Manchester City Council
Report for Information

Report to: Audit Committee – 19 November 2015

Subject: Treasury Management Interim Report 2015-16

Report of: City Treasurer

Purpose

To report the Treasury Management activities of the Council during the first six months of 2015-16.

Recommendation

The Audit Committee is asked to note the contents of the report.

Wards Affected:

Not Applicable

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Background documents (available for public inspection):

The following documents disclose important facts on which the report is based and have been relied upon in preparing the report. Copies of the background documents are available up to 4 years after the date of the meeting. If you would like a copy please contact one of the contact officers above.

- Treasury Management Strategy Statement and Borrowing Limits and Annual Investment Strategy Report 2015-16 (Executive Committee 13th February 2015)

1 Introduction and Background

1.1 Treasury Management in Local Government is regulated by the CIPFA Code of Practice on Treasury Management in Local Authorities. The City Council has adopted the Code and complies with its requirements. A primary requirement of the Code is the formulation and agreement by full Council of a Treasury Policy Statement which sets out Council, Committee and Chief Financial Officer responsibilities, and delegation and reporting arrangements. This was approved by the Council on the 8th October 2003, and updated and approved by the Executive on the 10th February 2010.

1.2 CIPFA amended the CIPFA Treasury Management in the Public Services Code of Practice in late 2009, and the revised Code recommended that local authorities include, as part of their Treasury Management Strategy Statement, the requirement to report to members at least twice a year on the activities of the Treasury Management function. The recommendation was included within the Treasury Management Statement Strategy approved by the Executive on the 10th February 2010, and by Council on the 3rd March 2010. This report therefore ensures that the Council meets the requirements of the Strategy, and therefore the Code.

1.3 The Code was revised in November 2011, acknowledging the effect the Localism Bill could have on local authority treasury management, however there were no major changes to the Code. This report has been prepared in accordance with the revised November 2011 Code.

1.4 Treasury Management in this context is defined as:

"The management of the organisation's investments and 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''.

1.5 This interim report covers:

Section 1: Introduction and Background
Section 2: The Council's Portfolio Position as at 30th September 2015
Section 3: Review of Economic Conditions
Section 4: External Borrowing in 2015-16 to date
Section 5: Compliance with Treasury Limits and Prudential Indicators
Section 6: Investment Strategy for 2015-16 to date
Section 7: Temporary Borrowing and Investment for 2015-16 to date
Section 8: Banking Contract
Section 9: Conclusion

Appendix A: PWLB Interest Rates
Appendix B: Treasury Management Prudential Indicators
Appendix C: Review of Economic Conditions, provided by advisors
Appendix D: Glossary of Terms

2 Portfolio Position as at 30 September 2015

2.1 As outlined in the approved Treasury Management Strategy for 2015-16 it was anticipated that there would be a need to undertake some permanent borrowing in 2015-16 to fund the capital programme and to replace some of the internal funds. However, cash balances during the year have been relatively high and, as it remains the policy to keep cash low and minimise temporary investments, no borrowing activity has been undertaken during the year to date.

2.2 The Council's debt position at the beginning of the financial year, and at the end of September (6 months) for comparison was as follows:

Loan Type	31-Mar-15		30-Sep-15	
	Principal	Average Rate	Principal	Average Rate
	£m	%	£m	%
PWLB	0	0.00	0	0.00
Temporary Borrowing	8.0	0.50	7.2	0.50
Market Loans	503.0	4.52	481.2	4.70
Stock	8.1	3.37	8.1	3.37
Government Funding	0	0.00	51.8	0.11
Gross Total	**519.1**	4.44	**548.3**	4.62
Temporary Deposits	-103.8	0.40	-178.8	0.35
Net Total	**415.3**		**369.5**	

Note: In the table above HCA monies of £11.8m have been reclassified in 2015-16 from Market Loans to Government Funding. £40m of the DCLG funding for the Housing Investment Fund was received in September 2015. This funding still constitutes a loan as it is ultimately repayable to the Government. It is considered more appropriate though to differentiate this from other Market Loans.

2.3 The temporary borrowing and deposit figures fluctuate daily to meet the daily cash flow requirements of the Council. The figures for these categories in the table above are therefore only a snapshot at a particular point in time.

2.4 An assumed borrowing need of £150m was identified in the budget for 2015-16 and this has reduced substantially by the 30th September 2015. The positive change is explained by favourable movements in the levels of receipts and payments together with a £40m loan from the DCLG for the Housing Investment Fund.

2.5 Given the cash deposit levels the Council is currently holding, and based on our experience of previous years, it is anticipated there will be no traditional borrowing need during the remainder of the year. However there may be a possibility of further advances from the HCA which will be classified as borrowing. This is together with the potential for funding advances from SALIX which will also constitute borrowing. Finance from SALIX provides interest free Government loan funding which can be applied for to fund public sector energy efficiency and carbon reduction initiatives.

3 Review of Economic Conditions: April to September 2015

3.1 In September the Bank of England maintained the key lending rate at a record low of 0.5%, where it has been since March 2009. The concerns expressed in the Council's past reports about many banks being reluctant to lend, thereby limiting opportunities for the Council to borrow from the market, continue to exist.

3.2 There remains concern that the new bank liquidity regime being pursued by the FSA may further impact the ability of the Authority to achieve interest rates above the base rate on short term deposits. The Treasury Management function is actively researching alternative options which may protect the average rate achieved on deposits, should the regime be implemented as planned.

3.3 Appendix C provides a more detailed review of the recent economic situation.

4 Treasury Borrowing in 2015-16 to date

4.1 PWLB interest rates during the first 6 months of the year are illustrated in the table below and the graph at Appendix A.

PWLB Borrowing Rates 2015-16 to date for 1 to 50 years					
	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.31%	2.02%	2.60%	3.26%	3.21%
Date	02/04/2015	02/04/2015	02/04/2015	02/04/2015	02/04/2015
High	1.55%	2.55%	3.26%	3.86%	3.78%
Date	05/08/2015	14/07/2015	14/07/2015	02/07/2015	14/07/2015
Average	1.46%	2.32%	2.96%	3.59%	3.49%

4.2 Manchester is on the approved list of authorities that can access the PWLB Certainty Rate going forward, giving the Council access to a 20 basis points reduction on the published PWLB rates. Manchester also has approval to access funds up to £25m against a PWLB project rate.

4.3 The Council has discussed a £100m facility with the European Investment Bank (EIB) which will form part of the Council's future overall borrowing strategy. The EIB's rates for sterling borrowing continue to be favourable compared to PWLB, allowing for existing planned future borrowing from PWLB to be replaced by cheaper funding from the EIB. The latest expectation is that the facility will start to be drawn down in 2016-17 to 2018-19. Whilst the EIB appraises its funding plans against individual schemes, particularly around growth and employment and energy efficiency, any monies borrowed are part of the Council's overall pooled borrowing.

5 Compliance with Treasury Limits

5.1 During the first half of the financial year, the Council operated within the Prudential Indicators set out in the Treasury Management Strategy Statement, however treasury limits were breached on one occasion as noted in paragraph 5.2 below. Performance against the Prudential Indicators is shown in Appendix B.

5.2 There was one breach of approved limits in the first half of 2015-16; on the 2nd April the upper limit of £10m on the Barclays Call account was exceeded. This was due to human error associated with transactions to transfer facilities from the existing Co-operative Bank to the new arrangements with Barclays Bank. The situation was corrected on the next working day and reported to the Treasurer.

6 Investment Strategy for 2015-16 to date

6.1 The Treasury Management Strategy Statement (TMSS) for 2015-16 was approved by Executive on 13th February 2015. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as (a) the security of capital and (b) liquidity of investments.

6.2 In order to achieve a higher level of security the City Treasurer introduced the following measures:

- Investments to be restricted to UK banks, building societies, local authorities and government institutions.
- Diversify the investment portfolio into more secure UK government and government backed institutions.
- Although the investment strategy allows investments up to 364 days, restrict deposits to as short a time period as feasible.

The City Council's temporary cash balances are managed by the City Treasurer in-house and invested with those institutions listed in the City's Approved Lending List. Officers can confirm these institutions meet the security criteria set out in the Annual Investment Strategy.

6.3 New European banking legislation is being introduced and is expected to be implemented in 2018. This is in response to the banking crisis when in the U.K. the Government used taxpayer funds to support banks in danger of failing. In future 'bail-in' will be applied in such a scenario which will mean after shareholders' equity, depositors' funds comprising balances over £85k will be used to support a bank at risk. This will increase the risk to the Council of holding cash deposits with banks and building societies.

6.4 In view of this new bail-in risk other investment options are being investigated. These include the purchase of treasury bills which are Government debt often referred to as 'Gilts'. The purchase of treasury bills offers the same security as depositing funds with the Government's Debt Management Office, (DMO) albeit they currently provide the benefit of much higher interest rates. In order to trade in treasury bills the Council will require a custodian facility. The custodian is usually a bank who holds the bills on the investor's behalf.

6.5 To provide further protection from bail-in risk the Council is also investigating other forms of secured investments with banks. Although the Council's approved 2015/16 maximum thresholds for investments with banks and building societies remain unchanged, the Council is now working to revised operating limits for bank deposits to reduce bail-in risk. The limits on bank deposits have been reduced in the range 50-100%, with the exception of the £10m limit with Barclays bank. Barclays is the Council's main banker and is the investment destination of last resort for the close of daily trading.

6.6 There are a number of custodian options available which have varying fee structures. These are being appraised together with the implications for the Council's existing daily treasury management operations and procedures. Additionally in response to bail-in risk the Council's investment limits for banks and building societies which are on its approved counterparty list are under review.

7 Temporary Borrowing and Investment Outturn 2015-16 to date

7.1 Investment rates available in the market continue to be at an historic low point. The average level of funds available for investment purposes in the first six months of 2015-16 was just over £162m. These funds were available on a temporary basis and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants, and progress on the capital programme.

7.2 Detailed below is the temporary investment and borrowing undertaken by the Council. As illustrated, the authority underperformed the benchmark by 2 basis points on investments due to the inter local authority market being relatively depressed.

7.3 The temporary borrowing consists of funds the Council holds for Manchester organisations that work closely with the Council. It was agreed the Council would pay interest on their funds in line with the base rate, which is why the Council are above the benchmark cost.

	Average temporary investment/ borrowing	**Net Return/Cost**	**Benchmark Return / Cost ***
Temporary Investments	£162.7m	0.34%	0.36%
Temporary Borrowing	£8.4m	0.50%	0.48%

* *Average 7-day LIBID rate sourced from Capita*

7.4 None of the institutions in which investments were made had any difficulty in repaying investments and interest in full during the period. The list of institutions in which the Council invests is kept under continuous review.

8. Banking Contract

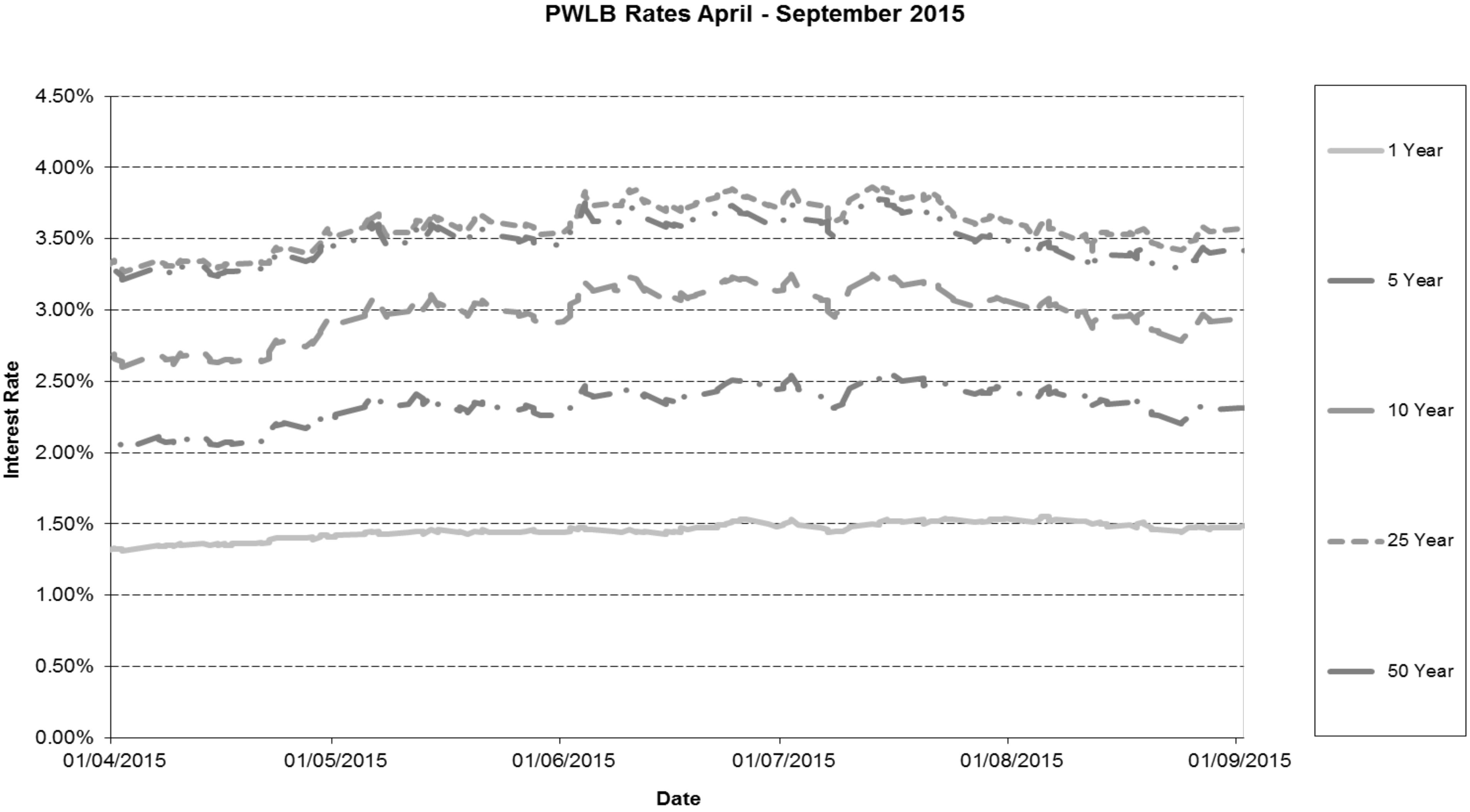
8.1 The Council's banking contract transferred to Barclays Bank Plc on the 1st April 2015. Migration has been successful and previous facilities with the Co-operative Bank will be closed when residual transactions are cleared.

9. Conclusion

9.1 The current borrowing position reflects the strong balance sheet of the Council. It enables net interest costs to be minimised and reduces credit risk by making temporary use of internal borrowing (reserves, provisions, positive cash flows, etc.) The Council's policy remains to keep cash as low as possible and not to borrow in advance of need for capital purposes. Cash balances have been relatively high and a further borrowing requirement is not expected in 2015-16.

9.2 Proactive treasury management during the year has enabled the Council to achieve an average net return on our investments of 0.34%, which although less than the benchmark average 7-day LIBID rate of 0.36% is higher than the rate offered by the DMO, which is the default option if there are no offers in the inter local authority market.

9.3 Officers will monitor the changes that may result from the downgrading in credit ratings, and take the necessary action to ensure the Council still adheres to its Treasury Management Strategy. This however, will limit the investment options available to the Council.


PWLB Rates April - September 2015
4.50%
4.00%
3.50%
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
Interest Rate
01/04/2015
01/05/2015
01/06/2015
01/07/2015
01/08/2015
01/09/2015
Date
1 Year
5 Year
10 Year
25 Year
50 Year

Treasury Management Prudential Indicators: 2015-16 to date

	Original £m	Minimum In Year to 30 Sept 2015 £m	Maximum In Year to 30 Sept 2015 £m
Operational Boundary for External Debt:			
Borrowing	929.6	508.7	548.7
Other Long Term Liabilities	216.0	161.3	161.3
Authorised Limit for External Debt:			
Borrowing	1,356.7	508.7	548.7
Other Long Term Liabilities	216.0	161.3	161.3
		Actual as at 30 Sept 2015	
Authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services	Yes	Yes	
Upper Limits for Interest Rate Exposure:			
Net Borrowing at Fixed Rate as a percentage of Total Net Borrowing	91%	73%	
Net Borrowing at Variable Rate as a percentage of Total Net Borrowing	88%	27%	
Upper Limit for Principal Sums Invested for over 364 days	£0	£0	

Maturity structure of Fixed Rate Borrowing	**Lower Limit 2015-16 Original**	**Upper Limit 2015-16 Original**	**Actual as at 30 Sept 2015**
under 12 months	0%	60%	0%
12 months and within 24 months	0%	100%	41%
24 months and within 5 years	0%	70%	50%
5 years and within 10 years	0%	60%	6%
10 years and above	0%	60%	3%

REVIEW OF ECONOMIC CONDITIONS APRIL TO SEPTEMBER 2015

This section has been prepared by the Authority's Treasury Advisors, Capita, and includes their forecast for future interest rates.

1 Economic performance to date

1.1 UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate posted the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly equalling that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) although the figure rebounded in quarter 2 to +0.7% (+2.4% y/y).

1.2 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. However, with the price of oil taking a fresh downward direction and Iran expected to soon re-join 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.

1.3 The American economy made a strong comeback after weak first quarter growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on 17 September, or if not by the end of 2015, the recent downbeat news about Chinese and Japanese growth and the knock on impact to emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from raising rates. The nonfarm payrolls figures for September and revised August figures, issued on 2 October, were disappointingly weak and confirmed concerns that US growth is likely to weaken. This has pushed back expectations of a first rate increase from 2015 to 2016. However, there are increasing concerns, both in the US and UK, that the growth rates currently being achieved are because of the highly aggressive monetary policy with central rates at near zero and huge QE in place. This is causing an increasing debate as to how realistic it will be for central banks to start reversing such aggressive monetary policy.

1.4 In the Eurozone, the ECB fired its big bazooka in January 2015, unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it 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 the start of a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the

ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

2 Outlook for the next six months of 2015/16

2.1 Growth is expected to weaken marginally to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation of Sterling against the Euro and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme, although the pace of reductions was eased in the May Budget. However, the Purchasing Manager's Index, (PMI), for services issued on 5 October indicated an even lower growth rate of around +0.3%, in quarter 4, which would be the lowest growth rate since the end of 2012. There are 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, and the volatility we have seen in equity and bond markets in 2015 so far, which could potentially spill over to impact real economies rather than just financial markets.

2.2 The recently published data suggest that the recovery in the Eurozone continues. It does so in a subdued manner, following the trend of the last few quarter. However, the recovery has become more firm. General economic sentiment indicators, such as the European Commission's Economic Sentiment Index, are stable and encouraging. Concurrently, investments, which have been the weakest point of the recovery for a long time, finally show positive signs. Albeit modestly, they have been growing, for the third quarter in a row. This implies that businesses are becoming increasingly confident about the broad based recovery.

2.3 Even though the underlying reasons causing the first-quarter weakness may spill over into the following quarters of 2015, the United States is expected to experience stronger expansion in the second half of the year. The Federal Open Market Committee of the Federal Reserve Board continues to monitor conditions, looking to judge the correct point to begin to raise interest rates. It is worth pointing out that there are no major imbalances at present—at least imbalances within US borders. However, there are a number of external scenarios that might spiral out of control and interrupt world growth.

3 Capita's interest rate 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%	4.42%
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%

Glossary of Terms

Authorised Limit - This Prudential Indicator represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need, with some headroom for unexpected movements.

Bank Rate – the rate at which the Bank of England offers loans to the wholesale banks, thereby controlling general interest rates in the economy.

Counterparty – one of the opposing parties involved in a borrowing or investment transaction

Credit Rating – A qualified assessment and formal evaluation of an institution's (bank or building society) credit history and capability of repaying obligations. It measures the probability of the borrower defaulting on its financial obligations, and its ability to repay these fully and on time.

Discount – Where the prevailing interest rate is higher than the fixed rate of a long-term loan, which is being repaid early, the lender can refund the borrower a discount, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender is able to offer the discount, as their investment will now earn more than when the original loan was taken out.

Fixed Rate Funding - A fixed rate of interest throughout the time of the loan. The rate is fixed at the start of the loan and therefore does not affect the volatility of the portfolio, until the debt matures and requires replacing at the interest rates relevant at that time.

Gilts - The loan instruments by which the Government borrows. Interest rates will reflect the level of demand shown by investors when the Government auctions Gilts.

High/Low Coupon – High/Low interest rate

LIBID (London Interbank Bid Rate) – This is an average rate, calculated from the rates at which individual major banks in London are willing to borrow from other banks for a particular time period. For example, 6 month LIBID is the average rate at which banks are willing to pay to borrow for 6 months.

LIBOR (London Interbank Offer Rate) – This is an average rate, calculated from the rates which major banks in London estimate they would be charged if they borrowed from other banks for a particular time period. For example, 6 month LIBOR is the average rate which banks believe they will be charged for borrowing for 6 months.

Liquidity – The ability of an asset to be converted into cash quickly and without any price discount. The more liquid a business is, the better able it is to meet short-term financial obligations.

LOBO (Lender Option Borrower Option) – This is a type of loan where, at various periods known as call dates, the lender has the option to alter the interest rate on the loan. Should the lender exercise this option, the borrower has a corresponding option to repay the loan in full without penalty.

Market - The private sector institutions - Banks, Building Societies etc.

Maturity Profile/Structure - an illustration of when debts are due to mature, and either have to be renewed or money found to pay off the debt. A high concentration in one year will make the Council vulnerable to current interest rates in that year.

Monetary Policy Committee – the independent body that determines Bank Rate.

Operational Boundary – This Prudential Indicator is based on the probable external debt during the course of the year. It is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an indicator to ensure the Authorised Limit is not breached.

Premium – Where the prevailing current interest rate is lower than the fixed rate of a long-term loan, which is being repaid early, the lender can charge the borrower a premium, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender may charge the premium, as their investment will now earn less than when the original loan was taken out.

Prudential Code - The Local Government Act 2003 requires the Council to ‘have regard to‘ the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council’s capital investment plans are affordable, prudent and sustainable.

PWLB - Public Works Loan Board. Part of the Government’s Debt Management Office, which provides loans to public bodies at rates reflecting those at which the Government is able to sell Gilts.

Specified Investments - Sterling investments of not more then one-year maturity. These are considered low risk assets, where the possibility of loss of principal or investment income is very low.

Non-specified investments - Investments not in the above, specified category, e.g., foreign currency, exceeding one year or outside our minimum credit rating criteria.

Variable Rate Funding - The rate of interest either continually moves reflecting interest rates of the day, or can be tied to specific dates during the loan period. Rates may be updated on a monthly, quarterly or annual basis.

Volatility - The degree to which the debt portfolio is affected by current interest rate movements. The more debt maturing within the coming year and needing replacement, and the more debt subject to variable interest rates, the greater the volatility.

Yield Curve - A graph of the relationship of interest rates to the length of the loan. A normal yield curve will show interest rates relatively low for short-term loans compared to long-term loans. An inverted Yield Curve is the opposite of this.