Appendix C

Treasury Management Update

Quarter Ended 30 September 2016

Report of Chief Officer (Resources)

Treasury Management Update

Quarter Ended 30 September 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. As such, it is a requirement that this half yearly update be referred onto Council for information.

2. Economic Background (provided by Capita Asset Services)

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.

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. 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.

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 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.

3. Interest Rate Forecast

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.

4. 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 aims 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 to cover cash flow needs, but also if and where appropriate, to seek out value available in periods up to 12 months with highly credit rated financial institutions, using the adopted creditworthiness approach, including minimum sovereign credit ratings and Credit Default Swap (CDS) overlay information.

Officers confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 30 September 2016.

Investment rates dropped significantly following the base rate cut on 04 August 2016. Whilst investment interest is still in line with the budget at this point in time there is estimated to be a shortfall of £63K by the year end. This is because, at the time the budget was set, forecasts originally predicted an increase in base rate to 0.75% by the end of this financial year.

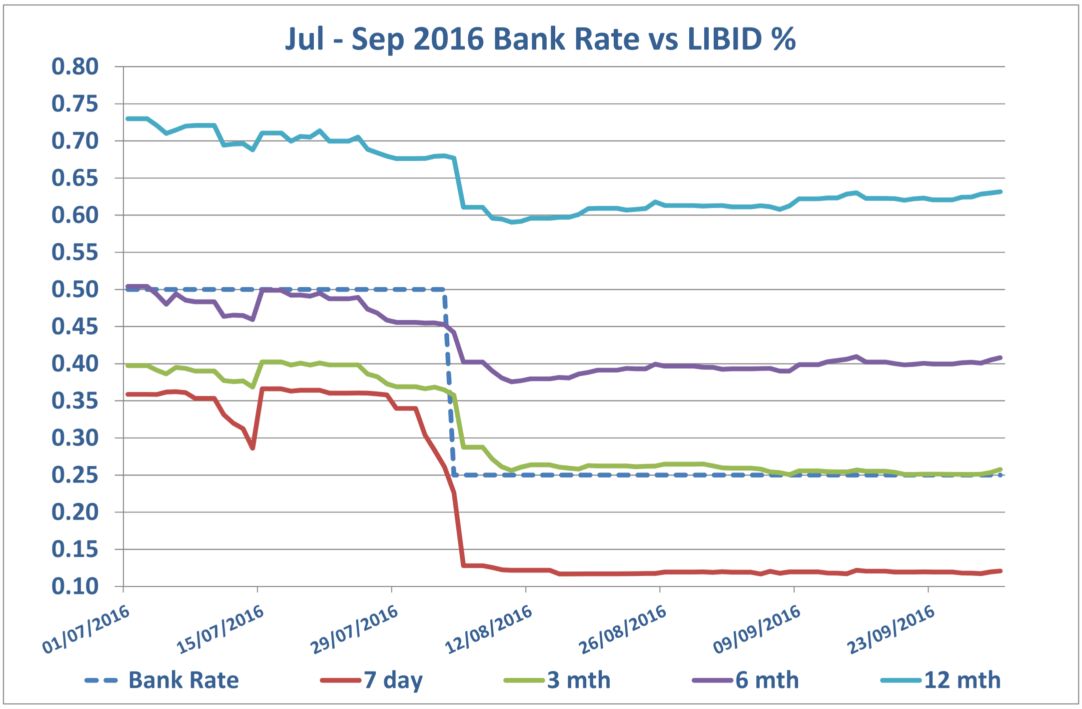
The average level of funds available for investment purposes during the quarter was £49M. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept and business rate related payments, the receipt of grants and progress on the Capital Programme.

In terms of performance against external benchmarks, the return on investments compared to the 7 day LIBID and bank rates at the end of the period 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	0.25%
7 day LIBID	0.12%
Lancaster City Council investments	0.30%

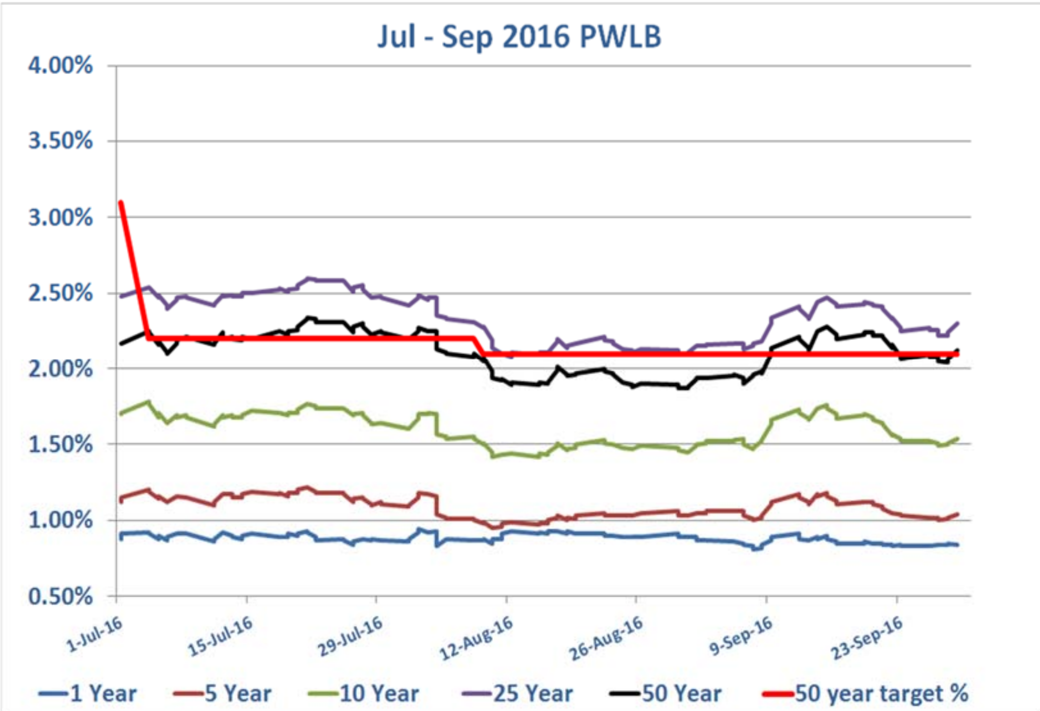
Investment performance against budget for quarter ended 30 September 2016

Other Investments	Term	Maturity Date	Opening £	Closing £	Indicative Rate (YTD)	Current Fixed Rate	Interest to Date £
Call Accounts							
Natwest (Cash Manager Plus)			38,555	70,444		0.25%	202
Santander			0	0		0.15%	281
Lancashire County Council			0	0		0.15%	413
Notice Accounts							
Svenska Handelsbanken (35 day)			6,000,000	6,000,000		0.34%	12,875
Money Market Funds							
Insight			470,000	6,000,000	0.30%		9,311
Blackrock Liquidity First			6,000,000	4,800,000	0.37%		13,505
Blackrock Sterling Govt Liquidity Fund			0	60,000	0.21%		1,198
Goldman Sachs			0	6,000,000	0.31%		3,271
LGIM			6,000,000	6,000,000	0.37%		14,027
Ignis			6,000,000	6,000,000	0.39%		14,515
Fixed Term Deposits							
Barclays	6 months	15/04/2016	0	0		0.69%	529
Barclays	3 months	01/07/2016	1,000,000	0		0.48%	1,197
Barclays	3 months	15/07/2016	2,000,000	0		0.48%	2,393
Lloyds	6 months	20/07/2016	2,000,000	0		0.75%	4,521
Lloyds	3 months	30/06/2016	1,000,000	0		0.57%	1,405
Birmingham City Council	6 months	29/04/2016	0	0		0.47%	4,326
Birmingham City Council	6 months	28/10/2016	12,000,000	12,000,000		0.48%	24,302
Sub-total			**42,508,555**	**46,930,444**			**108,271**
						Budgeted income	**108,900**
							-629



5. Borrowing (commentary provided by Capital Asset Services)

During the quarter ended 30 September 2016, the 50 year PWLB target (certainty) rate for new long term borrowing started at over 3.1% and ended at 2.1%. All other rates remained relatively stable.



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

6. 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, because of the high penalties associated with early repayment.

7. Compliance with Treasury and Prudential Limits

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.

It is a statutory duty for the Council to determine and keep under review its affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) as at 30 September are attached at Annex A. No changes are proposed as so the information is only for noting.

8. Risk Management (Key Aspects)

Investment Security:
There is still significant inherent risk generally affecting counterparties (i.e. who investments are placed with). These are considered to be managed effectively through the creditworthiness framework currently applied.

Liquidity:
The Council has higher risk that might be considered normal for a council of its size - cash balances remain extraordinarily high, but they are expected to reduce by well over £20 million in or around January 2017 (linked to business rates). Nonetheless liquidity risks are considered to be managed effectively, through cash flow monitoring arrangements and the periods chosen for investment, to help ensure that the Council will have sufficient cash available to meet its payment obligations and deal with the resulting impact on its cashflow.

Interest Risk:
Investment Returns are low and will reduce further. The Council has risk exposure because all of its borrowings are long-term/fixed, and inevitably its investments are shorter term, meaning that generally they are more affected or influenced by the Bank Rate. There is little that can be done to mitigate this risk at this point. That said, with the current Bank Rate being so low, there is not much further for interest rates to fall and so it is considered that the Council's net interest rate exposure (i.e. the difference between its borrowing and investment interest rates) cannot increase significantly.

Counterparty investment capacity (the counterparties and their combined investment limits currently available to the Council) is currently tight, and this can affect investment rates available, but this risk will reduce once cash balances have reduced as expected, and so no changes are proposed at this time.

Other general risks:
Treasury management staffing has now stabilised following restructuring, turnover and other vacancies. This, together with ongoing training for Officers and Members, will assist in the management of treasury related risk more generally. The need for any further measures will be considered during the budget, to ensure that treasury management is not compromised by other work demands.

ANNEX A

PRUDENTIAL INDICATORS - MID YEAR REVIEW

There are no policy changes required to the Treasury Management Strategy; the details in this annex provisionally updates relevant prudential indicators in light of capital expenditure and financing changes to date.

Prudential Indicator for Capital Expenditure

This table shows the current estimates for the General Fund and Housing Revenue Account capital programmes, compared to the original estimates.

Capital Expenditure by Service	2016/17 Original Estimate £m	 Quarter 2 Position £m
Environmental Services	1.37	1.43
Health & Housing	4.88	4.64
Regeneration & Planning	6.04	5.90
Resources	4.51	4.68
Total for General Fund	**16.79**	**16.64**
Council Housing (HRA)	**4.51**	**4.54**
Total Capital Expenditure	**21.29**	**21.18**

Changes to the Financing of the Capital Programmes

This table shows the changes in the financing of the capital programmes, and the level of borrowing required. The latter has reduced mainly due to the anticipated extra £850K general fund capital receipts.

Capital Expenditure	2016/17 Original Estimate £m	 Quarter 2 Position £m
Total capital expenditure	**21.29**	**21.18**
Financed by:		
Capital receipts	0.52	1.51
Capital grants	6.42	6.25
Capital reserves	5.53	5.52
Revenue	0.34	0.34
Total Financing	**12.81**	**13.62**
Borrowing Requirement	**8.48**	**7.56**

Changes to the Capital Financing Requirement

The following table shows that the capital financing requirement (CFR) is currently slightly lower than the original estimate due to changes in expenditure and financing of the capital programmes. As there is very little change in the CFR at this point in time, no formal changes are being recommended.

Capital Financing Requirement	2016/17 Original Estimate £m	 Quarter 2 Position £m
General Fund	57.72	57.29
HRA	26.03	25.96
Total Capital Financing Requirement	**83.75**	**83.25**
Net movement in CFR	**5.82**	**5.36**

Limits to Borrowing Activity

A key control over treasury management activity is to ensure that over the medium term, net borrowing (borrowings less investments) will only be for capital purposes. Gross external borrowing should not, except in the short term, exceed the total capital financing requirement.

The tables below shows that no extra debt is being taken on, and therefore total debt will not exceed borrowing need (CFR), the operational boundary or authorised external debt limit. As a result, there are no formal changes being recommended to the original approved indicators.

External Debt v Borrowing Need (CFR)	**2016/17 Original Estimate £m**	**2016/17 Quarter 2 Position £m**
External Debt	65.25	65.25
Other long term liabilities	0.09	0.09
Total Debt	**65.34**	**65.34**
Compared to current approved:		
Capital Financing Requirement	**83.75**	**83.75**
Operational Boundary	**83.53**	**83.53**
Authorised Limit	**100.00**	**100.00**

Definitions:

Operational Boundary

The limit beyond which external debt is not normally expected to exceed is known as the operational boundary.

Authorised Limit for External Debt

A further prudential indicator controls the overall level of borrowing. This is the authorised limit which represents the limit beyond which borrowing is prohibited. It reflects the level of borrowing which, whilst not desired, could be afforded in the short term, but it is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. There are no proposals to change the limit.