Mole Valley District Council

Agenda Item 8

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Ward(s) affected	The Treasury Management Mid Year Monitoring Report covers the whole District.

Subject	Treasury Management – Mid Year Monitoring Report – 2015/16.

RECOMMENDATIONS

The Committee is asked to:

1) Receive and note the Treasury Management Mid Year Monitoring Report for the period ended 30th September 2015.
2) Commend the report to Council, making any relevant recommendations and observations as Members see fit.

EXECUTIVE SUMMARY

This report outlines the performance of the Treasury Management function of the Council for the six months ending 30th September 2015. It provides an update on the current economic conditions affecting Treasury Management decision making and looks ahead to future reporting requirements.

The key points to note are:

- All treasury related transactions were undertaken by authorised officers and within the limits approved by the Council.
- All investments were to counterparties on the approved lending list.
- The Council operated within the Prudential Indicators for Treasury Management.

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) has been adopted by the Council. The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management function.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

- Receipt by Council of an annual Treasury Management Strategy Statement – including the Annual Investment Strategy and Minimum Revenue Provision Policy – for the year ahead, a **Mid-year Review Report** and an Annual Report covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.

This report meets that requirement. It also incorporates the needs of the Prudential Code to ensure adequate monitoring of the capital expenditure plans and the Council's prudential indicators (PIs). The Treasury Management Strategy and PIs were previously reported to Audit Committee on 12th March 2015 and Council on 10th March 2015.

CORPORATE PRIORITY OUTCOMES

Strong governance arrangements mean that resources are directed in accordance with the agreed strategies and according to prudential indicators and limits as set out in the Treasury Management Strategy that there is sound and inclusive decision making and that there is clear accountability for the use of those resources in order to achieve desired outcomes for communities and service users in accord with the Council's investment priorities of security (first), liquidity (second) and finally yield.

The Committee has the authority to determine the Recommendations.

1. Background

1.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operation ensures that this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.3 As a consequence treasury management is defined as:
'The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks'.

1.4 The report updates members on treasury management activities in the period to 30th September 2015 and covers:

- The general economic performance to date and outlook.
- Treasury Management Strategy Statement update
- Compliance with regulatory requirements (treasury and prudential limits), approved policies and practices for 2015/16.

2. Economic Update

2.1 Economic performance to date and outlook

2.2 Commentary from Capita Asset Services (Capita Asset Services is a trading name of Capita Treasury Solutions Limited and are the Council's treasury management advisors) is set out in Appendix A.

3. Treasury Management Strategy Statement update

3.1 The report is structured to highlight any key changes to the Council's capital activity (the prudential indicators (PIs)), the economic outlook and the actual and proposed treasury management activity (borrowing and investment).

3.2 The Treasury Management Strategy for 2015/16 was approved by the Council on 10th March 2015 there have been no changes to the Strategy in the half year to 30th September 2015.

4. Compliance with Regulatory Requirements (Treasury and Prudential Limits), Approved Policies and Practices for 2015/16.

Key Prudential Indicators

4.1 This part of the report is structured to update:

- The Council's capital expenditure plans
- How these plans are being financed
- The impact of the changes in the capital expenditure plans on the prudential indicators (PIs) and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

Borrowing

4.2 Prudential Indicators for 2015/16 were set in accordance with the Prudential Code and the Treasury Management Code of Practice and were approved by Council on 10th March 2015. These Prudential Indicators and the actual performance against them are set out below:

Prudential Indicators for Capital Expenditure and the Financing of the Capital Programme

Prudential Indicator 1 – Capital Expenditure Plans

4.3 The table below draws together the main strategy elements of the capital expenditure plans and the expected financing arrangements of this capital expenditure.

Capital Expenditure	2015/16 Original £m	2015/16 Updated (incl. c/f) £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Capital Expenditure	2.914	9.875	11.327	2.206	2.306
Financed by:					
Capital reserves	1.600	4.290	1.200	1.136	1.236
Government grants	0.329	0.329	0.270	0.270	0.270
Other grants and conts.	0.985	1.702	2.298	0.600	0.600
Revenue	0.000	3.551	2.559	0.200	0.200
Net financing need for the year	**0**	**0**	**5.000**	**0**	**0**

Prudential Indicator 2 - Capital Financing Requirement (CFR)

4.4 The CFR reflects the underlying need to finance capital expenditure by borrowing or other long-term liability arrangements. Other long-term liabilities include credit arrangements associated with finance leases. The CFR will increase whenever capital expenditure is incurred. If this expenditure is resourced immediately then there is a zero net increase in the CFR. If this expenditure is not immediately resourced then the CFR of the Authority will increase. A positive CFR indicates a borrowing requirement which will incur a Minimum Revenue Provision (MRP) or statutory repayment of principal and interest from the general fund.

4.5 The latest CFR projections are:

	2015/16 Original £m	2015/16 Revised £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Capital Financing Requirement (CFR)	2.485	2.491	6.991	6.491	5.991

Affordability Prudential Indicators

4.6 The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

4.7 **Ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

Prudential Indicator 3 – Ratio of financing costs to net revenue stream

	2015/16 Estimate £m	2015/16 Estimate (as at 30/09/15) £m
Net Finance Cost (Interest)	(0.50)	(0.50)
Revenue Budget	10.06	10.06
Ratio %	**(5.0)**	**(5.0)**

4.8 **Incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the revenue costs associated with changes to the three year capital programme recommended in the budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three-year period.

Prudential Indicator 4 - Incremental impact of capital investment decisions on the Band D Council Tax

	2015/16 Estimate £m	2015/16 Estimate (as at 30/09/15) £m
2014/15 MTFS	2.7	2.7
2015/16 MTFS	2.9	9.9
Increase / (Decrease) in Capital Programme	0.2	7.2
Interest rate assumption	0.75%	0.50%
(Loss) / Increase of interest due to use / (investment) of capital reserves	(0.002)	(0.036)
Council Tax Base	39,632	39,632
Increase / (Decrease) in Band D Council Tax	£0.05	£0.91

Borrowing

4.9 There is no requirement to borrow to fund the capital programme in 2015/16 but the increased size of the programme means that the Council will be drawing heavily on its reserves. A relatively small increase in capital expenditure may make borrowing a necessity. The position will be closely monitored.

4.10 There has been no requirement for any short-term borrowing during the first half of the year. The Council's last external loan was repaid in February 1997 and Mole Valley became debt free on 1st April 1997.

Prudential Indicators for Borrowing:

Borrowing Limits

4.11 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowing less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total CFR in the preceding year plus the estimates of any additional CFR for 2015/16 and the next two financial years. This would allow some flexibility for limited early borrowing for future years.

Prudential Indicator 5 – Gross Borrowing and Long-term Liabilities and the Capital Financing Requirement (CFR).

	2015/16 Original Estimate	2015/16 Revised Estimate
External debt	**£m**	**£m**
Debt at 1st April	0	0
Expected change in debt	0	0
Other long-term liabilities (OLTL)	2.7	2.7
Expected change in OLTL	(0.3)	(0.3)
Actual gross debt at 31st March	**2.4**	**2.4**
Capital Financing Requirement	**2.5**	**2.5**
Under/(over) borrowing	**0.1**	**0.1**

4.12 The Strategic Director (Section 151 Officer) reports that no difficulties are envisaged for the current year in complying with this prudential indicator.

Prudential Indicator 6 – Operational Boundary

4.13 The **Operational Boundary** is the expected borrowing position of the Council during the year and periods where the actual position is either below or over the Operational Boundary is acceptable subject to the Authorised Limit not being exceeded. The Treasury Management Strategy agreed by Council on 10th March 2015 included for an Operational Boundary of £4,000,000. The cost of finance leases included within the Operational Boundary in 2014/15 amounted to £2,697,000.

Prudential Indicator 7 – Authorised Limit

4.14 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, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. The Authorised Limit is the 'Affordable Borrowing Limit' required by Section 3 of the Local Government Act 2003 irrespective of its indebted status. The introduction of International Financial Reporting Standards (IFRS) required finance leases to be included under other long-term liabilities on the balance sheet. The Treasury Management Strategy agreed by Council on 10th March 2015 included for an Authorised Limit of £5,500,000. The cost of finance leases included within the Authorised Limit in 2014/15 amounted to £2,697,000.

4.15 Actual borrowing 1st April – 30th September 2015

Maximum external borrowings at any one time	0
Total borrowings during period	0
Debt repaid during period	0

4.16 Actual External Debt

Actual borrowing as at 30th September 2015	0
Actual other long term liabilities at 30th September 2015	£2.7m
Actual external debt as at 30th September 2015	£2.7m

4.17 NB – borrowing limits set out how much the Council is able to borrow at any one time. The Authorised Limit is the maximum amount of borrowing allowed whereas the Operational Boundary is the most likely requirement. It is permissible for the Council to exceed the Operational Boundary on occasion but not to exceed the Authorised Limit without approval from Council.

4.18 Interest Rate Exposure on Borrowing

Upper limit for fixed interest rate exposure	0%
Upper limit for variable interest rate exposure	0%

4.19 Actual Performance

Proportion of interest paid at fixed rates	0%
Proportion of interest paid at variable rates	0%

4.20 Maturity Structure of Borrowings

Upper limit (under 12 months)	0%
Lower limit (under 12 months)	0%

4.21 Actual Performance

Upper limit (under 12 months)	0%
Lower limit (under 12 months)	0%

4.22 The table below shows the impact of debt and investments on the revenue budget.

	2014/15 Actual £m	2015/16 Estimate £m	2015/16 Estimate 30/09/15 £m	2016/17 Estimate £m	2017/18 Estimate £m
Interest on borrowing	0	0	0	0	0
Interest on investments	0.507	0.498	0.498	0.476	0.390

Changes to Credit Rating Methodology

4.23 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. The change of credit rating methodology was first mentioned in the Treasury Management Strategy Report 2015/16 to 2017/18 that was considered by Audit Committee on 12th March 2015.

4.24 It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of sovereign support that has been built into ratings through the financial crisis. The eventual removal of implied sovereign support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

4.25 Both Fitch and Moody’s provide ‘standalone’ credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody’s has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments, both agencies have suggested going forward that these will be in line with their respective long-term ratings. As such, there is no point monitoring both long-term and these ‘standalone’ ratings.

4.26 Furthermore, Fitch has already begun assessing its Support ratings, with a clear expectation that these will be lowered to 5, which is defined as ‘A bank for which there is a possibility of external support, but it cannot be relied upon’. With all institutions likely to drop to these levels, there is little to no differentiation to be had by assessing Support ratings.

4.27 As a result of these rating agency changes, the credit element of Capita’s future methodology will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor’s that Capita have always taken, but a change to the use of Fitch and Moody’s ratings. Furthermore, Capita will continue to utilise credit default swap (CDS) prices as an overlay to ratings in their new methodology.

Investment Strategy

4.28 The objectives of the Council’s investment strategy are safeguarding the repayment of the principal and interest of its investments on time, the liquidity of those sums, with the investment return being the final objective. As set out in paragraph 2 (Economic Background) it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. Indeed, the introduction of the Funding for Lending Scheme has reduced market investment rates even further. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

4.29 The Council’s in-house investment team manages an investment portfolio of between £25 million and £40 million. Fluctuations will occur during the year as for example council tax and non-domestic rate direct debits are collected in ten months out of twelve and this has a significant effect on the balances that are held at year end. The opening and closing balances on the Council's investment portfolio for the first half of 2015/16 are as follows:

	Investments at 01/04/2015 £m	Investments at 30/09/2015 £m
Temporary investments	20.932	26.675
CCLA Property Fund investment	5.682	5.914
Total investments outstanding	26.614	32.589

4.30 The constituent parts of the investment position as at 30th September 2015 are:

Sector	Country	Up to 1 year £m	1 - 2 years £m	2 – 3 years £m	3 - 5 years £m
Banks	UK	12.675	0	0	0
Building Societies	UK	14.000	0	0	0
Property Fund investment	UK	5.914	0	0	0
Total		**32.589**	**0**	**0**	**0**

4.31 On 30th June 2013 the Council invested £5m in the Charities, Churches and Local Authorities (CCLA) Property Fund. This is a high quality, well diversified property fund. To realise the full potential of this investment it should be considered as a medium to long term placement. Income is received quarterly and in the current economic climate good yields were anticipated.

4.32 The Fund offers all of the advantages of a professionally managed property portfolio, with broadly diversified exposure to high quality properties in the strongest areas of the market. The Fund is a high quality, well diversified commercial and industrial property portfolio. There is a focus on delivering attractive income returns and the fund is actively managed to add value.

4.33 CCLA has been appointed by the Local Authorities' Mutual Investment Trust (LAMIT) to manage and administer the Local Authorities' Property Fund. LAMIT was established around 30 years ago to provide investment services for local authorities in the UK. It is controlled by Members and Officers appointed by the Associations of

Local Authorities in the United Kingdom and by Trust Members representing the Funds' unit holders.

4.34 Excellent returns continue to be received on this Fund. At 31st March 2015 the valuation of the Fund, based on the units held x the bid (selling) price amounted to £5.682m. The valuation as at 30th September 2015 was £5.914m an increase in the Fund valuation of £232,000 (4.1%). CCLA interest earnings to 30th September amounted to £162,000. It is anticipated that the annual interest earnings from the CCLA Property Fund investment will amount to £320,000 out of a total projected interest forecast of £498,000 (budget £498,000).

4.35 Banks and building societies have availed themselves of cheaper funds through the Bank of England's Funding for Lending Scheme (FLS), first introduced in August 2012. Unfortunately this has had a detrimental effect on the Council's investment interest earnings.

Prudential Indictors for Investments

4.36 The Council's Treasury Management Strategy has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011), which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

Prudential Indicator 8 – Principal Sums Invested > 364 days

4.37 Maximum principal sum limits for investments for periods longer than 364 days maturing in:

2015/16	£12,000,000
2016/17	£12,000,000
2017/18	£12,000,000

4.38 Actual Performance (as at 30/09/15)

Matured or maturing within 2015/16	£0
Maturing in 12 to 24 months (2016/17)	£0
Maturing in 24 to 36 months (2017/18)	£0
Maturing in 36 to 48 months (2018/19)	£0

Prudential Indicator 9 – Interest Rate Exposures

4.39 Interest Rate Exposure on Investments

Upper limit for fixed interest rate exposure	100%
Upper limit for variable interest rate exposure	35%

4.40 Actual Performance (as at 30/09/15)

Proportion of interest paid at fixed rates (April – September 2015)	80%
Proportion of interest paid at variable rates (April – September 2015)	20%

4.41 The Deputy Chief Executive (Section 151 Officer) confirms that all of the Council's investments were placed with organisations approved in the Annual Treasury Management Strategy for 2015/16 and in accordance with the Prudential Indicators set out in that Strategy and with the Treasury Management Code of Practice.

Prudential Indicator 10 – Fixed Interest Rate Borrowing

4.42 Maturity structure of fixed interest rate borrowing in 2015/16:

	Lower	Upper
Under 12 months	0%	0%
12 months to 2 years	0%	0%
2 years to 5 years	0%	0%
5 years to 10 years	0%	0%
10 years and above	0%	0%

4.43 Actual Performance (as at 30/09/15)

	Lower	Upper
Under 12 months	0%	0%
13 months to 2 years	0%	0%
2 years to 5 years	0%	0%
5 years to 10 years	0%	0%
10 years and above	0%	0%

4.44 Risk Benchmarking
A regulatory development is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are fairly new requirements to Member reporting, although the application of these is more subjective in nature. These were first set in the Treasury Strategy Report 26th January 2010 (Scrutiny and Audit Committee). The following reports the current position against the benchmarks originally approved.

4.45 Security
The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, was set as follows:

0.09% historic risk of default when compared to the whole portfolio.

The Deputy Chief Executive (Section 151 Officer) can report that the investment portfolio was maintained within this overall benchmark during this year to date.

Based on the Authority's minimum long-term credit rating of A/A3/A (Fitch/Moody's/Standard and Poor's) the security benchmarks for each individual year were set as:

Benchmarks	1 year	2 years	3 years	4 years	5 years
Maximum (01/04/15)	0.09%	0.25%	0.44%	0.62%	0.83%
Maximum (30/09/15)	0.09%	0.24%	0.43%	0.61%	0.86%

Since the benchmarks were first included in the Strategy our advisors have received more up to date default information, which reflects increased counterparty defaults during the banking crisis. The table shows how the Council is benchmarking risk.

The Deputy Chief Executive (Section 151 Officer) can report that these benchmarks were not breached during the year to date.

Note: The benchmarks are an average risk of default measure, and would not constitute an expectation of loss against a particular investment. Where a counterparty is not credit rated a proxy rating will be applied.

4.46 Liquidity

In respect of this area the Council set liquidity facilities/benchmarks to maintain:

- Bank overdraft - £100,000
- Liquid short term deposits of at least £2,000,000 available immediately.

The Deputy Chief Executive (Section 151 Officer) can report that liquidity arrangements were satisfactory during the year to date.

4.47 Yield

Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID (London Interbank BID) rate.

5 **Financial Implications** – are covered in the body of this report.

6. **Legal Implications**

The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance:

- The Local Government Act 2003 (the 2003 Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity.
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which

may be undertaken (no restrictions were made in the first six months of 2014/15).

- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act.
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA *Prudential Code for Capital Finance in Local Authorities.*
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services.
- Under the Act the DCLG has issued *Guidance on Local Government Investments* to structure and regulate the Council's investment activities. Updated guidance became available on 1st April 2010.

The Council has complied with all of the above relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

7. CORPORATE IMPLICATIONS

Monitoring Officer commentary – The Monitoring Officer confirms that all relevant legal implications have been taken into account.

S151 Officer commentary – The S151 Officer confirms that all financial implications have been taken into account.

Risk Implications – The Council considers security, liquidity and yield, in that order, when making investment decisions:

Security – counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swaps, gross domestic product (GDP) of the country in which the institution operates, the country's net debt as a percentage of GDP, any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for 2015/16 was A/A3/A (Fitch/Moody's/Standard and Poors).

Liquidity – the Council maintained a sufficient, though not excessive, level of liquidity during the half-year using various call accounts and short-term, fixed-rate, deposits.

Yield – the Council sought to optimise returns commensurate with its objectives of security and liquidity. Short-term money market rates remained at very low levels throughout the half-year which had a significant impact on investment income.

A high reliance on investment income can place the Council at significant risk of budget variation as interest rates rise and fall, which has an impact upon future

Council Tax levels. The Council's Medium Term Financial Strategy addresses this risk and seeks to reduce this reliance over time.

Locking significant investments into long-term fixed-rate transactions means the Council has a potential disadvantage in a rising interest market, especially if the interest rate rises above the assumption made when the long-term deal was placed.

To mitigate this, the Council's in-house team predominantly invest up to periods of three months only, hence advantage can be taken of prevailing interest rates upon the investments maturity. This minimises the disadvantage whilst maintaining certainty over the level of future return and stability in planned future Council Tax levels. With interest rates remaining at historically low levels the Authority has made some longer term investments that are higher yielding, although less liquid. This has proved to be a good decision as interest rates have remained at low levels throughout the first half-year.

The Council will continue to look to diversify its investment portfolio and the 2015/16 Treasury Management Strategy provides for alternative investment funds should the opportunity arise.

Security of capital is cited in the Financial Services Risk Register (FIN 06) and this is mitigated by use of counterparty credit security ratings. The lowering of these ratings increases risk. It is felt that a credit rating of A is acceptable for the Council's risk profile (being 'top six' out of a possible 28 ratings) and represents upper quartile performance (Appendix B refers). Officers will also use supplementary credit information to monitor investment counterparties.

Equalities Implications – There are no equalities implications arising as a direct consequence of this report.

Employment Issues - None within the report.

Sustainability Issues - None within the report.

Consultation - The Council is in regular contact with Capita Asset Services, the Council's appointed Treasury Management advisor. Conversations have been held during the first half-year involving Capita Asset Services and officers.

8. BACKGROUND PAPERS

Performance management information from Capita Asset Services.
CIPFA Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes (2011 edition).
CIPFA Treasury Management in the Public Services – Guidance Notes for Local Authorities including Police Authorities and Fire Authorities (2011 edition).
CIPFA Prudential Code for Capital Finance in Local Authorities (2011 edition).
Treasury Management Annual Strategy Report 2015-16 and Prudential Indicators 2015-16 to 2017-18.

APPENDIX A

1. **Economic Update**

1.1 **Economic performance to date and outlook**

1.2 Commentary from Capita Asset Services.

1.3 **United Kingdom**

1.4 UK Gross Domestic Product (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 is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% though there has been a rebound in quarter 2 to +0.7%. The Bank of England is forecasting growth to remain around 2.4% – 2.8% over the next three years. The most recent forward looking surveys in August for the services and manufacturing sectors showed a marked slow down in the rate of growth. This is not too surprising given the appreciation of Sterling against the Euro and weak growth in the EU, China and emerging markets creating headwinds for UK exporters. For this recovery to become more balanced and sustainable in the longer term, the recovery still needs to move away from dependence on consumer expenditure and the housing market to manufacturing and investment expenditure. This overall strong growth has resulted in unemployment falling quickly over the last few years although it has now ticked up recently after the Chancellor announced in July significant increases planned in the minimum (living) wage over the course of this Parliament.

1.5 The Monetary Policy Committee (MPC) has been particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. It has therefore been encouraging in 2015 to see wage inflation rising significantly above Consumer Price Index (CPI) inflation which slipped back to zero in June and again in August. However, with the price of oil taking a fresh downward direction and Iran expected to soon rejoin the world oil market after the impending 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. The August 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. Despite average weekly earnings ticking up to 2.9% y/y in the three months ending in July, as announced in mid-September, this is unlikely to provide ammunition for the MPC to take action to raise Bank Rate soon as labour productivity growth meant that net labour unit costs are still only rising by about 1% y/y.

1.6 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 central banks of both the US and the UK to raise rates as soon as had previously been expected, especially given the recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices. The volatility that has been seen in equity and bond markets in 2015 so far, could potentially spill over to impact the real economies rather than just financial markets. On the other hand, there are also concerns around the fact that the central banks of the UK and US have few monetary policy options left to them given that central rates are near to zero and huge quantitative easing (QE) is already in place. There are therefore arguments that they need to raise rates sooner, rather than later, so as to have ammunition to use if there was a sudden second major financial crisis. But it is hardly likely that they would raise rates until they are sure that growth was securely embedded and 'noflation' was not a significant threat.

1.7 The forecast for the first increase in Bank Rate has therefore been pushed back from Q1 to Q2 2016. Increases after that will be at a much slower pace and to much lower levels than prevailed before 2008, as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

1.8 The Government's revised Budget in July eased the pace of cut backs from achieving a budget surplus in 2018/19 to achieving that in 2019/20.

1.9 **United States**

1.10 GDP growth in 2014 of 2.4% was followed by first quarter 2015 growth depressed by exceptionally bad winter weather at only +0.6% (annualised). However, growth rebounded very strongly in Q2 to 3.9% (annualised) and strong growth is expected going forward. Until the turmoil in financial markets in August caused by fears about the slowdown in Chinese growth, it had been strongly expected that the Federal Reserve would start to increase rates in September. However, the Federal Reserve pulled back from a first increase due to global risks which might depress growth and put downward pressure on inflation, and due to a 20% appreciation of the dollar which has caused the Federal Reserve to lower its growth forecasts. However, despite inflation being subdued at the current time, a combination of ongoing strong economic growth and a return to full employment would tend to indicate that inflation must be due to make a return. The longer the Federal Reserve holds out against raising rates, the sharper is likely to be the subsequent pace of increases. While an increase in rates cannot be ruled out at the October or December meetings, market expectations have moved back to January 2016.

1.11 **Eurozone**

1.12 The European Central Bank (ECB) announced a massive €1.1 trillion programme of quantitative easing in January 2015 to buy up high credit quality government debt of selected Eurozone countries. This programme started in March 2015 and will run to September 2016. This seems to have already had a beneficial impact in improving confidence and sentiment. There has also been a continuing trend of marginal increases in the GDP growth rate which hit 0.4% in quarter 1 2015 (1.0% y/y) and +0.4%, (1.5% y/y) in Q2 GDP. The ECB has also stated it would extend its QE programme if inflation failed to return to its target of 2% within this initial time period.

1.13 Greece - During July, Greece finally capitulated to European Union (EU) demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.

1.14 **China and Japan**

1.15 Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth. In Q2 2015 growth was -1.6% (annualised) after a short burst of strong growth of 4.5% in Q1. During 2015, Japan has been hit hard by the downturn in China. This does not bode well for Japan as the Shinzo Abe government has already tried to stimulate recovery and a rise in inflation from near zero, but has dithered about deregulation of protected and inefficient areas of the economy, due to political lobbies which have traditionally been supporters of Abe's party.

1.16 As for China, the Government has been very active during 2015 in implementing several stimulus measures to try to ensure the economy hits the growth target of 7% for the current year and to bring some stability after the major fall in the onshore Chinese stock market. Many commentators are concerned that recent growth figures around that figure, could have been massaged to hide a downturn to a lower growth figure. There are also major concerns as to the creditworthiness of much bank lending to corporates and local government during the post 2008 credit expansion period and whether the bursting of a bubble in housing prices is drawing nearer. Overall, China is still expected to achieve a growth figure that the EU would be envious of. However, concerns about whether the Chinese cooling of the economy could be heading for a hard landing, and the volatility of the Chinese stock market, have caused major volatility in financial markets in August and September such that confidence is, at best, fragile.

1.17 **Emerging countries**

1.18 There are considerable concerns about the vulnerability of some emerging countries and their corporates which are getting caught in a perfect storm. Having borrowed massively in western currency denominated debt since the financial crisis, caused by western investors searching for yield by channeling investment cash away from western economies with dismal growth, depressed bond yields (due to QE), and near zero interest rates, into emerging countries, there is now a strong current flowing to reverse that flow back to those western economies with strong growth and an imminent rise in interest rates and bond yields. This change in investors' strategy and the massive reverse cash flow has depressed emerging country currencies and caused the US dollar and sterling to appreciate. In turn, this has made it much more costly for emerging countries to service their western currency denominated debt at a time when their earnings from commodities are depressed. There are also going to be major issues when previously borrowed debt comes to maturity and requires refinancing at much more expensive rates, if available at all.

1.19 Corporates (worldwide), heavily involved in mineral extraction and/or the commodities market may also be at risk and this could also cause volatility in equities and safe haven flows to bonds. Financial markets may also be buffeted by sovereign wealth funds of countries highly exposed to falls in commodity prices which, therefore, may have to liquidate investments in order to cover national budget deficits.

1.20 **Interest Rate Forecasts**

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

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

(The Capita Assets Services forecasts above are for PWLB certainty rates).

1.21 Capita Asset Services undertook a review of its interest rate forecasts on 11th August. Later in August, fears around the slowdown in China and Japan caused major volatility in equities and bonds and sparked a flight from equities into safe havens like gilts and so caused Public Works Loans Board (PWLB) rates to fall. However, there is much volatility in rates as news ebbs and flows in negative or positive ways and news in September in respect of Volkswagen, and other corporates, has compounded downward pressure on equity prices. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.

1.22 Despite market turbulence in late August, and then September, causing a sharp downturn in PWLB rates, the overall trend in the longer term will be for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

1.23 The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last. It also remains exposed to vulnerabilities in a number of key areas.

1.24 Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth turns significantly weaker than Capita Asset Services currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and/or the start of Federal Reserve rate increases, causing a flight to safe havens.

1.25 The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- Uncertainty around the risk of a UK exit from the EU.
- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.
- The commencement by the US Federal Reserve of increases in the Federal Reserve funds rate in 2015, causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Appendix B – Hierarchy of Counterparty Security Ratings

Short Term		
Fitch	**Moody's**	**S&P**
F1+	P-1	A-1+
F1		A-1
F2	P-2	A-2
F3	P-3	A-3
B		B
C		C
D		D

Long Term			Description
Fitch	**Moody's**	**S&P**	(AAA = highest, D = lowest)
AAA	Aaa	AAA	Highest security
AA+	Aa1	AA+	
AA	Aa2	AA	
AA-	Aa3	AA-	
A+	A1	A+	
A	A2	A	
A-	A3	A-	
BBB+	Baa1	BBB+	
BBB	Baa2	BBB	
BBB-	Baa3	BBB-	
BB+	Ba1	BB+	
BB	Ba2	BB	
BB-	Ba3	BB-	
B+	B1	B+	
B	B2	B	
B-	B3	B-	
CCC+	Caa1	CCC+	
CCC	Caa2	CCC	
CCC-	Caa3	CCC-	
CC+	Ca	CC+	
CC	Ca	CC	
CC-	Ca	CC-	
C+	C	C+	
C	C	C	
C-	C	C-	
DDD	D	DDD	
DD	D	DD	
D	D	D	Lowest Security