APPENDIX 2

HARLOW COUNCIL
TREASURY MANAGEMENT STRATEGY
MID-YEAR REVIEW, 2017/18

Summary of the Report

1. This report provides an update on economic conditions impacting on the Council and focusses on any major issues affecting borrowing and investments.

2. A full commentary is provided within this report by the Council's treasury management advisors, Arlingclose Ltd. In summary Bank whilst there was a Bank Rate rise on 2 November 2017 from 0.25% to 0.5%, interest rates have remained at an historic low following the UK referendum in June 2016 to leave the European Union (EU).

3. Officers are considering the cost and benefit of investments whilst recognising an overall need to ensure deposits are securely placed.

4. At all times the Council will take steps to protect its investment portfolio by placing security (the reduction of risk in order to protect the return of capital sums) and liquidity (being able to have immediate access to a reasonable amount of funds so that cashflow obligations may be met) above yield (i.e. the interest paid on investments).

5. In setting out the Council's strategy for 2018/19, a full report will be presented to Cabinet and Full Council in January / February 2018. This will be in conjunction with the 2018/19 budget proposals.

6. The Treasury Management Strategy for 2017/18 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFAs) Code of Practice on Treasury Management, which indicates the requirement for determining a treasury strategy for the likely financial and investment activity for the forthcoming financial year.

7. The Council is supported by treasury management advisors in decision making. Arlingclose Ltd. has been appointed for a further period of up to six years following a competitive tendering process during the summer of 2017.

Background

8. The Code also recommends that Councillors are informed of treasury management activities at least twice a year (mid-year and year end). This report therefore ensures this Council is embracing best practice in accordance with CIPFA's recommendations.

9. Treasury management is defined as: "The management of the local Council's investments and cash flows, its banking, money market and capital market

transactions; the effective control of risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

10. In addition to reporting on risk management related to treasury activities, the Treasury Management Code also requires the Council to report on any financial instruments entered into to manage treasury risks.

External Context: A commentary provided by the Council's Treasury Management advisors, Arlingclose Ltd. (October 2017)

11. **Economic backdrop**: Commodity prices fluctuated over the period with oil falling below $45 a barrel before inching back up to $58 a barrel. UK Consumer Price Inflation (CPI) index rose with the data print for August showing CPI at 2.9%, its highest since June 2013 as the fall in the value of sterling following the June 2016 referendum result continued to feed through into higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.7%.

12. The unemployment rate fell to 4.3%, its lowest since May 1975, but the squeeze on consumers intensified as average earnings grew at 2.5%, below the rate of inflation. Economic activity expanded at a much slower pace as evidenced by Q1 (Jan-Mar) and Q2 (Apr-Jun) GDP (Gross Domestic Product) growth of 0.2% and 0.3% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings falling and real wage growth negative, there are concerns that these will be a constraint on economic activity in the second half of the calendar year 2017.

13. The Bank of England made no change to monetary policy at its meetings in the first half of the financial year. The vote to keep Bank Rate at 0.25% narrowed to 5-3 in June highlighting that some MPC (Monetary Policy Committee) members were more concerned about rising inflation than the risks to growth. Although at September's meeting the Committee voted 7-2 in favour of keeping Bank Rate unchanged, the MPC changed their rhetoric, implying a rise in Bank Rate in "the coming months". The Council's treasury advisor Arlingclose is not convinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

14. In contrast, near-term global growth prospects improved. The US Federal Reserve (Fed) increased its target range of official interest rates in June for the second time in 2017 by 0.25% to between 1% and 1.25% and, despite US inflation hitting a soft patch with core CPI at 1.7%, a further similar increase is expected in its December 2017 meeting. The Fed also announced that it would be starting a reversal of its vast Quantitative Easing programme and reduce the $4.2 trillion of bonds it acquired by initially cutting the amount it reinvests by $10bn a month.

15. Geopolitical tensions escalated in August as the US and North Korea exchanged escalating verbal threats over reports about enhancements in North Korea's missile

programme. The provocation from both sides helped wipe off nearly $1 trillion from global equity markets but benefited safe-haven assets such as gold, the US dollar and the Japanese yen. Tensions remained high, with North Korea's threat to fire missiles towards the US naval base in Guam, its recent missile tests over Japan and a further testing of its latent nuclear capabilities.

16. Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty but the surprise result has led to a minority Conservative government in coalition with the Democratic Unionist Party. This clearly results in an enhanced level of political uncertainty. Although the potential for a so-called hard Brexit is diminished, lack of clarity over future trading partnerships, in particular future customs agreements with the rest of the EU block, is denting business sentiment and investment. The reaction from the markets on the UK election's outcome was fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations, the ultimate 'divorce bill' for the exit and whether new trade treaties and customs arrangements are successfully concluded to the UK's benefit.

17. In the face of a struggling economy and Brexit-related uncertainty, Arlingclose expects the Bank of England to take only a very measured approach to any monetary policy tightening, any increase will be gradual and limited as the interest rate backdrop will have to provide substantial support to the UK economy through the Brexit transition.

18. **Financial markets:** Gilt yields displayed significant volatility over the six-month period with the appearing change in sentiment in the Bank of England's outlook for interest rates, the push-pull from expectations of tapering of Quantitative Easing (QE) in the US and Europe and from geopolitical tensions, which also had an impact. The yield on the 5-year gilts fell to 0.35% in mid-June, but then rose to 0.80% by the end of September. The 10-year gilts similarly rose from their lows of 0.93% to 1.38% at the end of the quarter, and those on 20-year gilts from 1.62% to 1.94%.

19. The FTSE 100 nevertheless powered away reaching a record high of 7548 in May but dropped back to 7377 at the end of September. Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.30% and 0.65% over the period from January to 21 September.

20. **Credit background:** UK bank credit default swaps continued their downward trend, reaching three-year lows by the end of June. Bank share prices have not moved in any particular pattern.

21. There were a few credit rating changes during the quarter. The significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency

also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1, placed Lloyds Bank's A1 rating on review for upgrade, revised the outlook of Santander UK plc, and Nationwide and Coventry building societies from negative to stable but downgraded the long-term rating of Leeds Building Society from A2 to A3. The agency downgraded long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment and the ratings of the large Australian banks on its view of the rising risks from their exposure to the Australian housing market and the elevated proportion of lending to residential property investors.

22. S&P also revised Nordea Bank's outlook to stable from negative, whilst affirming their long-term rating at AA-. The agency also upgraded the long-term rating of ING Bank from A to A+.

23. Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May Councils were advised by Arlingclose reduced the maximum duration of unsecured investments with Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as until banks' new structures are finally determined and published, the different credit risks of the 'retail' and 'investment' banks cannot be known for certain. (Although Arlingclose still include banks on the Council's Lending List, locally our appetite for investment with these institutions has receded because of bail-in risk.)

24. The new EU regulations for Money Market Funds were finally approved and published in July and existing funds will have to be compliant by no later than 21 January 2019. The key features include Low Volatility Net Asset Value (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

Regulatory Updates

25. **MiFID II:** Local authorities are currently treated by regulated financial services firms as professional clients who can "opt down" to be treated as retail clients instead. But from 3 January 2018, as a result of the second Markets in Financial Instruments Directive (MiFID II), local authorities will be treated as retail clients who can "opt up" to be professional clients, providing that they meet certain criteria. Regulated financial services firms include banks, brokers, advisers, fund managers and custodians, but only where they are selling, arranging, advising or managing designated investments. In order to opt up to professional, the Council must have an investment balance of at least £10 million and the person authorised to make investment decisions on behalf of the authority must have at least one year's relevant professional experience. In addition, the firm must assess that that person has the expertise, experience and knowledge to make investment decisions and understand the risks involved.

26. Harlow has three MiFID II authorised officers who meet this criteria:
    - Head of Finance
    - Principal Finance Manager
    - Finance Manager (with responsibility for Treasury Management)

27. The main additional protection for retail clients is a duty on the firm to ensure that the investment is "suitable" for the client. However, local authorities are not protected by the Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service whether they are retail or professional clients. It is also likely that retail clients will face an increased cost and potentially restricted access to certain products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice. The Council has declined to opt down to retail client status in the past as the costs were thought to outweigh the benefits.

28. The Council meets the conditions to opt up to professional status and intends to do so in order to maintain its current MiFID status.

29. **CIPFA Consultation on Prudential and Treasury Management Codes:** In February 2017 CIPFA canvassed views on the relevance, adoption and practical application of the Treasury Management and Prudential Codes and after reviewing responses launched a further consultation on changes to the codes in August with a deadline for responses of 30 September 2017.

30. The proposed changes to the Prudential Code include the production of a new high-level Capital Strategy report to full Council which will cover the basics of the capital programme and treasury management. The prudential indicators for capital expenditure and the authorised borrowing limit would be included in this report but other indicators may be delegated to another committee. There are plans to drop certain prudential indicators, however local indicators are recommended for ring fenced funds (including the HRA) and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

31. Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties in the definition of "investments" as well as loans made or shares bought for service purposes. Another proposed change is the inclusion of financial guarantees as instruments requiring risk management and addressed within the Treasury Management Strategy. Approval of the technical detail of the Treasury Management Strategy may be delegated to a committee rather than needing approval of full Council. There are also plans to drop or alter some of the current treasury management indicators.

32. CIPFA intends to publish the two revised Codes towards the end of 2017 for implementation in 2018/19, although CIPFA plans to put transitional arrangements in place for reports that are required to be approved before the start of the 2018/19 financial year. The Department of Communities and Local Government (DCLG) and CIPFA wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. It is understood that DCLG will be revising its Investment Guidance (and its Minimum Revenue Provision guidance) for local authorities in England; however there have been no discussions with the devolved administrations yet.

Local Context

33. On 31 March 2017 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £230.009m, while usable reserves and working capital are the underlying resources available for investment was £44.803m. The Council had £211.837m of borrowing and £35.888m of investments. The Council's current strategy is to maintain borrowing and investments below their current underlying level, referred to as internal borrowing.

Borrowing during the half year

34. At 30 September 2017 the Council held £211.837m of loans. Taking advice from its Treasury Management Advisors, Arlingclose, there is no current requirement to undertake new external borrowing in 2017/18.

35. However there are two key development projects, the Enterprise Zone and development of Prentice Place, for which new external borrowing is forecast to be required. Members of Cabinet will be provided with update reports as appropriate, including an update in the 2018/19 Treasury Management Strategy Statement, which will accompany the Council's budget proposals in January. Meanwhile, should any new borrowing be required, it will remain within the Council's Authorised Limit for External Debt, approved by Full Council in February 2017.

Table 1: Borrowing Position

	31.3.17 Balance £m	Movement £m	30.9.17 Balance £m	30.9.17 Weighted average rate %	30.9.17 Weighted average maturity years
Public Works Loan Board	211.837	-	211.837	3.309	17.8
Total borrowing	**211.837**	**-**	**211.837**		

Investment Activity

36. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the first half of 2017/18 the Council's investment balance ranged between £35.438m and £48.269m due to timing differences between income and expenditure. The investment position during the half year is shown in table 2 (overleaf).

Table 2: Investment Position

	31.3.17 Balance £m	Movement £m	30.9.17 Balance £m	30.9.17 Weighted average rate %	30.9.17 Weighted average maturity: Days
Banks & building societies (unsecured)	13.073	(-)12.973	0.100	0.10	1
Government (incl. local authorities)	11.000	14.300	25.300	0.35	113
Money Market Funds	9.815	2.725	12.540	0.17	1
Other Pooled Funds	2.000	2.000	4.000	2.25	-
Total investments	**35.888**	**6.052**	**41.940**		

37. Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

38. In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Council has moved away from placing unsecured deposits with banks and building societies into the local authority market and other secure asset classes, also benefitting from some improvements in yields. A further £2m has been invested externally in a pooled fund, on this occasion in a Cash Plus Income Fund. Further consideration will be given to adding to the investment in an externally managed Property Fund. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 3 below.

Table 3: Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	4.04	AA-	56%	43	0.51%
30.06.2017	3.97	AA-	64%	51	0.62%
30.09.2017	3.87	AA-	33%	58	0.67%
Similar LAs	**4.39**	**AA-**	**65%**	**108**	**1.43%**
All LAs	**4.44**	**AA-**	**64%**	**40**	**1.12%**

*Weighted average maturity

39. The Council's £4m of externally managed pooled property and multi asset funds is likely to generate an average total return in 2017/18 of £90,000 (2.25%). Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives are regularly reviewed.

Other Investment Activity

40. Although not currently classed as treasury management activities and therefore not covered by the CIPFA Code, the Council also holds £3.709m of balances in loans to local businesses. This represents an increase of £2.709m on the previous year due to new investment in the Enterprise Zone and HTS (Property & Environment) Ltd.

41. These non-treasury investments will generate approximately £176,000 of credit interest for the Council, representing a rate of return of 4.75%. This is higher than the return earned on treasury investments, which stems from the Council's requirement to align its interest rate for these loans with commercial rates of interest.

42. If CIPFA's proposed amendments to the Treasury Management Code are adopted in the revised Code from 2018/19, these will be included in the expanded definition of "investments" if, or when, required by the new Code.

Compliance Report

43. The Head of Finance is pleased to report that all treasury management activities undertaken during the first half of 2017/18 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

Outlook for the remainder of 2017/18 (Arlingclose Ltd)

44. The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Both consumer and business confidence remain subdued. Household consumption growth, the driver of UK GDP growth, has softened following a contraction in real wages. Savings rates are at an all-time low and real earnings growth (i.e. after inflation) struggles in the face of higher inflation.

45. The Bank of England's Monetary Policy Committee has changed its rhetoric, implying a rise in Bank Rate in "the coming months". Arlingclose is not convinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

46. This decision is still very data dependant and Arlingclose is, for now, maintaining its central case for Bank Rate at 0.25% whilst introducing near-term upside risks to the forecast as shown below. Arlingclose's central case is for gilt yields to remain broadly stable in the medium term, but there may be near term volatility due to shifts in interest rate expectations.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Official Bank Rate													
Upside risk	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
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	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25