REPORT FOR:	**GOVERNANCE, AUDIT, RISK MANAGEMENT AND STANDARDS COMMITTEE**
Date of Meeting:	1 December 2014
Subject:	**INFORMATION REPORT** Treasury Management Strategy Statement and Annual Investment Strategy: Mid-year review 2014-15
Responsible Officer:	Simon George, Director of Finance and Assurance
Exempt:	No
Wards affected:	All
Enclosures:	Appendix A – Economic update and Interest Rate

Section 1 – Summary and Recommendations

This report sets out the mid-year review of treasury management activities for 2014/15. The counterparty schedule was amended by Council decision in November 2014. The change is discussed in the report.

Recommendations:

To note the Treasury Management Mid-Year Report for 2014/15.

Reason

(a) To promote effective financial management and comply with the Local Authorities (Capital Finance and Accounting) Regulations 2003 and other relevant guidance.

(b) To keep Members informed of Treasury Management activities and performance.

Section 2 – Report

Background

1 Treasury management is defined as:
"The management of the local authority'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."

2 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

3 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Introduction

4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) has been adopted by the Council.

5 The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

- Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.

- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Governance, Audit, Risk Management and Standards Committee.

6 The purpose of this report is to specifically meet one of the above requirements, namely the mid year report of treasury managements activities for financial year 2014/15. The report covers the following:

- Treasury Position as at 30 September 2014;
- An economic update and Interest Rates;
- Compliance with Prudential Indicators.

Treasury Position as at 30 September 2014.

7 The Council's treasury position as at 30 September 2014 is detailed below:

	As at 30 September 2014			As at 31 March 2014		
	Principal	Average Rate	Average Life	Principal	Average Rate	Average Life
	£m	%		£m	%	
Total Investments	**148.5**	**0.93**	**218 days**	**130.8**	**1.11**	**174 days**
Borrowing						
Public Works Loan Board	218.5	4.09	36.7 yrs	218.5	4.09	37.2 yrs
Market Loans	115.8	4.53	37.5 yrs	121.8	4.58	36.1 yrs
Total Debt	**334.3**	**4.24**	**37.0 yrs**	**340.3**	**4.26**	**36.8 yrs**

Review of Investment Portfolio

8 The Council remains a cautious investor placing security and liquidity considerations ahead of income generation. It is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. Indeed, the Funding for Lending scheme has reduced market investment rates even further. During the first half of the year the rates on offer for the call account has been 0.25%, three months are broadly in the range of 0.35% to 0.50% and for over one year period the rate is just under 1%. The potential for a prolonging of the Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

9 The Council held £148.5m of investments as at 30 September 2014 (£130.8m at 31 March 2014) and the investment portfolio yield for the first six months of the year is 0.93% against the three months LIBOR of 0.55%. The Council's investment income revised budget is £1.102m, the forecast outturn is a favourable variance of £167k resulting from higher than anticipated cash balances.

10 The only counterparties actively in use during the period have been Lloyds and Royal Bank of Scotland group, Enhanced Money Market Fund and Sevenska Handelsbanken.

11 The performance of the investment portfolio is benchmarked on a quarterly basis by Capita both against their risk adjusted model and the returns from other local authorities. As at 30 September 2014, the average yield on the portfolio of 0.93% exceeded the model return by 0.11%.

12 In addition to the investment of cash balances, The Council at its meeting in July 2013 approved a loan of £15m to West London Waste Authority to finance the cost of a new energy from waste plant. The term of the loan is 25 years at an interest rate of 7.604% on a reducing balance. The drawdown as at September 2014 is £5m of the total loan and the remaining facility of £10m will be used by June 2016. For the financial year 2014/15, the outturn forecast on the interest accrued is £400k which is included as part of the investment income.

13 The table below sets out the position as at 30 September 2014.

	2013/14				**2014/15**	
	Sep-13		**Mar-14**		**Sep-14**	
	£m	**%**	**£m**	**%**	**£m**	**%**
Specified Investments						
Banks & Building Societies	10.1	7.2	0	0	15.2	10.2
Money Market Funds	1.6	1.1	1.6	1.2	1.6	1.1
Non –Specified Investments						
Banks & Building Societies	109.1	77.5	109.1	83.5	111.6	75.2
Enhanced Money Market Funds	20	14.2	20.1	15.3	20.1	13.5
Total	**140.8**	**100**	**130.8**	**100**	**148.5**	**100.00**

14 The counter party limit for Enhanced Money Market Fund (Insight) was exceeded by £109k. This was due to the reinvestment of interest earned. The position was corrected in October 2014 by withdrawing part of the investment. Controls are already implemented to review the adherence to the counter party limits on daily basis to ensure compliance with the approved limits.

15 At its meeting in November the Council has approved HB Public Law Ltd. which is wholly owned by Harrow Council to be added to the counter party list. The Council has approved a start up loan of £100k for three years and therefore has increased the limit of over 24 months investment from £10m to £10.5m. To date there has not been any drawdown on this loan by HB Public Law Ltd.

Borrowing Portfolio

16 The table below analyses the maturity profile of borrowing.

Maturity structure of borrowing	upper limit %	lower limit %	LOBO final maturity £m	%
under 12 months	20	0	0	0.00%
12 months and within 24 months	20	0	0	0.00%
24 months and within 5 years	30	0	32	9.57%
5 years and within 10 years	40	5	5	1.50%
10 years and above	90	30	297.3	88.93%
Total			**334.3**	**100.00%**

17 The maturity category for '5 years and within 10 years' does not meet the lower limit criteria as the £12m loan matures in April 2019 which has moved in the first half of this financial from this category to the one above of '24 months and within 5 years' category. These limits will be reviewed as part of setting the strategy for 2015/16.

18 The Council held £334.3m of borrowing as at 30 September 2014 (£340.3m at 31 March 2014) and the average borrowing rate is 4.24%. The forecast outturn on borrowing cost is a small favourable variance of £185k on a revised budget of £7.710m.

Debt Rescheduling

19 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. Therefore, no debt rescheduling was undertaken during the first six months of the year.

Economic update and Interest Rates

20 An Economic update for the first part of the 2014/15 financial year along with the interest rate forecast provided by Capita is included as Appendix A.

Compliance with Prudential Indicators

Capital Expenditure

21 The Council's capital expenditure plans are the key drivers of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist Members' overview and confirm capital expenditure plans. The table below summarises the capital expenditure and funding for the current financial year:

	2013/14	2014/15	2014/15
	Actual	Estimate	Forecast
	£'000	£'000	£'000
Expenditure			
Non - HRA	29,022	69,571	78,209
HRA	6,261	9,527	6,865
TOTAL	**35,283**	**79,098**	**85,074**
Funding:-			
Grants	9,404	46,675	39,792
Capital receipts	4,434	13,483	740
Revenue financing	6,748	7,428	6,865
Section 106	76	366	266
TOTAL	**20,662**	**67,952**	**47,663**
Net financing need for the year	**14,621**	**11,146**	**37,411**

22 The increase in the net financing requirement for the capital programme is due to the carry forward of slippage from 2013/14 and reduced capital receipts from disposal programme than budgeted for. This will have an impact on the annual change in capital financing requirement and net borrowing requirement as detailed in tables below.

Capital Financing Requirement (CFR)

23 The CFR is the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any new capital expenditure, which has not immediately been paid for, will increase the CFR.

Capital Financing Requirement	2013/14	2014/15	2014/15
	Actual	Estimate	Forecast Outturn
	£'000	£'000	£'000
CFR as at 31 March			
Non – HRA	244,215	264,985	265,586
HRA	149,538	149,524	149,513
TOTAL	**393,753**	**414,509**	**415,099**
Annual change in CFR			
Non – HRA	26	- 3,922	21,371
HRA	- 36	- 25	- 25
TOTAL	**- 10**	**- 3,947**	**21,346**

24 The forecast outturn for CFR remains in line with the budget at £415m, however the annual change in CFR has increased significantly

25 Debt outstanding should not normally exceed CFR. The expectation is that the under borrowing will increase as cash balances are used to fund debt repayment. The Council forecast outturn shows in the table below that the under borrowing is in line with the estimate and will increase compared to 2013/14.

Changes to Gross Borrowing	2013/14	2014/15	2014/15
	Actual	Estimate	Forecast Outturn
	£'000	£'000	£'000
Debt 1st April	350,358	340,261	340,293
Change in Debt	-10065	-6000	-6,000
Other long term liabilities (OLTL) 1st April	23,923	22,121	21,841
Expected change in OLTL	-2,082	-1,535	-1,900
Actual gross debt at 31st March	**362,134**	**354,847**	**354,234**
CFR 31st March	**393,753**	**414,509**	**415,099**
Under / (over) borrowing	**31,619**	**59,662**	**60,865**

26 The table below shows the net borrowing after investment balances are taken into account.

Net Borrowing	2013/14	2014/15	2014/15
	Actual	Estimate	Forecast Outturn
	£'000	£'000	£'000
brought forward 1 April	273,284	243,937	230,942
carried forward 31 March	230,942	256,382	269,107
Change in net borrowing	**-42,342**	**12,445**	**38,165**

Operational Boundary and Authorised Limit

27 Operational Boundary – This is the limit is based on the Council's plans for capital expenditure, capital financing requirement and cash flow requirements for the year.

28 Authorised Limit – This represents a limit beyond which external debt is prohibited. It reflects the level of external debt which, while not desired, could be afforded in the short term, but may not be sustainable in the longer term. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

	2013/14	2014/15	2014/15
	Actual	Estimate	Forecast Outturn
	£m	£m	£m
Authorised Limit for external debt			
Borrowing and other long term liabilities	362	414	354
Operational Boundary for external debt			
Borrowing	340	345	334
Other long term liabilities	22	22	20
Total	362	367	354
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing	340	345	334
Upper limit for variable rate exposure			
Net principal re variable rate borrowing	0	0	0
Upper limit for principal sums invested over 364 days	25	40	40

Affordability Indicators

29 Ratio of Financing Cost to Revenue Stream – This indicator identifies the trend in the cost of capital (borrowing, depreciation, impairment and other long term obligation costs net of investment income) against the net revenue stream.

	2013/14	2014/15	2014/15
	Actual	Estimate	Forecast Outturn
	%	%	%
Non - HRA	12	14	14
HRA	45	43	47

30 Incremental impact of Capital Investment Decisions on Council Tax and Housing Rents – This indicator identifies the revenue costs associated with proposed changes to the capital programme and the impact on Council Tax and Housing Rents.

	2013/14	2014/15	2014/15
	Actual	Estimate	Forecast Outurn
	£	£	£
Incremental impact of capital investment decisions			
Increase in Council Tax (band D) per annum	21.71	11.43	60.81
Increase in average housing rent per week	2.65	-0.14	-1.39

31 The capital receipts from disposal programme are considerably less than budgeted for and this has a significant impact on the increase in Council Tax band D as shown in the table above.

Local HRA indicators

32 The ratio of gross revenue stream to debt shows a gradual increase which indicates that the ability of HRA to finance its debt is improving. As the number of dwellings reduces over the period, the debt outstanding per dwelling is estimated to increase. However, the annual increases are only marginal and the ratio compared to the average value of each dwelling is low enough for the measure to raise no concern.

	2013/14	2014/15	2014/15
	Actual	Estimate	Forecast Outturn
Debt (CFR) (£m)	149.5	149.5	149.5
Gross Revenue Stream (£m)	31.1	31.7	31.8
Ratio of Gross Revenue Stream to Debt (%)	**21**	**21**	**21**
Average Number of Dwellings	4933	4904	4892
Debt outstanding per dwelling (£)	**30,306**	**30,485**	**30,560**

33 HRA Debt Limit is shown in the table below

	2013/14	2013/14	2014/15
	Actual	Estimate	Forecast Outturn
	£'000	£'000	£'000
HRA Debt Limit	149,648	149,648	149,648
HRA CFR	149,537	149,524	149,501
Headroom	111	124	147

Financial Implications

34 Financial matters are integral to the report.

Equalities implications

35 There are no direct equalities impacts arising from the decisions within this report.

Council Priorities

36 This report deals with the Treasury Management activity and the Prudential Code which underpin the delivery of the Council's vision and priorities.

Section 3 - Statutory Officer Clearance

Name: Simon George………………. ☐	Chief Financial Officer
Date: 18th November 2014………..	

Ward Councillors notified:	**n/a**

Section 4 - Contact Details and Background Papers

Contact: **Ian Talbot** (Treasury and Pension Fund Manager) Tel: 020-8424-1450 / Email: ian.talbot@harrow.gov.uk

Background Papers:
http://moderngov:8080/documents/s112592/TMS.pdf

3 Economic update

3.1 Economic performance to date and outlook

3.1.1 U.K.

After strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1 and 0.9% in Q2 2014 (annual rate 3.2% in Q2), it appears very likely that strong growth will continue through 2014 and into 2015 as forward surveys for the services and construction sectors, are very encouraging and business investment is also strongly recovering. The manufacturing sector has also been encouraging though the latest figures indicate a weakening in the future trend rate of growth. However, for this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster through the initial threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. The MPC is particularly concerned that the current squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.5% in May and July, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly near to 1%. Overall, markets are expecting that the MPC will be cautious in raising Bank Rate as it will want to protect heavily indebted consumers from too early an increase in Bank Rate at a time when inflationary pressures are also weak. A first increase in Bank Rate is therefore expected in Q1 or Q2 2015 and they expect increases after that to be at a slow pace to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the 2013 Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed so far in 2014/15.

3.1.2 U.S.

In September, the Federal Reserve continued with its monthly $10bn reductions in asset purchases, which started in December 2014. Asset purchases have now fallen from $85bn to $15bn and are expected to stop in October 2014, providing strong economic growth continues. First quarter GDP figures for the US were depressed by exceptionally bad winter weather, but growth rebounded very strongly in Q2 to 4.6% (annualised).

The U.S. faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although the weak labour force participation rate remains a matter of key concern for the Federal Reserve when considering the amount of slack in the economy and monetary policy decisions.

3.1.3 Eurozone

The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In September, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB took some rather limited action in June to loosen monetary policy in order to promote growth. In September it took further action to cut its benchmark rate to only 0.05%, its deposit rate to -0.2% and to start a programme of purchases of corporate debt. However, it has not embarked yet on full quantitative easing (purchase of sovereign debt).
Concern in financial markets for the Eurozone subsided considerably during 2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

3.1.3 China and Japan

Japan is causing considerable concern as the increase in sales tax in April has suppressed consumer expenditure and growth. In Q2 growth was -1.8% q/q and -7.1% over the previous year. The Government is hoping that this is a temporary blip.
As for China, Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has raised fresh concerns. There are also major concerns as to the creditworthiness of much bank lending to corporates and local government during the post 2008 credit expansion period and whether the bursting of a bubble in housing prices is drawing nearer.

3.2 Interest rate forecasts

The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	2.00%	2.00%
5yr PWLB rate	2.70%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.50%
10yr PWLB rate	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.30%	4.30%
25yr PWLB rate	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.80%	4.90%	4.90%
50yr PWLB rate	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.80%	4.90%	4.90%

Capita Asset Services undertook a review of its interest rate forecasts in mid August, after the Bank of England's Inflation Report. By the beginning of September, a further rise in geopolitical concerns, principally over Ukraine but also over the Middle East, had caused a further flight into safe havens like gilts and depressed PWLB rates further. However, there is much volatility in rates as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 1 of 2015.

Our PWLB forecasts are based around a balance of risks. However, there are potential upside risks, especially for longer term PWLB rates, as follows: -

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Downside risks currently include:

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into economic warfare between the West and Russia where Russia resorted to using its control over gas supplies to Europe.
- UK strong economic growth is currently dependent on consumer spending and the unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK's main trading partners - the EU and US, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- Recapitalising of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.

- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity programme required and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.

- France: after being elected on an anti austerity platform, President Hollande has embraced a €50bn programme of public sector cuts over the next three years. However, there could be major obstacles in implementing this programme. Major overdue reforms of employment practices and an increase in competiveness are also urgently required to lift the economy out of stagnation.

- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.

- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.

- There are also increasing concerns that the reluctance of western economies to raise interest rates significantly for some years, plus the huge QE measures which remain in place (and may be added to by the ECB in the near future), has created potentially unstable flows of liquidity searching for yield and therefore heightened the potential for an increase in risks in order to get higher returns. This is a return of the same environment which led to the 2008 financial crisis.