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Report of the Director of Finance to the meeting of Governance and Audit Committee to be held on 30 October 2015.

Subject:

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Treasury Management Mid Year Review up to 31 August 2015.

Summary statement:

This report shows the Council's Treasury Mid Year Review up to 31 August 2015.

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Corporate

Treasury Management Review up to 31 August 2015

1. Introduction and Background

The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly (TMSS, annual and midyear reports). This report, therefore, ensures this Council is implementing best practice in accordance with the Code.

2.1 Economic Background

After strong UK GDP growth in 2013 at an annual rate of 2.7% and 3.0% in 2014, quarter 1 of 2015 was disappointing at only 0.4%, but rose to 0.7% in the second quarter. In its May quarterly Inflation Report, the Bank of England reduced its GDP forecast for 2015 from 2.9% to 2.5% and from 2.9% to 2.7% in 2016, while increasing its forecast for 2017 from 2.4% to 2.7%.

Uncertainty around the likely result of the UK general election in May has obviously now evaporated although this has been replaced by some uncertainty around the potential impact on the UK economy of the European referendum promised by, or in, 2017. In addition, the firm commitment of the Conservative Government to eliminating the deficit within the term of this Parliament will have an impact on Gross Domestic Product growth rates. However, the Monetary Policy Committee is fully alert to this and will take that into account, together with the potential spill over effects from the Greek crisis, when making its decisions on the timing of raising the Bank Rate.

US Gross Domestic Product expanded at 3.7% annual rate in the second quarter of 2015 as opposed to the 2.3% rate estimate last month. The larger growth in the economy was a result of the accumulation of inventories and greater consumer confidence, which accounts for two thirds of US economic activity. However, the instability caused by the slowdown of China's economy raised doubts that the US central bank would raise its interest rate in September.

In the Eurozone, the European Central Bank in January 2015 unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected Eurozone 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, though the Eurozone economy grew less than expected in quarter 2 increasing in the year by 1.2% against a expected amount of 1.3%.

Global markets were significantly shaken in August by growing concerns about the outlook for the Chinese economy. The prospect of an economic slowdown in China triggered a worldwide sell-off in equities despite measures by officials in Beijing to restore confidence. Furthermore, US crude oil prices fell to almost $40 a barrel in mid- August , the lowest since the global financial crisis of 2009.

In June Chinese shares had risen 150% year on year but this came to a shuddering halt in June as the Shanghai Composite index officially entered bear market conditions and fell 40%. This shock resulted in China devaluing the Yuan by approximately 4%, which served to intensify worries about the world's second-largest economy. This had multiple repercussions with World Stock markets falling in value(including the FTSE 100 which lost £74 billion) and commodities losing as much as a third of their value since June.

2.2 Interest Rate Forecast

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

	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%
5yr PWLB rate	2.30%	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%
10yr PWLB rate	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%
25yr PWLB rate	3.60%	3.70%	3.80%	4.00%	4.10%	4.20%	4.30%	4.40%	4.40%	4.50%	4.60%
50yr PWLB rate	3.60%	3.70%	3.80%	4.00%	4.10%	4.20%	4.30%	4.40%	4.40%	4.50%	4.60%

Capita Asset Services undertook a review of its interest rate forecasts after the May Bank of England Inflation Report. The European Central Bank quantitative easing programme to buy up Eurozone debt caused an initial widespread rise in bond prices and, correspondingly, a fall in bond yields to phenomenally low levels, including the debt of some European countries plunging into negative yields. Since then, fears about recession in the Eurozone, and around the risks of deflation, have abated and so there has been an unwinding of this initial phase with bond yields rising back to more normal, though still historically low yields.

This latest forecast includes a move in the timing of the first Bank Rate increase in from quarter 1 of 2016 to quarter 2 of 2016 as a result primarily of poor growth in quarter 1, weak wage inflation, and the recent sharp fall in inflation due to depressed oil prices and the impact of that on core inflation. The UK fell marginally into deflation in April (-0.1%) and figures near zero will prevail for about the next six months until the major fall in oil prices in the latter part of 2014 falls out of the twelve month calculation of CPI inflation. The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual. The Monetary Policy Committee is concerned about the impact of increases on many heavily indebted consumers, especially when average disposable income is only just starting to recover as a result of recent increases in the rate of wage inflation, although some consumers will not have seen that benefit come through for them.

2.3 Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2015/16, which includes the Annual Investment Strategy, was approved by the Council. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and

- Yield.

The Council will also aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods of up to 12 months with highly credit rated financial institutions, using our suggested creditworthiness approach, including a minimum sovereign credit rating, and Credit Default Swap (CDS) overlay information.

Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the period up to 31 August 2015.

Investment rates available in the market have been broadly stable during the quarter and have continued at historically low levels as a result of the ultra-low Bank Rate and other extraordinary measures such as the Funding for Lending Scheme. The average level of funds available for investment purposes up to 31st August was £107.1m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

The Council investments returned 0.66% outperforming the benchmark by 30 bps. The Council’s budgeted investment return for 2015/16 is £350k, and performance for the year to date is £100k above budget.

2.4 Borrowing

No new borrowing was undertaken up to 31st August 2015, but debt of £53.6m matured on the 27/4/15 and was repaid, the money coming from investments .This has reduced the councils debt from £383.9m to £330.3m and the investment balances have reduced also by £53.6m. Decisions will have to be taken whether to take new borrowing in the future at low rates or continue to reduce investments.

Public Works Loan Board certainty rates, ending 31st August 2015

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.11%	1.82%	2.40%	3.06%	3.01%
Date	02/04/2015	02/04/2015	02/04/2015	02/04/2015	02/04/2015
High	1.33%	2.32%	3.04%	3.65%	3.55%
Date	31/08/15	31/08/15	31/08/15	31/08/15	31/08/15

2.5 Borrowing in advance of need

This Council has not borrowed in advance of need.

2.6 Debt Rescheduling

Debt rescheduling opportunities have been limited in the current economic climate and following the increase in the margin added to government bond yields which has impacted Public Works Loan Board new borrowing rates since October 2010. Up to 31 August 2015, no debt rescheduling was undertaken.

2.7 Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved TMSS.

There is no expectation that any of the Prudential Indicators will be breached. However, in the unlikely circumstances that there is a rapid and significant rise in long term rates in the current financial year there is a small risk that the Lender Options Borrower Option loans could be called in. If that were to happen the value of those loans combined with the PWLB loans that have already reached maturity this year would be greater than the 20 per cent of total debt allowed to mature in one year set by the maturity structure of borrowing target. The prudential and treasury Indicators are shown in Appendix 1.

2.8 Changes to Treasury Management Policy

2.8.1 During the period of this report, governments have brought changes in to remove implied sovereign support for major national banks of systemic importance. This is through changing the bail in rules if a bank gets into trouble. Overall the proposed changes will see some increase in preferential creditors ahead of unsecured depositors (Local Authorities) around 10% over and above existing amounts. This means it may be easier to isolate a failing bank from the wider market. This does not mean that these banks are of any lower credit worthiness than they were before the changes. The changes do though reflect the substantial improvement in the strength of bank balance sheets since the 2008 crisis and changes in the regulatory environment within which banks now have to work which means that their own strength should make it unnecessary for national governments to provide financial support to banks in any future financial crisis. While sovereign ratings will remain part of the Council's credit rating methodology, the impact of this change means that the rating of individual bank becomes more important.

2.8.2 At present the four main UK Banks HSBC Bank, Barclays, Lloyds and RBS Bank (Nat West Bank) all are treated separately from the other banks in our Treasury Management Policy (£60m limits) because of their size and importance to the UK and their high expectation of support if they were to get into trouble. This in future may not be the case.

2.8.3 To change the four main UK banks so that they are in line with the rest of the banks/building societies in the Treasury Policy would mean at present the limits for each would be as follows; £30 million for HSBC, £20 million for Lloyds, £7m for Barclays limited to 100 days and £0m for Nat West Bank.

2.8.4 This would raise two issues

i) The council banks with Nat West Bank

ii) Schools bank accounts – The schools have their own individual balances with the four main banks. On 31/3/15 these were £25.4m with Lloyds, £9.0m with Barclays, £2.1m with HSBC Bank, £3.3m with Nat West and £880k with Yorkshire Bank.

2.8.5 Proposal

i) Due to the unique situation of Nat West Bank being part owned by the government an investment limit of £20m is suggested. Once finally sold off by the government, if the credit limit is still below the limits for investments, balances will be kept to a minimum but there will always be day to day exposure.

ii) The issue with schools is not as easy to resolve. No investments going forward will be placed centrally for Lloyds or for Barclays unless Barclays credit rating improves. Current investments will not be reinvested when matured and a review of the school's bank accounts should be undertaken to see how to progress in the future.

2.8.6 Accordingly, it is recommended that members approve the following changes to the Treasury Policy;

The limits for the four main UK banks of £60m should be removed and changed to using the same credit criteria as all the other banks/building societies, with the exception of Nat West Bank which will have a limit of £20m due to it still been part owned by the UK government.

2.8.7 A review to be undertaken on the schools bank accounts.

2.9 Other Issues

No other issues

3.0 Other considerations

None

4.0 Financial and Resources Appraisal

The financial implications are set out in Section 2

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 & Diversity – no direct implications

7.2 Sustainability implications- no direct implications

7.3 Green Gas Emissions impact – no direct implications

7.4 Community Safety Implications – no direct implications

7.5 Human Rights Act – no direct implications

7.6 Trade Unions – no direct implications

7.7 Ward Implications – none

8. Not for publication documents

None

9. Recommendations

That the changes to the Treasury Policy set out in section 2.8.6 be noted by the Governance and Audit Committee and passed to full council for adoption.

10. Appendices

Appendix 1 Prudential and Treasury Indicators

11. Background Documents

Treasury Management Practices

Treasury Management Schedules

Treasury Management Policy

APPENDIX 1: Prudential and Treasury Indicators as at 31 August 2015

Treasury Indicators	2015/16 Budget £m	(Apr-August) Actual £m
Authorised limit for external debt	660m	660m
Operational boundary for external debt	600m	600m
Gross external debt	349m	349m
Investments	101m	71m
Net borrowing	248m	259m
Upper limit for principal sums invested over 365 days	£0m	£0m
Maturity structure of fixed rate borrowing	Upper Limit	(Apr-March) Actual
Under 12 months	20%	14%
12 months and within 24 months	20%	16%
24 months and within 5 years	20%	10%
5 years and within 10 years	50%	10%
10 years and above	90%	50%