

## **APPENDIX 1**

### **TREASURY MANAGEMENT STRATEGY – 2017/2018**

#### **Introduction**

In February 2012 the Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice Fully Revised 2011 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year.

In addition, the Department for Communities and Local Government (CLG) issued revised guidance on local authority investments in March 2010 that requires the Council to approve an investment 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 both the CIPFA Code and the CLG Guidance.

The Authority has substantial amounts of borrowing and lending, 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 Authority's treasury management strategy.

Revised strategy: In accordance with the CLG Guidance, the Authority 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, or in the Authority's capital programme or in the level of its investment balance.

#### **Treasury Borrowing Limits for 2017/18 to 2019/20**

It is a statutory duty under s.3 of the Local Government Act 2003, and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. This amount is termed the 'Affordable Borrowing Limit'.

The Council must have regard to the Prudential Code when setting the Affordable Borrowing Limit. The Code requires an authority to ensure that its total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax levels is 'acceptable'.

The Affordable Borrowing Limit must include all planned capital investment to be financed by external borrowing and any other forms of liability, such as credit arrangements. The Affordable Borrowing Limit is to be set on a rolling basis for the forthcoming year and two successive financial years.

## Treasury Management Indicators for 2017/18 – 2019/20

The Council measures and manages its exposures to treasury management risks using the following indicators. The council is asked to approve the following indicators:

### Security: average credit rating

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.

	2017/18
Minimum Portfolio average credit rating	A-

### 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 an amount of net principal borrowed will be:

	2017/18	2018/19	2019/20
Upper limit on fixed interest rate exposures	£306m	£350m	£361m
Upper limit on variable interest rate exposures	£206m	£250m	£262m

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.

### 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:

	Upper	Lower
Under 12 months	50%	0%
12 months and within 24 months	75%	0%
24 months and within five years	75%	0%
Five years and within 10 years	100%	0%
10 years and above	100%	0%

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.

#### 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 proportion of total long-term principal sum invested to final maturities over 364 days will be:

	2017/18	2018/19	2019/20
Limit on proportion of principal invested over 364 days	£50m	£50m	£50m

#### Borrowing limits

The Authorised limits for external debt include current commitments and proposals in the budget report for capital expenditure, plus additional headroom over and above the operational limit for unusual cash movements.

The Operational boundary for external debt is based on the same estimates as the authorised limit but without the additional headroom for unusual cash movements. This level also factors in the proposed approach to use internal cash-flow and future capital receipts as the preferred financing method for the capital programme.

	2017/18	2018/19	2019/20
Operational boundary – borrowing	£306m	£350m	£361m
Operational boundary – other long-term liabilities	<u>£2m</u>	<u>£2m</u>	<u>£2m</u>
<b>Operational boundary – TOTAL</b>	<b>£308m</b>	<b>£352m</b>	<b>£363m</b>
Authorised limit – borrowing	£338m	£382m	£392
Authorised limit – other long-term liabilities	<u>£2m</u>	<u>£2m</u>	<u>£2m</u>
<b>Authorised limit – TOTAL</b>	<b>£340m</b>	<b>£384m</b>	<b>£394m</b>

#### **External Context & Prospects for Interest Rates (from Arlingclose Ltd)**

The Council has appointed Arlingclose as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following section gives their commentary on the economic context and views on the prospects for future interest rates.

**Economic background:** The major external influence on the Authority's treasury management strategy for 2017/18 will be the UK's progress in negotiating a smooth exit from the European Union. Financial markets were wrong-footed by the referendum outcome and have since been weighed down by uncertainty over whether leaving the Union also means leaving the single market. Negotiations are expected to start once the UK formally triggers exit in early 2017 and last for at least two years. Uncertainty over future economic prospects will therefore remain throughout 2017/18.

The fall and continuing weakness in sterling and the near doubling in the price of oil in 2016 have combined to drive inflation expectations higher. The Bank of England is forecasting that Consumer Price Inflation will breach its 2% target in 2017, the first time since late 2013, but the Bank is expected to look through inflation overshoots over the course of 2017 when setting interest rates so as to avoid derailing the economy.

Initial post-referendum economic data showed that the feared collapse in business and consumer confidence had not immediately led to lower GDP growth. However, the prospect of a leaving the single market has dented business confidence and resulted in a delay in new business investment and, unless counteracted by higher public spending or retail sales, will weaken economic growth in 2017/18.

Looking overseas, with the US economy and its labour market showing steady improvement, the market has priced in a high probability of the Federal Reserve increasing interest rates in December 2016 (\*). The Eurozone meanwhile has continued to struggle with very low inflation and lack of momentum in growth, and the European Central Bank has left the door open for further quantitative easing.

The impact of political risk on financial markets remains significant over the next year. With challenges such as immigration, the rise of populist, anti-establishment parties and negative interest rates resulting in savers being paid nothing for their frugal efforts or even penalised for them, the outcomes of Italy's referendum on its constitution (December 2016) (\*), the French presidential and general elections (April – June 2017) and the German federal elections (August – October 2017) have the potential for upsets.

(\*) Updates since Arlingclose drafting i) US interest rates were raised by 0,25% ii) Italy rejected constitutional changes

**Credit outlook:** Markets have expressed concern over the financial viability of a number of European banks recently. Sluggish economies and continuing fines for pre-crisis behaviour have weighed on bank profits, and any future 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. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however continue to fall.

**Interest rate forecast:** The Authority's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.25% during 2017/18. The Bank of England has, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further falls in the Bank Rate look less likely. Negative Bank Rate is

currently perceived by some policymakers to be counterproductive but, although a low probability, cannot be entirely ruled out in the medium term, particularly if the UK enters recession as a result of concerns over leaving the European Union.

Gilt yields have risen sharply, but remain at low levels. The Arlingclose central case is for yields to decline when the government triggers Article 50. Long-term economic fundamentals remain weak, and the quantitative easing (QE) stimulus provided by central banks globally has only delayed the fallout from the build-up of public and private sector debt. The Bank of England has defended QE as a monetary policy tool, and further QE in support of the UK economy in 2017/18 remains a possibility, to keep long-term interest rates low.

### Arlingclose Interest Rate Forecasts

*Arlingclose central interest rate forecast – December 2016*

	Bank Rate	3 month LIBID	12 month LIBID	20-year gilt yield*
Q1 2017	0.25	0.25	0.60	1.70
Q2 2017	0.25	0.25	0.50	1.50
Q3 2017	0.25	0.25	0.50	1.40
Q4 2017	0.25	0.30	0.50	1.40
H1 2018	0.25	0.30	0.50	1.40
H2 2018	0.25	0.30	0.55	1.43
H1 2019	0.25	0.30	0.77	1.53
H2 2019	0.25	0.30	0.90	1.63

\* The Council can currently borrow from the PWLB at 0.80% above gilt yields

The Council has budgeted for investment interest rates that will be made at an average rate of 0.3% for 2017/18 & beyond, reflecting the planned short-term duration of investments.

A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix 3.

## Local Context

### Current Portfolio Position

The Council's treasury portfolio position at 31<sup>st</sup> December 2016 comprised:

	<b>Principal</b>	<b>Ave. rate</b>
	£m	%
<b>External Borrowing</b>		
Fixed rate funding – PWLB	80	3.93
Fixed rate funding – LA's	20	1.16
Variable rate funding – LOBOs	20	4.50*
Other long term liabilities	Nil	N/A
<b>TOTAL GROSS EXTERNAL DEBT</b>	<b>120.0</b>	<b>3.56</b>
<b>Investments</b>		
Short Term Investments	60.1	0.40
Long Term Investments	Nil	N/A
<b>TOTAL INVESTMENTS**</b>	<b>60.1</b>	<b>0.40</b>
<b>NET DEBT</b>	<b>59.9</b>	<b>3.16</b>

\* The market loans are 'lenders options' or LOBO's. These are fixed at a relatively low rate of interest for an initial period but then revert to a higher rate of 4.5%. When the initial period is over the loans are then classed as variable, as the lender has the option to change the interest rate at 6 monthly intervals, however at this point the borrower has the option to repay the loan without penalty.

\*\* Total Investments includes Schools balances where schools have not opted for an external bank account and cash balances related to B&NES CHC Pooled budgets.

## Borrowing Strategy

As at 31<sup>st</sup> December 2016, the Council held £120.0 million of loans, of which £110m were long-term, and we will continue to monitor appropriate opportunities for borrowing in line with the overall Capital Financing Requirement.

The Council's capital financing requirement (CFR, or underlying need to borrow) as at 31<sup>st</sup> March 2017 is expected to be £223 million, and is forecast to rise to £338 million by March 2018 as capital expenditure is incurred.

The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The

flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

The maximum expected long-term borrowing requirement for 2017/18 is:

	£m
Not borrowed in previous years	103
Forecast increase in CFR	115
Loans maturing in 2017/18	0
<b>TOTAL</b>	<b>218</b>

Given the significant cuts to public expenditure and in particular to local government funding, the Authority'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.

By doing so, the Authority is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal borrowing will be monitored regularly against the potential risk for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose will assist the Authority with this 'cost of carry' and breakeven analysis, which may determine whether the Authority borrows additional sums at long-term fixed rates in 2017/18 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

Alternatively, the Authority may arrange forward starting loans during 2017/18, 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.

In addition, the Authority may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages.

#### Sources of borrowing

The approved sources of long-term and short-term borrowing will be:

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments that meets the investment criteria (this includes other local authorities)
- any other bank or building society approved by the Prudential Regulation Authority to operate in the UK
- UK public and private sector pension funds (except the Avon Pension Fund)
- Capital market bond investor
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

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

The Authority has previously raised the majority of its long-term borrowing from the Public Works Loan Board, 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.

**LGA Bond 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 may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans; 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 subject to specific approval in accordance with the Council's appropriate delegation.

The Authority holds £20m 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. All of these LOBOS have options during 2017/18, and although the Authority understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Authority will take the option to repay LOBO loans at no cost if it has the opportunity to do so.

Short-term and variable rate loans leave the Authority 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.

### Debt Rescheduling

The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Some bank lenders may also be prepared to negotiate premature redemption terms. The Authority may take advantage of this and



replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall saving or reduction in risk.

#### Policy on use of Financial Derivatives

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).

The Authority 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 Authority 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.

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.

#### Derivative counterparties

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.