TREASURY MANAGEMENT UPDATE FOR QUARTER 1, 2015

To:	**Governance and Audit Committee – 24 September 2015**
Main Portfolio Area:	**Finance**
By:	**Director of Corporate Resources (s151 Officer)**
Classification:	**Unrestricted**

Summary: **This report is to update the Governance and Audit Committee with the Treasury Management activity that has occurred for the quarter ended 30th June 2015.**

For Decision

1.0 Introduction and Background

1.1 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 mid year reports). This report therefore ensures this council is implementing best practice in accordance with the Code.

2.0 Economic Background for the Quarter Ended 30 June 2015 (issued by the Council's treasury advisor, Capita Asset Services (Capita), on 6 July 2015)

2.1 After strong UK Gross Domestic Product (GDP) growth in 2013 at an annual rate of 2.7% and 3.0% in 2014, quarter 1 of 2015 was disappointing at only 0.4%, though subsequent data indicates that this could well be revised up further down the line and also indicates a return to stronger growth in quarter 2. In its May quarterly Inflation Report, the Bank of England reduced its GDP forecast for 2015 from 2.9% to 2.5% and from 2.9% to 2.7% in 2016, while increasing its forecast for 2017 from 2.4% to 2.7%.

2.2 Uncertainty around the likely result of the UK general election in May has obviously now evaporated although this has been replaced by some uncertainty around the potential impact on the UK economy of the EU referendum promised by, or in, 2017. In addition, the firm commitment of the Conservative Government to eliminating the deficit within the term of this Parliament will have an impact on GDP growth rates. However, the Monetary

Policy Committee (MPC) is fully alert to this and will take that into account, and also the potential spill over effects from the Greek crisis, in making its decisions on the timing of raising Bank Rate.

2.3 As for the American economy, confidence has improved markedly in this quarter that the US will start increasing the Fed funds rate by the end of 2015 due to a return to strong economic GDP growth after a disappointing start to the year in quarter 1, (a contraction of 0.2%), after achieving 2.4% growth in 2014.

2.4 In the Eurozone, in 2015 the European Central Bank (ECB) unleashed a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected Eurozone (EZ) countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth, though it remains to be seen whether this will have an enduring effect as strong as the recovery in the US and UK.

3.0 Capita's Interest Rate Forecast (issued by Capita on 6 July 2015)

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

	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%
5yr PWLB rate	2.30%	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%
10yr PWLB rate	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%
25yr PWLB rate	3.60%	3.70%	3.80%	4.00%	4.10%	4.20%	4.30%	4.40%	4.40%	4.50%	4.60%
50yr PWLB rate	3.60%	3.70%	3.80%	4.00%	4.10%	4.20%	4.30%	4.40%	4.40%	4.50%	4.60%

3.2 Capita Asset Services undertook a review of its interest rate forecasts after the May Bank of England Inflation Report. The ECB's quantitative easing programme to buy up EZ debt caused an initial widespread rise in bond prices and, correspondingly, a fall in bond yields to phenomenally low levels, including the debt of some European countries plunging into negative yields. Since then, fears about recession in the EZ, and around the risks of deflation, have abated and so there has been an unwinding of this initial phase with bond yields rising back to more normal, though still historically low yields.

3.3 This latest forecast includes a move in the timing of the first increase in Bank Rate from quarter 1 of 2016 to quarter 2 of 2016 as a result primarily of poor growth in quarter 1, weak wage inflation and the recent sharp fall in inflation

due to the fall in the price of oil and the impact of that on core inflation. The UK fell marginally into deflation in April (-0.1%) and figures near zero will prevail for about the next six months until the major fall in oil prices in the latter part of 2014 falls out of the twelve month calculation of Consumer Price Index (CPI) inflation. The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when average disposable income is only just starting a significant recovery as a result of recent increases in the rate of wage inflation, though some consumers will not have seen that benefit come through for them.

4.0 Capita's forward view (issued by Capita on 6 July 2015)

4.1 Economic forecasting remains difficult with so many external influences weighing on the UK. Capita's Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

4.2 The overall longer run trend is 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.

4.3 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.

4.4 Capita would, however, remind clients of the view that it expressed in its previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are at present. We are experiencing exceptional levels of volatility which are highly correlated to geo-political and sovereign debt crisis developments. Capita's revised forecasts are based on the Certainty Rate (minus 20 basis points) which has been accessible to most authorities since 1st November 2012.

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

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows;
- UK strong economic growth being weaker than Capita currently anticipates;
- 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.

4.6 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 Fed. 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.

5.0 Annual Investment Strategy

5.1 The Treasury Management Strategy Statement (TMSS) for 2015/16, which includes the Annual Investment Strategy, was approved by the Council on 5 February 2015 and amendments were approved by the Council on 23 April 2015. It sets out the Council's investment priorities as being:

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

5.2 The Council will also aim to achieve the optimum return (yield) on 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 370 days with highly credit rated financial institutions, using Capita's suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Capita.

5.3 Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 30th June 2015 apart from the money limit with the Lloyds Banking Group (Lloyds) for the 11 day period from 15 May 2015 to 26 May 2015.

5.4 With effect from 15 May 2015 Capita changed its view on Lloyds, no longer regarding it as part nationalised. Given the credit rating of Lloyds, this meant that the Council's money limit with Lloyds reduced from £7m to £5m. The Council was able to reduce its deposits with Lloyds to under £5m on 26 May 2015, upon maturity of a £2m fixed term deposit with Lloyds.

5.5 The Council is also reducing the maximum duration of its deposits with Lloyds from 370 days to 6 months, in line with Capita's revised recommendation of 15 May 2015. The Council's pre-existing fixed term deposits with Lloyds will all have less than 6 months to run by the end of October 2015 and will all have matured by the end of April 2016.

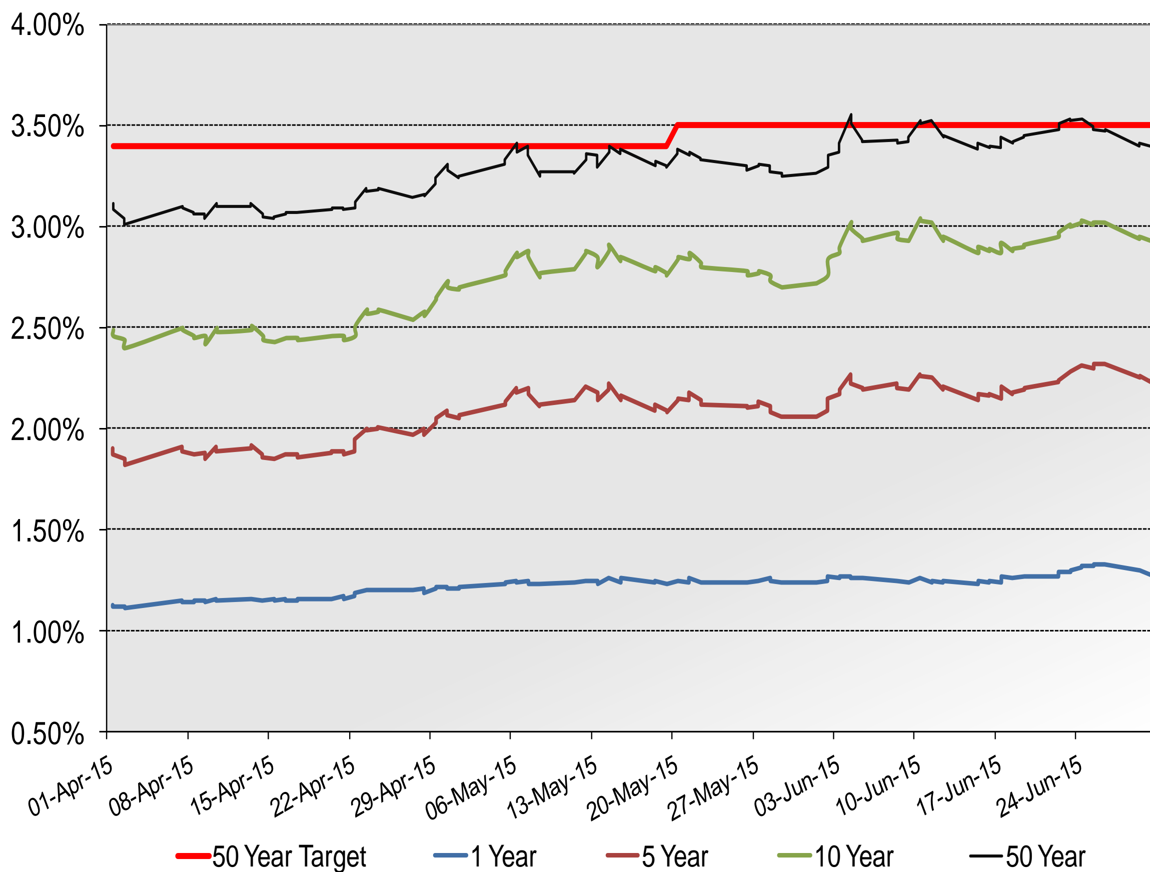
6.0 New Borrowing and Debt Rescheduling

6.1 Capita's target rate for the 25 year PWLB certainty rate for new long term borrowing for the quarter ending 30th June rose slightly from 3.40% to 3.50% after the May Bank of England Inflation report.

6.2 No new borrowing was undertaken during the quarter by the Council.

6.3 PWLB certainty rates, quarter ended 30th June 2015

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.11%	1.82%	2.40%	3.06%	3.01%
Date	02/04/2015	02/04/2015	02/04/2015	02/04/2015	02/04/2015
High	1.33%	2.32%	3.04%	3.65%	3.55%
Date	25/06/2015	25/06/2015	10/06/2015	24/06/2015	04/06/2015
Average	1.23%	2.09%	2.75%	3.37%	3.29%



6.4 To minimise investment risk, the Council has reduced the overall debt liability by repaying £1.199m of external debt (this relates to a maturing loan and to loans which are repayable by equal instalments of principal (EIP) over their lives). However, this policy will require on-going monitoring in the event that upside risk to gilt yields prevails.

6.5 This Council has not borrowed in advance of need during the quarter ended 30th June 2015 and has not borrowed in advance in all of 2014/15.

6.6 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. During the quarter ended 30th June 2015, no debt rescheduling was undertaken by the Council.

7.0 Compliance with Treasury and Prudential Limits

7.1 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.

7.2 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 apart from the money limit with Lloyds as described in section 5 of this report.

8.0 Credit Ratings – Sovereign Support

8.1 During this quarter, credit rating agencies have acted to remove implied sovereign support for major national banks of systemic importance. This does not mean that these banks are of any lower credit worthiness than they were before this change. This change does though reflect the substantial improvement in the strength of bank balance sheets since the 2008 crisis and changes in the regulatory environment within which banks now have to work which means that their own strength should make it unnecessary for national governments to provide financial support to banks in any future financial crisis. While sovereign ratings will remain part of the Council's credit rating methodology, the impact of this change means that the rating of an individual bank is now the overriding focus in selecting creditworthy banks to lend to.

9.0 Options

9.1 That the Governance and Audit Committee approves this report.

10.0 Corporate Implications

10.1 Financial and VAT

10.1.1 There are no financial or VAT implications arising directly from this report.

10.2 Legal

10.2.1 There are no legal implications arising directly from this report.

10.3 Corporate

10.3.1 This report is being brought before Members of the Governance and Audit Committee as recommended by the CIPFA Code of Practice as being best practice.

10.4 Equity and Equalities

10.4.1 There are no equality or equity issues arising directly from this report.

11.0 Recommendation

11.1 That the Governance and Audit Committee approves this report.

12.0 Decision Making Process

12.1 As per section 11.1 above.

13.0 Disclaimer

13.1 This report is a technical document focussing on public sector investments and borrowings and, as such, readers should not use the information contained within the report to inform personal investment or borrowing decisions. Neither Thanet District Council nor any of its officers or employees

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Annex List

N/A	

Corporate Consultation Undertaken

Finance	N/A
Legal	N/A