Appendix B

Treasury Management Update

Quarter Ended 30 June 2016

Report of Chief Officer (Resources)

Treasury Management Update

Quarter Ended 30 June 2016

1. Introduction

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 (through the reporting of the Treasury Management Strategy, and annual and midyear reports). This report is in line with best practice in accordance with that Code, to help demonstrate transparency and promote accountability.

2. Economic Background (provided by Capita Asset Services)

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country. However, the 2015 growth rate finally came in at a disappointing 1.8% so this shows that growth had slowed down, 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 again to +0.4% (2.0% y/y) in quarter 1 of 2016. 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 and uncertainty created by the Brexit referendum. However, since the peak in November 2015, sterling has fallen against the Euro by 14% which will help to make British goods and services much more competitive. In addition, the Chancellor has announced that the target of achieving a budget surplus in 2020 will have to be eased in order to help the economy recover from the expected slowing of growth during the second half of 2016.

The May Bank of England Inflation Report forecast was notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. However, the falls in the price of oil and food twelve months ago will be falling out of the calculation of CPI during 2016 and in addition, the recent 10% fall in the value of sterling is likely to result in a 3% increase in CPI over a time period of 3-4 years. There is therefore likely to be an acceleration in the pace of increase in inflation which could make life interesting for an MPC that wants to help promote growth in the economy by keeping the Bank Rate low.

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. In response to a continuation of weak growth, at the ECB's December meeting, this programme was extended to March 2017 but was not increased in terms of the amount of monthly purchases. 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. This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and a start to some improvement in economic growth. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) and is expected to continue growing but at only a modest pace. The ECB is also struggling to get inflation up from near zero towards its target of 2%.

3. UK Sovereign Rating

On 27 June the three main rating agencies made the following changes to their UK sovereign ratings:

Standard & Poors – Downgraded from “AAA” to “AA”, outlook unchanged at Negative.

Fitch – Downgraded from “AA+” to “AA”, outlook changed from Stable to Negative.

Moody’s – Rating Affirmed at “Aa1”, outlook changed from Stable to Negative.

The changes were in response to the outcome of the referendum held on 23 June, and their views that it will result in a period of uncertainty for the UK, and that it will have a negative impact on the UK economy, public finances and political continuity. In addition, a slowdown in short-term GDP growth is anticipated due to diminished confidence and lower spending and investment.

The Council’s Treasury Management Strategy already excludes the UK sovereign rating from its investment matrix, therefore, there is no direct impact on investment decisions as a result of the changes.

4. Interest Rate Forecast

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

	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.50%	0.50%	0.50%
5yr PWLB rate	1.00%	1.10%	1.10%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.30%	1.30%
10yr PWLB rate	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%	1.80%	1.80%	1.80%	1.90%
25yr PWLB rate	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%
50yr PWLB rate	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%

Capita Asset Services undertook a quarterly review of its interest rate forecasts on 4 July 2016 after letting markets settle down somewhat after the Brexit result of the referendum on 23 June. It is generally agreed that the referendum outcome will result in a slowing in growth in the second half of 2016 at a time when the Bank of England (BoE) has only limited ammunition in its armoury to promote growth by using monetary policy. From the interest rate forecast review, it was expected that the Bank Rate would be cut by 0.25%, at some point in the second quarter [and this was subsequently actioned by the BoE on 04 August]. *The review commented that the rate could even be cut to 0% or 0.10% over that quarter. Thereafter, it is not expected that the MPC will take any further action on the Bank Rate in 2016 or 2017 as it is expected the pace of recovery of growth to be weak during a period of great uncertainty as to the final agreement between the UK and the EU on arrangements after Brexit. However, the MPC may also consider renewing a programme of quantitative easing; the prospect of further purchases of gilts in this way has already resulted in 10 year gilt yields falling below 1% for the first time ever. The Bank Rate is not expected to start rising until quarter 2 2018 and for further increases then to be at a slower*

pace than before. The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual once they do start.

5. Annual Investment Strategy

The Treasury Management Strategy (TMS) for 2016/17, which includes the Annual Investment Strategy, was approved by the Council on 02 March 2016. 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 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 quarter ended 30 June 2016.

Investment rates available in the market were broadly stable during the first half of the quarter. They then took a slight downward path in the second half, concluding with a significant drop after the referendum. This reflected a sharp rise in expectations of an imminent cut in the Bank Rate, coupled with rates expected to remain lower for longer thereafter.

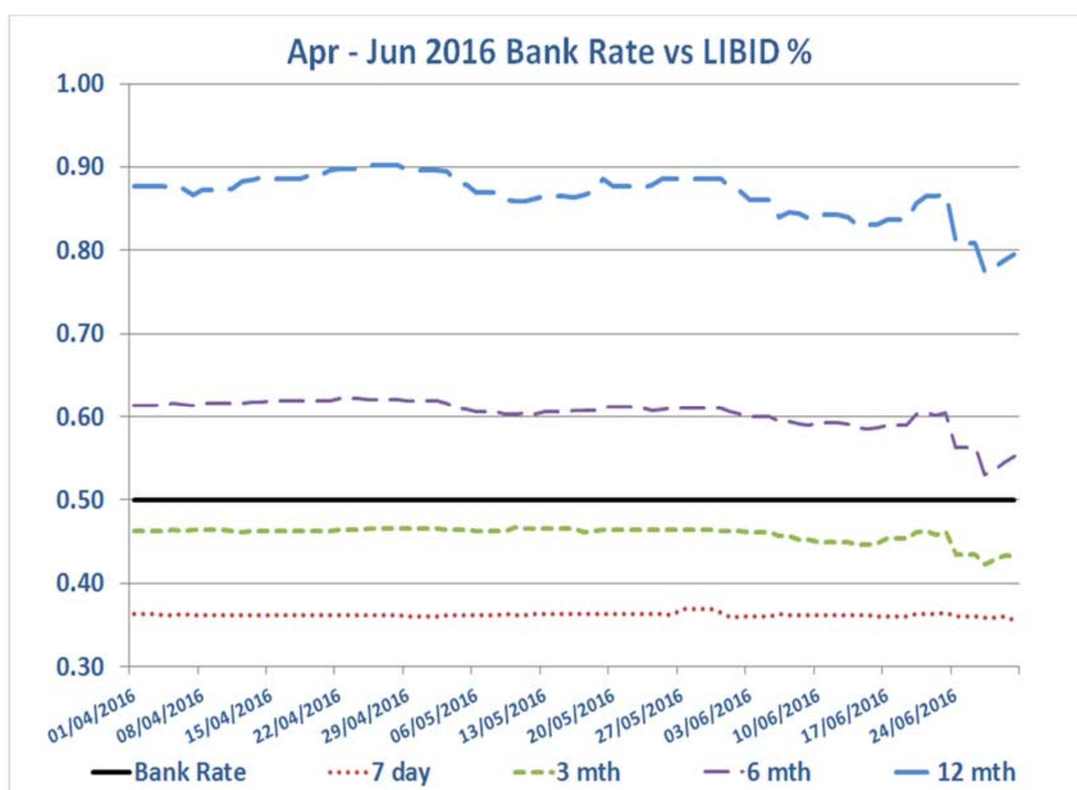
The average level of funds available for investment purposes during the quarter was £42M. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept and business rate related payments, the receipt of grants and progress on the Capital Programme.

In terms of performance against external benchmarks, the return on investments compared to the 7 day LIBID and bank rates over the year to date is as follows. This is viewed as reasonable performance, given the need to prioritise security of investments, and liquidity (i.e. making sure that the Council's cashflow meets its needs):

Base Rate	0.50%
7 day LIBID	0.36%
Lancaster City Council investments	0.51%

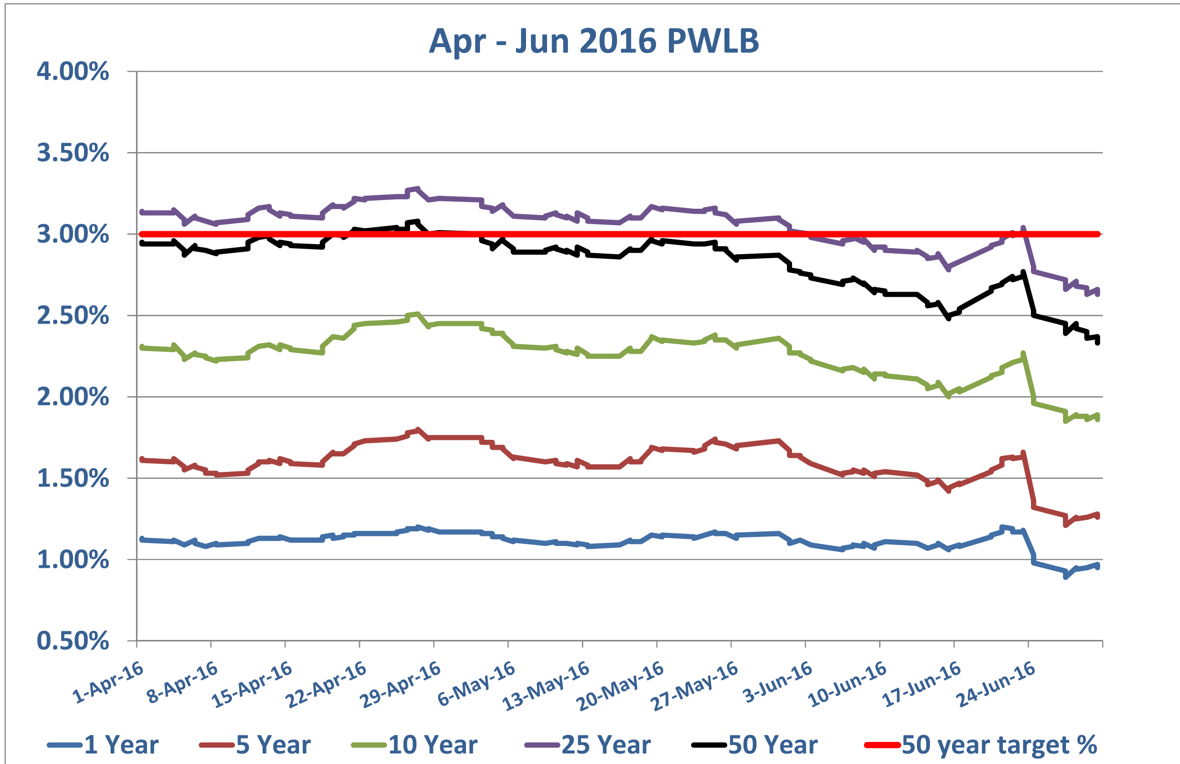
Investment performance against budget for quarter ended 30 June 2016

Other Investments	Term	Maturity Date	Opening £	Closing £	Indicative Rate (YTD)	Current Fixed Rate	Interest for Q1 £
Call Accounts							
Natwest (Cash Manager Plus)			231,415	38,555		0.25%	170
Santander			2,000,000	0		0.40%	242
Notice Accounts							
Svenska Handelsbanken (35 day)			3,000,000	6,000,000		0.45%	6,588
Money Market Funds							
Insight			216,000	470,000	0.46%		3,677
Blackrock Liquidity First			6,000,000	6,000,000	0.48%		7,166
Goldman Sachs			0	0	0.46%		215
LGIM			6,000,000	6,000,000	0.50%		7,547
Ignis			6,000,000	6,000,000	0.51%		7,636
Fixed Term Deposits							
Barclays	6 months	15/04/2016	2,000,000	0		0.69%	529
Barclays	3 months	01/07/2016	0	1,000,000		0.48%	1,197
Barclays	3 months	15/07/2016	0	2,000,000		0.48%	1,999
Lloyds	6 months	20/07/2016	2,000,000	2,000,000		0.75%	3,699
Lloyds	3 months	30/06/2016	0	1,000,000		0.57%	1,405
Birmingham City Council	6 months	29/04/2016	12,000,000	0		0.47%	4,326
Birmingham City Council	6 months	28/10/2016	0	12,000,000		0.48%	9,784
Sub-total			**39,447,415**	**42,508,555**			**56,180**
						Budgeted income	**50,000**
							6,180



6. Borrowing (commentary provided by Capital Asset Services)

As depicted in the graph(s) below, there has been significant volatility in PWLB rates during quarter 1 culminating in a progressive fall in rates during the first three weeks in June as confidence rose that the polls were indicating an 'IN' result for the referendum. This was followed by a sharp rise in the run up to the referendum day as the polls swung the other way, followed by a sharp fall to the end of the month in anticipation that there is likely to be further quantitative easing purchases of gilts in the coming months.



During the quarter ended 30 June 2016, the 50 year PWLB target (certainty) rate for new long term borrowing remained at 3%. *(However, the target rate was cut to 2.20% on 4 July 2016 due to the sharp fall in gilt yields after the referendum.)*

Due to the overall financial position there is no underlying need to borrow for capital purposes (the Capital Financing Requirement – CFR), therefore no new borrowing was undertaken.

7. Debt Rescheduling

Officers continue to monitor potential saving opportunities associated with the early repayment of existing debt. This takes into account the premiums or discounts associated with early repayment and the projected cost of refinancing or loss in investment interest. At present, it would not be financially prudent to repay any debt based on the current rates being offered.

8. 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 Treasury Management Strategy.

During the financial year to date the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy and in compliance with the Council's Treasury Management Practices.

9. Risk Management

The recent changes in the UK sovereign rating following the referendum have no direct impact on the Council's ability to invest as it has excluded the UK from its sovereign rating criteria overlay. Furthermore, the changes are not considered to represent a material risk to the Council's current investment strategy.

There is financial risk attached to the longer term debt portfolio (associated with interest rate exposure) as all of the debt is on fixed interest but there has been no change to this over the quarter. Low investment returns mean that using cash invested to repay debt can appear more attractive, however this is not a financially viable option at present due to the penalties associated with early repayment.