

Treasury Management Update

Quarter Ended 31st March 2016

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.

1. Economic Background

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate +2.1% was again a leading rate in the G7 though the US achieved a higher rate of +2.4%. Growth in quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a slight increase in quarter 2 to +0.5% (+2.3% y/y) before falling back again to +0.4% (+2.2% y/y) in quarter 3. Growth improved to +0.6% in quarter 4 (+2.1% y/y) but overall this was a disappointing outturn for the year which dashed earlier forecasts for a significantly higher rate. The economy now faces headwinds for exporters from the appreciation during 2015 of Sterling against the Euro, (which has only been minimally reversed in 2016), 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 coming up in June.

The Bank of England February Inflation Report included a forecast for growth for 2016 of 2.2% and 2.3% for 2017, down from 2.5% and 2.6% respectively. Nevertheless, this is still a reasonable rate of growth which is being driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a limited recovery in wage inflation and falls in many prices, especially fuel, which has seen CPI inflation fall to, or near to, zero over the last quarter.

The February 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, with the price of oil taking a fresh downward direction and Iran expected to soon re-join the world oil market after the lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

There are, therefore, considerable risks around whether inflation will rise in the near future as strongly as previously expected; this will make it more difficult for the Bank of England to make a start on raising Bank Rate during 2016, especially given the subsequent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets over the last year, which could potentially spill over to impact the real economies rather than just financial markets.

The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015 before easing back to +2.0% in quarter 3 and to 1.4% in quarter 4, leaving growth in 2015 as a whole at 2.4%. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on

17 September, downbeat news during the summer about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from making that start. The nonfarm payrolls figures for September and revised August, issued on 2 October, were also disappointingly weak so the first increase did not eventually come until its December meeting. At that point, confidence was high that there would then be four more increases to come in 2016, but since then, more downbeat news on the international scene has caused a re-emergence of caution over the timing and pace of further increases.

In the Eurozone, in January 2015 the ECB unleashed a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it was intended to run initially to September 2016. 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. The ECB also cut its deposit facility rate by 10bps from -0.2% to -0.3%. This programme of easing was then strengthened at its March meeting by cutting this rate further to -0.4% and its main refinancing rate from 0.05% to zero, and increased its monthly asset purchases to €80bn. This 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 to 0.6% in quarter 1 2015 (1.3% y/y) but has then eased back to +0.4% (+1.6% y/y) in quarter 2 and to +0.3% (+1.6%) in quarters 3 and 4. The ECB is also struggling to get inflation up from around or below zero towards its target of 2%.

2. Interest Rate Forecast

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

| | Jun-16 | Sep-16 | Dec-16 | Mar-17 | Jun-17 | Sep-17 | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 |
|-----------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Bank rate | 0.50% | 0.50% | 0.50% | 0.75% | 0.75% | 1.00% | 1.00% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% |
| 5yr PWLB rate | 1.90% | 2.00% | 2.10% | 2.20% | 2.30% | 2.40% | 2.60% | 2.70% | 2.80% | 2.90% | 3.00% | 3.10% |
| 10yr PWLB rate | 2.40% | 2.50% | 2.60% | 2.70% | 2.80% | 2.90% | 3.00% | 3.10% | 3.30% | 3.40% | 3.50% | 3.60% |
| 25yr PWLB rate | 3.20% | 3.30% | 3.30% | 3.50% | 3.50% | 3.60% | 3.60% | 3.70% | 3.70% | 3.70% | 3.80% | 3.80% |
| 50yr PWLB rate | 3.00% | 3.10% | 3.10% | 3.30% | 3.30% | 3.40% | 3.40% | 3.50% | 3.60% | 3.60% | 3.70% | 3.70% |

Capita Asset Services undertook an early quarterly review of its interest rate forecasts on 20 January 2016, before the quarterly Bank of England Inflation Report issued on 4 February, due to the run of recent downbeat UK and world economic news and the extreme volatility in financial markets. However, a further revised forecast was then done on 12 February due to a further resurgence of various fears and renewed extreme volatility in markets. Consequently, the forecast for the timing of the first increase in Bank Rate was overall moved from quarter 2 of 2016 to quarter 1 2017. With CPI inflation now expected to be between 0% and 1% during the whole of 2016, it is likely to be very difficult for the MPC to make a start on increasing Bank Rate in 2016. The Inflation Report forecast was also notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. In addition, average weekly earnings excluding bonuses were weak at only 2.2% in the three months to January and so this is unlikely to provide ammunition for the MPC to take action to dampen inflationary pressures as labour productivity growth would mean that net labour unit costs

are still not rising by the significantly more than 2% level which the MPC wants to see before starting to raise Bank Rate.

The Governor of the Bank of England, 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 for some consumers, who have had no increases in pay, could be non-existent (other than through some falls in prices).

3. Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2015/16, which includes the Annual Investment Strategy, was approved by the Council on 04/03/2015, and an update was approved at Council on 30/09/2015. The update was needed due to higher levels of in-house funds following the return of monies from Investec on their withdrawal from custodianship arrangements on 30/06/2015. The TMSS 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 31st March 2016, with the exception of the £10m limit on deposits in the Special Interest Bearing Account (SIBA) with the Council's operating bank, NatWest. This is due to unusually high levels of cash balances including, for example, more than £3m remaining in the Council's bank account awaiting payment requests from Discovery Park, where the Council is acting as the accountable body (intermediary) for "Building Foundations for Growth" grant received from DCLG. The SIBA balance reached £17m by 17th February 2016. Levels have normalised since, and were mostly within the £10m limit up to 31st March 2016, except for 15th-20th March when they slightly exceeded the limit in the range £10.70m - £11.75m. The reduction in cash by 31st March is normal and expected, as council tax receipts dip (usually paid in ten instalments from April to January) and a further PWLB loan repayment is made at the end of March, alongside other normal payments. SIBA balances are "instant access" and therefore lower risk.

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. 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 currently holds **£42m** core cash balances for investment purposes (i.e. funds available for more than one year), although Appendix 2 shows a lower amount as some funds were being held in instant access

accounts until additional longer term investments were made in June 2016 following a review. The higher level of core cash balances is shown on Appendix 4 as at 31st July 2016.

Investment performance for quarter ended 31st March 2016

| Benchmark | Benchmark Return | Council Performance | Investment Interest Earned |
|-----------|------------------|---------------------|----------------------------|
| 7 day | 0.36% | 0.51% | £313k approx. |

As illustrated, the Council outperformed the benchmark by 15 **bps**. The Council's budgeted investment return for 2015/16 was **£333k**, and performance for the year to date was £313k, which is **£20k** below budget.

4. New Borrowing

As outlined below, the general trend in PWLB rates during 2015/16 was an increase in rates during the first quarter followed by marked bouts of sharp volatility since July 2015 but with an overall dominant trend for rates to fall to historically low levels by the end of the year.

During the quarter ended 31st March 2016, the 50 year PWLB target (certainty) rate for new long term borrowing fell from 3.50% to 3.00%.

No borrowing was undertaken during the quarter.

PWLB certainty rates quarter ended 31st March 2016

| | 1 Year | 5 Year | 10 Year | 25 Year | 50 Year |
|----------------|------------|------------|------------|------------|------------|
| Low | 1.02% | 1.51% | 2.14% | 3.01% | 2.85% |
| Date | 11/02/2016 | 11/02/2016 | 11/02/2016 | 11/02/2016 | 11/02/2016 |
| High | 1.18% | 2.12% | 2.74% | 3.44% | 3.27% |
| Date | 04/01/2016 | 04/01/2016 | 04/01/2016 | 04/01/2016 | 04/01/2016 |
| Average | 1.10% | 1.72% | 2.39% | 3.20% | 3.02% |

Borrowing in advance of need

This Council has not borrowed in advance of need during the quarter ended 31st March 2016 and has not borrowed in advance in all of 2015/16.

5. Debt Rescheduling

No debt rescheduling was undertaken during the quarter.

6. 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.

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 Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury Indicators are shown after point (7) below.

7. Other

Treasury Management Strategy Statement

The treasury management strategy statement (TMSS) has been revised to take account of the higher level of in-house funds being managed by DDC. We have opened further accounts with highly credit-rated institutions, at low risk, to enable higher returns with a view to minimising any further shortfall of investment income against budget in 2015/16. As a result, the estimated annual shortfall reported at the end of December 2015 of £29k has been reduced to a shortfall of only £20k based on final figures to 31st March 2016.

Changes in credit rating methodology

The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. Commencing in 2015, in response to the evolving regulatory regime, all three agencies have begun removing these "uplifts" with the timing of the process determined by regulatory progress at the national level. The process has been part of a wider reassessment of methodologies by each of the rating agencies. In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A consequence of these new methodologies is that they have also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

In keeping with the agencies' new methodologies, the credit element of our own credit assessment process now focuses solely on the Short and Long Term ratings of an institution. While this is the same process that has always been used by Standard & Poor's, this has been a change to the use of Fitch and Moody's ratings. It is important to stress that the other key elements to our process, namely the assessment of Rating Watch and Outlook information as well as the Credit Default Swap (CDS) overlay have not been changed.

It is important to stress that these rating agency changes do not reflect any changes in the underlying status or credit quality of the institution, merely a reassessment of their methodologies in light of enacted and future expected changes to the regulatory environment in which financial institutions operate. While some banks have received lower credit ratings as a result of these changes, this does not mean that they are suddenly less credit worthy than they were formerly. Rather, in the majority of cases, this mainly reflects the fact that implied sovereign government support has effectively been withdrawn from banks. They are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In fact, in many cases, the balance sheets of banks are now much more robust than they were before the 2008 financial crisis when they had higher ratings than now. However, this is not universally applicable, leaving some entities with modestly lower ratings than they had through much of the “support” phase of the financial crisis.

Prudential and Treasury Indicators as at 31st March 2016

| Treasury Indicators | 2015/16 Budget £'000 | Quarter 4 (Jan-Mar) Actual £'000 |
|--|-------------------------|--|
| Authorised limit for external debt | 113,500 | 113,500 |
| Operational boundary for external debt | 108,000 | 108,000 |

| | | |
|--|--------|--------|
| Maturity structure of fixed rate borrowing - upper and lower limits | | |
| Under 12 months | 2,086 | 2,086 |
| 12 months to 2 years | 3,256 | 3,256 |
| 2 years to 5 years | 6,993 | 6,993 |
| 5 years to 10 years | 13,232 | 13,232 |
| 10 years and above | 64,188 | 64,188 |

| Prudential Indicators | 2015/16 Budget £'000 | Quarter 4 (Jan-Mar) Actual £'000 |
|-------------------------------------|-------------------------|--|
| Capital expenditure | 15,429 | 11,370 |
| Capital Financing Requirement (CFR) | 98,233 | 90,060 |