**APPENDIX A**

# HARLOW COUNCIL
# TREASURY MANAGEMENT STRATEGY
# MID-YEAR REVIEW, 2018/19

**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 whilst there was a Bank Rate rise on 2 August 2018 from 0.5% to 0.75%, 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. Brexit, which includes the possibility of 'no deal' with European nations, is a concern. Arlingclose writes that banks are inherently safe from financial shock but encourages Councils to ensure that investment through the Government's Debt Management Office is available as a fall-back strategy. It is.

6. In setting the Council's strategy for 2019/20, a full report will be presented to Cabinet and Council in January / February 2019. This will be in conjunction with the 2019/20 budget proposals and Capital Strategy.

7. The Treasury Management Strategy for 2018/19 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's 'Treasury Management in the Public Services: Code of Practice' (the CIPFA Code) which requires the Council to approve treasury management half-year and annual reports.

8. The Council is supported by treasury management advisors, Arlingclose Ltd., in decision making.

**Background**

9. The Council's treasury management strategy for 2018/19 was approved at a meeting of Council on 1 February 2018. The Council has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful

identification, monitoring and control of risk is therefore central to the Council's treasury management strategy.

10. Following consultation in 2017, CIPFA published new versions of the 'Prudential Code for Capital Finance in Local Authorities' (Prudential Code) and the 'Treasury Management Code of Practice' but has yet to publish the local authority specific Guidance Notes to the latter. In England the Ministry of Housing Communities and Local Government (MHCLG) published its revised Investment Guidance which came into effect from April 2018.

11. The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council will be producing its Capital Strategy later in 2018/19 for approval by Council early in 2019.

**External Context: A commentary provided by the Council's Treasury Management advisors, Arlingclose Ltd. (October 2018)**

12. **Economic background**: Oil prices rose by 23% over the six months to around $82 a barrel. UK Consumer Price Inflation (CPI) for August 2018 rose to 2.7% year on year, above the consensus forecast and that of the Bank of England's in its August 'Inflation Report', as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4%, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9% providing some evidence that a shortage of workers is providing support to wages. However real wages (i.e. adjusted for inflation) grew only by 0.2%, a marginal increase unlikely to have had much effect on households.

13. The rebound in quarterly GDP growth in Q2 (Apr-Jun) to 0.4% appeared to overturn the weakness in Q1 (Jan-Mar) which was largely due to weather-related factors. However, the detail showed much of Q2 GDP growth was attributed to an increase in inventories. Year on year GDP growth at 1.2% also remains below trend. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.

14. Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in each of June and September by 0.25% to the current 2%-2.25%. Markets now expect one further rise in 2018.

15. The escalating trade war between the US and China as tariffs announced by the Trump administration appeared to become an entrenched dispute, damaging not just to China but also other Asian economies in the supply chain. The fallout, combined with tighter monetary policy, risks contributing to a slowdown in global economic activity and growth in 2019.

16. The 'EU Withdrawal Bill', which repeals the 'European Communities Act 1972' that

took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament. With just six months to go when ‘Article 50’ expires on 29 March 2019, neither the Withdrawal Agreement between the UK and the EU which will be legally binding on separation issues and the financial settlement, nor its annex which will outline the shape of their future relationship, have been finalised, extending the period of economic uncertainty.

17. **Financial markets:** Gilt yields displayed marked volatility during the period, particularly following Italy’s political crisis in late May when government bond yields saw sharp moves akin to those at the height of the European financial crisis with falls in yield in safe-haven UK, German and US government bonds. Over the period, despite the volatility, the bet change in gilt yields was small. The 5-year benchmark gilt only rose marginally from 1.13% to 1.16%. There was a larger increase in 10-year gilt yields from 1.37% to 1.57% and in the 20-year gilt yield from 1.74% to 1.89%. The increase in Bank Rate resulted in higher money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.56%, 0.70% and 0.95% respectively over the period.

18. **Credit background:** Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ringfenced bank NatWest Markets plc rose relatively sharply over the period to around 96bps. (0.96%). The CDS for the ringfenced entity, National Westminster Bank plc, has held steady below 40bps. (0.40%). Although the CDS of other UK banks rose marginally over the period, they continue to remain low compared to historic averages.

19. The ringfencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc – is complete, the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.

20. There were a few credit rating changes during the period. Moody’s downgraded Barclays Bank plc’s long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ringfencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody’s and to A- from BBB+ by both Fitch and Standard & Poor’s (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody’s.

21. The Council’s banker is Barclays Bank with whom money is deposited overnight and therefore fully liquid.

22. Our treasury advisor Arlingclose will henceforth provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities’ flexibility during bail-in. Arlingclose’s creditworthiness advice will continue to include unsecured bank deposits and CDs

but not senior unsecured bonds issued by commercial banks. The Council does not invest in the latter.

**Local Context**

23. On 31 March 2018, the Council had net investments of £37.490m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

| | 31.3.18 Actual £m |
|---|---|
| General Fund CFR | 46.258 |
| HRA CFR | 187.370 |
| **Total CFR** | **233.628** |
| Less: Other debt liabilities | - |
| **Borrowing CFR** | **233.628** |
| External borrowing | (-)211.837 |
| **Internal borrowing** | 21.791 |
| Less: Usable reserves | (-)51.581 |
| Less: Working capital | (-)7.700 |
| **Net investments** | **(-)37.490** |

24. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

25. The treasury management position at 30 September 2018 and the change during the period is show in Table 2 below.

Table 2: Treasury Management Summary

| | 31.3.18 Balance £m | Movement £m | 30.9.18 Balance £m | 30.9.18 Rate % |
|---|---|---|---|---|
| Public Works Loan Board | 211.837 | - | 211.837 | 3.309 |
| **Total borrowing** | **211.837** | **-** | **211.837** | **3.309** |
| Short-term investments | (-)15.300 | 8.300 | (-)7.000 | 1.79 |
| Cash and cash equivalents | (-)22.190 | (-)15.820 | (-)38.010 | 0.68 |
| **Total investments** | **(-)37.490** | **(-)7.520** | **(-)45.010** | **0.852** |
| **Net borrowing** | **174.347** | **(-)7.520** | **166.827** | |

## Borrowing Strategy during the period

26. At 30 September 2018 the Council held £211.837m of loans. Taking advice from Arlingclose there is no current requirement to undertake new external borrowing in 2018/19 because the cost of carrying external debt remains high as well as recognising risks of bail-in for the investment market.

Table 3: Borrowing Position

| | 31.3.18 Balance £m | Net Movement £m | 30.9.18 Balance £m | 30.9.18 Weighted Average Rate % | 30.9.18 Weighted Average Maturity (years) |
|---|---|---|---|---|---|
| Public Works Loan Board | 211.837 | - | 211.837 | 3.309 | 16.8 |
| **Total borrowing** | **211.837** | **-** | **211.837** | | |

## Treasury Investment Activity

27. The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six-month period, the Council's investment balance ranged between £37.490m and £53.740m due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

| | 31.3.18 Balance £m | Net Movement £m | 30.9.18 Balance £m | 30.9.18 Rate of Return % | 30.9.18 Weighted Average Maturity days |
|---|---|---|---|---|---|
| Banks & building societies (unsecured) | 0.020 | 0.830 | 0.850 | 0.60 | 1 |
| Local authorities | 19.300 | 7.700 | 27.000 | 0.73 | 106 |
| Money Market Funds | 14.170 | (-)1.010 | 13.160 | 0.63 | 1 |
| Other Pooled Funds: | | | | | |
| Cash plus fund | 2.000 | - | 2.000 | 0.56 | |
| Property fund | 2.000 | - | 2.000 | 4.24 | |
| **Total investments** | **37.490** | **7.520** | **45.010** | | |

28. 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 treasury investments before seeking the optimum 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.

29. In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Council is not routinely placing unsecured deposits with individual banks and building societies preferring instead to spread risk in Money Market Funds, a Cash Plus Fund and a Property Fund. It

has found local authority investment to be a secure means of investment. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

| | **Credit Score** (see Note below) | **Credit Rating** | **Bail-in Exposure** | **Weighted Average Maturity (days)** | **Rate of Return %** |
|---|---|---|---|---|---|
| **Harlow DC** | | | | | |
| 31.03.2018 | 4.10 | AA- | 42% | 53 | 0.73% |
| 30.09.2018 | 4.25 | AA- | 34% | 70 | 0.86% |
| **Similar LAs** | **4.28** | **AA-** | **56%** | **88** | **1.37%** |
| **All LAs** | **4.38** | **AA-** | **60%** | **37** | **1.17%** |

**Note:** Through benchmarking information provided by Arlingclose, the Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk. The table above shows that Harlow Council's exposure to risk is similar to other Councils, but with less bail-in exposure as a consequence of not making direct investments in banks or building societies at this time. Investments in Money Market Funds carry bail-in risk but the risk itself is spread across numerous counter-parties.

30. The Council's £4m of externally managed pooled property and multi asset funds is likely to generate an average total return in 2018/19 of £98,400 (2.46%). 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 is regularly reviewed.

31. MHCLG consulted on statutory overrides relating to the IFRS 9 Financial Instruments accounting standard from 2018/19. The consultation recognised that the requirement in IFRS 9 for certain investments to be accounted for as fair value through profit and loss may introduce "more income statement volatility" which may impact on budget calculations. The consultation proposed a time-limited statutory override and sought views whether it should be applied only to pooled property funds. The Council responded to the consultation which closed on 28 September, stating that the statutory override should not be time-limited to three years and should apply to all pooled funds. In the event, MHCLG agreed that the statutory override should apply for <u>at least</u> five years.

**<u>Non-Treasury Investments</u>**

32. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

33. The Council also holds £3.436m of such investments in:

- loans to local businesses and landlords, £2.5m;
- loans to subsidiaries, HTS (Property & Environment) Ltd, £0.936m.

34. These investments will generate approximately £176,000 of credit income for the Council, representing a rate of return of 4.75%.

35. In addition the Council holds nine assets, classed as 'Investment Properties', solely for the purpose of generating income. The annual rental income totals £124,000, representing a return of 6.67% on the capital value.

**Compliance**

36. The Head of Finance reports that all treasury management activities undertaken during the first half of the financial year complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

**Outlook for the remainder of 2018/19**

37. Having raised policy rates in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon.

38. The MPC has a definite bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that (a) ultra-low interest rates result in other economic problems, and that (b), higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise and cuts are required.

39. Arlingclose's central case is for Bank Rate to rise twice in 2019. The risks are weighted to the downside. The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 (Apr-Jun) 2018, but the annual growth rate of 1.2% remains well below the long term average.

| | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Official Bank Rate | | | | | | | | | | | | | |
| **Upside risk** | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| Arlingclose Central Ca | **0.75** | **0.75** | **1.00** | **1.00** | **1.25** | **1.25** | **1.25** | **1.25** | **1.25** | **1.25** | **1.25** | **1.25** | **1.25** |
| **Downside risk** | 0.00 | 0.00 | 0.50 | 0.50 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 |

40. The view is that the UK economy still faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Central bank actions and geopolitical risks, such as prospective trade wars, have and will continue to produce significant volatility in financial markets, including bond markets.