HARLOW COUNCIL
TREASURY MANAGEMENT STRATEGY
MID-YEAR REVIEW, 2016/17

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 interest rates have fallen since the UK referendum to leave the European Union with prospect of unchanged or even lower rates into the foreseeable future. Officers are considering the cost and benefit of investments whilst recognising an overall need to ensure deposits are securely placed.

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 so that cashflow obligations may be met) above yield (i.e. the interest paid on investments).

4. In setting out the Council's strategy for 2017/18, a full report will be presented to Cabinet and Full Council in January / February 2017. This will be in conjunction with the 2017/18 budget proposals.

Background

5. The Treasury Management Strategy for 2016/17 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFAs) Code of Practice on Treasury Management, which includes the requirement for determining a treasury strategy for the likely financial and investment activity for the forthcoming financial year.

6. 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.

7. 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".

8. 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 2016)

9. The preliminary estimate of Q2 (June) 2016 GDP showed reasonably strong growth as the economy grew 0.7% quarter-on-quarter, as compared to 0.4% in Q1 and year/year growth running at a healthy pace of 2.2%. However the UK economic outlook changed significantly on 23 June 2016. The result of the referendum on European Union membership prompted forecasters to rip up previous projections and dust off worst-case scenarios. Growth forecasts had already been downgraded as 2016 progressed, as the very existence of the referendum dampened business investment, but the crystallisation of the risks and the subsequent political turmoil prompted a sharp decline in household, business and investor sentiment.

10. The repercussions of this plunge in sentiment on economic growth were judged by the Bank of England to be severe, prompting the Monetary Policy Committee to initiate substantial monetary policy easing at its August meeting to mitigate the worst of the downside risks. This included a cut in Bank Rate to 0.25%, further gilt and corporate bond purchases (QE: Quantitative Easing) and cheap funding for banks (Term Funding Scheme) to maintain the supply of credit to the economy. The minutes of the August meeting also suggested that many members of the Committee supported a further cut in Bank Rate to near-zero levels (the Bank, however, does not appear keen to follow peers into negative rate territory) and more QE should the economic outlook worsen.

11. In response to the Bank of England's policy announcement, money market rates and bond yields declined to new record lows. Since the onset of the financial crisis over eight years ago, Arlingclose's rate outlook has progressed from 'lower for longer' to 'even lower for even longer' to, now, 'even lower for the indeterminable future'.

12. The new members of the UK government, particularly the Prime Minister and Chancellor, are likely to follow the example set by the Bank of England. After six years of fiscal consolidation, the Autumn Statement on 23 November is likely to witness fiscal initiatives to support economic activity and confidence, most likely infrastructure investment. Tax cuts or something similar cannot be ruled out.

13. Whilst the economic growth consequences of BREXIT remain speculative, there is uniformity in expectations that uncertainty over the UK's future trade

relations with the EU and the rest of the world will weigh on economic activity and business investment, dampen investment intentions and tighten credit availability, prompting lower activity levels and potentially a rise in unemployment. These effects will dampen economic growth through the second half of 2016 and in 2017.

14. Meanwhile, inflation is expected to pick up due to a rise in import prices, dampening real wage growth and real investment returns. The August Quarterly *Inflation Report* from the Bank of England forecasts a rise in the Consumer Price Index (CPI) to 0.9% by the end of calendar 2016 and thereafter a rise closer to the Bank’s 2% target over the coming year, as previous rises in commodity prices and the sharp depreciation in Sterling begin to drive up imported material costs for companies. Annual CPI to September 2016 was 1%.

15. The rise in inflation is highly unlikely to prompt monetary tightening by the Bank of England, with policymakers looking through import-led CPI spikes, concentrating instead on the negative effects of Brexit on economic activity and, ultimately, inflation.

16. **Market reaction:** Following the referendum result gilt yields fell sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. The yield on the 10-year gilt fell from 1.37% on 23 June to a low of 0.52% in August, a quarter of what it was at the start of 2016. The 10-year gilt yield has since risen to 0.69% at the end of September. The yield on 2- and 3-year gilts briefly dipped into negative territory intra-day on 10 August to -0.1% as prices were driven higher by the Bank of England’s bond repurchase programme. However both yields have since recovered to 0.07% and 0.08% respectively. The fall in gilt yields was reflected in the fall in PWLB borrowing rates.

17. On the other hand, after an initial sharp drop, equity markets appeared to have shrugged off the result of the referendum and bounced back despite warnings from the IMF on the impact on growth from ‘Brexit’ as investors counted on QE-generated liquidity to drive risk assets.

18. The most noticeable fall in money market rates was for very short-dated periods (overnight to 1 month) where rates fell to between 0.1% and 0.2%.

<u>Local Context</u>

19. At 31 March 2016 the Council’s underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £226.894m, while usable reserves and working capital, which are the underlying resources available for investment, were £41.390m. The Council had £211.837m of borrowing and £44.545m of investments. The Council’s

current strategy is to maintain borrowing and investments below their current underlying levels, referred to as internal borrowing.

Borrowing Strategy

20. At 30 September 2016 the Council held £211.837m of loans. It does not expect to borrow any additional sums in 2016/17.

Borrowing Activity in 2016/17

	Balance on 1 April 2016 £000	Maturing Debt £000	Debt Prematurely Repaid £000	New Borrowing £000	Balance on 30 Sep. 2016 £000	Avg Rate % and Avg Life (yrs)
CFR	226,894				226,894	
Short Term Borrowing	0	0	0	0	0	
Long Term Borrowing	211,837	0	0	0	211,837	Ave Rate: 3.309%. Ave life 18.8yrs
TOTAL BORROWING	211,837	0	0	0	211,837	
Other Long Term Liabilities	0	0	0	0	0	
TOTAL EXTERNAL DEBT	211,837	0	0	0	211,837	

Investment Activity

21. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. Cashflow forecasts indicate that during 2016/17 the Council's investment balances will range between £17.755m and £55.668m, which is considerably more than planned. Some example of elements leading to higher-than-expected investment balances include delayed cash outflows on capital expenditure, beneficial income profiles for Business Rates and higher than forecast Right To Buy housing sales.

22. Consequently, the higher cashflow streams necessitate a clarification / amendment of the counterparty limits. Arlingclose has recommended that as the Council's "investment balances have been much higher than anticipated, in order to pragmatically accommodate investments in CDs and term deposits with the higher rated counterparties, the Council may wish to consider increasing the individual counterparty limit to £4m for banks/ building societies with long-term ratings of 'A' and higher."

23. It is recommended that Table 2 of the Treasury Management Strategy is changed from immediate effect to that shown below:

Table 2: Approved Investment Counterparties and Limits

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	£ Unlimited Years	n/a	n/a
AAA	£4m * 5 years	£4m 20 years	£4m 50 years	£2m 20 years	£2m 20 years
AA+	£4m * 5 years	£4m 10 years	£4m 25 years	£2m 10 years	£2m 10 years
AA	£4m * 4 years	£4m 5 years	£4m 15 years	£2m 5 years	£2m 10 years
AA-	£4m * 3 years	£4m 4 years	£4m 10 years	£2m 4 years	£2m 10 years
A+	£4m * 2 years	£4m 3 years	£2m 5 years	£2m 3 years	£2m 5 years
A	£4m * 13 months	£4m 2 years	£2m 5 years	£2m 2 years	£2m 5 years
A-	£2m 6 months	£4m 13 months	£2m 5 years	£2m 13 months	£2m 5 years
BBB+	£1m 100 days	£2m 6 months	£1m 2 years	£1m 6 months	£1m 2 years
None	£1m 6 months	n/a	£4m 25 years	£50,000 5 years	£2m 5 years
Pooled funds	£4m per fund				

Note: * Previously £2m

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 2016/17

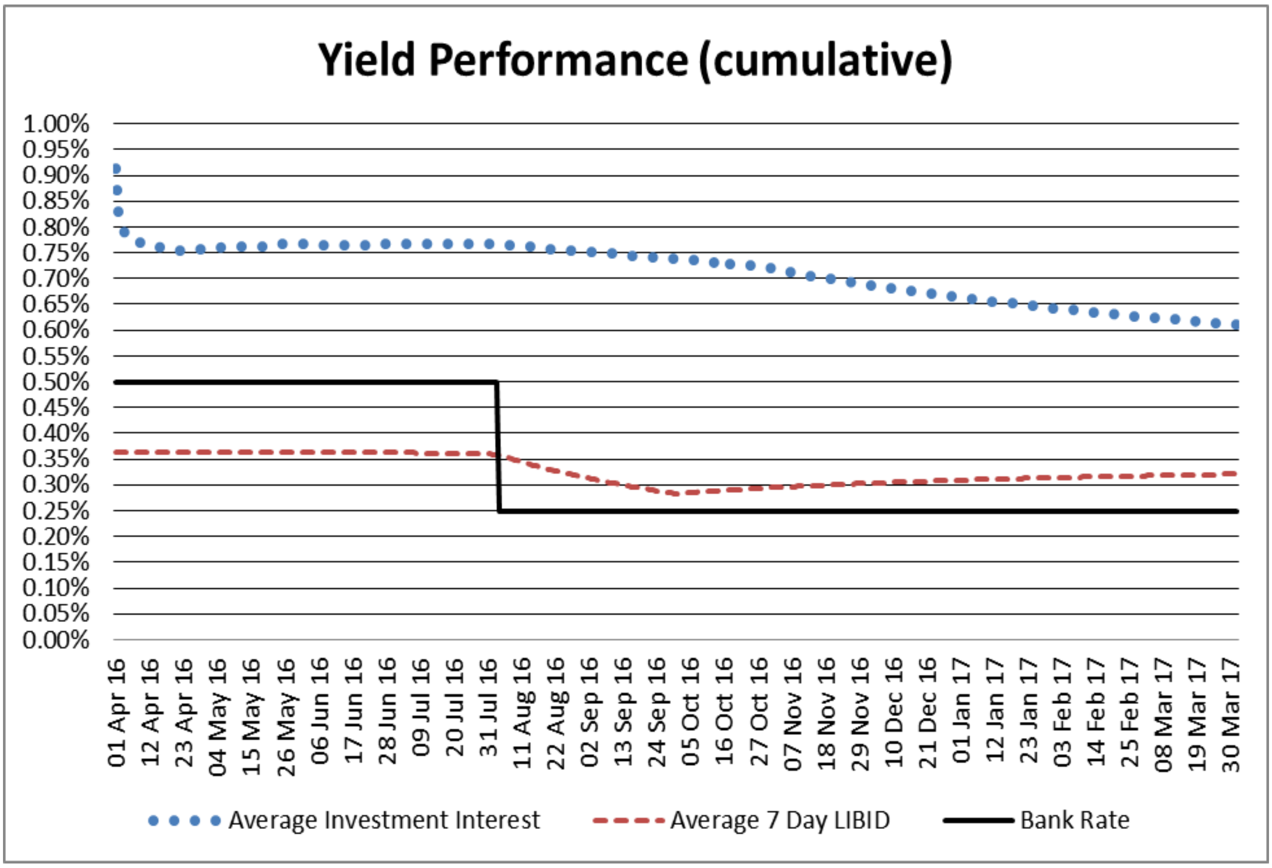
Investments	Balance on 1 April 2016 £000	Balance on 30 Sep. 2016 £000	Average Rate/Yield (see note) (%)
Short term investments (call accounts, deposits and CDs) with financial institutions: Banks and Building Societies – with credit rating	24,965	26,727	0.61%
Investments with other Local Authorities	0	4,000	0.21%
Money Market Funds	16,580	14,070	0.34%
Other Pooled Funds: Property Fund (CCLA)	2.000	2,000	c.4.30%
Investments in Building Societies without credit ratings	1.000	1,000	0.75%
TOTAL INVESTMENTS	44.545	45,797	
Increase/ (Decrease) in Investments		1,252	

Note: The average yield quoted is for each investment instrument as at 30 September 2016. Yields for investments made prior to the rate reduction were much higher so the average will decline as these investments mature.

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 2016/17.

26. Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is BBB+ across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

27. The graph below gives an indication of the diminishing return as a consequence of external economic circumstances.



Counterparty Update (Arlingclose Ltd)

28. 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.

29. 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. S&P also downgraded the long-term ratings of the local authorities to which it assigns ratings as well as the long-term rating of the EU from AA+ to AA, the latter on the agency's view that it lowers the union's fiscal flexibility and weakens its political cohesion.

30. Moody's affirmed the ratings of nine UK banks and building societies but revised the outlook to negative for those that it perceived to be exposed to a more challenging operating environment arising from the 'leave' outcome.

31. There was no immediate change to Arlingclose's credit advice on UK banks and building societies as a result of the referendum result. Our advisor believes there is a risk that the uncertainty over the UK's future trading prospects will bring forward the timing of the next UK recession.

32. The European Banking Authority released the results of its 2016 round of stress tests on the single market's 51 largest banks after markets closed on Friday 29 July. The stress tests gave a rather limited insight into how large banks might fare under a particular economic scenario. When the tests were designed earlier this year, a 1.7% fall in GDP over three years must have seemed like an outside risk. Their base case of 5.4% growth now looks exceptionally optimistic and the stressed case could be closer to reality. No bank was said to have failed the tests. The Royal Bank of Scotland made headline news as one of the worst performers as its ratios fell by some of the largest amounts, but from a relatively high base. Barclays Bank and Deutsche Bank ended the test with Common Equity Tier 1 (CET1) ratios below the 8% threshold, and would be required to raise more capital should the stressed scenario be realised. The tests support our cautious approach on these banks.

33. In July Arlingclose completed a review of unrated building societies' annual financial statements. Cumberland, Harpenden and Vernon Building Society were removed from Arlingclose's advised list, following a deterioration in credit indicators. The maximum advised maturity was also lowered for eleven societies from 6 months to 100 days due to the uncertainty facing the UK property market following the EU referendum.

34. Fitch also upgraded Svenska Handelsbanken's long-term rating from AA- to AA reflecting the agency's view that the bank's earnings and profitability will remain strong, driven by robust income generation, good cost efficiency and low loan impairments.

Compliance with Prudential Indicators

35. The Council confirms compliance with its Prudential Indicators for 2016/17, which were set in February 2016 as part of the Council's Treasury Management Strategy Statement.

Outlook for the remainder of 2016/17 (Arlingclose Ltd)

36. The economic outlook for the UK has immeasurably altered following the vote to leave the EU. The long-term position of the UK economy will be largely dependent on the agreements the government is able to secure with the EU, particularly with regard to Single Market access.

37. The short to medium-term outlook as been more downbeat due to the uncertainty generated by the result and the forthcoming negotiations. Economic and political uncertainty will likely dampen or delay investment intentions, prompting lower activity levels and potentially a rise in unemployment. The downward trend in growth apparent on the run up to the referendum may continue through the second half of 2016, although some economic data has held up better than was initially expected, perhaps suggesting a less severe slowdown than feared.

38. Arlingclose has changed its central case for the path of Bank Rate over the next three years. Arlingclose believes any currency-driven inflationary pressure will be looked through by Bank of England policymakers. Arlingclose's central case is for Bank Rate to remain at 0.25%, but there is a 40% possibility of a drop to close to zero, with a small chance of a reduction below zero.

39. Gilt yields are forecast to be broadly flat from current levels, albeit experiencing short-term volatility.

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25
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	-0.25	-0.25	-0.25	-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

40. Global interest rate expectations have been pared back considerably. There remains a possibility that the Federal Reserve will wait until after November's presidential election, and probably hike interest rates in December 2016 but only if economic conditions warrant that.

41. In addition, Arlingclose believes that the Government and the Bank of England have both the tools and the willingness to use them to prevent market-wide problems leading to bank insolvencies. The cautious approach to credit advice means that the banks currently on the Council's counterparty list have sufficient equity buffers to deal with any localised problems in the short term.