

MEETING: **PENSIONS COMMITTEE**

DATE: **10 NOVEMBER 2016**

TITLE: **TREASURY MANAGEMENT 2016/17 – MID YEAR REVIEW**

PURPOSE: **CIPFA’s Code of Practice recommends that a report on the Council’s actual Treasury Management during the current financial year is produced.**

RECOMMENDATION: **RECEIVE THE REPORT FOR INFORMATION**

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## **1. INTRODUCTION**

The Chartered Institute of Public Finance and Accountancy’s Treasury Management Code (CIPFA’s TM Code) requires that Authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end). This report provides a mid-year update.

The Council’s Treasury Management Strategy for 2016/17 was approved by full Council on 3 March 2016 which can be accessed on <https://democratiaeth.cyngor.gwynedd.gov.uk/ielistdocuments.aspx?cid=130&mid=286&ver=4&>

The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk.

## **2. EXTERNAL CONTEXT**

As we entered 2016, there was a significant uncertainty about the outlook for global growth. The slowdown in the Chinese economy and the knock-on effects for both trading partners and commodity prices, the uncertainty over the outcome of the US presidential election (no clear party or candidate being identified as an outright winner) and the impending referendum on the UK’s future relationship with the EU, all resulted in nervousness and a shaky start for markets.

Fluctuations in the opinion polls on the EU referendum prompted pronounced volatility in exchange rates, gilts, corporate bonds and equities as the result became increasingly uncertain. Immediately prior to the result, financial market sentiment shifted significantly in favour of a Remain outcome, a shift swiftly reversed as the results came in. The vote to leave the EU sent shockwaves through the domestic,

European and global political spectrum, the most immediate impact being the resignation of Prime Minister David Cameron.

Between 23<sup>rd</sup> June and 1<sup>st</sup> July the sterling exchange rate index fell by 9% and short-term volatility of sterling against the dollar increased significantly. Worldwide, markets reacted very negatively with a big initial fall in equity prices. Government bond yields also fell sharply by 20-30 bps across all maturities (i.e. prices rose) as investors sought safe haven from riskier assets. The 10-year benchmark gilt yield fell from 1.37% to 0.86%.

Yet, a week on from the result the overall market reaction, although significant, was less severe than some had feared. The 5-year CDS for the UK (the cost of insuring against a sovereign default) rose from 33.5 basis points to 38.4 basis points. The FTSE All Share index, having fallen sharply by 7% from 3,481 points on 23<sup>rd</sup> June to 3,237 after the result, had subsequently risen to 3,515 by the end of the month.

The Bank of England sought to reassure markets and investors. Governor Mark Carney's speeches on 24<sup>th</sup> and 30<sup>th</sup> June in response to the referendum result stressed that the Bank was ready to support money market liquidity and raised the likelihood of a cut in policy rates 'in the summer'. In August the Bank cut the base rate to 0.25% and the impact of this will take some time to work through the system.

### **3. INVESTMENT ACTIVITY**

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held.

The Welsh Government's Investment Guidance gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

The transposition of European Union directives into UK legislation places the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors through potential bail-in of unsecured bank deposits.

Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the Council's aim to further diversify into more secure and/or higher yielding asset classes during 2016/17. The majority of the Council's surplus cash has been invested in short-term unsecured bank deposits, certificates of deposit and money market funds. Diversification into securities with underlying collateral and investments with organisations which are not subject to bail-in will represent develop going forward.

## Investment Activity in 2016/17

Investments	Balance on 01/04/16 £'000	Investments Made £'000	Maturities/ Investments Sold £'000	Balance on 31/08/16 £'000	Average Rate %
Unsecured Investments with financial institutions rated A- or higher - call accounts - deposits and CDs	3,300 49,000	41,635 42,500	(41,510) (44,000)	3,425 47,500	0.44 0.44
Secured Investments with financial institutions - covered bonds	2,184	-	-	2,184	1.75
Investments with Corporates - corporate bonds issued by companies	-	-	-	-	-
Money Market Funds	9,100	101,435	(95,135)	15,400	0.52%
<b>TOTAL INVESTMENTS</b>	<b>63,584</b>	<b>185,570</b>	<b>(180,645)</b>	<b>68,509</b>	
Increase in Investments				4,925	

Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2016/17.

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

### Credit Risk

Counterparty credit quality as measured by credit ratings is summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/16	4.34	AA-	3.57	AA-
30/06/16	4.49	AA-	3.43	AA

#### Scoring:

-Value weighted average reflects the credit quality of investments according to the size of the deposit

-Time weighted average reflects the credit quality of investments according to the maturity of the deposit

-AAA = highest credit quality = 1

-D = lowest credit quality = 26

-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Investments were made with banks and building societies and included call accounts, fixed-rate term deposits and certificates of deposit, Money Market Funds and covered bonds.

## **Counterparty Update**

Various indicators of credit risk reacted negatively to the result of the referendum on the UK's membership of the European Union. UK bank credit default swaps saw a modest rise but bank share prices fell sharply, on average by 20%, with UK-focused banks experiencing the largest falls. Non-UK bank share prices were not immune although the fall in their share prices was less pronounced.

Fitch downgraded the UK's sovereign rating by one notch to AA from AA+, and Standard & Poor's downgraded its corresponding rating by two notches to AA from AAA. Fitch, S&P and Moody's have a negative outlook on the UK. S&P took similar actions on rail company bonds guaranteed by the UK Government.

Moody's affirmed the ratings of nine UK banks and building societies and revised the outlook to negative for those banks and building societies that it perceived to be exposed to a more challenging operating environment arising from the 'leave' outcome.

There was no immediate change to Arlingclose's credit advice on UK banks and building societies as a result of the referendum result. Our advisor believes there is a risk that the uncertainty over the UK's future trading prospects will bring forward the timing of the next UK recession. In the coming weeks and months Arlingclose will therefore review all UK based institutions, and it is likely that, over time, will advise shortening durations on those institutions considered to be most affected.

Earlier in the year Moody's downgraded Deutsche Bank's long-term rating from Baa1 to Baa2 reflecting the agency's view of increased execution risks for the implementation of Deutsche Bank's strategic plan. In June Moody's downgraded Finland from Aaa to Aa1 on its view that Finnish economic growth will remain weak over the coming years, reducing the country's ability to absorb economic shocks.

Fitch upgraded the long-term rating of ING Bank from A to A+ based on Fitch's view of the bank's solid and stable financial metrics and its expectation that that the improvement in earnings will be maintained. Fitch also upgraded Svenska Handelsbanken's long-term rating from AA- to AA reflecting the agency's view that the bank's earnings and profitability will remain strong, driven by robust income generation, good cost efficiency and low loan impairments.

## **Budgeted Income and Outturn**

The average cash balances were £\*m (\* figure will be presented on the day of the Committee) during the five months. The UK Bank Rate had been maintained at 0.5% since March 2009 but on 4<sup>th</sup> August 2016 the rate was changed to 0.25%. This even lower rate will have an impact on the interest earned in the future although the fixed deposits currently held will reduce the effect in the short term.

All investments will be impacted going forward and we will work closely with our advisors to use appropriate investments to maximise the interest whilst following the principal aim which is to protect the sum invested.

The Council's budgeted investment income for the year is estimated at £0.36m. based on an investment outturn of 0.5% for the whole year.

The Bank Rate is expected to be cut further towards zero in the coming months, which will in turn lower the rates short-dated money market investments with banks and building societies. As some of the Council's surplus cash continues to be invested in short-dated money market instruments, it will most likely result in a fall in investment income over the year.

### Update on Investments with Icelandic Banks

The Council has now received repayment of 98% of the investment in Heritable Bank. The outstanding amount is now £80,376. It is likely that a further distribution will be received although the administrator has not yet made an official estimate of the final recovery.

### Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators.

**Interest Rate Exposures:** This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

	2016/17	2017/18	2018/19
Upper limit on fixed interest rate exposure	100%	100%	100%
Actual	100%		
Upper limit on variable interest rate exposure	50%	50%	50%
Actual	0%		

**Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2016/17	2017/18	2018/19
Limit on principal invested beyond year end	£40m	£20m	£10m
Actual	£2.18m	£2.18m	£2.18m

**Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating or credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target	Actual
Portfolio average credit score	6.0	3.43

## 7. Investment Training

During the period officers have attended investment training with Arlingclose and CIPFA relevant to their roles.

## 8. Outlook for the Remainder of 2016/17

Following the UK's vote to leave the European Union, the economic outlook for the UK has immeasurably altered. It will to a large extent be dependent on the nature of the future relationship negotiated with the EU, particularly in relationship to trade. The negotiations crucially hinge on domestic politics which, at the end of the June quarter, were unsettled themselves.

The domestic outlook is uncertain, but likely to be substantially weaker in the short term than previously forecast. Arlingclose has changed its central case for the path of Bank Rate over the next three years. Arlingclose believes any currency-driven inflationary pressure will be looked through by Bank of England policymakers.

	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
Official Bank Rate													
Upside risk	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

Arlingclose believes that the Government and the Bank of England have both the tools and the willingness to use them to prevent any immediate market-wide problems leading to bank insolvencies. The cautious approach to credit advice means that the banks currently on the Authority's counterparty list have sufficient equity buffers to deal with any localised problems in the short term.