AGENDA ITEM NO. 17

BRISTOL CITY COUNCIL

AUDIT COMMITTEE

25th April 2014

Report of: Service Director of Finance

Report Title: Treasury Management Briefing / Update

Ward: City Wide

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Treasury Management briefing / update

Treasury Management is the management of the organisation's cash flow, its banking, money market and capital market transactions; the effective management of the risks associated with those activities and the pursuit of optimum performance consistent with those risks"

The Treasury Management function publish as a minimum three reports a year

- The Treasury Management Strategy – This report and most important covers
    - capital plans (including prudential indicators);
    - minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
    - the treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators;
    - an investment strategy (the parameters on how investments are to be managed).

- **The Treasury Management - Mid Year report** - This will update the Mayor with the progress of the capital position, amending prudential indicators as necessary, and whether the treasury strategy is meeting the strategy or whether any policies require revision.

- **The Treasury Management – Outturn report** - This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

Current Position – 31st March 2014

As at the 31st March 2014 the authority held debt of £415m (£291m PWLB, £124m Market) and investments of £196m (£119m time deposits maturing within 1 year and £77m on call), and the turnover for financial year ending 31st March 2014 was £1.3bn.

There are many significant risks associated with the treasury activities for this authority including credit / counter party risk, liquidity risk, interest rate risk, exchange rate risk, and refinancing risk. These risks are managed on a daily basis by monitoring changes in the financial environment and market place whilst carrying out analysis and identifying trends.

The authority uses multiple sources of information to monitor the financial environment including the procurement of specialist treasury advisory services from Capital Asset Services. A brief summary of their functions and their financial outlook is attached.

CAPITA

Asset Services

Treasury solutions

Treasury management services

Our treasury solutions team is the market leading provider of treasury management and capital finance services to public and private sector organisations in the UK and overseas. This includes local authorities, colleges, universities, leisure trusts, housing associations, health services and FTSE 100 companies.

Our specialist team includes a number of finance practitioners with many years treasury experience who offer an unrivalled breadth and depth of experience, providing an independent and responsive service to each client.

The quality of our service is supported by the largest technical, treasury management and asset finance teams in the sector.

CAPITA

Strategy meetings

Effective two-way communication and a thorough understanding of client requirements is a key element of our treasury management service and we believe this is best achieved through regular meetings and frequent dialogue with the organisation.

Credit ratings from all three rating agencies (Fitch, Moody's and S&P)

The turmoil in the financial markets over the past couple of years has highlighted the need for a wholly independent source of credit advice. We fulfil this role by collecting and interpreting data from all the major credit rating agencies including Fitch, Moody's and Standard & Poor's. The data is used to provide sound, reliable and pragmatic advice on which to structure and maintain credit policies and up-to-date counterparty lists and limits.

Credit policy

Although no combination of ratings can be viewed as entirely fail-safe, we re-designed our credit policy to adapt to the changing market conditions that have occurred since 2008, to ensure that our creditworthiness policy is sufficiently robust to withstand any future credit events. We work closely with organisations to develop a credit and counterparty list that is compatible with their individual risk appetite.

Investment advisory service

Whilst our services are designed first and foremost to help mitigate risks, our objective is also to find ways to improve investment returns. We provide advice, information and assistance on how to structure an appropriate investment strategy.

Debt advisory service

We provide a full range of advice and expertise in the area of debt management, including the provision of supporting working papers, spreadsheet calculations and year end input that is IFRS compliant. We work with organisations to ensure that when new borrowing is required, it is undertaken at the most opportune time and for the appropriate duration, to suit its individual strategy and requirements. Once borrowing has been undertaken, the portfolio will be monitored to take advantage of any restructuring opportunities.

Information updates

The money markets are constantly reacting to changes in the economic environment and we realise the importance of keeping clients updated on these changes. Our regular economic and investment bulletins / circulars reflect economic, fiscal and political factors as well as on-going economic and interest rate forecasts and daily rates from the market via email.

Helpline

Our helpline encompasses access to all staff to ensure that any specific issue can be addressed at any time.

Fair Value disclosure services

The IFRS Code requires organisations to calculate the Fair Value of all financial instruments at the end of the financial year. We have provided these calculations for all clients as part of our treasury management service.

Technical Advisory Group (TAG)

We have the best resourced Technical Advisory Group in the market, comprising ten qualified accountants. The group provides technical support on issues relating to treasury management, capital finance and a broad range of accountancy issues.

Treasury management template documents

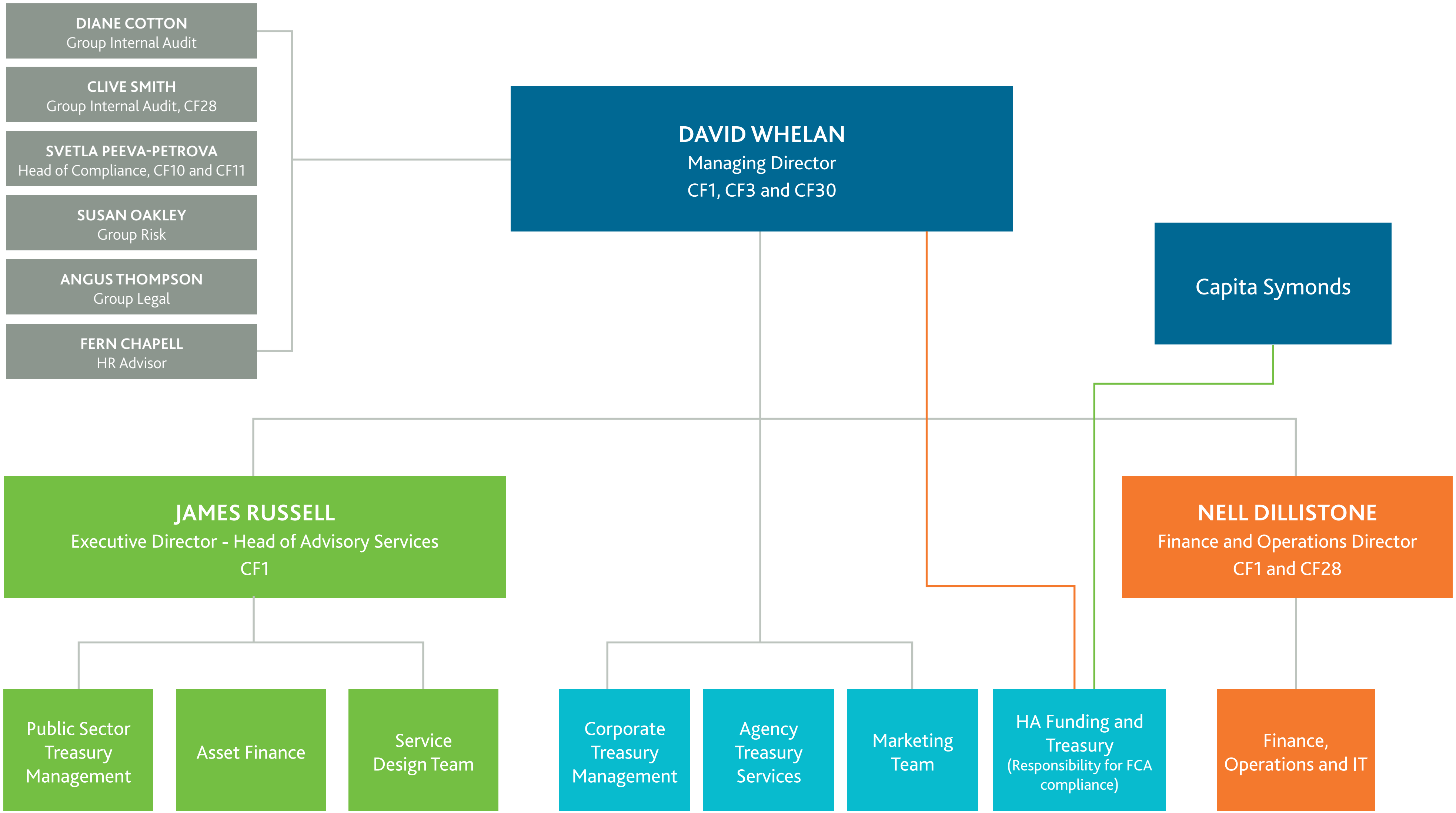
We provide advice on the drafting and review of all major treasury management reports, including the Treasury Management Policy Statement, the Annual Treasury Management Strategy Statement (incorporating the investment strategy), the Annual Treasury Report, the Half-Yearly Report, the Quarterly Reports and the Treasury Management Practices.

Training sessions and seminars

We believe a practical understanding of the regulatory framework and the financial markets is essential for all organisations. This is particularly important as the treasury management function operates in a dynamic market environment.

Our seminars and training workshops aim to raise awareness of topical treasury and economic issues to ensure that officers have the necessary skills to perform these tasks. Our regular training workshops are provided on a structured basis to ensure that different levels of treasury management experience and skills are accommodated.

We have agreement from all of the main UK accountancy institutes (and the AAT) that participation in our events may count as a recognised activity for their Continuing Professional Development (CPD).



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CF1 and CF28
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Asset Finance
Service Design Team
Corporate Treasury Management
Agency Treasury Services
Marketing Team
HA Funding and Treasury
(Responsibility for FCA compliance)
Finance, Operations and IT

CAPITA

Asset Services

Treasury solutions

Updated Interest Rate Forecast
14 February 2014

Capita Asset Services Updated Interest Rate Forecast

Nothing to get excited about!

- *We have moved forward the first Bank Rate increase by two quarters from Q2 2016 to Q4 2015 but with Bank Rate remaining at 0.75% for the first two quarters*

- *Bank Rate then increases to 1.75% in Q1 2017, (previously 1.25%), to reflect the stronger outlook for growth, but with only 0.25% increases per quarter from Q2 2016 onwards i.e. slow and gradual*

Following the Bank of England's quarterly Inflation Report this week, we have undertaken an updating of our interest rate forecasts. Over the last six months, we have had a continuing run of strong economic news which has consolidated confidence in a UK economic recovery. Widespread disbelief that unemployment would take three years to fall to 7%, as the Bank forecast at the time of the August Inflation Report, has indeed proved to be well founded. Accordingly, this latest Inflation Report has seen the Bank provide a major revision to its forecasting approach and to its forecasts themselves: -

The August forward guidance based on a single indicator i.e. no rate rises before unemployment falls to 7% has been replaced by the following: -

1. The MPC reckons there is spare capacity in the economy of 1-1.5% of GDP, mainly in the labour market.
2. They will refrain from raising Bank Rate until a significant inroad has been made into reducing this spare capacity.
3. They will provide additional forecasts based on eighteen economic indicators which they will take into account in considering the path of Bank Rate and Quantitative Easing (QE).
4. GDP has grown at an annualised rate of 3% since last August.
5. GDP forecasts upped for 2014 from 2.8% to 3.4%, 2015 from 2.3% to 2.7%, and for 2016 from 2.5% to 2.8%.
6. Inflation to be well behaved over the next two years: 1.9% in two years time.
7. First increase in Bank Rate likely to be around Q2 2015.
8. Rate rises will be slow and gradual (translation - probably 25bp per quarter).
9. Carney expected that Bank Rate would be around 2% in three years time i.e. Q1 2017.
10. Bank Rate is unlikely to get back up to pre crisis levels of 5% even when the economy has returned to normal.
11. They will not sell any of their portfolio of asset purchases before the first rise in the Bank Rate (but that does not mean they WILL start then!) and will also reinvest maturing gilts until then.
12. They were more pessimistic on growth of productivity which has failed to keep pace with rises in output.
13. They will make it a priority to protect growth in the economy provided inflation remains subdued.

The response of financial markets to all this has been to move forward their expectation of the first increase in Bank Rate to Q4 2014. We disagree with this view and also are cautious about the strength of GDP growth in the Bank's forecasts for GDP over the next three years. Accordingly, we are forecasting slower increases in Bank Rate over the next three years than what the Bank is indicating and our forecasts have, therefore, not changed materially. We have reservations that the Bank's current forecasts for GDP growth are over optimistic and that strong economic growth will wilt as the major stimulus to date has come from consumer spending and an uplift in borrowing to buy property. Whilst the release of this burst of pent up demand to buy property is having a very welcome effect on the economy, this surge is very likely to fade in time and will then leave a major question mark over where growth is going to come from. Basically, there are four main areas of demand in the UK economy: -

1. Consumers – but most consumers are maxed out on borrowing and trying to pay down debt. In addition, most consumers are experiencing declining disposable income as wage increases are less than inflation. This will not reverse until productivity and business investment improve so as to warrant paying higher wages. It is mainly higher wages that could provide a solid stimulus to an increase in consumer expenditure which would then underpin strong growth. There are also concerns that a significant number of mortgage holders are going to find it very difficult to manage increases in Bank Rate, as they feed through to mortgage rates, when they do start.

2. Government – again, maxed out on borrowing and committed to austerity programmes to reduce its expenditure.

3. Foreigners buying our exports – but the European Union (EU), our major export market, are likely to experience tepid growth, at best, for the next few years.

4. Business investment in fixed capital formation; but this has fallen from 13.5% to 10.4% of GDP over 2008 - 2013. There are some encouraging signs that businesses are catching the upturn in optimism and are beginning to increase investment and exports into new markets in emerging countries. But this will take a significant length of time before it starts to make a material impact on total UK GDP growth rates.

Short term turbulence in financial markets

We can only repeat our previous warnings that we are in times when events can precipitate major volatility in markets. During the past few weeks we have seen a sudden flight to safe havens resulting from investment flows out of emerging economy countries back to western economies as the prospects for higher growth in these economies have improved. This has been triggered by the Fed's start to tapering and two successive months of reducing QE purchases by $10bn per month. There have also been particular concerns around adverse political and economic developments in Argentina and Turkey.

As for the Eurozone (EZ), while Ireland has made very good progress towards being able to exit from its bail out soon, it looks increasingly likely that Greece is now going to need a third bailout package, though not one on the same scale as the first two. A growing lack of confidence in the EZ austerity programmes could cause bond yields to rise for EZ countries. This could help maintain UK gilts as a safe haven and so depress gilt yields close to current levels for an extended period.

This updated forecast is based on an initial assumption that we will not be heading into a major resurgence of the EZ debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and is, therefore, likely to dampen UK growth, as the EU is our biggest export market. We are also concerned that some EZ countries experiencing low growth, will, over the next few years, see a significant increase in total government debt to GDP ratios. There is a potential danger for these ratios to rise to the point where markets lose confidence in the financial viability of one, or more, countries. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a resurgence of the EZ debt crisis. While the European Central Bank (ECB) has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the large countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Our PWLB forecasts are based around a balance of risks. However, we would flag up the potential for upside risks, especially for longer term PWLB rates, as follows: -

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Downside risks currently include:

- UK strong economic growth is currently very dependent on consumer spending and recovery in the housing market. This is unlikely to endure much beyond 2014 as most consumers are maxed out on borrowing and wage inflation is less than CPI inflation, so disposable income is being eroded.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK’s main trading partners - the EU and US, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the EZ sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and EZ governments to deal with the potential size of the crisis.
- Recapitalising of European banks requiring more government financial support.
- Lack of support by populaces in EZ countries for austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.

- The Italian political situation is frail and unstable; this will cause major difficulties in implementing austerity measures and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- A lack of political will in France, (the second largest economy in the EZ), to dynamically address fundamental issues of low growth, poor international uncompetitiveness and the need for overdue reforms of the economy.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the EZ and Japan.
- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.

We would remind clients of the view that we expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are as we are experiencing exceptional levels of volatility which are highly correlated to political developments, (or lack of them), in the sovereign debt crisis. Please find below our revised forecasts which are based on the new Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.75
3 month LIBID	0.50	0.50	0.50	0.50	0.50	0.50	0.60	0.70	0.80	0.90	1.00	1.20	1.50	1.70
6 month LIBID	0.58	0.60	0.60	0.60	0.60	0.60	0.70	0.80	1.00	1.20	1.30	1.50	1.70	2.00
12 month LIBID	0.80	0.80	0.80	0.80	0.80	0.90	1.10	1.20	1.40	1.60	1.70	1.90	2.10	2.30
5 yr PWLB	2.60	2.60	2.60	2.70	2.80	2.90	2.90	3.00	3.10	3.20	3.20	3.30	3.40	3.50
10 yr PWLB	3.60	3.70	3.70	3.80	3.80	3.90	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.50
25 yr PWLB	4.30	4.40	4.40	4.50	4.60	4.70	4.70	4.80	4.90	5.00	5.00	5.10	5.10	5.10
50 yr PWLB	4.30	4.40	4.50	4.50	4.60	4.80	4.80	4.90	5.00	5.10	5.10	5.10	5.20	5.20

BANK RATE	now	previously
Q1 2014	0.50%	0.50%
Q1 2015	0.50%	0.50%
Q1 2016	0.75%	0.50%
Q1 2017	1.75%	1.25%

Our target borrowing rates and the current PWLB (certainty) borrowing rates are set out below.

PWLB debt	Current borrowing rate 14.2.14	Target borrowing rate now	Target borrowing rate previous
5 year	2.63%	2.60%	2.50%
10 year	3.65%	3.70%	3.60%
25 year	4.32%	4.40%	4.40%
50 year	4.29%	4.40%	4.40%

Our suggested budgeted investment earnings rates for investments up to about three months duration in each financial year for the next seven years are as follows: -

Average earnings in each year	Now	Previously
2014/15	0.50%	0.50%
2015/16	0.60%	0.50%
2016/17	1.40%	1.00%
2017/18	2.25%	2.00%
2018/19	2.75%	3.00%
2019/20	3.75%	4.00%
2020/21	4.25%	4.50%
Later years	4.25%	4.75%

As there are significant potential risks from the EZ and from financial flows from emerging markets in particular, caution must be exercised in respect of all interest rate forecasts at the current time. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is expected to remain unchanged, as market fundamentals will focus on the sheer volume of UK gilt issuance (and also US Treasury issuance) and the price of those new debt issues. Negative (or positive) developments in the EZ sovereign debt crisis could significantly impact safe-haven flows of investor money into UK, US and German bonds and produce shorter term movements away from our central forecasts.

Our interest rate forecast for Bank Rate is in steps of 25 bps whereas PWLB forecasts have been rounded to the nearest 10 bps and are central forecasts within bands of + / - 25 bps.

Naturally, we continue to monitor events and will update our forecasts as and when appropriate.

Interest Rate Strategy Group

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We are Capita Asset Services, a division of Capita plc, a FTSE 100 company and the UK's leading provider of business process outsourcing and integrated professional support solutions.

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