, as long as balances are cleared to the council main bank account on a daily basis.

2.7 Addition to report 14/11/16.

On Wednesday the 9/11/16 the headlines were dominated by news that Donald Trump was the new presidential elect, defying expectations and spurring an initial volatility in financial markets. At first the reaction was for capital to move into safer investments, as many market participants unwound positions based on a Clinton victory. Bonds were then sold off as analyst predicted that Trump's spending on infrastructure would place upward pressure on inflation, but equities rallied, led by sharp rises in pharmaceuticals, miners and defence stocks. While Donald Trump tame post-election speech seemed to calm global markets, participants will be watching closely to see whether he delivers on his campaign promises or whether they are simply pre-election rhetoric. Part of the process will include a close study of the team that he selects between now and his inauguration in January. Markets will continue to monitor any announcement by Donald Trump, as investors look for clarity of his future policy proposals.

The Donald Trump election has also brought into focus other election/referendum taking place in the next year including in Italy, France and Germany. The results from these could have the potential to change the landscape in Europe. This adds another layer of uncertainty going forward.

The PWLB rates (rates the council borrow at) have been increasing and this raises the issue of when the Council needs to borrow. It also means that forecast going forward for borrowing need to be reassessed as rates may go higher quicker than originally expected.

3. Other considerations

None

4. Financial and Resources Appraisal

The financial implications are set out in section 2 of this report

5.Risk Management and Governance Issues

None

6.Legal Appraisal

Any relevant legal considerations are set out in the report

7. Other Implications

7.1 Equal Rights implications – no direct implications
7.2 Sustainability implications – no direct implications
7.3 Green house Gas Emissions Impact – no direct implications
7.4 Community safety implications – no direct implications
7.5 Human Rights Act – no diret implications
7.6 Trade Unions – no direct implications
7.7 Ward Implications – no direct implications

8. Not for publications documents – none

9 Recommendations

9.1. That the changes to the Treasury policy set out in section 2.6.3 be noted by the Governance and Audit Committee and referred to Council for adoption.

10. Background Documents

Treasury Management Schedules

Treasury Management Schedules

Treasury Policy