Chichester District Council

THE CABINET **6 September 2016**

Treasury Management Out-turn and Progress Report

1. Contacts

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2. Executive Summary

As required by the Chartered Institute of Public Finance (CIPFA), this report reviews the treasury management activity and Prudential Indicators out-turn for the financial year 2015-16.

The investment interest earned in the year amounted to £400,000 based on an average portfolio of £51.2m. The actual annual return on internally managed treasury investments was 0.8%, which met the original target for the year. The comparative return for all other District Councils published by Arlingclose is 0.71%.

The total investments held at 31 March 2016 amounted to £48.8m (£40.7m at 31 March 2015). Direct property investments at year end amounted to £3.9m and achieved a return of 9.09%.

There were no breaches of the Council's Treasury strategy, although bank balances intermittently exceeded guidelines set out in the Council's Treasury Management Practice statements. The reasons for these are explained in section 8 of this report.

Looking ahead, as the Council's cash balances continue to increase, and interest rates are likely to stay low for longer, mixed asset and other pooled investment vehicles are increasingly attractive options. Whilst this report provides an update on the Council's proposed further investment in the Local Authority Property Fund officers are continuing to assess options for investment in other pooled funds.

Finally, this report provides an economic update following the EU referendum and details of changes to counterparties that are available for treasury investments.

3. Recommendation

3.1 That the Cabinet notes the final Prudential Indicators for 2015-2016 to 2020-2021 as detailed in appendix 1 to the report.

3.2 That the Cabinet considers;

- **The treasury management outturn performance for 2015-2016 and**
- **The treasury management performance for the three months to 30 June 2016.**

4. Background

4.1 This report covers treasury management activities and prudential indicators for 2015-16 and quarter 1 2016-17. To meet the requirements of CIPFA's Treasury Management Code of Practice and Prudential Code for Capital Finance these must be considered by the same body of members who approved them as part of the Treasury Management Strategy prior to the start of the financial year. The Council approved the original 2015-16 prudential indicators on 10 March 2015. Further amendments were agreed by Council on 26 February 2016.

5. Outcomes to be achieved

5.1 This report summarises:

- Capital activity and how it was financed
- Investment performance for 2015-16 and quarter 1 2016-17
- The Council's prudential indicators as at 31 March 2016; and,
- The local treasury management context and outlook.

5.2 The report demonstrates that the capital investment continues to meet the principles that spending is prudent, affordable and sustainable, and that treasury management activity is in accordance with the Council's Treasury Management Strategy.

6. Capital Expenditure and Financing 2015-2016

6.1 Under the Prudential Code, the Council is required to take into account the following:

- Affordability;
- Prudence and sustainability;
- Professional good practice;
- Transparency; and
- The Council's treasury management framework.

6.2 Capital expenditure in 2015-16 and financing is shown in appendix 1. Total expenditure, including the asset replacement programme, was £4.833m, some £4.974m less than the revised estimate of £9.807m due largely to capital budget underspends which will slip into FY2016/17, including:

- £1.871m relating to development of Plot 21 Terminus Rd;
- £530,000 on Avenue De Chartres car park structural replacement works;
- £502,000 replacing three trade waste vehicles at CCS Depot;
- £304,000 relating to the refurbishment of CCS Depot; and,
- £283,000 for purchasing a new Council telephony system.

6.3 Some £1.108m of total project spend was considered to be revenue in nature and was therefore funded from a combination of revenue reserves and revenue grants and contributions

6.4 The balance of £3.725m was funded by capital receipts, the capital projects fund and capital grants and contributions thereby negating the need to borrow funds from external bodies.

6.5 The credit agreement in respect of the Council's multi-function devices leased in 2014-15 continues to require a small Minimum Revenue Provision (MRP) charge (£23k per annum) to be made against the Council's General Fund.

7. <u>Investment Activity and performance</u>

Internally Managed Funds

7.1 The Council continues to manage significant resources as part of its treasury management function. The funds managed increased in 2015-16 by £8.1m and have subsequently increased further to £50.7m as at 30 June 2016 (exhibit 1).

<u>Exhibit 1 1: Movement in treasury funds</u>

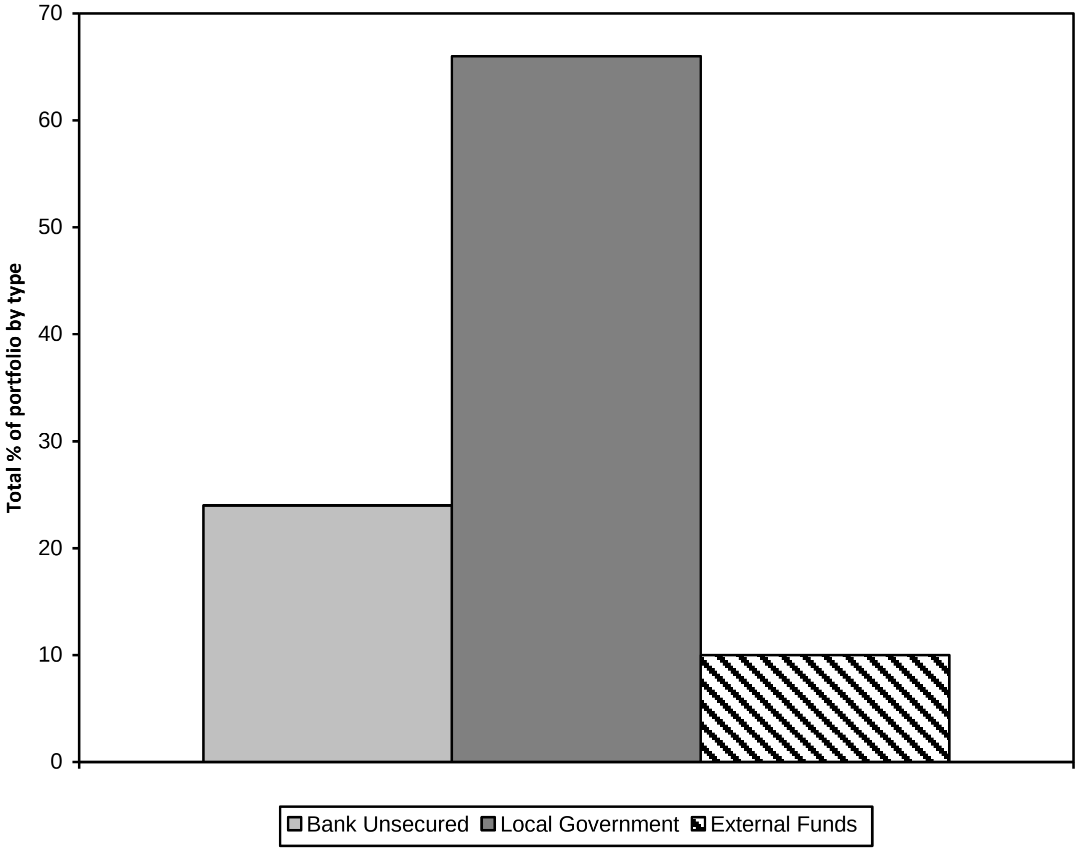
Investments £000	Balance 01/04/2015	Movement	Balance 31/03/2016	Movement	Balance 30/06/16
Short term Investments (cash, call accounts, deposits)	32,700	(3,265)	29,465	3,450	32,915
Money Market Funds	0	4,420	4,420	(1,610)	2,810
Total liquid investments	**32,700**	**1,185**	⇧ **33,885**	**1,840**	⇧ **35,725**
Long term Investments	8,000	2,000	10,000	-	10,000
Pooled funds – Local Authority Property fund	0	5,000	5,000	-	5,000
TOTAL INVESTMENTS	40,700	8,185	⇧ 48,885	1,840	⇧ 50,725

7.2 The increase in funds managed continues to be driven by the receipt of new homes bonus funding and cash reserves set aside to fund the Council's asset replacement programme.

7.3 The end of bank bail-outs, the introduction of bail-ins and the uncertainty surrounding the EU referendum meant that the risks of making unsecured deposits continues to be elevated relative to other investment options.

7.4 To mitigate this risk, the Council favoured local government investments during 2015-16, as shown in exhibit 2. Local Authority investments are secured on the entire revenues of the Council and are therefore considered to be a secure form of investing, often with a trade-off against return.

Exhibit 2: Investment counterparty types at 31 March 2016



Externally Managed Funds

7.5 The Council purchased 1,609,166 units in the Local Authority's property fund for £5,000,000 in February 2016. This diversifies treasury investments into asset classes other than cash without the need to own and manage the underlying investments. They offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short-term.

7.6 On purchase, the Council recognised an initial capital loss of £0.36m, which represents the difference between the acquisition and sale price of fund units. This loss will only be charged to the Council's General Fund when the asset becomes impaired, is sold or is derecognised. At present this is not expected to occur as, although money can be redeemed from this fund at short notice, the Council's intention is to hold them over the medium to long term. The balance presented above is therefore the principal sum invested.

Estates portfolio

7.7 The rent roll (before concessions and other allowances) for the non-operational property and licence fees is about £2.5 million including the investment acquisitions in 2014/15 and 2015/16. This income, is from rents from 49 industrial units, 72 commercial and industrial ground leases, 40 shops, 17 offices, 27 lettings to sports, community and voluntary organisations, 7 kiosks and concessions (including the Chichester Traders Market), 17 town centre commercial access agreements, miscellaneous lettings such as the crematorium and a very large number of residential vehicular and pedestrian access agreements.

7.8 In 2014/15 and 2015/16 the Council purchased 3 properties primarily as income producing investments although ownership of those purchased to date also provides economic development benefits . These purchases comprise a building for office/storage use and showroom in Terminus Road, a group of industrial buildings, also in Terminus Road and a parade of 10 shops in Chichester. The Council is seeking to purchase more property to provide revenue income but availability is limited and the Council is competing with other investors.

Benchmarking

7.9 The Council has traditionally reported benchmark data prepared by CIPFA in these reports. This report has moved away from using CIPFA benchmarks to use those supplied by the Council's own investment advisor, Arlingclose due to the higher participation rate, the use of more consistent investment counterparty guidance across the population and the more frequent provision of benchmarking data. The terms used by the benchmarks are explained in Appendix 4.

7.10 The data below is presented in terms of the key objectives of public sector treasury management, Security, Liquidity and Yield, and from quarter two onwards, which represents the first period metrics were prepared for.

Security

	CDC Actuals					
Measure	Qtr2	Qtr3 15-16	Qtr4	Qtr 1 16-17	Non-met District average	Rating
Average Credit Score (time-weighted)	2.61	2.52	2.38	2.85	3.66	GREEN
Average Credit Rating (time weighted)	AA	AA	AA+	AA	AA-	GREEN
Proportion Exposed to Bail-in (%)	24	29	18	19	68	GREEN

7.11 The Council's unsecured investments have been maintained above the target credit rating of A+ set out in Table 7 of its Treasury Management Strategy. The risk of bail-in has been successfully managed by reducing the Council's exposure to banks and building societies as set out in paragraph 7.4 and only 18% of Council investments were exposed to possible bail-in at 31 March 2016.

Liquidity

	CDC Actuals					
Measure	Qtr2	Qtr3 15-16	Qtr4	Qtr 1 16-17	Non-met districts (average)	Rating
Proportion available within 7 days (%)	7	15	16	7	39	AMBER
Proportion available within 100 days (%)	38	53	39	49	64	GREEN
Average days to maturity	328	273	288	246	153	AMBER

7.12 The Council has a voluntary liquidity measure to maintain a minimum of £10m available within 3 months and this has been complied with throughout the period in question.

7.13 The relatively low proportion of funds available within 7 days reflects the Council's active management of its investments to limit its exposure to bank bail-in, the majority of short term deposits being for periods of 1 to 6 months with Local Authorities.

7.14 The relatively high average days to maturity figure reflects a number of longer term investments which generate additional returns for the Council's general fund. The Council's ability to commit funds to such long-term investments reflects both the size of funds available for treasury management and also the integration of this with medium and long term financial forecasting undertaken by the Council.

Return

	CDC Actuals					
Measure	Qtr2	Qtr3 15-16	Qtr4	Qtr 1 16-17	Non-met districts (average)	Rating
Internal investment return %	0.80	0.79	0.84	0.82	0.71	GREEN
External funds – income return %	-	-	4.63	4.55	3.00	GREEN
External funds – capital gains/losses %	-	-	(7.20)	(10.13)	(0.69)	AMBER
Total treasury Investments – income return %	0.80	0.79	1.20	1.16	1.06	AMBER

Property – income return %	9.09	9.09	9.09	9.09	N/A	GREEN

7.15 The overall internal investment return on internal treasury investments met the target return for the year (0.8%). A number of medium term investments will mature in 2016-17 creating downward pressure on investment returns. The Council's response to this is explored briefly in this report and will be re-appraised more fully in the 2017-18 Treasury Management Strategy.

7.16 The capital return on the Council's external funds reflects the circumstances described in section 7.2 relating to the Local Authority Property Fund.

Daily Cash Management

8.1 The Council's change of banker on 1 April 2016 proved challenging for short term management of cash balances. During the period there were a number of occasions when the requirements of the Council's Treasury Management Practices (TMPs) guideline to maintain the current bank balance below £150,000 was exceeded.

8.2 The most significant being;

- On 21 March 2016 the Council's HSBC bank account was £3.6m overdrawn as an investment repayment was made into the Council's new Nat-West account before the official change-over date. The reverse of this is that the Nat-West account was in credit overnight by £3.8m on the same date.

- On 23 May 2016 the Council's Nat-West bank account was overdrawn by £1.7m as an investment repayment was credited to the Council's old HSBC bank account despite all counterparties being advised of the change to the Council's banker prior to 1 April 2016.

- On six occasions between 11 April and 17 May 2016 the Council's Nat-West current account was overdrawn by between £150k and £612k. These instances arose as the Council's new arrangements to automatically move money between its current and investment accounts at the Nat-West did not operate as initially expected. The matter is subject to ongoing discussions with Nat-West to establish the most suitable arrangements going forward. In the meantime, local procedures have been introduced to avoid further occurrence.

8.3 Other breaches, not related to the Council's new banking arrangements were as follows:

- Between the 26 and 28 February 2016 (a weekend) the Council's HSBC account was overdrawn by £2.3m as a counterparty could not process a requested redemption of £2.4m in advance of Friday's close of business. Bank charges and interest incurred due to this have been refunded to the Council.

- On 4 January 2016 the HSBC bank account was in credit by £841k reflecting the payments received during the Council's Christmas closure

- Between 15 to 17 January 2016 (over a weekend) the HSBC bank account was in credit by £279k as the Council received an unanticipated receipt from the DCLG after investment activity had been completed for the day.

8.4 As in previous periods, the limit was also exceed 15 times between 1 January and 30 June by small amounts (maximum £323k held) due to additional income, mainly from National Non-Domestic Rate, being received after the daily cash flow and investment decisions had been taken.

8.5 Finally, following the move to the Council's new banker, the Council's old HSBC account is being wound down. A number of receipts are still being received into this account, although the amount is diminishing as taxpayers and other parties are contacted. Officers continue to monitor this and transfer funds to the Council's Nat-West account when the cost of transferring such funds is warranted. The value of funds in the HSBC account during this period has ranged from £259k to £753k.

9 Local Context and Outlook

Investment returns

9.1 Following the EU referendum the Council's present interest rate assumptions (below) are optimistic and they are being reviewed as part of the Council's financial forecast update.

	2015-16 Revised	2016-17	2017/18	2018/19	2019/20	2020/21
Investment Rates	0.80%	0.75%	1.00%	1.15%	1.20%	1.25%

9.2 Arlingclose currently projects that the likely path for Bank Rate is downwards and the central case is 0.25%, but there is a 40% possibility of that the rate is cut to zero.

Official bank rate	Three years to Sep 19
Upside	0.25
Central Case	0.25
Downside	-0.25

9.3 At the August 2016 MPC meeting a majority of members expected a further cut to the Bank Rate if the incoming data proved broadly consistent with the August Report forecast. This raised the possibility of the official interest rate (i.e. Bank Rate) being moved to its 'effective lower bound' or, after the reduction to 0.25%, to zero. More detail on the economic context for this report is contained in appendix 2.

9.4 As interest rates are likely to stay low for longer and the Council's cash balances are increasing, medium to long-term bonds or mixed asset and other pooled investment vehicles are increasingly attractive options.

9.5 Although one pooled fund is the Local Authority Property Fund, officers are reviewing options for investments in other pooled funds. The Council's 2017-18 Treasury Management Strategy will provide more details on this when it is presented to Council later this year.

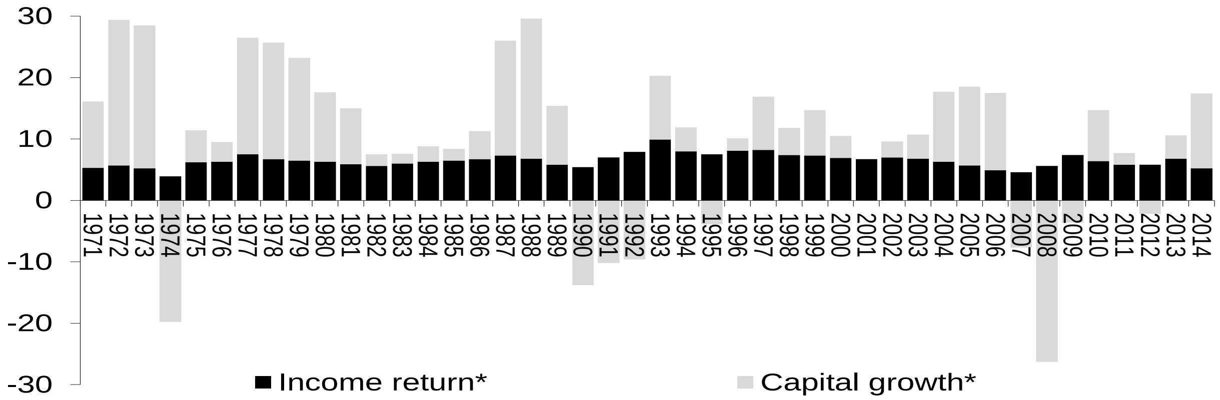
The Local Authority Property Fund

9.6 The Council invested £5m with the CCLA Local Authority Property Fund during the first half of 2016. Although further investment in the CCLA Local Authority Property Fund was originally scheduled for 2016 uncertainty over post-referendum commercial property values has delayed this decision.

9.7 Immediately post Brexit, CCLA reduced the value of its shares by 5%, a reduction supported by the subsequent valuation of the fund as at 28 June. Although the net asset price fell from 295p to 283p, the fund size itself, adjusting for changes in net asset value, remained stable at £620m.

9.8 Officers have continued to monitor the area. In this period of general uncertainty it remains their view that the long term benefits of property fund are attractive, as demonstrated by the exhibit below which provides detail of property investment returns since 1970.

<u>Property investment returns (capital and income %) from 1970</u>



Source: CCLA and IPD

9.9 Officers are continuing to monitor the post-Brexit reaction in the property sector. It is still early to be clear as to the extent of any reduction in value of the Property Fund following Brexit as July and August are traditionally quiet periods for commercial property. Officers intend to review the results of the valuation of the Property Fund conducted in August and September before making a final decision to invest further.

9.10 Further information on the external economic context for this report and investment counterparties is found in Appendices 2 and 3.

10. Resources and Legal Implications

10.1 Any investment interest received in the year is not used to help balance the revenue budget, but used to fund one off costs or towards funding capital projects. Any underperformance may therefore have an impact on the Council's overall funding position, but this is kept under review and reported to members as part of the budget process. Currently the approved capital programme remains fully funded.

10.2 The Council has complied with all the relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management, means that, its capital expenditure is prudent, affordable and sustainable, and demonstrates a low risk approach.

11. Other Implications

Crime and Disorder	None
Climate Change	None
Human Rights and Equality Impact	None
Safeguarding	None

12. Appendices

12.1 Appendix 1 – Capital expenditure out-turn 2015-16 and prudential indicators.

12.2 Appendix 2 – External economic update

12.3 Appendix 3 – Counterparty update

12.4 Appendix 4 – Benchmarking definitions

13. Background Papers

Arlingclose Benchmarking Report for 2015-16 (contains exempt information under Paragraph 3 (information relating to the financial or business affairs of any particular person (including the authority holding that information) of Part I of Schedule 12A to the Local Government Act 1972.

Appendix 1: CAPITAL EXPENDITURE OUT TURN AND PRUDENTIAL INDICATORS 2015-16

Actual Spend compared to Original and Revised Estimate

2015-16				
Original Estimate £000's	Revised Estimate £000's	Out-turn £000's	Out-turn Variance to Original £000's	Out-turn Variance to Revised £000's
8,355	**9,807**	**4,833**	**-3,522**	**-4,974**

The overall spend on projects was £4.833m, of which £3.725m met the definition of capital expenditure as determined by the Local Government Act 2003. The balance of £1.108m of project spend was deemed to be more of a revenue nature, and charged to the income and expenditure account and funded from the revenue reserves or income. Due to the tighter definition of capital expenditure the current "capital" programme contains a number of schemes that are strictly revenue.

The sources of funding for the capital expenditure incurred in 2015-16 were

Capital Receipts	**£**
Capital Receipts Reserve	2,704
Capital Grants & Contributions	
Renovation Grants	501
Section 106 Contributions	13
Revenue Reserves	38
Other Contributions	469
TOTAL FUNDING	**3,725**

Prudential Indicators 2015-16

The Local Government Act 2003 requires the Authority to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Authority has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Adoption of the CIPFA Treasury Management Code: The Authority adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition in February 2012.

Estimates of Capital Financing Requirement:
The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31.03.16 Actual £m	31.03.17 Estimate £m	31.03.18 Estimate £m	31.03.19 Estimate £m	31.03.20 Estimate £m	31.03.21 Estimate £m

CFR	-1.38	-1.37	-1.40	-1.43	-1.44	-1.44

The CFR is forecast to remain negative over the next three years as the Council expects to remain debt-free over this period..

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Authority should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	31.03.16 Actual £m	31.03.17 Estimate £m	31.03.18 Estimate £m	31.03.19 Estimate £m	31.03.20 Estimate £m	31.03.21 Estimate £m
Borrowing (Operational Boundary only)	0	**0**	0	0	0	0
Finance leases	0.1	0.1	0.1	0.05	0	0
Total Debt	**0.1**	**0.1**	**0.1**	**0.05**	**0**	**0**

The actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt, below.

Operational Boundary for External Debt: The operational boundary is based on the Authority's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

Operational Boundary	2015/16 Approved £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m
Borrowing	5	**5**	5	5	5	5
Other long-term liabilities	0	**0**	0	0	0	0
Total Debt	**5**	**5**	**5**	**5**	**5**	**5**

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	2015/16 Approved £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m
Borrowing	10	**10**	10	10	10	10
Other long-term liabilities	0	**0**	0	0	0	0
Total Debt	**10**	**10**	**10**	**10**	**10**	**10**

No borrowing was undertaken other than the short-term use of the Council's overdraft facility for short term liquidity and an ongoing credit arrangement of £123k for multi-function devices acquired in 2014-15. The authorised limit or operational boundaries were not exceeded at any point during 2015-16.

Ratio of Financing Costs to Net Revenue Stream: This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2015/16 Actual %	2016/17 Estimate %	2017/18 Estimate %	2018/19 Estimate %	2019/20 Estimate %	2020/21 Estimate %
General Fund	-2.92	-2.16	-3.22	-3.37	-3.70	-4.00

The estimates of financing costs reflect the Budget Spending Plans for 2016-17 to be reported to Cabinet on 9 February 2016 and considered by Council on 1 March 2016. These indicators have been updated to reflect the current phasing of the capital programme and the effect on the cash flow forecasts for investments.

The percentages are negative as the Council has a net income stream from its entire Treasury activities (including any debt financing).

Incremental Impact of Capital Investment Decisions:
This is an indicator of affordability that shows the theoretical impact of capital investment decisions on Council Tax levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme expenditure at the start of this appendix.

Incremental Impact of Capital Investment Decisions	2015/16 Actual £	2016/17 Estimate £	2017/18 Estimate £	2018/19 Estimate £	2019/20 Estimate £	2020/21 Estimate £
General Fund - increase in annual band D Council Tax	-3.39	-2.60	-3.09	-3.06	-3.03	-3.00

Interest Rate Exposures

Prior to the start of the financial year, the Council is required to determine its upper limits on fixed and variable interest exposures – netting off investments and borrowing where appropriate.

For 2015-16 these were set at:-

- £24m for Upper limit on Fixed Interest Rate exposure of Net Investment Principal
- £60m for Upper limit on Variable Interest Rate exposure of Net Investment Principal.

For the purposes of this indicator fixed interest rate investments exclude long-term fixed rate financial instruments that matured during 2015-16.

These limits were not exceeded during the year, as the maximum levels achieved were £15m for fixed interest rate investments (26 February 2016 onwards) and £48m for variable interest investments (2 September 2015).

Total Principal Sums Invested for Periods Longer than 364 days

The indicator set for the prudential limits for principal sums invested for periods for longer than 364 days was set at £25m.

During the year sums invested for periods longer than 364 days rose from £8m to £15m, including new investments with:

- the London Borough of Enfield (£3m until July 2020);
- Glasgow City Council (£2m until November 2018);
- Fife Council (£2m until September 2017);
- The Local Authority Property Fund (£5m).

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Appendix 2: External economic context

Growth, Inflation, Employment

The UK economy slowed in 2015 with GDP growth falling to 2.3% from a robust 3.0% the year before. CPI inflation hovered around 0.0% through 2015 with deflationary spells in April, September and October. 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.

Data released in the April-June quarter showed UK GDP at 2% year/year to March 2016 and annual inflation at 0.3% in May. Inflation remained subdued as a consequence of weak global price pressures, past movements in sterling and restrained domestic price growth. Internationally, a modest pace of growth in the UK's main trading partners remained the most likely prospect.

During the first half of 2016, fluctuations in opinion polls on the EU referendum prompted pronounced volatility in exchange rates, gilts, corporate bonds and equities as the result became increasingly uncertain. 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 which will increase uncertainty over the medium term.

Post referendum result, the overall market reaction, although significant, was less severe than some had feared. The 5-year credit default swaps 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 23rd June to 3,237 after the result, had subsequently risen to 3,707 by 8 August
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UK Monetary Policy

Following the EU referendum, the Bank of England sought to reassure markets and investors. Governor Mark Carney's speeches during the immediate aftermath stressed that the Bank was ready to support money market liquidity and raised the likelihood of a cut in policy rates 'in the summer'. The door was also left open for an increase in the Bank's asset purchase facility (QE). The Governor noted that the Bank would weigh the downside risks to growth against the upside risks to inflation from a fall in the value of sterling.

At its meeting in August, the Monetary Policy Committee voted unanimously to cut Bank Rate to 0.25% from 0.5%, to increase the stock of purchases of gilts and to purchase £10 billion of corporate bonds.

The Committee noted that following the United Kingdom's vote to leave the European Union, the exchange rate had fallen with the risk this would push up CPI inflation in the near term, hastening its return to the 2% target.

The MPC was unanimous in the view that some policy easing was needed to reduce the amount of spare capacity and thus ensure that inflation returned sustainably to the target.

It also considered an expansion of its asset purchase programme for UK government bonds, financed by the issuance of central bank reserves. This would trigger portfolio rebalancing into riskier assets, lowering the real cost of borrowing for households and companies.

The MPC viewed the domestic banking system as being much better placed to face the challenging outlook than during earlier periods of stress. Over recent years, regulators in the United Kingdom and internationally had required banks to strengthen their balance sheets so that the financial system had become more resilient.

The Committee discussed whether to cut Bank Rate immediately to its effective lower bound, close to but a little above zero, or whether to cut Bank Rate by 25 basis points. For a majority of Committee members a case could be made for cutting Bank Rate immediately to the effective lower bound. However, most Committee members also thought there was value in delivering the required stimulus via a broad package of measures and recognised that there would be further opportunities to assess economic prospects at coming meetings in the light of new data.

If the incoming data proved broadly consistent with the August Inflation Report forecast, a majority of members expected to support a further cut in Bank Rate to its effective lower bound at one of the MPC's forthcoming meetings during the course of the year. The MPC currently judged this bound to be close to, but a little above, zero.

Market reaction

Through 2015-16 10-year gilt yields moved from 1.58% on 31/03/2015 to a high of 2.19% in June before falling back and ending the financial year at 1.42%. The pattern for 20-year gilts was similar, the yield rose from 2.15% in March 2015 to a high of 2.71% in June before falling back to 2.14% in March 2016. The FTSE All Share Index fell 7.3% from 3664 to 3395 and the MSCI World Index fell 5.3% from 1741 to 1648 over the 12 months to 31 March 2016.

The UK economic environment had already deteriorated ahead of the EU Referendum, as the potential for a leave vote amid the government's warnings of economic meltdown dampened business and consumer confidence. This debate arose in an already uncertain economic environment – the previous 12 months were characterised by substantial financial market corrections on the back of concerns about global growth prospects. Banks were one of the sectors targeted by investors worried about exposures to underperforming industries, such as oil and mining. UK business investment was a significant casualty of this economic uncertainty, contracting 0.8% year on year in the first quarter of 2016, a warning of the possible economic performance to come.

It is still early to assess any official post-referendum economic data. However, evidence suggests that the pre-vote downturn in business confidence worsened considerably after the result. The Lloyds Business Barometer survey for the subsequent week indicated a sharp fall in both business confidence and expectations of business activity over the next 12 months. Both investment and employment intentions may be affected as businesses delay or cancel spending and investment decisions, while business solvency will come under pressure due to lower activity levels.

The possible rise in unemployment will affect consumer confidence and consequently spending decisions. Even if consumer spending in nominal terms holds up, the rise in inflation prompted by the devaluation of sterling is likely to depress real spending levels.

The repercussions of the above may be felt in asset values, particularly commercial and residential property. The latest RICS housing market survey indicated a sharp decline in new buyer interest. Although supply of properties for sale declined equally rapidly, surveyors expect residential property prices to fall over the next 12 months. Any decline in residential property is likely to feed into lower consumer sentiment.

Post-referendum commercial property data is still emerging, but the action of fund managers in voluntarily marking down shares reflects lower expected property valuations.

While the EU referendum result could be described as a surprise, the outcome was always expected to be close - close enough that UK policymakers and banks were busy devising contingency plans on a leave vote. The Bank of England governor Mark Carney emphasised the stability of the UK financial system, clearly realising that looser monetary policy is severely limited if the wholesale funding markets stop working (a credit crunch-type situation) and banks stop lending. To this end, liquidity has been made available to the banking sector through the Bank's open market operations, while capital adequacy rules have been eased by the Financial Policy Committee

Following the EU referendum, the sterling exchange rate index fell by 9% and short-term volatility of sterling against the dollar increased significantly. Worldwide, markets reacted negatively with a big initial fall in equity prices. Government bond yields also fell sharply by 20-30 basis points 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%.

The result the overall market reaction, although significant, has to date been 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 23rd June to 3,237 after the result, had subsequently risen to 3,707 by 2 August.

GBP Money Market Funds were largely unaffected by the EU referendum. Yields barely moved, with the average of the top yielding GBP Prime MMFs staying within a band of 0.52 and 0.53%.

Appendix 3: Counterparty Update

The transposition of two European Union directives into UK legislation placed the burden of rescuing failing EU banks disproportionately onto unsecured institutional investors which include local authorities and pension funds. During the year, all three credit ratings agencies reviewed their ratings to reflect the loss of government support for most financial institutions and the potential for loss given default as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions saw upgrades due to an improvement in their underlying strength and an assessment that that the level of loss given default is low.

Fitch reviewed the credit ratings of multiple institutions in May. Most UK banks had their support rating revised from 1 (denoting an extremely high probability of support) to 5 (denoting external support cannot be relied upon). This resulted in the downgrade of the long-term ratings of Royal Bank of Scotland (RBS), Deutsche Bank, Bank Nederlandse Gemeeten and ING.

Moody's concluded its review in June and upgraded a number of long-term ratings including Close Brothers, Standard Chartered Bank, HSBC, RBS, Coventry Building Society, Leeds Building Society, Nationwide Building Society, Svenska Handelsbanken and Landesbank Hessen-Thuringen.

S&P reviewed UK and German banks in June, downgrading the long-term ratings of Barclays, RBS and Deutsche Bank.

In December the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies which showed that the Royal Bank of Scotland and Standard Chartered Bank were the weakest performers. However, the regulator did not require either bank to submit revised capital plans, since both firms had already improved their ratios over the year.

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.

Following Brexit Arlingclose has reviewed all UK based institutions, with the following results:

Credit rated banks and building societies

- no changes were made to approved counterparties or durations as a result

Unrated building societies

- Three Building Societies were removed from Arlingclose’s advised list, following a deterioration in credit indicators
- Maximum advised maturities were reduced for eleven societies due to the uncertainty facing the UK property market following the EU referendum.
- No new building societies were added to the approved Counterparty list at this review

At the end of July 2016 the European Banking Authority released the results of its 2016 round of stress tests on the single market’s 51 largest banks. The Royal Bank of Scotland made headline news as one of the worst performers, although no bank was said to have failed the tests.

Appendix 4 – Benchmarking definitions

The benchmarking compares various measures of risk and return, which are calculated as follows:

Investment Value
For internal investments, the value is the sum initially invested. For external funds, the value is the fund's bid price on the quarter end date multiplied by the number of units held.

Rate of Return
For internal investments, the return is the effective interest rate, which is also the yield to maturity for bonds. For external funds (LAPF) this is measured on an offer-bid basis less transaction fees. For external funds the income only return excludes capital gains and losses.

Average returns are calculated by weighting the return of each investment by its value. All interest rates are quoted per annum.

Duration
This measure applies to internal investments only. This is the number of days to final maturity. For instant access money market funds, the number of days to final maturity is one.
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Average duration is calculated by weighting the duration of each investment by its value. Higher numbers indicate higher risk.

Credit Risk
Each investment is assigned a credit score, based where possible on its average long-term credit rating from Fitch, Moody's and Standard & Poor's. This is converted to a number, so that AAA=1, AA+=2, etc. Higher numbers therefore indicate higher risk. Unrated local authorities are assigned a score equal to the average score of all rated local authorities.

Average credit risk is measured in two ways. The value-weighted average is calculated by weighting the credit score of each investment by its value. The time-weighted average is calculated by weighting the credit score of each investment by both its value and its time to final maturity. Higher numbers indicate higher risk.