**BARNSLEY METROPOLITAN BOROUGH COUNCIL**

**This matter is not a Key Decision within the Council's definition and has not been included in the relevant Forward Plan**

**Report of the Executive Director of Core Services**

# TREASURY MANAGEMENT ACTIVITIES & INVESTMENT PERFORMANCE - QUARTER ENDED 30TH JUNE 2017

## 1. Purpose of the Report

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 that the Council is implementing best practice in accordance with the Code.

## 2. Recommendations

2.1 It is recommended that Members note:-

- **the Treasury Management activities undertaken during the quarter and compliance with the Prudential Indicators;**
- **the Authority's latest borrowing position; and**
- **the Authority's latest investment portfolio and performance for the quarter.**

## 3. Economic Summary

3.1 Highlights and key messages:

- UK economic growth held up better than expected in the 6 months following the Brexit vote;
- Growth slowed in the first half of 2017 as inflation rose sharply, putting a squeeze on household spending power;
- Growth is expected to slow further due to political and economic uncertainty relating to the outcome of the Brexit negotiations (particularly in light of the general election result), and
- The UK base rate is likely to remain at 0.25% in the short term, but the case for a rate rise could build if growth and inflation continue as forecast.

3.2 A detailed commentary from our advisors on developments during the quarter is provided in Appendix 3.

## 4. Interest Rate Forecast

4.1 The table below outlines the latest base rate projections from our advisors:

| Base Rate | Jun 2017 | Sep 2017 | Dec 2017 | Mar 2018 | Jun 2018 | Sep 2018 | Dec 2018 | Mar 2019 | Jun 2019 | Sep 2019 | Dec 2019 | Mar 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Capita Asset Services** | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.50% | 0.50% | 0.75% | 0.75% |
| **Capital Economics** | 0.25% | 0.25% | 0.25% | 0.25% | 0.50% | 0.50% | 0.75% | 0.75% | 1.00% | 1.00% | 1.25% | - |

4.2 The UK base rate was cut in August 2016 (from 0.50% to 0.25%) following signs of a sharp slowdown in growth in the second half of the year, however this did not materialise. Inflation rose substantially in the first half of 2017, owing to the fall in value of sterling since the referendum. As a result the base rate has not been reduced further.

4.3 The forecast from our advisors (Capita Assets Services) remains unchanged from the previous quarter, which suggests a rate increase is unlikely to happen until 2019 after the Brexit negotiations have been concluded.

4.4 However the prospect of a rate rise has increased since the Monetary Policy Committee (MPC) met in June, where 3 out of 8 members voted to increase the base rate by 0.25%, which is reflected in the forecast from Capital Economics. This shows that, if strong domestically generated inflation was to emerge (e.g. from wage increases in the UK), the pace and timing of increases could be brought forward to as early as June 2018.

4.5 A detailed commentary from our advisors on the interest rate forecast is provided in Appendix 4.

## 5. The Authority's Borrowing Position

5.1 The table below outlines the movement on the Authority's borrowing position during the quarter:

| | **Balance on 01/04/2017 £m** | **New Borrowing £m** | **Debt Repaid £m** | **Balance on 30/06/2017 £m** | **Net Increase/ (Decrease) £m** |
|---|---|---|---|---|---|
| Short Term Borrowing | 69.603 | 51.080 | (31.400) | 89.283 | 19.680 |
| PWLB Borrowing | 414.979 | - | (20.918) | 394.061 | (20.918) |
| Other Long Term Loans | 63.000 | - | - | 63.000 | 0.000 |
| Long Term Local Authority | 3.897 | - | - | 3.897 | 0.000 |
| **TOTAL BORROWING** | **551.479** | **51.080** | **(52.318)** | **550.241** | **(1.238)** |

5.2 The Authority's overall debt position reduced by £1.2M during the quarter. Two PWLB loans matured in May reducing the balance by £20M, which was offset by a net increase in temporary borrowing from other Local Authorities, taking advantage of some very low rates.

5.3 A Debt Options analysis has been carried out to assess the current position of the GF and requirements over the next 5 years. It is important to ascertain the right approach in a difficult climate. An analysis has been completed to project the impact of taking various decisions and how this feeds through to the Capital Financing Budget.

5.4 Several options were outlined in the 2017/18 Treasury Management Strategy to address the Authority's borrowing position, as set out in section 8.

New Borrowing

5.5 No new long-term borrowing was undertaken during the quarter, but the borrowing requirements of the Authority, together with the borrowing rates available are being closely monitored by Officers. The latest PWLB certainty rate forecasts are shown within Appendix 4.

Borrowing in Advance of Need

5.6 The Council has not borrowed in advance of need during the quarter ended 30th June 2017.

Debt Rescheduling

5.7 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. No debt rescheduling was undertaken during the quarter.

5.8 As mentioned above, various borrowing opportunities are currently being explored with an ongoing review of the Council's treasury management position.

## 6. The Authority's Investment Portfolio

6.1 The table below outlines the movement on the Authority's investment portfolio during the quarter:

| | **Balance on 01/04/2017 £m** | **Investments Made £m** | **Investments Repaid £m** | **Balance on 30/06/2017 £m** | **Net Increase/ (Decrease) £m** |
|---|---|---|---|---|---|
| Long-Term Investments | 7.000 | - | - | 7.000 | - |
| Short-Term Investments | 17.000 | 17.000 | (19.000) | 15.000 | (2.000) |
| Money Market Funds / Instant Access | 38.250 | 88.900 | (102.550) | 24.600 | (13.650) |
| **TOTAL INVESTMENTS** | **62.250** | **105.900** | **(121.550)** | **46.600** | **(15.650)** |

6.2 The Authority's overall investment portfolio reduced by £15.65M during the quarter, which can be attributed to the £26.48M pension deficit contribution made in April. The contribution was paid up front (instead of over a 3 year period) to avoid significant interest costs. This resulted in a saving to the Authority which was reflected in the Medium Term Financial Strategy (MTFS).

6.3 All of our investments are in-line with the investment priorities and approved limits set out in the Treasury Management Strategy Statement (TMSS) for 2017/18 (further details below):

1. Security of capital;
2. Liquidity; and
3. Yield.

Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter.

| Counterparty | Rating | Principal (£m) | Status |
|---|---|---|---|
| Lloyds | A | 5.00 | Fixed deposit to 09.10.17 |
| Goldman Sachs International Bank | A | 5.00 | Fixed deposit to 04.12.17 |
| Leeds City Council | AA | 5.00 | Fixed deposit to 27.09.17 |
| Svenska Handelsbanken | AA- | 9.40 | Instant Access |
| Money Market Funds | AAAmmf | 15.20 | Instant Access |
| Enhanced Money Market Funds | AAAmmf | 7.00 | Accessible within 3 days |
| **TOTAL INVESTMENTS** | | **46.60** | |

6.4 Following the base rate cut in August 2016, the Authority has seen interest rate reductions across its instant access accounts and money market funds. Officers are continuing to assess daily cash flows and liquidity requirements to ensure the Authority's investments are the most suitable within the current environment.

6.5 The 7 day London Interbank Bid Rate (LIBID) is used as a performance indicator for measuring the return on investments. The average rate of return on the Authority's investments for the quarter was 0.42%, exceeding the 7 day LIBID benchmark of 0.11%.

## 7. 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 Prudential and Treasury Indicators (affordability limits) are included in the approved TMSS.

7.2 During the quarter the Council 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 in Appendix 1.

## 8. The Future Outlook for Treasury Management Activities

8.1 Financial Services continue to closely monitor the Council's borrowing position together with projected interest rate forecasts for the next two years.

8.2 Affordability and the 'cost of carry' (the difference between long-term borrowing rates and short-term investment rates) remain important influences on the borrowing strategy and the Authority determines it cost effective in the short-term to use internal resources. However, the Council will not be able to sustain a temporary / internally borrowed position indefinitely and will eventually need to fix out more borrowing in the near future to fund the town centre and other previously approved commitments. In addition to this, the Council has a number of loans that will mature over the next 2-3 years at relatively high rates. Financial Services will again seek to replace these loans at lower rates as part of the process to optimise the Council's longer term borrowing position.

8.3 Several borrowing recommendations were outlined in the 2017/18 Treasury Management Strategy including:

1) Borrowing from the newly formed Municipal Bond Agency. The Agency has been established to provide an alternative source of funding for Local Authorities from the PWLB. The Agency is a new initiative and has not yet made its first bond issue. Should the bond issue fail to materialise within our required timescales, the Authority will look into alternative borrowing options.

2) Fixing out a proportion of the debt portfolio, to move towards fixing out temporary variable loans as a policy objective. The variable rate debt will not incur a penalty if repaid early, will reduce variable rate risk, but clearly will introduce additional costs to refinance.

3) Reviewing the feasibility of taking out deferred loans to cover off a large variable loan due to mature in 2019/20. Options are available to fix the rate now for a period of up to 5 or 6 years in advance. This would allow the Authority to maintain a short term, cheap position, with the comfort of fixed rate loans being delivered in the future. The risks are, once committed the funds must be taken and the market rates could potentially be cheaper in future although this is unlikely with current interest rates so low. Financial Services are currently looking at options with our advisers and in active discussions with a lending institution to implement a forward loan. It should be noted that arranging the loans could be quite a lengthy process involving a great deal of due diligence with commercial lenders.

8.4 In addition to the above, ongoing work is being undertaken to review other areas in the Council's debt portfolio to create further savings. A specific example is the review of the Building Schools for the Future PFI programme. This has already been completed for phase 2 in conjunction with the Local Education Partnership and it is proposed to complete phase 1 and 3 during 2017/18 and 2018/19.

8.5 Opportunities to repay the Authority's LOBO loans have been investigated, but at this time further progress has not been made. This is primarily due to the German lenders, FMS, who do not appear to want to engage in discussions to re-negotiate the deal despite initially encouraging dialogue. As a result this option has been discounted for the time being but will be re-established if further opportunities present themselves in future.

8.6 The Authority is aware of two upcoming reforms that may impact on its investment activities in the near future:

1) Markets in Financial Institutions Directive (MiFiD II). MiFiD II is a wide-ranging Directive which aims to strengthen the investment services market. It introduces a number of key changes to client categorisation, meaning Local Authorities will have to opt up to professional client status in order to access certain products. To do so they will have to meet a number of qualitative and quantitative tests. These changes are set to take effect from January 2018.

2) Money Market Fund Reform. The Money Market Fund Reform introduces a new structural fund - the Low Volatility Net Asset Value (LVNAV) Fund – and some changes to the existing Money Market Funds. These regulations will apply to new funds from July 2018 and existing funds from January 2019.

8.7 The full impact of these reforms is not known at this time however officers will continue to monitor the situation and provide an update in quarter 2.

Appendix 1

**Prudential and Treasury Indicators as at 30th June 2017**

| Prudential Indicators | Limit for 2017/18 (£'000) | Quarter 1 Actual (£'000) | Compliance with Indicator? |
|---|---|---|---|
| **Maximum Debt Compared to Authorised Limit** | 990.591 | 807.964 | Yes |
| **Average Debt Compared to Operational Boundary** | 960.591 | 798.453 | Yes |

| Maturity structure of fixed rate borrowing | Upper Limit (%) | Lower Limit (%) | Quarter 1 Actual (£'000) | Quarter 1 Actual (%) | Compliance with Indicator? |
|---|---|---|---|---|---|
| **Under 12 months** | 0 | 50 | 135.913 | 29 | Yes |
| **12 months to 2 years** | 0 | 25 | 24.415 | 5 | Yes |
| **2 years to 5 years** | 0 | 25 | 15.228 | 3 | Yes |
| **5 years to 10 years** | 0 | 25 | 53.472 | 11 | Yes |
| **10 years to 20 years** | 0 | 75 | 27.430 | 6 | Yes |
| **20 years to 30 years** | 0 | 75 | 55.553 | 12 | Yes |
| **30 years to 40 years** | 0 | 75 | 67.400 | 14 | Yes |
| **40 years to 50 years** | 0 | 75 | 86.030 | 18 | Yes |

| Treasury Indicators | Limit for 2017/18 (%) | Quarter 1 Actual (%) | Compliance with Indicator? |
|---|---|---|---|
| **Upper limit of fixed interest rates based on net debt** | 90 | 85 | Yes |
| **Upper limit of variable interest rates based on net debt** | 25 | 15 | Yes |

| Treasury Indicators | Limit for 2017/18 £'000 | Quarter 1 Actual (£'000) | Compliance with Indicator? |
|---|---|---|---|
| **Upper limit for principal sums invested over 364 days*** | 20.000 | - | Yes |

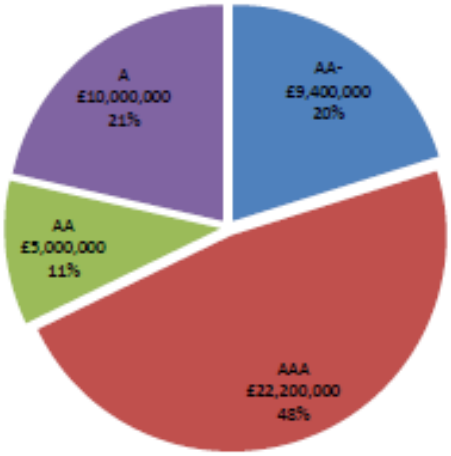
** The 'long-term investments' referred to in section 6.1 are long-term in the sense that they're invested for an indefinite period, however they can be recalled within 3 days we have excluded them from the indicator above.*

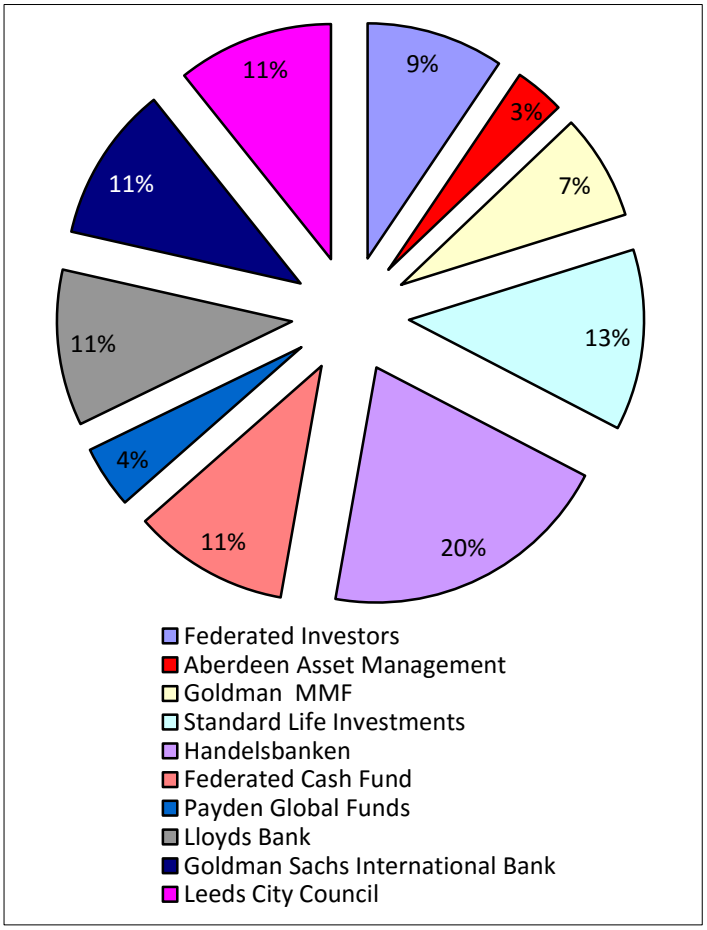
Appendix 2

## Analysis of Investment Portfolio as at 30th June 2017

| Borrower | Principal (£) | Interest Rate | Start Date | Maturity Date | Lowest Long Term Rating | Historic Risk of Default |
|---|---|---|---|---|---|---|
| MMF Federated Investors (UK) | 4,400,000 | 0.24% | | MMF | AAA | 0.000% |
| MMF Aberdeen | 1,600,000 | 0.16% | | MMF | AAA | 0.000% |
| MMF Goldman Sachs | 3,400,000 | 0.16% | | MMF | AAA | 0.000% |
| MMF Standard Life | 5,800,000 | 0.22% | | MMF | AAA | 0.000% |
| Svenska Handelsbanken AB | 9,400,000 | 0.30% | | Call | AA- | 0.000% |
| USDBF Federated Sterling Cash Plus Fund | 5,000,000 | 0.70% | | USDBF | AAA | 0.000% |
| USDBF Payden Sterling Reserve Fund | 2,000,000 | 1.54% | | USDBF | AAA | 0.000% |
| Leeds City Council | 5,000,000 | 0.25% | 27/06/2017 | 27/09/2017 | AA | 0.006% |
| Lloyds Bank Plc | 5,000,000 | 0.55% | 06/04/2017 | 09/10/2017 | A | 0.016% |
| Goldman Sachs International Bank | 5,000,000 | 0.64% | 02/06/2017 | 04/12/2017 | A | 0.024% |
| **Total Investments** | **£46,600,000** | **0.42%** | | | | 0.005% |

Rating Exposure




| Investments by Counterparty | £ | Type |
|---|---|---|
| Federated Investors | 4,400,000 | MMF |
| Aberdeen Asset Management | 1,600,000 | MMF |
| Goldman MMF | 3,400,000 | MMF |
| Standard Life Investments | 5,800,000 | MMF |
| Handelsbanken | 9,400,000 | Non-UK Bank |
| Federated Cash Fund | 5,000,000 | Short Duration |
| Payden Global Funds | 2,000,000 | Short Duration |
| Lloyds Bank | 5,000,000 | UK Bank |
| Goldman Sachs International Bank | 5,000,000 | UK Bank |
| Leeds City Council | 5,000,000 | Local Authority |
| **TOTAL** | **46,600,000** | |

**Detailed Commentary on Developments during the Quarter (Capita Asset Services)**

- During the quarter ended 30th June 2017:
  - The economy showed signs of re-accelerating;
  - There was an intensifying squeeze on households' real earnings;
  - The MPC took a more hawkish turn, with 3 members voting to raise interest rates;
  - A snap General Election delivered a hung Parliament;
  - Face-to-face negotiations with the EU began.

- After sluggish growth of 0.2% in Q1, the early indications are that the economy has re-gained some momentum in Q2. There is some concern, however, about the sustainability of consumer spending. The National Accounts for Q1 showed that the quarterly rise in spending was funded entirely through households reducing their savings to just 1.7% of their income, the lowest level since comparable records began. What's more, unsecured consumer borrowing has been rising at an annual rate of over 10%.

- Annual growth in the headline measure of average weekly earnings was just 2.1% in the three months to April, down from the 2.3% rate recorded in Q1 and below CPI inflation of 2.4% over the same period. Given that inflation picked up to 2.9% in May, the squeeze on real earnings is likely to have intensified since then.

- Inflation has risen faster than expected. But this appears to be because the impact of the drop in the pound is feeding through faster than in previous depreciations, rather than by a larger amount. Accordingly, inflation still looks set to peak before the end of this year, at around 3.2% in Q4. Given that it has accelerated more quickly than anticipated, it should fall back quicker as well. We think that inflation should be close to 2% by the end of 2018.

- Given the continued weakness in wage growth, and the fact that inflation's rise is set to be only temporary, it is perhaps surprising that the Monetary Policy Committee (MPC) appeared to take a more hawkish stance in the second quarter. The Committee came closest to voting for a rate hike since 2007 at its June meeting, with 3 out of 8 members voting to increase the base rate by 0.25%. The outcome of the August bot is not at all clear, although Mark Carney's list of specific conditions, including signs that wage growth is firming, and that business investment and net trade pick up the slack from slower consumer spending growth, may not be met.

- One possibility is that the MPC could vote to simply reverse the emergency cut in interest rates that took place following the EU referendum, but then leaves rates on hold for a while thereafter. This appears to be an argument that one or two MPC members are sympathetic to. That being said, markets still expect rates to remain on hold until August 2018, around six months earlier than they thought at the end of Q1.

Appendix 4

**Detailed Commentary on Interest Rate Forecasts and Forward View (Capita Asset Services)**

**May Quarterly Inflation Report Review**

Our treasury management advisers, Capita Asset Services have provided us with the following update to their interest rate forecasts.

| | Sep-17 | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank rate | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.50% | 0.50% | 0.75% | 0.75% |
| 5yr PWLB rate | 1.40% | 1.50% | 1.60% | 1.70% | 1.70% | 1.80% | 1.80% | 1.90% | 1.90% | 2.00% | 2.00% |
| 10yr PWLB rate | 2.10% | 2.20% | 2.30% | 2.30% | 2.40% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% |
| 25yr PWLB rate | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% |
| 50yr PWLB rate | 2.60% | 2.70% | 2.70% | 2.80% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% |

- We've made a number of adjustments to our forecasts to reflect the continuing lower gilt yields since February. We have also made some minor adjustments by lowering a few 25 and 50 year PWLB rate forecasts by 10 bps in later quarters. We have left our forecasts for Bank Rate unchanged.

- The key points from the latest Inflation Report are as follows: -

  - Forecast for GDP growth for 2017 shaved from 2.0% to 1.9% to reflect a weak start in quarter 1 of only +0.3%, (but the Bank expects that figure to be revised to +0.4%); 2018 and 2019 upped from 1.8% to 1.9%. (2016 was 1.8%.)
  - Little change in inflation forecasts; inflation to fall back to 2.2% in just over 2 years' time and to pick up slightly going into 2020.
  - In February, the Bank cut the equilibrium rate of unemployment from 5.0% to 4.5%. This potentially means that the MPC could wait longer before taking action to combat rising inflation.
  - Some MPC members were clearly more concerned about the degree to which they could look through increases in inflation caused by the effective devaluation of the pound since the referendum and the consequent feed through into the CPI measure on inflation.

- Our forecasts assume that there is no cancellation of the emergency cut in Bank Rate in August 2016 from 0.50% to 0.25% and a stop to the Quantitative Easing (QE) programme in the shorter-term. There is a potential risk that the MPC could muster a majority to reverse both before reaching a time when there is a progression to a sustained trend of gentle increases in Bank Rate. Our forecasts for both Bank Rate and PWLB rates would then need revision if both were to occur.

- The Bank also warned that markets were too pessimistic in thinking Bank Rate would not start rising until towards the end of 2019 as the Bank expects wage growth to accelerate due to continuing falls in unemployment and rising vacancy levels. Again, we do feel some caution on this area as wage growth has been remarkably benign despite continuing falls in unemployment; this may reflect hidden levels of unemployment e.g. people wanting to move from part time to full time employment. We do feel that the MPC will focus on inflation risks, ahead of protecting growth, if inflation looks like rising to levels significantly above current forecasts. However, it is very difficult to be at all certain about risks around this, especially when currency movements in the pound, dollar and euro will be very hard to predict and are subject to major unknowns.

- Capital Economics' forecasts for UK economic growth are as follows: 2017 +2.0%; 2018 +2.3%; 2019 +2.0%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators. They are forecasting that the first increase in Bank Rate will occur in quarter 2 2018 whereas our first increase is in quarter 2 2019 - after the end of Brexit negotiations.

**Capita Asset Services' Forward View**

- Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts (and also MPC decisions) will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. 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.

- The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. A world economic recovery will likely see investors switching from the safe haven of bonds to equities.

- We have pointed out consistently that the Fed. Rate is likely to go up more quickly and more strongly than Bank Rate in the UK and recent events have not changed that view, just that the timing of such increases may well have been deferred somewhat during 2016. While there is normally a high degree of correlation between the two yields, we would expect to see a growing decoupling of yields between the two i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and the resulting effect on PWLB rates.

  - The overall balance of risks to economic recovery in the UK remains to the downside, particularly with the current uncertainty over the final terms of Brexit.
  - The balance of risks to increases in Bank Rate and shorter term PWLB rates are to the upside and are dependent on how quickly inflation pressures rise and how high the peak will be.
  - Our forecasts are predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), within our forecasting time period despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China, which have a major impact on international trade and world GDP growth.

- We would, as always, remind clients of the view that we have expressed in our 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. Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

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

  - Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows.
  - UK economic growth and increases in inflation are weaker than we currently anticipate.
  - Weak growth or recession in the UK's main trading partners - the EU and US.
  - A resurgence of the Eurozone sovereign debt crisis.
  - Weak capitalisation of some European banks.
  - Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the Eurozone and Japan.