Appendix 2

HARLOW COUNCIL
TREASURY MANAGEMENT STRATEGY
MID-YEAR REVIEW, 2019/20

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.

3. The economy is functioning within uncertain times. Brexit, which includes the possibility of 'no deal' with European nations, remains a concern with a further extension of the withdrawal date up until 31 January 2020. In the meantime the UK is going to the polls on 12 December 2019.

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 the Council's strategy for 2020/21, a full report will be presented to Cabinet and Council in January / February 2020. This will be in conjunction with the 2020/21 budget proposals and Capital Strategy.

6. The Treasury Management Strategy for 2019/20 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.

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

Background

8. The Council's treasury management strategy for 2019/20 was approved at a meeting of Council on 7 February 2019. 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.

9. The Council operates within the framework of CIPFA's 'Prudential Code for Capital Finance in Local Authorities' (Prudential Code), the 'Treasury Management Code of Practice' and, the Ministry of Housing Communities and Local Government (MHCLG) Investment Guidance.

10. The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital Strategy, complying with CIPFA's requirement, was approved by Council on 7 February 2019.

External Context: Based upon commentary provided by the Council's Treasury Management advisors, Arlingclose Ltd. (October 2019)

11. **Economic background:** UK Consumer Price Inflation (CPIH) fell to 1.7% year/year in August 2019 from 2.0% in July, below the expected forecast of 1.9% and below the Bank of England's target. The most recent labour market data for the three months to July 2019 showed the unemployment rate at 3.8% while the employment rate remained at 76.1%. Nominal annual wage growth measured by the 3-month average excluding bonuses was 3.8% and 4.0% including bonuses. Adjusting for inflation, real wages were up 1.9% excluding bonuses and 2.1% including.

12. The Quarterly National Accounts for Q2 (Apr-Jun) GDP confirmed the UK economy contracted by 0.2% following the 0.5% gain in Q1 (Jan-Mar) which was distorted by stockpiling ahead of Brexit. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 (Oct-Dec) 2012. Business investment fell by 0.4% (revised from -0.5% in the first estimate) as Brexit uncertainties impacted on business planning and decision-making.

13. The political climate both nationally and internationally has continued to be a big driver of financial markets over the last quarter.

14. Tensions continue between the US and China with no trade agreement and both countries imposing further tariffs on each other's goods. The US Federal Reserve cut its target Federal Funds rates by 0.25% in September mainly to maintain economic growth. There are also escalating concerns over the trade war and in turn a weaker economic environment leading to more pronounced global slowdown. The euro area Purchasing Manager Indices (PMIs) pointed to a deepening slowdown in the Eurozone. These elevated concerns have caused key government yield curves to invert, something seen by many commentators as a predictor of a possible global recession. Market expectations are for further interest rate cuts from the Fed

and in September the European Central Bank reduced its deposit rate to -0.5% and announced the recommencement of quantitative easing from 1 November 2019.

15. The Bank of England maintained Bank Rate at 0.75% and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction.

16. **Financial markets:** After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a move security and in anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April.

17. Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63% at the end of June, the 5-year benchmark gilt yield fell to 0.32% by the end of September. There were falls in the 10-year and 20-year gilts over the same period, with the former dropping from 0.83% to 0.55% and the latter falling from 1.35% to 0.88%. 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65%, 0.75% and 1.00% respectively over the period.

18. Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77%.

19. **Credit background:** Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ringfenced bank NatWest Markets plc fell back to around 80bps (0.8%) by the end of September, while for the ringfenced entity, National Westminster Bank plc, the spread remained around 40bps (0.4%). The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 34 and 76bps (0.34% - 0.76%) at the end of the period.

20. There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.

Local Context

21. On 31 March 2019, the Council had net investments of £31.700m 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

	31.3.19 Actual £m
General Fund CFR	53.358
HRA CFR	187.370
Total CFR	**240.728**
Less: Other debt liabilities	-
Loans CFR	**240.728**
External borrowing	(-)211.837
Internal borrowing	28.891
Less: Usable reserves	(-)54.175
Less: Working capital	(-)6.416
Net investments	**(-)31.700**

22. The Council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

23. The treasury management position at 30 September 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.19 Balance £m	Movement £m	30.9.19 Balance £m	30.9.19 Rate %
Long-term borrowing: Public Works Loan Board	211.837	-	211.837	3.309
Total borrowing	**211.837**	**-**	**211.837**	**3.309**
Long-term investments Short-term investments Cash and cash equivalents	(-)4.000 (-)7.500 (-)20.200	- 7.500 (-)6.080	(-)4.000 - (-)26.280	2.53 - 0.75
Total investments	**(-)31.700**	**1.420**	**(-)30.280**	**0.99**
Net borrowing	**180.137**	**1.420**	**181.557**	

Borrowing Strategy during the period

24. At 30 September 2019 the Council held £211.837m of loans as part of its strategy for funding previous years' capital programmes. Outstanding loans on 30 September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.19 Balance £m	Net Movement £m	30.9.19 Balance £m	30.9.19 Weighted Average Rate %	30.9.19 Weighted Average Maturity (years)
Public Works Loan Board	211.837	-	211.837	3.309	15.8
Total borrowing	**211.837**	**-**	**211.837**		

25. The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

Treasury Investment Activity

26. 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 balances ranged between £29.420m and £42.270m due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.19 Balance £m	Net Movement £m	30.9.19 Balance £m	30.9.19 Income Return %
Banks & building societies (unsecured)	3.710	(-)3.270	0.440	0.50
Government	5.280	(-)5.280	-	-
Local authorities	9.000	3.500	12.500	0.83
Money Market Funds	9.710	3.630	13.340	0.69
Other Pooled Funds				
Cash plus funds	2.000	-	2.000	0.91
Property funds	2.000	-	2.000	4.15
Total investments	**31.700**	**(-)1.420**	**30.280**	

27. Both the CIPFA Code and government guidance require the Authority 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 Authority'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.

28. 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	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2019	4.16	AA-	48%	71	1.09%
30.09.2019	3.99	AA-	52%	36	1.01%
Similar LAs	**4.26**	**AA-**	**61%**	**91**	**1.58%**
All LAs	**4.28**	**AA-**	**62%**	**64**	**1.22%**

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.

29. The Council's £4m of externally managed pooled property and multi asset funds is likely to generate an average total return of £101,200 (2.53%). 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.

30. Readiness for Brexit: The revised leave date for the UK to leave the EU is now 31 January 2020. The Council will ensure that it holds sufficient facilities with UK-domiciled banks and Money Market Funds to enable sufficient liquidity to be held within the UK coupled with the ongoing use of its account with the Debt Management Account Deposit Facility (DMADF) with HM Treasury to manage the situation leading up to and after the UK leaves the EU.

Non-Treasury Investments

31. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority 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.

Service Investments: Loans

32. The Council lends money to its subsidiary and a local business, to support local public services and stimulate local economic growth.

33. HTS (Property and Environment) Ltd is a wholly owned subsidiary of Harlow Council which began trading on 1 February 2017. The Council provided a start-up loan to the business of £1.209m repayable over five years, two months, approved on 21 July 2016. The balance outstanding as at 31 March 2018 was £0.702m. A report elsewhere on the Cabinet agenda also details proposals for a second loan to HTS (P&E) Ltd associated with the acquisition of replacement fleet for a sum of £670,000.

34. Harlow Property Limited was provided with two loans to support the development of the Enterprise Zone, approved on 23 January 2014. The amounts loaned were £1m on 15 March 2016 and a further £1.5m on 3 March 2017 secured against the value of the properties at the KAO Park facility. Interest accrues on these loans with the total outstanding as at 31 March 2019 being £2.802m.

35. Accounting standards require the Council to set aside loss allowance for loans, reflecting the likelihood of non-payment. The Council considers that this loss should be zero because, (1) HTS is the sole shareholder of the Council; (2) HPL loans are a charge secured against property which considerably exceeds the value of the loan.

Commercial Investments: Property

36. The Ministry of Housing, Communities and Local Government (MHCLG) defines property to be an investment if it is held primarily or partially to generate a profit.

37. The Council has historically held nine commercial and residential properties with the intention of making a profit that will be spent on local public services. These include telecommunication masts, a Golf Club, and three other properties with a total value of £1.861m. Annual income from all these assets is about £125,000.

Loan Commitments and Financial Guarantees

38. Although not strictly counted as investments, since no money has exchanged hands yet, loan commitments and financial guarantees carry similar risks to the Council and are included here for completeness.

39. In 1987 and 1992 the Council agreed to undertake joint liability with a number of other local authorities to guarantee loans of £66.3 million and £17.3 million to Home Housing Association (previously called North Housing Association) in support of their private initiative for the provision of housing in Harlow and surrounding authorities. The guarantee is for a 50-year period ending 2037. The Council's proportion of the total liability is £4.5 million. The Council considers that the probability of the guarantee being called upon is low.

Compliance

40. The Deputy to the Chief Executive and Head of Finance & Property reports that all treasury management activities undertaken during the quarter complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

Outlook for the remainder of 2019/20

41. The global economy is entering a period of slower growth in response to

political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth as a response to the downturn in global activity and also as a result of the ongoing uncertainty regarding Brexit. In response, global and UK interest rate expectations have also reduced.

42. Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

43. The Council's treasury advisor Arlingclose expects the Bank Rate to remain at 0.75% for the foreseeable future but there remain substantial risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judge the risks to be weighted to the downside and that volatility will continue to offer longer-term borrowing opportunities

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Cas	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Downside risk	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75