

Appendix B

Treasury Management Update

Quarter Ended 31 December 2017

Report of Chief Officer (Resources)

2017/18 Treasury Management Update

Quarter Ended 31 December 2017

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 update (provided by Link Asset Services - formerly Capita Asset Services)

After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 was disappointingly weak in the first half of the year; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y), which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of GDP, has seen weak growth as consumers cut back on their expenditure.

However, growth picked up in quarter 3 to 0.4% and in quarter 4 there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole. Growth in quarter 4 is expected to be around 0.4% again which would see annual growth in 2017 coming in at around 1.7 – 1.8%, almost as strong as the recently upwardly revised figure for 2016 of 1.8%, (which meant that the UK was equal to Germany as having the strongest GDP growth figure for the G7 countries in 2016).

The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in its words warning that the Bank Rate will need to rise. Recent Bank of England Inflation Reports have flagged up that they expected CPI inflation to peak at just over 3% in late 2017, before falling back to near to its target rate of 2% in two years' time. Inflation actually came in at 3.1% in November. The reason why the MPC became so aggressive with its wording in September and November around increasing the Bank Rate was due to an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of increasing globalisation. This effectively means that the UK labour faces competition from overseas labour e.g. in outsourcing work to third world countries, and this therefore depresses the negotiating power of UK labour. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so would be inflationary over the next few years.

It was therefore no surprise that the MPC increased the Bank Rate by 0.25% to 0.5% in November. However, their forward guidance of two more increases of 0.25% by 2020 was viewed as being more dovish than markets had expected. However, some forecasters are flagging up that they expect growth to improve significantly in 2018, as the fall in inflation will bring to an end the negative impact on consumer spending power while a strong export performance will compensate for weaker services sector growth. If this scenario were to materialise, then the MPC would have added reason to embark on more than one increase in Bank Rate during 2018. While there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two years will pan out.

3. Interest Rate Forecast

The council's treasury advisor, Link Asset Services has provided the following forecast:

Link Asset Services Interest Rate View													
	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%
5yr PWLB rate	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%
10yr PWLB rate	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%
25yr PWLB rate	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%

Link Asset Services undertook its last review of interest rate forecasts on 7 November after the quarterly Bank of England Inflation Report and MPC meeting. As expected, the MPC policy raised the Bank Rate by 0.25% to 0.50%. The MPC also gave forward guidance that they expected to raise the Bank Rate by 0.25% only twice more in the next two years to reach 1.0% by 2020. This was very much in line with previous guidance that the Bank Rate would only go up very gradually and to a limited extent.

The overall balance of risks to economic recovery in the UK is probably currently to the downside due to the uncertainties around Brexit; however, given those uncertainties, there is a wide diversity of possible outcomes for the strength of economic growth and inflation, and the corresponding speed with which Bank Rate could go up.

4. Investing Activities

The Treasury Management Strategy Statement (TMSS) for 2017/18, which includes the Annual Investment Strategy, was approved by the Council on 01 March 2017. It sets out the Council's investment priorities as being:

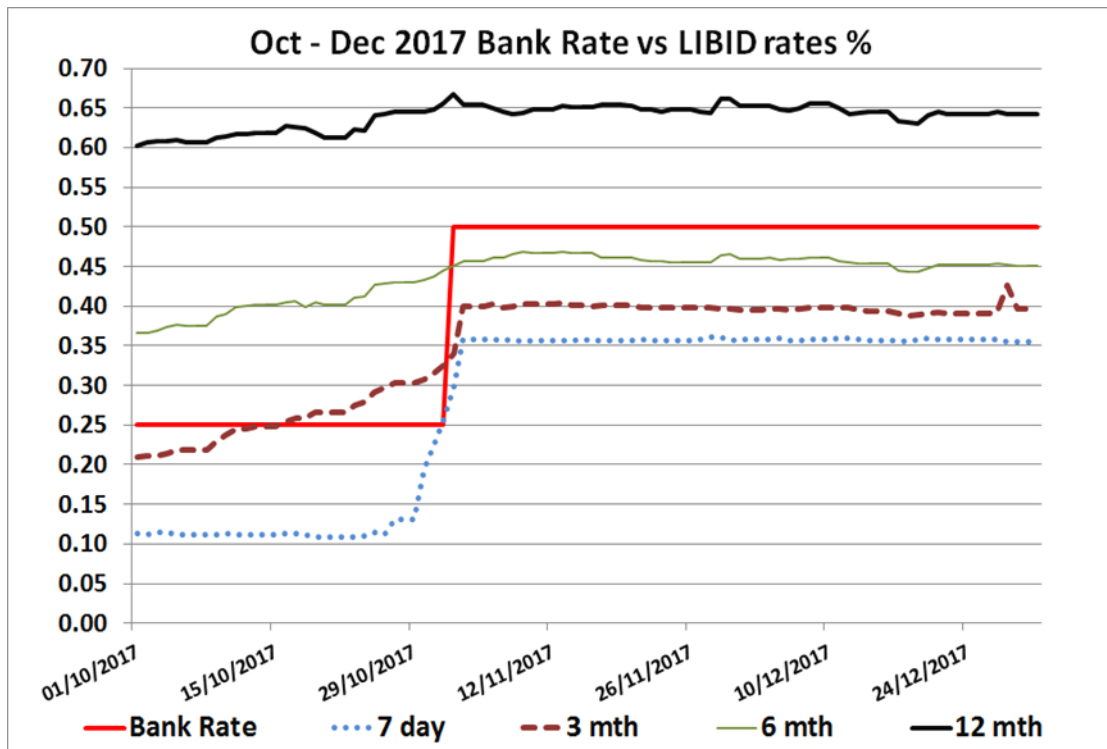
- Security of capital;
- Liquidity; and
- Yield.

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 term 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 a minimum sovereign credit rating, and Credit Default Swap (CDS) overlay information.

The average level of funds available for temporary investment purposes during the quarter was £41M. 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.

Base Rate	0.50%
7 day LIBID	0.35%
Lancaster City Council investments	0.39%

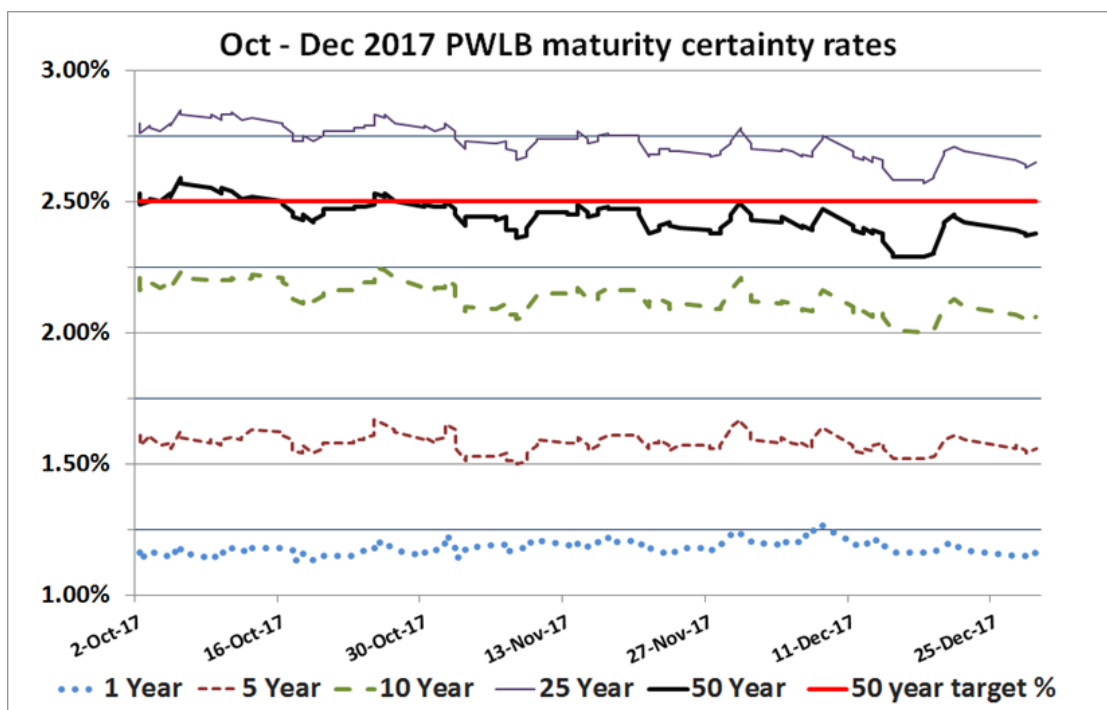
Other Investments	Term	Maturity Date	Opening £	Closing £	Indicative Rate (YTD)	Current Fixed Rate	Interest to Date £
Call Accounts							
Natwest (Cash Manager Plus)			137,490	141,816		0.01%	23
Money Market Funds							
Goldman Sachs			0	0	0.16%		2,243
Insight			0	0	0.30%		729
Blackrock Sterling Liquidity First Fund			4,000,000	0	0.31%		5,259
LGIM			6,000,000	2,500,000	0.33%		9,966
Ignis			6,000,000	6,000,000	0.35%		11,489
Lancashire County Council			0	0	0.25%		962
Fixed Term Deposits							
Cambridgeshire County Council	6 months	04/07/2017	0	0		0.35%	10,932
Leeds City Council	6 months	16/07/2017	0	0		0.36%	5,277
Guildford Borough Council	364 days	17/07/2018	5,000,000	5,000,000		0.53%	12,125
Rugby Borough Council	11 months	29/06/2018	1,000,000	1,000,000		0.35%	1,467
Antrim & Newtown Abbey BC	364 days	06/08/2018	3,000,000	3,000,000		0.37%	4,470
Suffolk County Council	6 months	28/02/2018	5,000,000	5,000,000		0.30%	5,055
Broxtowe Borough Council	364 days	28/09/2018	1,000,000	1,000,000		0.40%	1,030
Uttlesford District Council	1 week	06/10/2017	4,000,000	0		0.30%	230
London Borough of Islington	364 days	01/10/2018	0	2,000,000		0.40%	1,995
London Borough of Newham	171 days	29/03/2018	0	5,000,000		0.30%	3,452
Surrey Heath Borough Council	181 days	15/05/2018	0	5,000,000		0.50%	3,219
Rhondda Cyon Taf County BC	23 days	02/11/2017	0	0		0.20%	378
Staffordshire County Council	8 days	21/12/2017	0	0		0.30%	197
Sub-total			35,137,490	35,641,816			80,498
Budgeted income							84,750
							(4,252)



5. Borrowing Activities

PWLB rates jumped up sharply after the 14 September MPC meeting but then fell back somewhat during the quarter, except for the 1 year rate which peaked in early December.

During the quarter, the 50 year PWLB target (certainty) rate for new long term borrowing was unchanged at 2.50%.



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. Debt rescheduling opportunities have been limited in the current economic climate and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. At present it would not be financially prudent to repay any debt because of the high penalties associated with early repayment. No debt rescheduling was, therefore undertaken during the quarter.

7. Compliance with Treasury and Prudential Limits

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 are included in the approved Treasury Management Strategy.

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:

Liquidity risks are considered to be managed effectively through cash flow monitoring and 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 cash flow.

Interest Risk:

Investment Returns are inevitably low. 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.

9. Other Issues

Canal Corridor North

The Treasury Management Strategy for 2018/19 and beyond will need to be set prior to having certainty on the scheme. Any changes needed to the Strategy during 2018/19 will be reported to Council in line with the formal reporting requirements.

Revised CIPFA Codes

In December, The Chartered Institute of Public Finance and Accountancy, (CIPFA), issued a revised Treasury Management Code and Cross Sectoral Guidance Notes, and a revised Prudential Code.

A particular focus of these revised codes was how to deal with local authority investments which are not treasury type investments, such as investing in property in order to generate income for the authority at a much higher level than can be attained by treasury investments. In addition, there is a recommendation that local authorities should produce a new report to

members to give a high level summary of the overall capital strategy and to enable members to see how the cash resources of the authority have been apportioned between treasury and non-treasury investments. Officers will report back to members when the implications of the new codes have been assessed as to the likely impact on the Council.

Markets in Financial Instruments Directive (MIFID II)

The EU set the deadline of 03 January 2018 for the introduction of regulations under MIFID II. These regulations govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This will entail increased administration for each institution dealing with this authority and for each type of investment instrument we use. The fact that a significant proportion of the Councils investment portfolio is held in simple term deposits (which are excluded from MIFIDII) will mean that this will have minimal impact on the Authority.

Treasury Management Glossary of Terms

- **Annuity** – method of repaying a loan where the payment amount remains uniform throughout the life of the loan, therefore the split varies such that the proportion of the payment relating to the principal increases as the amount of interest decreases.
- **CIPFA** – the Chartered Institute of Public Finance and Accountancy, is the professional body for accountants working in Local Government and other public sector organisations, also the standard setting organisation for Local Government Finance.
- **Call account** – instant access deposit account.
- **Counterparty** – an institution (e.g. a bank) with whom a borrowing or investment transaction is made.
- **Credit Rating** – is an opinion on the credit-worthiness of an institution, based on judgements about the future status of that institution. It is based on any information available regarding the institution: published results, Shareholders' reports, reports from trading partners, and also an analysis of the environment in which the institution operates (e.g. its home economy, and its market sector). The main rating agencies are Fitch, Standard and Poor's, and Moody's. They analyse credit worthiness under four headings:
 - **Short Term Rating** – the perceived ability of the organisation to meet its obligations in the short term, this will be based on measures of liquidity.
 - **Long Term Rating** – the ability of the organisation to repay its debts in the long term, based on opinions regarding future stability, e.g. its exposure to 'risky' markets.
 - **Individual/Financial Strength Rating** – a measure of an institution's soundness on a stand-alone basis based on its structure, past performance and credit profile.
 - **Legal Support Rating** – a view of the likelihood, in the case of a financial institution failing, that its obligations would be met, in whole or part, by its shareholders, central bank, or national government.

The rating agencies constantly monitor information received regarding financial institutions, and will amend the credit ratings assigned as necessary.

- **DMADF and the DMO** – The DMADF is the 'Debt Management Account Deposit Facility'; this is highly secure fixed term deposit account with the Debt Management Office (DMO), part of Her Majesty's Treasury.
- **EIP** – Equal Instalments of Principal, a type of loan where each payment includes an equal amount in respect of loan principal, therefore the interest due with each payment reduces as the principal is eroded, and so the total amount reduces with each instalment.
- **Gilts** – the name given to bonds issued by the U K Government. Gilts are issued bearing interest at a specified rate, however they are then traded on the markets like shares and their value rises or falls accordingly. The Yield on a gilt is the interest paid divided by the Market Value of that gilt.
E.g. a 30 year gilt is issued in 1994 at £1, bearing interest of 8%. In 1999 the market value of the gilt is £1.45. The yield on that gilt is calculated as $8\%/1.45 = 5.5\%$.
See also PWLB.

- **LIBID** – The London Inter-Bank Bid Rate, the rate which banks would have to bid to borrow funds from other banks for a given period. The official rate is published by the Bank of England at 11am each day based on trades up to that time.
- **LIBOR** – The London Inter-Bank Offer Rate, the rate at which banks with surplus funds are offering to lend them to other banks, again published at 11am each day.
- **Liquidity** – Relates to the amount of readily available or short term investment money which can be used for either day to day or unforeseen expenses. For example Call Accounts allow instant daily access to invested funds.
- **Maturity** – Type of loan where only payments of interest are made during the life of the loan, with the total amount of principal falling due at the end of the loan period.
- **Money Market Fund (MMF)** – Type of investment where the Council purchases a share of a cash fund that makes short term deposits with a broad range of high quality counterparties. These are highly regulated in terms of average length of deposit and counterparty quality, to ensure AAA rated status.
- **Nonfarm Payroll Employment** - is a compiled name for goods, construction and manufacturing companies in the US. It does not include farm workers, private household employees, or non-profit organization employees.
- **Policy and Strategy Documents** – documents required by the CIPFA Code of Practice on Treasury Management in Local Authorities. These set out the framework for treasury management operations during the year.
- **Public Works Loans Board (PWLb)** – a central government agency providing long and short term loans to Local Authorities. Rates are set daily at a margin over the Gilt yield (see Gilts above). Loans may be taken at fixed or variable rates and as Annuity, Maturity, or EIP loans (see separate definitions) over periods of up to fifty years. Financing is also available from the money markets, however because of its nature the PWLB is generally able to offer better terms.
- **Capita Asset Services** – are the City Council's Treasury Management advisors. They provide advice on borrowing strategy, investment strategy, and vetting of investment counterparties, in addition to ad hoc guidance throughout the year.
- **Yield** – see Gilts

Members may also wish to make reference to *The Councillor's Guide to Local Government Finance*.