

APPENDIX 1

TREASURY MANAGEMENT STRATEGY – 2018/2019

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.

CIPFA issued an updated Treasury Management in Public Services: Code of Practice in late December 2017 and the code will be effective for the 2018/19 Financial Year.

The Arlingclose advice received has been that Local authorities are legally obliged to "have regard" to the Treasury Management Code and the Prudential Code "as amended or reissued from time to time" by relevant Capital Finance Regulations. The Council is awaiting publication, expected later in 2018, by CIPFA of the associated new Treasury Management Code Guidance Notes which will include the Treasury Management indicators, and new DCLG Investment Guidance, so it can fully consider any changes that may be required to the treasury management strategy.

The advice received is therefore to continue to obtain full council approval for the 2018/19 Treasury Management Strategy under the requirements of the 2011 Codes, not least because the new code does not recommend any changes to the format or content of the TMS. If any updates are required once further guidance notes are published these will be reported in future treasury management reports.

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. Other than code changes, other 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 2018/19 to 2020/21

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 2018/19 – 2020/21

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.

	2018/19
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:

	2018/19	2019/20	2020/21
Upper limit on fixed interest rate exposures	£403m	£442m	£451m
Upper limit on variable interest rate exposures	£246m	£285m	£294m

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:

	2018/19	2019/20	2020/21
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.

	2018/19	2019/20	2020/21
Operational boundary – borrowing	£403	£442m	£451m
Operational boundary – other long-term liabilities	<u>£2m</u>	<u>£2m</u>	<u>£2m</u>
Operational boundary – TOTAL	£405m	£444m	£453m
Authorised limit – borrowing	£434m	£473m	£481m
Authorised limit – other long-term liabilities	<u>£2m</u>	<u>£2m</u>	<u>£2m</u>
Authorised limit – TOTAL	£436m	£475m	£483m

External Context & Prospects for Interest Rates (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 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 Authority; returns from cash deposits however remain very low.

Interest rate forecast: The Authority’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 ongoing 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.

Arlingclose Interest Rate Forecasts

Arlingclose central interest rate forecast – November 2017

	Bank Rate	3 month LIBID	12 month LIBID	20-year gilt yield*
Q1 2018	0.50	0.50	0.70	1.85
Q2 2018	0.50	0.50	0.70	1.85
Q3 2018	0.50	0.50	0.70	1.85
Q4 2018	0.50	0.50	0.70	1.85
H1 2019	0.50	0.50	0.80	1.87
H2 2019	0.50	0.50	0.80	1.92
H1 2020	0.50	0.50	0.80	1.97
H2 2020	0.50	0.50	0.80	2.05

*

The Council can currently borrow from the PWLB at 0.60% above gilt yields

The Council has budgeted for investment interest rates will be made at an average rate of 0.45% for 2018/19 & beyond, reflecting the planned short-term duration of investments.

A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix 4.

Local Context

Current Portfolio Position

The Council's treasury portfolio position at 31st December 2017 comprised:

	Principal	Ave. rate
	£m	%
External Borrowing		
Fixed rate funding – PWLB	124.4	3.36%
Fixed rate funding – LA's	32.5	1.0%
Variable rate funding – LOBOs *	20.0	4.50*%
Other long term liabilities	Nil	N/A
TOTAL GROSS EXTERNAL DEBT	176.9	3.06%
Investments		
Short Term Investments	29.3	0.31%
Long Term Investments	0	
TOTAL INVESTMENTS**	29.3	0.31%
NET DEBT	147.6	3.61%

* These market loans are 'Lenders Options, Borrow Options' or LOBO's. They were taken out on October 2004 and April 2005 and were fixed at a relatively low rate of interest for an initial period and are now payable at 4.5%. The loans are classed as variable, as the lender has the option to change the interest rate at 6 monthly intervals, however at this point the borrower also has the option to repay the loan without penalty.

** Total Investments includes Schools balances where schools have not opted for an external bank account.

Borrowing Strategy

As at 31st December 2017, the Council held £176.9 million of long-term loans, 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 31st March 2018 is expected to be £282 million, and is forecast to rise to £434 million by March 2019 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 2018/19 is:

	£m
Not borrowed in previous years	105
Forecast increase in CFR	152
Loans maturing in 2018/19	19
TOTAL	276

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 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. Its output may determine whether the Authority 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.

Alternatively, the Authority 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.

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 as 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 2018/19, 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.