London Borough of Barnet

Treasury Management Strategy Statement and Annual Investment Strategy

Mid-year Review Report 2017/18

1 Background

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.

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.

Accordingly, 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 Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by this Council on 3 January 2003.

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. 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.
4. 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.
5. 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 Performance and Contract Management Committee:

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2017/18 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);

- A review of the Council's investment portfolio for 2017/18;
- A review of the Council's borrowing strategy for 2017/18;
- A review of compliance with Treasury and Prudential Limits for 2017/18.

No changes to the 2017/18 TMSS are proposed.

3 Economics and interest rates

3.1 Economics update

UK. After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y) which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise. The Bank of England Inflation Reports during 2017 have clearly flagged up that they expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. Inflation actually came in at 2.9% in August, (this data was released on 12 September), and so the Bank revised its forecast for the peak to over 3% at the 14 September meeting MPC. With unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, the amount of spare capacity in the economy was significantly diminishing towards a point at which the Bank needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of increasing globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so would be inflationary over the next few years.

The Bank acted on the above concerns by increasing the Bank Rate to 0.5% on 1st November pointing to the reduced slack in the economy with unemployment at a 42 year low. The minutes of the meetings suggested that any future increases in Bank Rate would be expected to be at a gradual pace and to a limited extent. As at the start of October, short sterling rates are indicating that financial markets do not expect a second increase until May 2018 with a third increase in November 2019. However, some forecasters are flagging up that they expect growth to improve significantly in 2017 and into 2018, as the fall in inflation will bring to an end the negative impact on consumer spending power while a strong export performance will compensate for weak services sector growth. If this scenario were to materialise, then the MPC would have added reason to embark on a series of slow but gradual increases in Bank Rate during 2018. While there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two years will pan out.

EU. Economic growth in the EU (the UK's biggest trading partner) has been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of Quantitative Easing (QE). However, growth picked up in 2016 and now looks to have gathered ongoing substantial strength and momentum thanks to this stimulus. GDP growth was 0.5% in quarter 1

(2.0% y/y) and 0.6% in quarter (2.3% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in August inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019.

USA. Growth in the American economy has been volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1%, resulting in an overall annualised figure of 2.1% for the first half year. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.4%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with three increases since December 2016; and there could be one more rate rise in 2017 which would then lift the central rate to 1.25 – 1.50%. There could then be another four more increases in 2018. At its June meeting, the Fed strongly hinted that it would soon begin to unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

Japan is struggling to stimulate consistent significant growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

3.2 Interest rate forecasts

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

	NOW	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.25
3 month LIBID	0.40	0.40	0.40	0.40	0.40	0.60	0.60	0.60	0.70	0.90	0.90	1.00	1.20	1.20	1.20
6 month LIBID	0.45	0.50	0.50	0.50	0.60	0.80	0.80	0.80	0.90	1.00	1.00	1.10	1.30	1.30	1.40
12 month LIBID	0.65	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.10	1.30	1.30	1.40	1.50	1.50	1.60
5 yr PWLB	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.10	2.10	2.20	2.30	2.30
10 yr PWLB	2.10	2.10	2.20	2.30	2.40	2.40	2.50	2.60	2.60	2.70	2.70	2.80	2.90	2.90	3.00
25 yr PWLB	2.70	2.80	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.40	3.50	3.50	3.60	3.60
50 yr PWLB	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40	3.40

Capita Asset Services undertook its last review of interest rate forecasts on 7th November after the quarterly Bank of England Inflation Report. The previous meeting of the MPC had increased the Bank Rate to 0.5% and indicated slow but gradual increases in the rate thereafter.

The overall balance of risks to economic recovery in the UK is currently to the downside but huge variables over the coming few years include just what final form Brexit will take, when finally agreed with the EU.

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

- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.
- Monetary policy action failing to stimulate sustainable growth and to get inflation up consistently to around monetary policy target levels.

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

- The pace and timing 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 causing an increase in the inflation premium inherent to gilt yields.

For LB Barnet with its significant capital expenditure plans and future borrowing requirements as set out in the 2017/18 TMSS, the expectation of interest rate increases but uncertainty as to extent and timing has implications for borrowing decisions.

4 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by this Council on 7 March 2017. There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

5 The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed as part of the Budget.

Capital Expenditure	**2017/18 as shown in TMSS**	**2017/18 Approved budget**	**2017/18 Revised Estimate**
	£'000	£'000	£'000
Non-HRA	306,686	319,339	259,616
HRA	77,118	89,214	58,686
Total	**383,804**	**408,553**	**318,302**

There have been new additions to the capital programme of £4.8 million and projected slippage of £95.1 million (Non-HRA £71.1m and HRA £24.0m).

5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure Financing	**2017/18 as shown in TMSS**	**2017/18 Approved budget**	**2017/18 Revised Estimate**
	£'000	£'000	£'000
Capital receipts	59,182	82,256	60,692
Capital Grants	56,124	77,170	58,225
Capital Reserves	47,554	37,531	26,528
Revenue	37,018	39,867	41,335
Total Financing	199,878	236,824	186,780
Borrowing requirement	183,926	171,729	131,522
	383,804	**408,553**	**318,302**

Projected changes for the capital programme have resulted in a reduced new borrowing requirement of £40.2 million.

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, how this has changed compared with the estimate contained within the TMSS and the debt headroom based on the operational boundary for debt.

	31 March 2017 Actual	**2017/18 as shown in TMSS**	**2017/18 Revised Estimate**
Prudential Indicator - Capital Financing Requirement			
	£'000	£'000	£'000
CFR - Non Housing	234,415	409,939	341,181
CFR - Housing	201,614	228,145	216,157
Total CFR	436,029	638,084	557,338
Net movement in CFR		202,055	121,309
Prudential Indicator - the operational boundary for external debt	**Actual**	**TMSS Projection**	**Revised Projection**
	£'000	£'000	£'000
Borrowing	304,080	488,006	378,389
Other Long term liabilities	16,034	15,661	15,661
Total debt (year-end position)	320,114	503,667	394,050
TMSS Operational boundary		614,063	614,063
Debt headroom available		**110,396**	**220,013**

Due to slippage in the capital programme as noted above, the projected year end CFR has reduced by £80.7 million to £557.3 million.

The impact on projected debt is that the current forecast year-end borrowing is £378.4 million, which is an increase in the year of £73.9 million, much lower than the original increase projected of £183.6 million. It would not be a surprise if further slippage in the capital programme resulted in less year-end debt than projected above. Further details of the net debt position are given below.

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and the next two financial years. This allows some flexibility for limited early borrowing for

future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

Estimate of the net debt position	31 March 2017 Actual £'000	As at 30 September 2017 £'000	2017/18 Revised Estimate £'000
Borrowing	304,080	304,080	378,389
Other long term liabilities	16,034	16,034	15,661
Treasury investments	-80,200	-100,000	-30,200
Net debt	239,914	220,114	363,850
CFR	436,029		557,338

The Director of Resources reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	2017/18 original indicator £'000	current position £'000	2017/18 Revised Estimate £'000
Borrowing	598,029	304,080	378,389
other long term liabilities	31,034	16,034	15,661
Total	629,063	320,114	394,050

** Includes on balance sheet PFI schemes and finance leases etc.*

The projected year end position is significantly lower than the authorised limit for external debt.

6 Investment Portfolio 2017/18

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As shown by forecasts in section 3.2, 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 current 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

The Council held £100.0m of investments as at 30 September 2017 (£80.2m at 31 March 2017) and the investment portfolio yield for the first six months of the year is 0.39% against a 7 day LiBID benchmark) of 0.11%.

A full list of investments held as at 30th September 2017 is in appendix 1:

The Director of Resources confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2017/18.

The Council's budgeted investment return for 2017/18 is £1.7 million and performance for the year to date is significantly below budget with a projection of £0.5 million. Cash balances are being minimised to avoid taking on additional debt as was projected in the TMSS. The recent increase in bank rate offers the scope to earn additional interest.

The treasury team continues to abide by the counterparty limits set out in the TMSS. Daily reports on credit rating are received and monitored. The treasury portfolio is signed of daily by the Head of Treasury and all deals are approved by Capita before completion.

Investment Counterparty criteria

Although the current treasury plan is to minimise investment balances (and therefore minimise borrowing needs) there will always be core cash balances due to the prudence built into treasury forecasting and the need to ensure liquidity. As demonstrated above, treasury balances invested in traditional cash and money market instruments are generating minimal returns. The investment strategy currently allows investment in a wide range of non-cash asset classes; bonds, property, commodities (gold) and equity via collective funds. Depending on the structure of the investment, individual limits of £10 million or £25 million are permitted.

As yet no investments have been made in non-traditional asset classes. However, opportunities are currently been investigated to make selective investments in long term bonds, property and low risk multi asset funds. When making these types of investments the emphasis will remain on low volatility and liquidity. Individual investments into non-traditional collective funds will not exceed £5 million. Advice is taken from Capita Treasury Solutions in structuring and allocating treasury investments.

7 Borrowing

As indicated above the current projected capital programme for 2017-18 requires additional borrowing of £74.3 million. Over the three years of the TMSS to March 2020, debt funded capital expenditure was projected at £322 million. As at September 2017 no new debt has been raised and cash balances of £100 million remain significant.

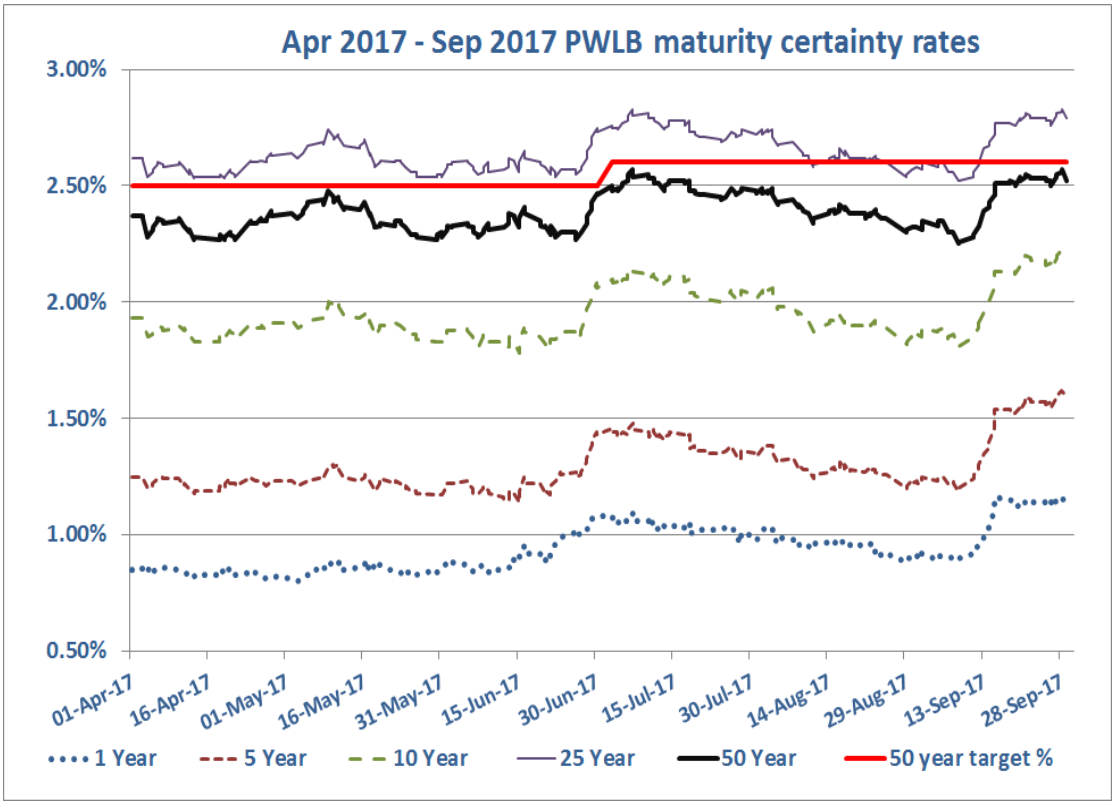
With Capita's projections in section three indicating that PWLB borrowing interest rates will gradually rise, consideration has been given to locking in borrowing rates to provide protection against increases in future costs. There are two reasons for not doing so; firstly the unpredictability of the scale and timing of the capital programme and secondly the cost of carrying excess cash with short term interest rate on high security investments yielding less than 0.5%.

Monitoring of both the capital programme and projections in interest rates are ongoing. Opportunities to fix borrowing rates for loans with a future commencement date are being investigated and it is anticipated that either new borrowing will be undertaken in 2017/18 or commitments will be entered into for future borrowing at agreed rates.

Historically, debt has been taken from both the PWLB and commercial banks, the latter being the LOBO loans. Opportunities to lock in future borrowing rates are not available through the PWLB but a number of insurance companies are interested in such arrangements, particularly for long term (20 year plus) debt.

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates 1 April 2017 to 30 September 2017



The upward trend in rates is expected to continue as shown in 3.2. Therefore as soon as capital expenditure projections are seen as robust it would be prudent to fund, or at least part fund, to reduce the risks of increasing funding costs.

8 Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

9 Other

9.1 Revised CIPFA Codes

The Chartered Institute of Public Finance and Accountancy, (CIPFA), is currently conducting an exercise to consult local authorities on revising the Treasury Management Code and Cross Sectoral Guidance Notes, and the Prudential Code. CIPFA is aiming to issue the revised codes during November.

A particular focus of this exercise is how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the authority at a much higher level than can be attained by treasury investments. One recommendation is that local authorities should produce a new report to members to give a high level summary of the overall capital strategy and to enable members to see how the cash resources of the authority have been apportioned between treasury and non-treasury investments. Officers are monitoring developments and will report to members when the new codes have been agreed and issued and on the likely impact on this authority.

9.2 MIFID II

The EU has now set a deadline of 3 January 2018 for the introduction of regulations under MIFID II. These regulations will govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. The Council has to date been classified as a professional investor. The classification is relevant to our treasury advisors and counterparties as they may have limitations on the types of clients they deal with and their client obligations (such as the format of reporting) varies depending on the status of each client.

Under revised MIFID II, local authorities will be classified as retail (the least able to understand financial products) investors. Our treasury advisors, brokers and some counterparties are not authorised to deal with retail investors. The regulations allow for local authorities to elect to be treated as professional investors. The Director of Resources has agreed that the Council should make this election. Information has been submitted to advisors, brokers and counterparties to substantiate our treasury, experience, expertise and procedures. Each of these parties will have to assess our competency. For the classes of investments we have used to date, it is likely that all our elections will be accepted. However, if we should seek to invest in asset classes for which we have little previous experience e.g. property, it is not certain that we will meet the criteria determined by counterparties for classification as professional investors.

Part of the justification for being treated as professional investors is that Councillors who sit on Committees that formulate and scrutinise treasury policy and activity are provided with training and receive advice from the Council's appointed treasury advisors. It is proposed that as part of the process for approving the treasury management strategy statement for 2018/19 training is provided to the members of the Policy and Resources Committee (responsible for the overall strategic direction of the Council's treasury management strategy) and members of the Performance and Contract Management Committee (responsible for scrutinising treasury management performance).

Investment Portfolio as at 30 September 2017

The table below lists the Council's treasury investments as at 30 September 2017.

	Balance £'000	Limit £'000	Long term credit rating (lowest)	Yield %	Maturity
Money Market Funds					
Federated Prime Rate	10,300	£25 million	AAA	0.20	daily
Aviva Liquidity	5,100	£25 million	AAA	0.18	daily
Invesco	8,600	£25 million	AAA	0.19	daily
Standard Life	11,000	£25 million	AAA	0.20	daily
Total Money Market	**35,000**				
Enhanced Cash Funds				Yield %	
Federated Prime Rate cash Plus	**20,000**	£25 million	AAA	0.53	one day notice
Local Authority Deposits				Yield %	
Lancashire County Council	5,000	£25 million		1.05	06-Nov-17
Stockport Metropolitan Borough Council	6,000	£25 million		0.30	22-Nov-17
Dudley Metrpolitan Borough Council	5,000	£25 million		0.34	02-Jan-18
Total Local Authority	**16,000**				
Banks				Yield %	
Australian and New Zealand Banking Group	5,000	£25 million	AA3	0.22	31-Oct-17
Australian and New Zealand Banking Group	6,000		AA3	0.34	31-Jan-18
Goldman Sachs International Bank	17,500	£25 million	A	0.37	21-Dec-17
Bank of Scotland Call Account	500	£25 million	A	0.15	daily
Total Banks	**29,000**				
Total Investments	**100,000**				

In addition to the above, the Council's pension fund has cash balances of £1.9 million, mostly invested with Standard Life money market fund.