

Subject: **Treasury Management Strategy 2019/20**
Report to: Policy and Resources Committee – 5th February 2019
Full Council – 19th February 2019
Report by: Finance Director

SUBJECT MATTER/RECOMMENDATIONS

To consider and recommend to Council the 2019/20 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 2019/20 financial year is attached and includes the following:
- Annual Investment Strategy (section 4)
 - 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 2019/20.

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 Cabinet agree and recommend to Council:

- a) The TMS for 2019/20
- b) The Annual Investment Strategy (section 4)
- c) Operational Boundary and Authorised Limits (Appendix C)

5. BACKGROUND PAPERS

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

Area for consideration	Comment
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 2019/20

1. Introduction

- 1.1 Treasury management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council has borrowed and invested substantial 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 financial risk are therefore central to the Council's prudent financial management.
- 1.2 Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.
- 1.3 Investments held for service purposes or for commercial profit are not considered within this report, a separate Investment Strategy that covers this will be presented later in the year.
- 1.4 Appendix A and B provide more detailed commentary on current economic context and interest rate forecast.

2. Current Position and Projection

- 2.1 On 31st December 2018, the Council held £125,872m of borrowing and £28,335m of investments, excluding the investment in Equinox. Table 1 below provides a summary of the Council's treasury portfolio at the end of December 2018.

Table 1: Councils treasury portfolio as at 31st December 2018

As at 31/12/18	Principal £000	Average Interest Rate %
Call accounts	1,250	0.60%
Money Market Funds	10,000	0.67%
DMO	16,085	0.50%
Local Authority	1,000	0.70%
Total Investments	28,335	
Long –term PWLB loans	71,388	3.15 - 4.40%
Long-term loans other	37,480	3.35 - 4.44%
Short term borrowing	17,004	0.75 - 1.10%
Total Borrowing	125,872	
Net Borrowing	97,537	

2.2 Future forecast borrowing is shown below in the balance sheet analysis in table 2. The forecast changes in these sums have been informed by future housing revenue account and general fund capital programmes.

Table 2: Balance sheet summary and forecast

	31.3.18 Actual £m	31.3.19 Estimate £m	31.3.20 Forecast £m	31.3.21 Forecast £m	31.3.22 Forecast £m
General Fund CFR	50.013	52.102	60.376	64.539	68.455
HRA CFR	81.542	83.640	85.779	87.900	90.112
Total CFR	131.555	135.742	146.155	152.439	158.567
Less: *Other debt liabilities	(1.010)	(0.119)	(0.110)	(0.087)	(0.084)
Borrowing CFR	130.545	135.623	146.045	152.352	158.483
Less: External borrowing **	(109.893)	(117.852)	(108.768)	(86.180)	(82.852)
Internal (over) borrowing	20.652	17.771	37.277	66.172	75.631
Less: Usable reserves	(26.139)	(25.862)	(24.626)	(22.541)	(20.342)
Less: Working capital	(6.000)	(6.000)	(6.000)	(6.000)	(6.000)
Investments or (New borrowing)***	11.487	14.091	(6.651)	(37.631)	(49.289)

* 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

2.3 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.

2.4 The Council has an increasing CFR due to the timing of the approved capital programme, but minimal investments and will therefore be required to borrow up to £49m over the forecast period.

2.5 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 2019/20, and Appendix C illustrates the Operational Boundary and Authorised Limits.

3. Borrowing Strategy

- 3.1 The Council currently holds £125,872 million of loans, an increase of £16 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 would be expected to borrow £6m in 2019/20 if it used of all its internal resources (i.e. usable reserves and working capital shown in Table 2). However, as the Council will need to maintain investments of at least £10m to remain a Professional Client under MiFID II (see paragraph 6.8), this net borrowing requirement will rise to £16m. The Council may borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £156 million as per the Councils operational boundary and authorised limits (detailed in Appendix C).
- 3.2 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 near term to use internal resources or forward borrowed on a short-term basis (within year only).
- 3.3 **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.
- 3.4 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 2019/20 with a view to keeping future interest costs low, even if this causes additional cost in the short-term. The cost of carry analysis performed by the Council's treasury management advisors Arlingclose has not indicated any value in borrowing in advance for future year's planned expenditure and therefore none has been undertaken.
- 3.5 Alternatively, the Council may arrange forward starting loans during 2019/20, 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.
- 3.6 In addition, the Council may borrow further short-term loans to cover unplanned cash flow shortages.
- 3.7 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
 - any other UK public sector body
 - 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 Council bond issues
- 3.8 In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:
- leasing
 - hire purchase
 - Private Finance Initiative
 - sale and leaseback
- 3.9 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.
- 3.10 **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.
- 3.11 LOBOs: The Council 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 Council 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 2nd November 2019.
- 3.12 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 net interest rate exposure limits in the treasury management indicators below.
- 3.13 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).

4. Investment Strategy

- 4.1 The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past year, the Council's investments balance average at £22 million, and similar levels are expected to be maintained in the forthcoming year.
- 4.2 Both the CIPFA Code requires 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.
- 4.3 If the UK enters into a recession in 2019/20, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.
- 4.4 **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 2019/20. This is especially the case for the estimated £10m that is available for longer-term investment. All of the Council's surplus cash (average £22m) is currently invested in a mixture of short-term secured and unsecured bank deposits, Local Authorities and money market funds. This diversification will represent a substantial change in strategy over the coming year.
- 4.5 **Business models:** Under the new IFRS 9 standard, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.
- 4.6 The Council may invest its surplus funds with any of the counterparty types in table 3 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 3: Approved investment counterparties and limits

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 year	£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	£1m 5 years
None	£1.0m 6 months	n/a	n/a	£0.5m 5 years	£1m 5 years
UK Govt		UK Local Council £2m 2 years (per council)			
Pooled funds		£3m per fund			

This table must be read in conjunction with the notes below

- 4.7 **Credit rating:** Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. 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.
- 4.8 **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.
- 4.9 **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.
- 4.10 **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 generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

- 4.11 **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.
- 4.12 **Registered providers:** Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are tightly regulated by the Regulator of Social Housing and, as providers of public services, they retain the likelihood of receiving government support if needed.
- 4.13 **Pooled funds:** Shares or units in diversified investment vehicles consisting of the 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.
- 4.14 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.
- 4.15 **Operational bank accounts:** The Council may incur operational exposures, for example though 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.
- 4.16 **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.

- 4.17 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.
- 4.18 **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, reports in the quality financial press and analysis and advice from the Council’s treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.
- 4.19 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 to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. 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 but will protect the principal sum invested.

4.20 Investment limits

- 4.21 The Council’s revenue reserves available to cover investment losses are forecast to be £6 million on 31st March 2019. In order that to reduce the 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 £2 million, other than pooled funds for which the limit per fund is £3m and for UK central government where there is no limit. 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: Maximum Investment limits by category

	Cash limit
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	£1.5m per country
Registered providers and registered social landlords	£2m in total
Unsecured investments with building societies	£1.5m in total
Loans to unrated corporates	£1m in total
Money market funds	£12m in total

4.22 Cash Flow/Liquidity management:

4.23 The Council officers maintain a detailed cash flow forecast for each coming year revising it as more information becomes 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. Treasury Management Indicators

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

5.2 **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.

Credit risk indicator	Target
Portfolio average credit rating	A

5.3 **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.

Liquidity risk indicator	Target £m
Liquid short term deposits	£11.000
Bank Overdraft	£0.25

- 5.4 **Interest rate exposures:** This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	Limit £'000
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£15,403
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	(£15,403)

- 5.5 The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

- 5.6 **Maturity structure of borrowing:** This indicator is set to control all the Council's exposure to refinancing risk, both fixed and variable. The upper and lower limits on the maturity structure of borrowing will be:

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	30%	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%

- 5.7 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.

- 5.8 **Principal sums invested for periods longer than a year:** 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:

	2019/20	2020/21	2021/22
Limit on principal invested beyond year end	£12m	£12m	£12m

6. Other Treasury Management issues

- 6.1 The CIPFA Code requires the Council to include the following in its Treasury Management Strategy.

6.2 Policy on use of financial derivatives:

- 6.3 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).

- 6.4 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.
- 6.5 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.
- 6.6 **Policy on apportioning interest the HRA:** On 1st 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 allocated interest between the General Fund and HRA.
- 6.7 **Treasury Management advisors:** The Council's treasury management advisor is Arlingclose Ltd. 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 it treasury officers. The quality of the 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.
- 6.8 **Markets in Financial Instruments Directive (MiFID II):** The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the Chief Financial Officer believes this to be the most appropriate status.

7. Financial Implications

- 7.1 The budget for investment income in 2019/20 is £401 thousand, based on an average investment portfolio of £16 million at an interest rate of 0.6%. The budget for debt interest paid for general fund and HRA in 2019/20 is £3.5 million. Actual levels of investments and borrowing, and actual interest rates are monitored during the year as part of the budget monitoring process.

7.2 Other Options Considered

7.3 The CIPFA Code does 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 and 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

The following provides commentary around the current economic background and interest rate forecast and the potential implications for 2019/20.

The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Council's treasury management strategy for 2019/20.

UK Consumer Price Inflation (CPI) for October was up 2.4% year/year, slightly below the consensus forecast and broadly in line with the Bank of England's November Inflation Report. The most recent labour market data for October 2018 showed the unemployment rate edged up slightly to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pull on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level still likely to have little effect on consumer spending.

The rise in quarterly GDP growth to 0.6% in Q3 from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in Q1. At 1.5%, annual GDP growth continues to remain below trend. Looking ahead, the BoE, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy has been made since. However, the Bank expects that should the economy continue to evolve in line with its November forecast, further increases in Bank Rate will be required to return inflation to the 2% target. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.

While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2%-2.25% in September. Markets continue to expect one more rate rise in December, but expectations are fading that the further hikes previously expected in 2019 will materialise as concerns over trade wars drag on economic activity.

Credit outlook

The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ringfencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ringfenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.

The Bank of England released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and

potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading here. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be very high if ever needed. The uncertainty caused by protracted negotiations between the UK and EU is weighing on the creditworthiness of both UK and European banks with substantial operations in both jurisdictions.

Interest rate forecast

Following the increase in Bank Rate to 0.75% in August 2018, the Council's treasury management adviser Arlingclose is forecasting two more 0.25% hikes during 2019 to take official UK interest rates to 1.25%. The Bank of England's MPC has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

The UK economic environment remains relatively soft, despite seemingly strong labour market data. Arlingclose's view is that the economy still faces a challenging outlook as it exits the European Union and Eurozone growth softens. While assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity (*at the time of writing this commentary in mid-December*). As such, the risks to the interest rate forecast are considered firmly to the downside.

Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on Arlingclose's interest rate projections, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.7% and 2.2% respectively over the interest rate forecast horizon, however volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.

A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix B.

Appendix B

Arlingclose Economic & Interest Rate Forecast December 2018

Underlying assumptions:

- Our central interest rate forecasts are predicated on there being a transitional period following the UK's official exit from the EU.
- The MPC has a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. We believe that MPC members consider that: 1) tight labour markets will prompt inflationary pressure in the future, 2) ultra-low interest rates result in other economic problems, and 3) higher Bank Rate will be a more effective policy weapon if downside risks to growth crystallise.
- Both our projected outlook and the increase in the magnitude of political and economic risks facing the UK economy means we maintain the significant downside risks to our forecasts, despite the potential for slightly stronger growth next year as business investment rebounds should the EU Withdrawal Agreement be approved. The potential for severe economic outcomes has increased following the poor reception of the Withdrawal Agreement by MPs. We expect the Bank of England to hold at or reduce interest rates from current levels if Brexit risks materialise.
- The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in the middle quarters of 2018, but more recent data suggests the economy slowed markedly in Q4. Our view is that the UK economy still faces a challenging outlook as the country exits the European Union and Eurozone economic growth softens.
- Cost pressures are easing but inflation is forecast to remain above the Bank's 2% target through most of the forecast period. Lower oil prices have reduced inflationary pressure, but the tight labour market and decline in the value of sterling means inflation may remain above target for longer than expected.
- Global economic growth is slowing. Despite slower growth, the European Central Bank is conditioning markets for the end of QE, the timing of the first rate hike (2019) and their path thereafter. More recent US data has placed pressure on the Federal Reserve to reduce the pace of monetary tightening – previous hikes and heightened expectations will, however, slow economic growth.
- Central bank actions and geopolitical risks have and will continue to produce significant volatility in financial markets, including bond markets.

Forecast:

- The MPC has maintained expectations of a slow rise in interest rates over the forecast horizon, but recent events around Brexit have dampened interest rate expectations. Our central case is for Bank Rate to rise twice in 2019, after the UK exits the EU. The risks are weighted to the downside.

- Gilt yields have remained at low levels. We expect some upward movement from current levels based on our central case that the UK will enter a transitional period following its EU exit in March 2019. However, our projected weak economic outlook and volatility arising from both economic and political events will continue to offer borrowing opportunities.

	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.17
Arlingclose Central Case	0.75	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.13
Downside risk	0.00	-0.50	-0.75	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-0.85
3-mth money market rate														
Upside risk	0.10	0.10	0.10	0.10	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.17
Arlingclose Central Case	0.90	0.95	1.10	1.30	1.40	1.40	1.40	1.35	1.35	1.35	1.35	1.35	1.35	1.27
Downside risk	-0.20	-0.45	-0.60	-0.80	-0.90	-0.90	-0.90	-0.85	-0.85	-0.85	-0.85	-0.85	-0.85	-0.76
1-yr money market rate														
Upside risk	0.20	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.33
Arlingclose Central Case	1.15	1.25	1.35	1.50	1.70	1.60	1.50	1.40	1.35	1.35	1.35	1.35	1.35	1.40
Downside risk	-0.35	-0.50	-0.60	-0.80	-0.90	-0.90	-0.90	-0.85	-0.85	-0.85	-0.85	-0.85	-0.85	-0.77
5-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.37
Arlingclose Central Case	1.15	1.25	1.35	1.50	1.50	1.40	1.35	1.35	1.30	1.30	1.30	1.30	1.30	1.33
Downside risk	-0.50	-0.60	-0.65	-0.80	-0.80	-0.70	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.66
10-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.37
Arlingclose Central Case	1.50	1.65	1.70	1.80	1.80	1.75	1.75	1.70	1.70	1.70	1.70	1.70	1.70	1.70
Downside risk	-0.55	-0.70	-0.70	-0.80	-0.80	-0.75	-0.75	-0.70	-0.70	-0.70	-0.70	-0.70	-0.70	-0.71
20-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.37
Arlingclose Central Case	2.00	2.10	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.18
Downside risk	-0.60	-0.70	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.73
50-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.37
Arlingclose Central Case	1.90	1.95	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	1.99
Downside risk	-0.60	-0.70	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.73

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%

PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%

Appendix C

Operational Boundary and Authorised Limits

Operational boundary £m	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Debt	£139.000	£149.000	£155.000	£162.000
Other long term liabilities	£2.000	£2.000	£2.000	£2.000
Total	£141.000	£151.000	£157.000	£164.000

Authorised limit £m	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Debt	£144.000	£154.000	£160.000	£167.000
Other long term liabilities	£2.000	£2.000	£2.000	£2.000
Total	£146.000	£156.000	£162.000	£169.000