

Subject: **Treasury Management Strategy 2018/19**

Report to: Policy and Resources Committee – 6 February 2018

Full Council – 20 February 2018

Report by: Finance Director

### **SUBJECT MATTER/RECOMMENDATIONS**

To consider and recommend to Council the 2018/19 Treasury Management Strategy and Annual Investment Strategy.

#### **1. INTRODUCTION/BACKGROUND**

- 1.1 The Council is required to determine annually its Treasury Management Strategy (TMS). The TMS for 2018/19 financial year is attached and includes the following:
  - Annual Investment Strategy (section 5)
  - Operational Boundary and Authorised Limits (Appendix C)
- 1.2 The Council continues to maintain an under-borrowed position which means the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. The strategy is prudent as investment returns are low and counterparty risk is relatively high. An under borrowing position is forecast to continue.
- 1.3 The Council is required to operate a balanced budget, whereby cash raised during the year will meet the cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk appetite, providing adequate liquidity initially before considering investment return.
- 1.4 The second main function of the treasury management service is the funding of the Council's planned capital plans. These capital plans provide a guide to the borrowing need of the Council, informing the longer term cash flow planning, to ensure the Council can meet its capital spending obligations.
- 1.5 The 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 the Council risk or cost objectives.
- 1.6 The treasury strategy has been informed by the current capital programme and updates to the programme as included within the budget report which is being recommended elsewhere on the agenda.
- 1.7 The revenue implications of the strategy have been included in the General Fund and HRA budgets for 2018/19.

#### **2. FINANCIAL AND RISK IMPLICATIONS**

- 2.1 Detailed within the Strategy Document.

### **3. CONCLUSIONS**

3.1 The Council is required to determine the TMS, as covered within the attached reports Treasury Management Strategy, Annual Investment Strategy and Operational Boundary and Authorised Limits

### **4. RECOMMENDATIONS**

4.1 It is recommended that the Policy and Resources Committee agree to recommend to Council:

- a) The TMS for 2018/19
- b) The Annual Investment Strategy (section 5)
- c) Operational Boundary and Authorised Limits (appendix C)

### **5. BACKGROUND PAPERS**

5.1 The Council is required to determine annually its Treasury Management Strategy.

<b>Area for consideration</b>	<b>Comment</b>
Monitoring Officer Consultation:	
Section 151 Officer Consultation:	Yes
Existing Council Policies:	Yes
Financial Implications:	Contained within the detail of the report
Legal Implications (including human rights):	Yes
Risk Implications:	No
Equality Issues/EQIA assessment:	No
Crime & Disorder:	No
Every Child Matters:	No

# **Treasury Management Strategy Statement 2018/19**

## **1. Introduction**

### **The purpose of this report**

- 1.1 The council has significant investments and borrowing which bring with them financial risks including the loss of invested funds and the revenue effect of changing interest rates. It therefore requires an overall strategy as well as sets of practices and procedures to identify, monitor and control those risks. There is a body of statute and other regulations that lays down what a strategy should do. This report sets out a Treasury Management Strategy for 2018/19 that fulfils the legal requirement and provides a workable framework for day-to-day operations.

## **2. Background**

### **Economic background**

- 2.1 The Councils Treasury Management Strategy must take into account the expectations for the economy and specifically the finance sector. The Council receives advice on this from Arlingclose Ltd and Appendix A is a commentary by them on the economic background, the outlook for creditworthiness and interest rates.
- 2.2 The forecast for the Bank Rate is that it remains at 0.50%. For the purpose of the budget any new investments are estimated to be on or about the Bank Rate.
- 2.3 The treasury management environment remains difficult with yields and quality counterparties remaining reduced in the aftermath of the financial crisis of 2008 with no return to pre-crisis rates envisaged in the medium term. Governments and regulators have put in place measures prompted by the crisis that restrict any government bail-out of individual financial institutions exposing the Council to participate in a bail-in if has invested in an affected institution.

### **Statutory background**

- 2.4 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the Department for Communities and Local Government (DCLG)'s Guidance on Investments which require the Council to approve a treasury management strategy which incorporates the investment strategy before the start of each financial year.
- 2.5 The regulatory background is complicated by both CIPFA and DCLG revising their codes and guidance on treasury management and prudential indicators. Whilst CIPFA has published the new Codes in December 2017 it has yet to publish the accompanying treasury management Guidance Notes for local authorities. The DCLG's final investment guidance is also awaited and the timing relative to the Council's meetings dealing with 2018/19 strategy is not ideal. The background to possible changes to the regulations is further explained in Appendix B. The situation will be monitored and an updated strategy will be brought forward to Members if needed.

2.6 The Council has borrowed and invested material sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

2.7 In accordance with the CLG Guidance, the Council will be asked to approve a revised Treasury Management Strategy Statement should the assumptions on which this report is based change significantly. Such circumstances would include, for example, a large unexpected change in interest rates, in the Council's capital programme or in the level of its investment balance.

### 3. Current Position and Projection

3.1 Table 1: The Council's treasury portfolio at the end of December 2017 was:

	Principal £m	Average Interest Rate %
Call accounts	3.000	<b>0.25%</b>
Money Market Funds	8.780	<b>0.65%</b>
<b>Total Investments</b>	<b>11.780</b>	
Long –term PWLB loans	71.388	<b>3 - 4.4%</b>
Long-term loans other	10.504	<b>3.35 - 11.0%</b>
Short term borrowing	21.000	<b>0.40 - 0.55%</b>
<b>Total Borrowing</b>	<b>102.892</b>	
<b>Net Borrowing</b>	<b>91.112</b>	

3.2 On 31 December 2017, the Council held £102.892m of borrowing and £11.780m of investments. This is set out in further detail at above. Forecast changes in these sums are shown in the balance sheet analysis in table 2 below which shows the Council anticipates a borrowing requirement of around £36.5 million by 31/3/2021.

Table 2: Balance sheet summary and forecast

	31/03/2017 Actual £'000	31/03/2018 Estimate £'000	31/03/2019 Estimate £'000	31/03/2020 Estimate £'000
General Fund CFR	46,292	50,636	53,420	58,394
HRA CFR	78,867	79,984	81,344	83,483
<b>Total CFR</b>	<b>125,160</b>	<b>130,620</b>	<b>134,764</b>	<b>141,877</b>
Less: Other Debt Liabilities *	(1,104)	(931)	(826)	(720)
<b>Borrowing CFR</b>	<b>124,056</b>	<b>129,689</b>	<b>133,938</b>	<b>141,157</b>
Less: External borrowing **	88,217	102,800	81,678	81,678
<b>Internal (over) borrowing</b>	<b>35,839</b>	<b>26,889</b>	<b>52,260</b>	<b>59,479</b>
Less: Useable Reserves	(23,478)	(21,527)	(20,034)	(18,135)
Less: Working Capital <b>(New Borrowing requirement)/Investments</b>	<b>(16,320)</b>	<b>(240)</b>	<b>388</b>	<b>1,553</b>
	(3,959)	5,121	32,614	42,897

\*finance leases, PFI liabilities and transferred debt that form part of the Council's total debt

\*\* shows only loans to which the Council is committed and excludes optional refinancing

3.3 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

3.4 CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 2 shows that the Council expects to comply with this recommendation during 2018/19, and Appendix C illustrates the Operational Boundary and Authorised Limits.

#### 4. Borrowing Strategy

4.1 As at 31 December the Council held £102.9 million in loans (table 1), an increase of £15 million on the previous year, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 2 shows that the Council expects to borrow a further £5m in 2018/19. The Council may borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £142million per Appendix C.

4.2 The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. With short-term interest rates lower than long-term borrowing rates, the Council has felt it was more cost effective in the short-term to use internal resources. Effectively the Council has borrowed from its own internal resources.

4.3 **Strategy:** Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

4.4 By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2018/19 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

4.5 Alternatively, the Council may arrange forward starting loans during 2018/19, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

4.6 In addition, the Council may borrow further short-term loans to cover unplanned cash flow shortages.

4.7 The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds (except Norfolk Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

4.8 In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

4.9 The Council has previously raised a significant proportion of its long-term borrowing from the PWLB but it continues to investigate other sources of finance, such as local authority loans and bank loans that may be available at more favourable rates.

4.10 **Municipal Bonds Agency:** UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a joint and several guarantee

to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

- 4.11 LOBOs: The Authority holds £3m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. The next date for this option is 1st May 2018.
- 4.12 Short-term and variable rate loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.
- 4.13 As short term borrowing rates will be considerably cheaper than long term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

## 5. **Investment Strategy**

- 5.1 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past year, the Council's investment balance has been up to £18 million and similar levels are expected to be maintained in the forthcoming year.
- 5.2 Both the CIPFA Code and the CLG Guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.
- 5.3 **Strategy:** Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to diversify into more secure and/or higher yielding asset classes during 2018/19. This is especially the case for the estimated £10m that is available for longer-term investment. All of the Council's surplus cash is currently invested in short-term unsecured bank deposits and money market funds. This diversification will represent a substantial change in strategy over the coming year.
- 5.4 The Council may invest its surplus funds with any of the counterparty types in table 2 below, subject to the cash limits (per counterparty) and the time limits shown:

Table 2: Approved investment counterparties and limits

Credit rating	Banks unsecured	Banks secured	Government	Corporates	Registered Providers
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Credit rating	Banks unsecured	Banks secured	Government	Corporates	Registered Providers
UK Govt	N/A	N/A	£unlimited 50 years	N/A	N/A
AAA	£1.5m 3 years	£2m 20 years	n/a	£1m 20 years	£1.5m 20 years
AA+	£1.5m 1 years	£2m 10 years	n/a	£1m 10 years	£1.5m 10 years
AA	£1.5m 1 years	£2m 5 years	n/a	£1m 5 years	£1.5m 10 years
AA-	£1.5m 1 years	£2m 4 years	n/a	£1m 4 years	£1.5m 10 years
A+	£1.5m 1 years	£2m 3 years	n/a	£1m 3 years	£1.5m 5 years
A	£1.5m 1 years	£2m 2 years	n/a	£1m 2 years	£1.5m 5 years
A-	£1.5m 6 months	£2m 13 months	n/a	£1m 13 months	£1.5m 5 years
None	£1.0m 6 months	n/a	n/a	£1m 5 years	£1.5m 5 years
UK Govt	UK Local Authority £3m 2 years				
Pooled funds	£3m per fund				

This table must be read in conjunction with the notes below.

5.5 **Credit rating:** Investment limits are set by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

5.6 **Banks unsecured:** Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

5.7 **Banks secured:** Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

5.8 **Government:** Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments

are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

5.9 **Corporates:** Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made following an external credit assessment and will be subject to individual business cases and not for treasury management purpose but for service purpose.

5.10 **Registered providers:** Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing, formerly known as housing associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services, they retain the likelihood of receiving government support if needed.

5.11 **Pooled funds:** Shares in diversified investment vehicles consisting of any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

5.12 Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.

5.13 **Operational bank accounts:** The Council may incur operational exposures, for example through current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in. Balances will be kept as low as possible without affecting operations. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

5.14 **Risk assessment and credit ratings:** Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

5.15 Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as “rating watch negative” or “credit watch negative”) so that it may fall below the approved rating criteria, then no investments other than call investments will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

5.16 **Other information on the security of investments:** The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the Council’s credit rating criteria.

5.17 When financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments. If these restrictions mean that insufficient commercial organisations of high credit quality are available, then the Council will use the UK Government or other local authorities although this will cause a reduction in the level of investment income earned.

5.18 **Specified and Non- Specified investments:** The CLG Guidance defines specified investments as those:

- denominated in pound sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
  - the UK Government,
  - a UK local authority, parish council or community council, or
  - a body or investment scheme of “high credit quality”.

5.19 The Council defines “high credit quality” organisations and securities as those having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher. For money market funds and other pooled funds “high credit quality” is defined as those having a credit rating of A- or higher.

5.20 Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in table 3 below.

Table 3: Non-specified investment limits

	<b>Cash limit</b>
Total long-term investments	£12m
Total investments without credit ratings or rated below [A-] (except UK Government and local authorities)	£11m
Total investments (except pooled funds) with institutions domiciled in foreign countries rated below [AA+]	£1m

### **5.21 Investment limits**

5.22 The Council's revenue reserves available to cover investment losses are forecast to be £8 million on 31 March 2018. In order that to reduce risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £3 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

Table 4: Investment limits

	<b>Cash limit</b>
Any single organisation, except the UK Central Government	£2m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£2m per group
Any group of pooled funds under the same management	£4m per manager
Negotiable instruments held in a broker's nominee account	£4m per broker
Foreign countries	£1m per country
Registered providers	£2m in total
Unsecured investments with building societies	£1m in total
Loans to unrated corporates	£1m in total
Money Market Funds	£10m in total

### **5.23 Cash Flow/Liquidity management:**

5.24 The Council officers maintain a detailed cash flow forecast for each coming year revising it as more information is available. This informs the short term investments such as those to cover precept payments. The forecast is compiled on a prudent basis with receipts under-estimated and payments over-estimated to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Long-term investment strategy is based on the Council's medium term financial strategy.

## 5.25 Non-Treasury Investments

5.26 Although not classed as treasury management activities and therefore not covered by the CIPFA Code or the CLG Guidance, the Council may also purchase property for investment purposes and may also make loans and investments for service purposes. Such loans and investments will be subject to the Council's normal approval processes for revenue and capital expenditure and need not comply with this treasury management strategy. The prospective changes in CIPFA Codes and DCLG Guidance imply these investments will be included in future annual investment strategies although exactly what detail is required is not certain until the final versions are published. When the final versions are available a revised report including the extra detail may be required. To give some context the Council's non-treasury investments are mostly its commercial properties which at the last valuations totalled around £31.8m (As at 31/03/17).

## 6 Treasury Management Indicators

6.1 The Council measures and manages its exposures to treasury management risks using the following indicators.

6.2 **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	Target
Portfolio average credit rating	A

6.3 **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments it can borrow each quarter without giving prior notice.

	Target £m
Liquid short term deposits	£11.000
Bank Overdraft	£0.25

6.4 **Interest rate exposures:** This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

	2018/19	2019/20	2020/21
Upper limit on fixed interest rate exposure	100%	100%	100%
Upper limit on variable interest rate exposure	100%	100%	100%

6.5 Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

6.6 **Maturity structure of borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	<b>Upper</b>	<b>Lower</b>
Under 12 months	20%	0%
12 months and within 24 months	40%	0%
24 months and within 5 years	60%	0%
5 years and within 10 years	80%	0%
10 years and above	100%	0%

6.7 Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

6.8 **Principal sums invested for periods longer than 364 days:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

	<b>2018/19</b>	<b>2019/20</b>	<b>2020/21</b>
Limit on principal invested beyond year end	£12m	£12m	£12m

## **7 Other Treasury Management issues**

7.1 There are a number of additional items that the Council is obliged by CIPFA or CLG to include in its Treasury Management Strategy.

### **7.2 Policy on the use of financial derivatives:**

7.3 Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

7.4 The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds

and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

- 7.5 Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.
- 7.6 **Policy on apportioning interest to the HRA:** On 1 April 2012, the Council notionally split each of its existing long-term loans into General Fund and HRA pools. In the future, new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged/ credited to the respective revenue account. Annually a calculation is performed to allocate interest between the General Fund and HRA.
- 7.7 **Treasury Management advisers:** The Council's treasury management advisor is Arlingclose Limited. Arlingclose provide advice and information on the Council's investment, borrowing and capital financing activities. However, responsibility for final decision making remains with the Council and its treasury officers. The quality of service will be monitored by the S 151 Officer and treasury officers using the service and meet with a representative of the advisor at least twice a year.
- 7.8 **Staff training:** The needs of the Council's treasury management staff for training in investment management are assessed regularly as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.
- 7.9 **Investment of money borrowed in advance of need:** The Council may, from time to time, borrow in advance of need, where this is expected to provide the best long-term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.
- 7.10 The total amount borrowed will not exceed the authorised borrowing limit of £142 million (Appendix C). It should be noted that the Council is not required to link particular loans with particular items of expenditure.

## 8. Financial Implications

The budget for investment income in 2018/19 is £64k, based on an average investment portfolio of £15 million at an average interest rate of 0.32%. The budget for debt interest paid for general fund and HRA in 2018/19 is £3.4 million (2017/18 £3.2m). If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

## 9 Other Options Considered

The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The S 151 Officer believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain

## **Appendix A Economic background and interest rate forecast**

### **Economic background**

The major external influence on the Council's treasury management strategy for 2018/19 will be the UK's progress in negotiating its exit from the European Union and agreeing future trading arrangements. The domestic economy has remained relatively robust since the surprise outcome of the 2016 referendum, but there are indications that uncertainty over the future is now weighing on growth. Transitional arrangements may prevent a cliff-edge, but will also extend the period of uncertainty for several years. Economic growth is therefore forecast to remain sluggish throughout 2018/19.

Consumer price inflation reached 3.0% in September 2017 as the post-referendum devaluation of sterling continued to feed through to imports. Unemployment continued to fall and the Bank of England's Monetary Policy Committee judged that the extent of spare capacity in the economy seemed limited and the pace at which the economy can grow without generating inflationary pressure had fallen over recent years. With its inflation-control mandate in mind, the Bank of England's Monetary Policy Committee raised official interest rates to 0.5% in November 2017.

In contrast, the US economy is performing well and the Federal Reserve is raising interest rates in regular steps to remove some of the emergency monetary stimulus it has provided for the past decade. The European Central Bank is yet to raise rates, but has started to taper its quantitative easing programme, signalling some confidence in the Eurozone economy.

### **Credit outlook**

High profile bank failures in Italy and Portugal have reinforced concerns over the health of the European banking sector. Sluggish economies and fines for pre-crisis behaviour continue to weigh on bank profits, and any future economic slowdown will exacerbate concerns in this regard.

Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the European Union, Switzerland and USA, while Australia and Canada are progressing with their own plans. In addition, the largest UK banks will ringfence their retail banking functions into separate legal entities during 2018. There remains some uncertainty over how these changes will impact upon the credit strength of the residual legal entities.

The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Council; returns from cash deposits however remain very low.

### **Interest rate forecast**

The Council's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.50% during 2018/19, following the rise from the historic low of 0.25%. The Monetary Policy Committee re-emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

Future expectations for higher short term interest rates are subdued and on-going decisions remain data dependant and negotiations on exiting the EU cast a shadow over monetary policy decisions. The risks to Arlingclose's forecast are broadly balanced on both sides. The Arlingclose central case is for gilt yields to remain broadly stable across the medium term. Upward movement will be limited, although the UK government's seemingly deteriorating fiscal stance is an upside risk.

	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	Average
<b>Official Bank Rate</b>														
Upside risk	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.19
<b>Arlingclose Central Case</b>	<b>0.50</b>													
Downside risk	0.00	0.00	0.00	0.00	0.00	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.15
<b>3-month LIBID rate</b>														
Upside risk	0.10	0.10	0.10	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.22
<b>Arlingclose Central Case</b>	<b>0.50</b>													
Downside risk	-0.10	-0.10	-0.15	-0.15	-0.15	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.20
<b>1-yr LIBID rate</b>														
Upside risk	0.15	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.27
<b>Arlingclose Central Case</b>	<b>0.70</b>	<b>0.70</b>	<b>0.70</b>	<b>0.70</b>	<b>0.80</b>	<b>0.77</b>								
Downside risk	-0.15	-0.20	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.15	-0.26
<b>5-yr gilt yield</b>														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.32
<b>Arlingclose Central Case</b>	<b>0.75</b>	<b>0.75</b>	<b>0.80</b>	<b>0.80</b>	<b>0.80</b>	<b>0.85</b>	<b>0.90</b>	<b>0.90</b>	<b>0.95</b>	<b>0.95</b>	<b>1.00</b>	<b>1.05</b>	<b>1.10</b>	<b>0.89</b>
Downside risk	-0.20	-0.20	-0.25	-0.25	-0.25	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.33
<b>10-yr gilt yield</b>														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.32
<b>Arlingclose Central Case</b>	<b>1.25</b>	<b>1.25</b>	<b>1.25</b>	<b>1.25</b>	<b>1.25</b>	<b>1.30</b>	<b>1.30</b>	<b>1.35</b>	<b>1.40</b>	<b>1.45</b>	<b>1.50</b>	<b>1.55</b>	<b>1.55</b>	<b>1.36</b>
Downside risk	-0.20	-0.25	-0.25	-0.25	-0.25	-0.30	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.33
<b>20-yr gilt yield</b>														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.32
<b>Arlingclose Central Case</b>	<b>1.85</b>	<b>1.85</b>	<b>1.85</b>	<b>1.85</b>	<b>1.85</b>	<b>1.90</b>	<b>1.90</b>	<b>1.95</b>	<b>1.95</b>	<b>2.00</b>	<b>2.05</b>	<b>2.05</b>	<b>2.05</b>	<b>1.93</b>
Downside risk	-0.20	-0.30	-0.25	-0.25	-0.30	-0.35	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	-0.38
<b>50-yr gilt yield</b>														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.32
<b>Arlingclose Central Case</b>	<b>1.70</b>	<b>1.70</b>	<b>1.70</b>	<b>1.70</b>	<b>1.70</b>	<b>1.75</b>	<b>1.80</b>	<b>1.85</b>	<b>1.90</b>	<b>1.95</b>	<b>1.95</b>	<b>1.95</b>	<b>1.95</b>	<b>1.82</b>
Downside risk	-0.30	-0.30	-0.25	-0.25	-0.30	-0.35	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	-0.39

## **Appendix B Changes to codes and guidance relating to treasury management**

### **CIPFA Codes**

CIPFA published new versions of its Treasury Management in the Public Services: Code of Practice and Cross-sectoral Guidance Notes (TM Code) and The Prudential Code for Capital Finance in Local Authorities (Prudential Code) in late December 2017. It is understood that the Guidance Notes for local authorities will be published later in 2018. CIPFA has stated the time was right for a general review of the Codes and at the same time has reacted to discussions about concerns that local authorities have greatly increased investments in properties and were using increased borrowing to fund this and this should be subject to the same framework as traditional treasury management.

The updated Prudential Code includes a new requirement for local authorities to produce a 'capital strategy' which is a summary document approved by full Council including capital expenditure and funding plans, the overall approach to investment and borrowing and the governance arrangements to be approved by the full Council allowing a more detailed treasury strategy to be delegated to another committee.

Significantly the new codes bring a wider set of investments into the annual strategy including commercial property investments. It asks local authorities to make clear its process of governance and analysis of potential investments. The revised Treasury Management Code also includes a new requirement for management practices for non-treasury investments, including loans made and guarantees given for service purposes, shareholdings in subsidiaries and direct property investments.

### **DCLG guidance**

Department for Communities and Local Government (DCLG) issued revised guidance on local authority investments in March 2010. DCLG has consulted on new guidance and is expected to issue final guidance by late January 2018. The DCLG has also expressed concerns that local authorities were funding increased investments in properties with increased borrowing and have suggested changes to make this more transparent.

## Appendix C – Operational Boundary and Authorised Limits

Operational boundary £m	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Debt	£133.000	£135.000	£141.000	£142.000
Other long term liabilities	£2.000	£2.000	£2.000	£2.000
Total	£135.000	£137.000	£143.000	£144.000

Authorised limit £m	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Debt	£138.000	£140.000	£146.000	£147.000
Other long term liabilities	£2.000	£2.000	£2.000	£2.000
Total	£140.000	£142.000	£148.000	£149.000

HRA Debt Limit £m	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
HRA debt cap	£89.998	£89.998	£89.998	£89.998
HRA CFR	£79.984	£81.344	£83.483	£85.604
HRA headroom	£10.014	£8.654	£6.515	£4.394