APPENDIX A

HARLOW COUNCIL
TREASURY MANAGEMENT STRATEGY
MID-YEAR REVIEW, 2014/15

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 economic commentary is provided within the report. In summary interest rates remain low and the continued likelihood is that they will remain so for the foreseeable future. Whilst an increase in interest rates is anticipated during 2015/16, the return on investments continues to be low. In relation to borrowing for capital financing, no external loans have been taken out so far this year.

3. 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) above yield (i.e. the interest paid on investments).

4. A key feature of the Council's treasury management and daily banking activity has been the difficulties of our current bankers, the Cooperative Bank plc. The Council has appointed Barclays Bank plc, through a competitive tendering process, to provide banking services. Migration of banking transactions will begin in autumn 2014 with the new bank planned to be providing all services by the end of March 2015.

5. In setting out the Council's strategy for 2015/16, a full report will be presented to Cabinet and Full Council in January / February 2015. This will be in conjunction with the 2015/16 budget proposals.

Background

6. The Treasury Management Strategy for 2014/15 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy for the likely financial and investment activity for the forthcoming financial year.

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

8. 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 the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

9. 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.

<u>Economic Background: A commentary provided by the Council's Treasury Management advisors, Arlingclose Ltd</u>

10. **Growth and Inflation:** The recent strong performance of the UK economy continued with output growing at 0.8% in Q1 (Jan – Mar) 2014 and at 0.9% in Q2. The services sector once again grew strongly. On the back of strong consumption growth, business investment appeared to be recovering quickly, albeit from a low base. The annual Consumer Price Index (CPI) inflation rate fell to 1.5% year-on-year in August.

11. Revisions to the Gross Domestic Product (GDP) methodology, now compliant with the European System of Accounting 2010, mean that growth is now estimated to be 2.7% above its pre-recession peak in Q1 2008 rather than just 0.2% higher, the general theme being that the recession was not as deep and the recovery was earlier than initially estimated. In anticipation of these revisions, the Monetary Policy Committee of the Bank of England (MPC) has forecast growth at 3.4% in 2014.

12. **Unemployment:** The labour market continued to improve, with strong employment gains and the headline unemployment rate falling to 6.2%. However, earnings growth remained very weak, rising just 0.6% for the three months May-July 2014 when compared to the same period a year earlier. The growth in employment was masked by a large number of zero-hour contracts and involuntary part-time working.

13. **UK Monetary Policy**: The MPC made no change to the Bank Rate of 0.5% and maintained asset purchases at £375bn. However, there was a marked shift in tone from the Bank of England's Governor and other MPC members. In his Mansion House speech in June Governor Mark Carney warned that interest rates might rise sooner than financial markets were expecting. Following some mixed messages from Governor Carney later in the summer, the minutes of the August and September MPC meetings revealed a split vote with regards to the Bank Rate. Two out of the nine members voted to increase Bank Rate by 0.25%, arguing economic circumstances were sufficient to justify an immediate rise. The MPC emphasised that when Bank Rate did begin to rise, it was expected to do so only gradually and would likely remain below average historical levels for some time to come.

14. In the Bank of England's August Inflation Report the Bank forecast growth to be around 3½% in 2014, easing back thereafter to around its pre-crisis historical average rate. Inflation was forecast to remain at, or slightly below, 2% before reaching the target at the end of the 2-year forecast period.

15. The Bank's Financial Policy Committee also announced a range of measures to cool the UK's housing market to avert the potential of spiralling house prices derailing a sustainable economic recovery. Key recommendations

included lenders stress-testing mortgage applicants can cope with a 3% rise in interest rates; putting a 15% cap on the number of mortgages at more than 4.5 times the borrower's income; and a separate Treasury pledge banning anyone applying for a loan through the Help to Buy scheme borrowing more than 4.5 times their income. The Prudential Regulation Authority also announced that it intends to consult on capital requirements for mortgages.

16. Eurozone inflation continued to fall towards zero (HICP inflation registered just 0.3% in September), and there was mounting evidence that the already feeble recovery was losing pace. The unemployment rate remained stubbornly high at 11.5%. The European Central Bank (ECB) lowered its official benchmark interest rate from 0.15% to 0.05%. The rate it pays on commercial bank balances held with it was also cut further into negative territory from (-)0.1% to (-)0.2% and the Marginal Lending Facility rate cut further to 0.3%. The ECB also announced a programme of acquiring Asset Backed Securities (ABS) from banks in an effort to encourage lending which was viewed as being one step away from full blown Quantitative Easing (QE) adopted by the US, UK and Japanese central banks. The minutes of the Bank of England's MPC meeting in September noted that "weakness in the euro area had been the most significant development during the month" and that, if it led once again to uncertainty about the sustainability of euro-area public and external debt, it could damage confidence and disrupt financial markets.

17. There was no change from the US Federal Reserve as the central bank kept policy on its current track with a reduction in asset purchases by $10 billion per month. Asset purchases are expected to end by October 2014, expectations therefore turned towards the timing of rate increases. The US economy rebounded strongly in Q2 with annualised growth of 4.6%.

18. **Market reaction**: Gilt yields have continued to decline and hit a financial year low at the end of August, before ticking upwards in the run up to the Scottish referendum. What has driven yields lower is a combination of factors but the primary drivers have been the escalation of geo-political risk within the Middle East and Ukraine alongside the slide towards deflation within the Eurozone (EZ).

Local Context

19. At 31 March 2014 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £226.227m, while usable reserves and working capital which are the underlying resources available for investment were £34.172m.

20. At 31 March 2014, the Council had £212.463m of borrowing and £28.460m of investments. The Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

Borrowing Strategy

21. At 30 September 2014 the Council held £211.837m of PWLB loans. It does not expect to borrow any additional sums in 2014/15.

Borrowing Activity in 2014/15

	Balance on 01/04/2014 £m	Maturing Debt £m	Debt Prematurely Repaid £m	New Borrowing £m	Balance on 30/09/2014 £m	Avg Rate % and Avg Life (yrs)
CFR	226,227				226,227	
Short Term Borrowing (loans with maturities less than 1 year)	0	0	0	0	0	
Long Term Borrowing	211,837	0	0	0	211,837	Ave Rate: 3.309%. Ave Life: 20.8 years
TOTAL BORROWING	211,837	0	0	0	211,837	
Other Long Term Liabilities	626	0	0	0	626	
TOTAL EXTERNAL DEBT	212,463	0	0	0	212,463	

22. **PWLB Certainty Rate and Project Rate Update:** The Council qualifies for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 1 November 2013. In April the Council submitted its application to the CLG along with the 2014/15 Capital Estimates Return to access this reduced rate for a further 12 month period from 1 November 2014.

Investment Activity

23. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. Cashflow forecasts indicate that during 2014/15 the Council's investment balances would range between £15.1m and £40.9 million.

24. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

Investment Activity in 2014/15

Investments	Balance on 01/04/2014 £m	Balance on 30/09/2014 £m	Avg Rate/Yield (%)
Short term Investments	28.460	32.782	0.537%
Long term Investments	0	0	
TOTAL INVESTMENTS	28.460	32.782	0.537%

25. Security of capital has remained the Council’s main investment objective. This has been maintained by following the Council’s counterparty policy as set out in its Treasury Management Strategy Statement for 2014/15.

26. Counterparty credit quality continues to be assessed and monitored with reference to credit ratings (the Council’s minimum long-term counterparty rating is A(-) across rating agencies Fitch, Standard & Poor and Moody’s); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. It is proposed that with effect from 1 January 2015 the counterparty rating is amended to BBB+ (see paragraph 30 below).

Counterparty Update (Arlingclose Ltd)

27. The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on 15 April 2014. Taking the view that potential extraordinary government support available to banks' senior unsecured bondholders will likely diminish within its two-year rating horizon for investment-grade entities, in April S&P’s revised the outlook of Barclays, Deutsche Bank, Credit Suisse and ING Bank from Stable to Negative (note, this is not the same as a rating review negative). In May, Moody’s also changed the outlook from stable to negative for 82 European banks and from positive to stable for two European banks. The institutions affected on the Council’s lending list are Nationwide Building Society, Pohjola Bank, Svenska Handelsbanken, Landesbank Hessen-Thuringen, and Nordea Bank.

28. In August Moody’s changed its outlook for the UK banking system from stable to negative, citing the reduction of government support for systemic banks as the reason. Although the agency believes that the stand-alone financial strength of UK institutions is improving they believed that this is more than offset by the potential bail-in risk now faced by investors. Similarly, in August S&P revised the outlooks for major Canadian banks to negative following the government’s announcement of a potential bail-in policy framework.

29. There was strong likelihood that the UK, alongside Germany and Austria, would accelerate the adoption of the BRRD and that the implementation of bail-in resolutions would be fast-tracked in these countries to 1 January 2015, a full year ahead of other EU nations.

30. The UK will be implementing the final bail-in provisions of the BRRD from 1 January 2015, a year ahead of most countries. Credit rating agencies have stated they plan to review EU banks’ ratings in line with each country’s implementation of the directive. Many UK banks, have standalone ratings in the ‘BBB’ category, with uplifts for potential government support taking them into the ‘A’ category. There is therefore a real risk that some major UK banks’ credit ratings will fall below A(-) this financial year if this uplift is removed. To safeguard against this risk, and to allow the Council to

continue investing with UK banks, it is proposed to amend *in italics* Table 2 of the Counterparty list approved in February 2014.

Table 2: Approved Investment Counterparties

Counterparty		Cash limit	Time limit
Banks and other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:	*BBB+*	*£4m each (Group: £5m in total)*	*100 days*
Banks and other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:	AAA	£4m each (Group: £5m in total)	6 months (max 190 days)
	AA+		
	AA		
	AA-		
	A+		
	A		
	A-		
The Council's current account bank (Cooperative Bank plc) not meeting the above criteria. (See also paragraph 36)		£2m (£3m during the Christmas period)	next day
UK Central Government: Debt Management Office Deposit Facility		£20m	364 days maximum
UK Local Authorities (irrespective of credit rating)		£5m each	364 days maximum
UK Building Societies without three credit ratings		£1m each	1 year
Money market funds and other pooled funds		£4m each	n/a
All other specified investments (see para. 44 below)		£3m	Next day

31. Banks in the UK and EU face stress tests this autumn, which may result in some institutions having to additionally bolster their capital buffers. The extent to which this might be required and the form they will have to take casts uncertainty over capital requirements in the system.

32. Moody's further downgraded the long-term rating of Co-op Bank from Caa1 to Caa2 in April 2014 to reflect the agency's view that the ongoing deleveraging process at the Co-op will lead to a smaller and less systemically important institution, with the result there is a much reduced likelihood the UK government would commit taxpayer's money to inject capital into the bank if required. The Council made contingency arrangements for its banking facilities with another bank last November to mitigate the risk of the Co-op Bank failing. It does not use the Co-op Bank as an investment counterparty and, since May 2013, suspended making overnight deposits in its Business Reserve account. Furthermore it has endeavoured to maintain a ledger balance at the close of each business day as close to nil as possible, with a tolerance of +/(-)£100,000.

33. In November 2013 the Co-op Bank announced a planned withdrawal from the local authority market. The Council's contract for banking services with the Bank will end no later than 31 March 2015. It has therefore been obliged

to seek new bankers through a tendering process and, in August 2014, appointed Barclays Bank plc to provide services for a term of up to 4½ years with a possible extension of 2 years. Autumn 2014 will see the orderly migration of the Council's banking transactions (payments and income) to our new bankers. Barclays Bank plc has an acceptable credit rating. The Council already invests with the bank. It will refocus its investment to allow overnight deposits to be made through a Business Reserve account within a maximum permitted investment of £4m.

34. The Council will continue to use the PayPoint (cash management service) sponsored by the Co-op Bank, so will not be ending its relationship with the bank completely.

Compliance with Prudential Indicators

35. The Council confirms compliance with its Prudential Indicators for 2014/15, which were set in February 2014 as part of the Council's Treasury Management Strategy Statement.

Outlook for Q3 and Q4 2014/15 (Arlingclose Ltd)

36. The stronger economic growth seen in the UK over the past six months is likely to use up spare capacity more quickly than previously assumed. Arlingclose has brought forward the timing for the first rise in Bank Rate to Q3 (Jul – Sep) 2015.

37. In addition to two MPC members having voted for a rate rise in August and September, the rhetoric from Committee members has in general become more hawkish. However, the lack of inflationary pressure is expected to allow policymakers to hold off monetary tightening for longer than the market currently expects. The near-term risk is that the Bank Rate could rise sooner than anticipated, which is captured in the 'upside risk' range of our forecast table below.

38. The focus is now on the rate of increase and the medium-term peak and, in this respect, expectations are that rates will rise slowly and to a lower level than in the past.

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Official Bank Rate											
Upside risk	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.50**
Downside risk				0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00

ABBREVIATIONS

ABS Asset Backed Security
BRRD Bank Recovery & Resolution Directive

CFR	Capital Financing Requirement
CIPFA	Chartered Institute of Public Finance & Accountancy
CLG	Department of Communities and Local Government
CPI	Consumer Price Indices
ECB	European Central Bank
EZ	Eurozone
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
HRA	Housing Revenue Account
LIBID	London Interbank Bid (or deposit) rate
MPC	Monetary Policy Committee
PWLB	Public Work Loans Board
QE	Quantitative Easing
S&P	Standard & Poor (Credit Rating Agency)

Annex
Money Market Data and PWLB Rates

The average, low and high rates correspond to the rates during the financial year rather than those in the tables below.

Please note that the PWLB rates below are Standard Rates. Councils eligible for the Certainty Rate can borrow at a 0.20% reduction.

Table 1: Bank Rate, Money Market Rates

Date		Bank Rate		O/N LIBID	7-day LIBID	1-month LIBID	3-month LIBID	6-month LIBID	12-month LIBID	2-yr SWAP Bid	3-yr SWAP Bid	5-yr SWAP Bid
01/04/2014		0.50		0.36	0.39	0.42	0.46	0.56	0.84	1.05	1.44	2.03
30/04/2014		0.50		0.36	0.40	0.42	0.47	0.57	0.85	1.09	1.47	2.02
31/05/2014		0.50		0.35	0.40	0.43	0.48	0.67	0.87	1.11	1.46	1.98
30/06/2014		0.50		0.36	0.40	0.43	0.50	0.71	0.94	1.33	1.70	2.17
31/07/2014		0.50		0.37	0.41	0.43	0.50	0.72	0.97	1.34	1.71	2.17
31/08/2014		0.50		0.36	0.42	0.43	0.50	0.77	0.98	1.22	1.53	1.93
30/09/2014		0.50		0.43	0.45	0.43	0.51	0.66	1.00	1.25	1.57	1.99
Average		**0.50**		**0.37**	**0.41**	**0.43**	**0.49**	**0.67**	**0.92**	**1.21**	**1.57**	**2.06**
Maximum		**0.50**		**0.43**	**0.50**	**0.43**	**0.51**	**0.81**	**1.00**	**1.38**	**1.77**	**2.26**
Minimum		**0.50**		**0.24**	**0.36**	**0.42**	**0.46**	**0.56**	**0.84**	**1.00**	**1.36**	**1.91**
Spread		--		**0.19**	**0.14**	**0.01**	**0.05**	**0.25**	**0.16**	**0.38**	**0.41**	**0.35**

Table 2: PWLB Borrowing Rates – Fixed Rate, Maturity Loans

Change Date	Notice No	1 year	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01/04/2014	127/14	1.44	2.85	3.83	4.41	4.51	4.49	4.47
30/04/2014	166/14	1.45	2.86	3.79	4.37	4.46	4.43	4.41
31/05/2014	206/14	1.45	2.78	3.65	4.27	4.38	4.35	4.33
30/06/2014	248/14	1.63	2.95	3.74	4.30	4.40	4.36	4.34
31/07/2014	294/14	1.66	2.96	3.70	4.21	4.30	4.27	4.25
31/08/2014	334/14	1.55	2.70	3.38	3.88	3.97	3.94	3.93
30/09/2014	378/14	1.57	2.77	3.46	3.96	4.07	4.05	4.03
	Low	1.40	2.68	3.36	3.87	3.96	3.94	3.92
	Average	1.55	2.86	3.67	4.22	4.32	4.29	4.27
	High	1.69	3.07	3.86	4.42	4.52	4.49	4.48