REPORT FOR: **GOVERNANCE, AUDIT, RISK MANAGEMENT AND STANDARDS COMMITTEE**

Date of Meeting:	8 December 2015
Subject:	Treasury Management Strategy Statement and Annual Investment Strategy: Mid-year review 2015-16
Responsible Officer:	Dawn Calvert, Director of Finance
Exempt:	No
Wards affected:	All
Enclosure:	Appendix A – Economic and Interest Rates update

Section 1 – Summary and Recommendations

Summary

This report sets out the mid-year review of treasury management activities for 2015/16.

Recommendation

To note the Treasury Management Mid-Year Report for 2015/16.

Harrow COUNCIL LONDON

Section 2 – Report

INTRODUCTION

1. The Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management 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."

   The Council has adopted this definition.

2. The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure.

3. The first main function of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. In line with the Treasury Management Strategy Statement surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

4. 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 that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion, any debt previously drawn may be restructured to meet Council risk or cost objectives.

5. The Local Government Act 2003 and supporting regulations require the Council to 'have regard to' the CIPFA Prudential Code and Treasury Management Code of Practice to set Treasury and Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

6. The CIPFA Code of Practice on Treasury Management (revised 2011) has been adopted by the Council.

7. 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.

8. The purpose of this report is specifically to meet one of the above requirements, namely the mid year report of treasury management activities for financial year 2015/16. The report covers the following:
   - Treasury Position as at 30 September 2015;
   - An economic update and Interest Rates;
   - Compliance with Prudential Indicators.

TREASURY POSITION AS AT 30 SEPTEMBER 2015

9. The Council's borrowings and investment (cash balances) position as at 30 September 2015 is detailed below:

Table 1: Outstanding Borrowings and Investments

	As at 30 September 2015			As at 31 March 2015		
	Principal £m	Average Rate %	Average Life	Principal £m	Average Rate %	Average Life
Total Investments	**109.1**	**0.9**	**145 days**	**119.1**	**1.0**	**214 days**
Total Borrowing						
Public Works Loan Board	218.5	4.09	35.7 yrs	218.5	4.09	36.2 yrs
Market Loans	115.8	4.53	36.5 yrs	115.8	4.53	37.0 yrs
Total	**334.3**	**4.24**	**36.0 yrs**	**334.3**	**4.24**	**36.5 yrs**

The above analysis assumes loans structured as LOBOs mature at the end of the contractual period. If the first date at which the lender can reset interest rates was used as the maturity date, the average life for market loans would be 1.3 years and for the whole debt portfolio 23.7 years

Review of Investment Portfolio

10. The Council remains a cautious investor placing security and liquidity considerations ahead of income generation. With Bank Rate remaining at

0.5% it is impossible to invest at interest rates commonly seen in previous decades. During the first half of the year the rate on offer for instant access investments has been 0.25%, for investments of three months broadly in the range of 0.45% to 0.55% and for investments of over one year period just over 1%.

11. The Council held £109.1m of investments as at 30 September 2015 (£119.1m at 31 March 2015) and the investment portfolio yield for the first six months of the year is 0.9% against the three months LIBOR of 0.58%. The reduction in investments is due primarily to the substantial expenditure undertaken on schools building projects. The Council's investment income budget is £1.588m and the forecast outturn is a favourable balance of £0.1m.

12. The only counterparties actively in use during the period have been Lloyds, Royal Bank of Scotland Group, Enhanced Money Market Funds and Svenska Handelsbanken.

13. The performance of the investment portfolio is benchmarked on a quarterly basis by the Treasury Management Adviser both against their risk adjusted model and the returns from other local authorities. As at 30 September 2015, the average yield on the portfolio of 0.9% was in line with the model return and was in the top quartile of all Local Authorities.

14. 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 2015 is £11.3m and the remaining facility of £3.7m is predicted to be drawn by June 2016. For the financial year 2015/16, the outturn forecast on the interest accrued is £0.9m which is included as part of the investment income budget of £1.558m.

15. The table below sets out the counter-party position as at 30 September 2015.

Table 2: Investment Balances

	2014/15				2015/16	
	Sep-14		Mar-15		Sep-15	
	£m	%	£m	%	£m	%
Specified Investments						
Banks & Building Societies	15.2	10.2	5.3	4.5	14.3	13.1
Money Market Funds	1.6	1.1	1.6	1.3	1.6	1.5
Local Authority	0.0	0.0	5.0	4.2	0.0	0.0
Non –Specified Investments						
Banks & Building Societies	111.6	75.2	101.1	84.9	93.1	85.3
Enhanced Money Market Funds	20.1	13.5	6.1	5.1	0.1	0.1
Total	**148.5**	**100**	**119.1**	**100**	**109.1**	**100.00**

16. During the half year, on one occasion due to an external banking error by Lloyds the counterparty limit of 50% investments with RBS was breached by 4% over one weekend.

17. On 20 May Capita advised the Council that Fitch, the rating agency, had concluded that many of the west European banks had a reduced likelihood of sovereign support and had therefore downgraded this aspect of their rating from 1 (the highest level) to 5 (the lowest level).The Council's minimum credit criterion for these banks was level 1. Of the significant counterparties this affected Lloyds and RBS and the Council had several fixed term loans outstanding with these banks. The Council did not seek immediate recovery of these investments since this would have potentially been in breach of contract and would certainly have been expensive and administratively difficult. Capita also advised that this "…….*is not indicative of deteriorating credit quality in the institution concerned. Instead it is reflective of underlying methodology changes by the agencies in light of regulatory changes."* The Council has since revised its policy.

18. At its meeting in November 2014 the Council approved HB Public Law Ltd. which is wholly owned by the Council to be added to the counter party list. The Council has approved a start-up loan of £100,000 for three years. To date there has been a drawdown of £40,000 in April 2015.

Review of Borrowing Portfolio

19. The table below analyses the maturity profile of borrowing.

Table 3: Borrowing Maturity Profile

	upper limit %	lower limit %	LOBO final maturity		LOBO interest reset date	
			£m	%	£m	%
under 12 months	30	0	0.0	0.00%	83.80	25.07%
12 months and within 24 months	20	0	10.0	2.99%	10.00	2.99%
24 months and within 5 years	30	0	22.0	6.58%	22.00	6.58%
5 years and within 10 years	40	0	5.0	1.50%	5.00	1.50%
10 years and above	90	30	297.3	88.93%	213.50	63.86%
Total			**334.3**	100.00%	**334.3**	100.00%

20. The Council held £334.3m of borrowing as at 30 September 2015 (£334.3m at 31 March 2015) and the average borrowing rate is 4.24%. The forecast outturn on borrowing cost is in line with the budget of £7.834m.

21. Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. A detailed review of the possibilities was discussed with the Treasury Management Adviser in July who advised that in a period of such low interest rates there are no financial advantages available which could be recommended for acceptance. Hence, no debt rescheduling was undertaken during the first six months of the year.

ECONOMIC UPDATE AND INTEREST RATES

22. An Economic update for the first part of the 2015/16 financial year along with the interest rate forecast and commentary provided by Capita as at 30th September 2015 is included as Appendix A.

COMPLIANCE WITH PRUDENTIAL INDICATORS

Capital Expenditure and Funding

23. 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 statutory 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:

Table 4: Capital Expenditure

	2014/15	2015/16	2015/16
	Actual	Estimate	Forecast
	£'000	£'000	£'000
Expenditure			
Non - HRA	57,927	57,061	100,230
HRA	4,443	21,656	16,037
TOTAL	**62,370**	**78,717**	**116,267**
Funding:-			
Grants	27,779	29,142	56,943
Capital receipts	179	9,359	3,741
Revenue financing	5,534	9,638	52,439
Section 106 / Section 20	553	923	1,408
TOTAL	**34,045**	**49,062**	**114,531**
Net financing need for the year	**28,325**	**29,655**	**1,736**

24. The increase in the expenditure on the capital programme is due primarily to the carry forward of slippage from 2014/15. 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)

25. 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.

Table 5: Capital Financing Requirement

	2014/15	2015/16	2015/16
	Actual	Estimate	Forecast Outturn
	£'000	£'000	£'000
CFR as at 31 March			
Non – HRA	256,390	270,118	287,692
HRA	149,526	151,214	151,232
TOTAL	**405,916**	**421,332**	**438,924**
Annual change in CFR			
Non – HRA	12,175	13,728	31,302
HRA	- 12	1,688	1,706
TOTAL	**12,163**	**15,416**	**33,008**

26. Debt outstanding, including that arising from PFI and leasing schemes, should not normally exceed the Capital financing requirement. As the Council has funded a substantial amount of capital expenditure from revenue resources, as shown in table 6 below current gross debt of £353m is well below the CFR of £439m.

Table 6: Changes to Gross Debt

	2014/15	2015/16	2015/16
	Actual	Estimate	Forecast Outturn
	£'000	£'000	£'000
Borrowing 1st April	350,358	334,293	334,261
Change in Borrowing	-10,065	0	0
Other long term liabilities (OLTL) 1st April	23,923	20,306	20,306
Expected change in OLTL	-2,082	-1,534	-1,534
Actual gross debt at 31st March	**362,134**	**353,065**	**353,033**
CFR 31st March	**405,916**	**421,332**	**438,924**
Under / (over) borrowing	**43,782**	**68,267**	**85,891**

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

Table 7: Net Borrowing

	2014/15	2015/16	2015/16
	Actual	Estimate	Forecast Outturn
	£'000	£'000	£'000
brought forward 1 April	230,942	269,107	239,258
carried forward 31 March	239,258	282,736	279,261
Change in net borrowing	**8,316**	**13,629**	**40,003**

The estimated balance at 31 March 2016 is made up of outstanding borrowing of £334.3m and estimated other long term liabilities of £19.0m partly offset by estimated investment balances of £80.0m.

Operational Boundary and Authorised Limit

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

29. 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.

Table 8: Boundaries

	2014/15	2015/16	2015/16
		Original	Revised
	£m	£m	£m
Authorised Limit for external debt			
Borrowing and other long term liabilities	406	421	439
Operational Boundary for external debt			
Borrowing	334	334	334
Other long term liabilities	20	19	19
Total	354	353	353
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing	334	334	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	28	40.5	40.5

Affordability Indicators

30. **Ratio of Financing Costs to Revenue Streams** – 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. Table 9 below shows the current position

Table 9: Ratio of Financing Costs to Net Revenue Streams

	2014/15	2015/16	2015/16
	Actual	Estimate	Forecast Outturn
	%	%	%
Non - HRA	14	13	12
HRA	48	41	41

31. **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

32. The table below identifies the revenue costs associated with the proposed capital programme and the impact on Council Tax and housing rents.

Table 10: Incremental Impact of Capital Investment Decisions

	2014/15	2015/16	2015/16
	Actual	Estimate	Forecast Outturn
	£	£	£
Increase in Council Tax (band D) per annum	33.32	42.49	46.78
Increase in average housing rent per week	0.11	1.34	-2.97

Local HRA indicators

33. The ratio of gross revenue stream to debt shows a consistent pattern which is affordable by the HRA. 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.

Table 11: Local HRA Indicators

	2014/15	2015/16	2015/16
	Actual	**Estimate**	**Forecast Outturn**
Debt (CFR) (£m)	149.5	151.2	151.2
Gross Revenue Stream (£m)	31.8	32.2	32.2
Ratio of Gross Revenue Stream to Debt (%)	**21**	**21**	**21**
Average Number of Dwellings	4892	4877	4867
Debt outstanding per dwelling (£)	**30,565**	**31,005**	**31,069**

34. HRA Debt Limit is shown in the table below

Table 12: HRA Debt

	2014/15	2015/16	2015/16
	Actual	**Estimate**	**Forecast Outturn**
	£'000	**£'000**	**£'000**
HRA Debt Limit	149,648	151,337	151,337
HRA CFR	149,526	151,213	151,213
Headroom	122	124	124

Financial Implications

35. In addition to supporting the Council's revenue and Capital programmes the Treasury Management net budget of £6.3m (Interest payable £7.9m; Interest receivable £1.6m) discussed in paragraphs 11 and 20 is an important part of the General fund budget. Any saving achieved, or overspends incurred have a direct impact on the achievements of the budgetary policy.

Risk Management Implications

36. The identification, monitoring and control of risk are central to the achievement of the Treasury objectives. Potential risks are included in the directorate risk register and are identified, mitigated and monitored in accordance with Treasury Practice notes approved by the Treasury Management Group.

Equalities Implications

37. There are no equalities implications arising from this report.

Corporate Priorities

38. This report deals with the Treasury Management activity which plays a significant part in supporting the delivery of all the Council's corporate priorities.

Section 3 - Statutory Officer Clearance

Name: Dawn Calvert	✓	Chief Financial Officer
Date: 25 November 2015		
Name: Caroline Eccles	✓	on behalf of the Monitoring Officer
Date: 24 November 2015		

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: None.

Appendix A

Provided by Capita Asset Services at 30 September 2015

Economic update

UK. UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y). Growth is expected to weaken to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation of Sterling against the Euro and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme, although the pace of reductions was eased in the May Budget. Despite these headwinds, the Bank of England August Inflation Report had included a forecast for growth to remain around 2.4 – 2.8% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth. However, since the report was issued, the Purchasing Manager's Index, (PMI), for services on 5 October would indicate a further decline in the growth rate to only +0.3% in Q4, which would be the lowest rate since the end of 2012. In addition, worldwide economic statistics and UK consumer and business confidence have distinctly weakened so it would therefore not be a surprise if the next Inflation Report in November were to cut those forecasts in August.

The August Bank of England Inflation Report forecast was notably subdued in respect of inflation which was forecast to barely get back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction and Iran expected to soon rejoin the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

There are therefore considerable risks around whether inflation will rise in the near future as strongly as had previously been expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as was being forecast until recently, especially given the recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets in 2015 so far, which could potentially spill over to impact the real economies rather than just financial markets.

USA. The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on 17 September, or if not by the end of 2015, the recent downbeat news about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from making that start. The nonfarm payrolls figures for September and revised August, issued on 2 October, were disappointingly weak and confirmed concerns that US growth is likely to weaken. This has pushed back expectations of a first rate increase from 2015 into 2016.

EZ. In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

Interest rate forecasts

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

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
5yr PWLB rate	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
50yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%

Capita Asset Services undertook its last review of interest rate forecasts on 11 August shortly after the quarterly Bank of England Inflation Report. Later in August, fears around the slowdown in China and Japan caused major volatility in equities and bonds and sparked a flight from equities into safe havens like gilts and so caused PWLB rates to fall below the above forecasts for quarter 4 2015. However, there is much volatility in rates as news ebbs and flows in negative or positive ways and news in September in respect of Volkswagen, and other corporates, has compounded downward pressure on equity prices. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.

Despite market turbulence since late August causing a sharp downturn in PWLB rates, the overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

The disappointing US nonfarm payrolls figures and UK PMI services figures at the beginning of October have served to reinforce a trend of increasing concerns that growth is likely to be significantly weaker than had previously been expected. This, therefore, has markedly increased concerns, both in the US and UK, that growth is only being achieved by monetary policy being highly aggressive with central rates at near zero and huge QE in place. In turn, this is also causing an increasing debate as to how realistic it will be for central banks to start on reversing such aggressive monetary policy until such time as strong growth rates are more firmly established and confidence increases that inflation is going to get back to around 2% within a 2-3 year time horizon. Market expectations in October for the first Bank Rate increase have therefore shifted back sharply into the second half of 2016.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth turns significantly weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Fed. rate increases, causing a flight to safe havens

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- Uncertainty around the risk of a UK exit from the EU.
- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.
- The commencement by the US Federal Reserve of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.