Treasury Management Strategy Report 2017/18

Summary
Report for Executive to consider and recommend to Council the treasury strategy for 2017/18

Portfolio - Finance
Date Portfolio Holder signed off report: 18 January 2017 (by the Leader)

Wards Affected All

Recommendation
The Executive is advised to approve and recommend to Council the adoption of the following:

(i) The Treasury Management Strategy for 2017/18.

(ii) The Treasury Management Indicators for 2017/18 at Annex A.

(iii) The Minimum Revenue Provision policy statement and estimated minimum revenue provision payment table at Annex F.

1. Resource Implications

1.1. The budget for investment income in 2017/18 is £300,000 based on an average investment portfolio of £25 million at an interest rate of 1.2%. The budget for external debt interest paid in 2017/18 is £2.8m, based on an average debt portfolio of £124 million at an average interest rate of 2%. If actual levels of investments, borrowing and interest rates differ from those forecast, this will affect actual performance against budget.

1.2. Funding for the proposed corporate capital programme for 2017/18 – 2019/20 will need to be funded by borrowing or out of revenue due as the Council does not hold any capital receipts.

1.3. Any changes to levels of investments and borrowing, or to the interest rates forecast in this report and which result in changes to the approved treasury management indicators will be reflected in relevant future reports for Executive and Council to consider.

2. Key Issues

2.1. Treasury Management is “the management of the Council’s cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks”.

2.2. The Council’s investment portfolio comprises of funds available for longer-term investment, and short term investments sufficient to meet cash flow requirements. Investment income is a significant source of income which is used to maintain services.

2.3. On 22nd February 2013 the Authority adopted the Chartered Institute of Public Finance and Accountancy’s Treasury Management in the Public Services: Code of Practice 2011 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year.

2.4. In addition, the Department for Communities and Local Government (CLG) issued revised Guidance on Local Authority Investments in March 2010 that requires the Authority to approve an investment strategy before the start of each financial year.

2.5. This report fulfils the Authority’s legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Guidance.

2.6. The Authority has 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 risk are therefore central to the Authority’s treasury management strategy.

2.7. 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.

3. Options

3.1. The Executive can receive or amend the report, or ask for further information.

3.2. The Executive can approve or amend the proposed recommendations to Council.

4. Proposals

4.1. The Executive is asked to approve and recommend to Council the adoption of:
a) The Treasury Management Strategy for 2017/18 at Annex B.
b) The Treasury Management Indicators for 2017/18 at Annex C.
c) The minimum revenue provision policy statement at Annex F which is unchanged from that approved by the Executive on 9th February 2016.

5. Supporting Information

5.1. External Context

The Council's treasury management advisors Arlingclose Limited have advised us of their assessment of the external context the council's investment strategy needs to consider in terms of the economy, interest rates and credit outlook. This is shown below:

5.2. 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, wrong-footed by the referendum outcome, 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.

5.3. 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.

5.4. 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.

5.5. 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.

5.6. 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.

5.7. 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.

5.8. 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.

5.9. 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.

5.10. 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.

5.11. A more detailed economic and interest rate forecast provided by Arlingclose is attached at Annex A.

5.12. For the purpose of setting the budget, it has been assumed that no new investments will be made and that new long-term loans will be borrowed at an average rate of 2%.

Local Context

5.13. The budget for investment income for 2017/18 is £300k based on the current investment strategy and the one proposed. However this level of income is not guaranteed as it depends on the performance of the markets and the world economy.

5.14. The Council currently has £131m of external borrowing and £35 million of investments (as at 31st December 2016) as set out in Annex E.

Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance Sheet Summary and Forecast

	31.3.16 Actual £m	31.3.17 Estimate £m	31.3.18 Forecast £m	31.3.19 Forecast £m	31.3.20 Forecast £m
Borrowing CFR	18	138	135	133	132
Less: External borrowing	-18	-131	-130	-128	-126
Internal borrowing	**0**	**7**	**5**	**5**	**6**
Less: Usable reserves	20	20	19	18	17
Less: Working Capital	6	6	6	6	6
Investments	**26**	**19**	**16**	**19**	**17**

5.15. 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, subject to holding a minimum of £5million. However the Council will also borrow externally if there is a sound business case for doing so.

5.16. The Authority has a falling CFR due to repayments of debt however this could increase significantly if further investment in property is undertaken.

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 1 shows that the Authority expects to comply with this recommendation during 2017/18.

Borrowing Strategy

5.17. The Authority currently holds £131 million of loans, an increase of £114 million on the previous year, as part of its strategy for funding and acquiring property. The balance sheet forecast in table 1 shows that the Authority expects to borrow up to £4m in 2017/18. The Authority may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £167 million.

5.18. Objectives:
The Authority'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. The flexibility to renegotiate loans should the Authority's long-term plans change is a secondary objective.

5.19. Strategy:
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. The Council has fixed some of its borrowing for the longer term to give certainty of cost. On the advice of its treasury advisors, the Council will continue to borrow in the short term. The policy will be kept under review during the year.

5.20. By doing so, the Authority 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 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 2017/18 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

5.21. 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.

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

Sources:

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 Surrey Pension Fund)
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues
- Local Enterprise Partnership

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 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. As at 31st December 2016, the Council has borrowed £16.2m from the PWLB, £1.1m from the M3 LEP and £114m from local authorities.

5.23. <u>Municipal Bond Agency</u>**:**
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.

5.24. <u>Short-term and Variable Rate loans:</u>
These 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.

5.25. <u>Debt Rescheduling</u>:
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. Other 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 cost saving or a reduction in risk.

5.26. Annual Minimum Revenue Provision (MRP) Statement

When a Council borrows, it is required to indicate how it intends to fulfil its duty to make prudent provision for the repayment of the capital borrowed from revenue. This provision is called the Minimum Revenue Payment or MRP. Best practice guidance recommends that Councils prepare a statement of policy on making MRP in respect of the forthcoming financial year. The Council's MRP statement was approved by the Executive on 9th February 2016.

The recommended policy is attached in Annex F.

The forecast MRP is shown in the table below:

	2016/17	**2017/18**	**2018/19**	**2019/20**
	£m	£m	£m	£m
Forecast MRP	0.2	1.4	1.7	1.7

Investment Strategy

5.27. The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's investment balance has ranged between £26million and £40million, but these levels are expected to decrease based on the expected low returns in 2017/18.

5.28. Objectives**:**
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 Authority'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. The Council will consider reducing its investments to minimise net borrowing costs.

5.29. Negative Interest Rates**:**
If the UK enters into a recession in 2017/18, 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.

5.30. Strategy:

Given the increasing risk and falling returns from short-term unsecured bank investments, the Authority aims to remain diversified into higher yielding asset classes during 2017/18. This is especially the case for the estimated £8m that is available that is available for longer-term investment which has been invested in to Corporate Bond, Equity and Property Funds. The remainder of the Authorities surplus cash is currently invested in short-term unsecured bank deposits, Loans to other Councils and money market funds. No changes are proposed to the 2016/17 investment strategy for 2017/18.

5.31. Approved Counterparties**:**

The Authority may invest its surplus funds with any of the counterparty types in the table 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	Building Societies	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£2m 5 years	£3m 10 years	£2m 3 years	n/a	£2m 20 years	£2m 20 years
AA+	£2m 5 years	£3m 10 years	£2m 3 years	n/a	£2m 10 years	£2m 10 years
AA	£2m 4 years	£3m 5 years	£2m 3 years	n/a	£2m 5 years	£2m 10 years
AA-	£2m 3 years	£3m 4 years	£2m 3 years	n/a	£2m 4 years	£2m 10 years
A+	£2m 2 years	£3m 3 years	£2m 2 years	n/a	£2m 3 years	£2m 5 years
A	£2m 13 months	£3m 2 years	£2m 12 months	n/a	£1m 2 years	£2m 5 years
A-	£2m 6 months	£3m 13 months	£1m 6 months	n/a	£1m 13 months	£2m 5 years
BBB+	£3m next day only	£3m 6 months	£1m 100 days	n/a	n/a	£1m 2 years
None	£1m 6 months	n/a	£1m 6 months	n/a	n/a	n/a
Pooled funds	£2m per fund					
Challenger Banks	£1m for 6 months					
Supranational Banks	£3m for up to 5 years where rated A or above					
UK Local Councils	£2m per authority for up to 5 years					

This table must be read in conjunction with the notes below

5.32. 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.

5.33. Banks Unsecured:
Accounts, deposits, certificates of deposit and senior unsecured bonds with 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. Unsecured investments with banks rated BBB+ are restricted to overnight deposits at the Authority’s current account bank NatWest Bank.

5.34. Banks Secured:
Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks. 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 highest 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.

5.35. Building Societies

Covered Bonds, accounts and deposits with Building Societies. The Council invests with unrated building societies where independent credit analysis shows them to be suitably creditworthy. In respect of insolvency Building societies are now treated the same as banks and there is no preferential treatment for depositors.

5.36. Government:

Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities. 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.

5.37. 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 as part of a diversified pool in order to spread the risk widely.

5.38. 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.

5.39. 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.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority 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 Authority's investment objectives will be monitored regularly.

5.40. Challenger Banks

Loans, covered bonds and deposits placed in unrated challenger 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. The strategy has been changed on the advice of our advisors to bring the investment period in to line with unrated building societies. i.e. from £2m for 1 year to £1m for 6 months. The Council currently has no investments with Challenger Banks.

5.41. Supranational Banks

Loans bonds and bills issued or guaranteed by Supranational Banks such as the European Investment Bank, European central bank etc. These investments are not subject to bail-in, and there is an insignificant risk of insolvency.

5.42. UK Local Authorities

Loans to UK local authorities and statutory bodies whether credit rated or not.

5.43. Risk Assessment and Credit Ratings:

Credit ratings are obtained and monitored by the Authority'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.

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 only investments that can be withdrawn on the next working day 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.

5.44. Other Information on the Security of Investments:

The Authority 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 credit rating criteria.

When deteriorating 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 Authority 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 to invest the Authority’s cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

5.45. 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”.

5.46. The Authority defines “high credit quality” organisations and securities as those having a credit rating of A- or higher that are domiciled in the UK. For money market funds and other pooled funds “high credit quality” is defined as those having a credit rating of A- or higher.

5.47. Non-specified Investments:
Any investment not meeting the definition of a specified investment is classed as non-specified. The Authority 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 the table below.

Non-Specified Investment Limits

	Cash limit
Total long-term investments	£15m
Total investments without credit ratings or rated below A-	£10m
Total investments (except pooled funds) with institutions domiciled in foreign countries rated	£10m
Total non-specified investments	£35m

5.48. Investment Limits:

The Authority’s revenue reserves available to cover investment losses are forecast to be £15 million on 31st March 2017. In order that no more than 20% of available reserves will be put at 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.

Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£3m each
UK Central Government	Unlimited

Any group of organisations under the same ownership	£3m per group
Any group of pooled funds under the same management	£5m per manager
Negotiable instruments held in a broker's nominee account	£10m per broker
Registered Providers	£5m in total
Unsecured investments with Building Societies	£5m in total
Loans to unrated corporates	£2m in total
Money Market Funds	£10m in total

5.49. Liquidity Management:
The Authority uses purpose-built cash flow forecasting spreadsheets to determine the maximum period for which funds may prudently be committed.

6. **Other Items**

6.1. There are a number of additional items that the Council is obliged by CIPFA or CLG to include in its treasury management strategy. These are shown in Annex B.

7. Treasury Management Indicators

7.1. The Council measures and manages its exposures to treasury management risks using a range of indicators which members are asked to approve. These are set out at Annex C.

8. Corporate Objectives and Key Priorities

8.1. The Treasury Management supports the Council's Key Priority 2.

9. Policy Framework

9.1. The Council fully complies with the requirements of the CIPFA Code of Practice on Treasury Management. The current relevant criteria and constraints incorporated into the Treasury Management Policy Statement are:

a. New borrowing is to be contained within the limits approved by the Council, in accordance with the CIPFA Prudential Code for Capital Finance in Local Authorities, and the Council's prudential indicators.

b. Investments to be made in accordance with the CLG guidance on Local Council Investments, on the basis of Fitch, Moody's and Standard &

Poors credit ratings for rated institutions and as detailed in the Treasury Management Policy statement and approved schedules and practices.

c. Sufficient funds to be available to meet the Council's estimated outgoings for any day.

d. Investment objectives are to maximise the return to the Council, subject to the overriding need to protect the capital sum.

e. The Council's response to interest rate changes is to minimise the net interest rate burden on borrowing and maximise returns from investments, subject to (a-d) above.

10. **Legal Issues**

10.1. These are addressed in the report and relate to a requirement to set and agree both a treasury management strategy and prudential indicators.

11. **Governance Issues**

11.1. The recommendations address best practice and are required as part of the CIPFA code.

12. **Sustainability**

12.1. None

13. Risk Management

13.1. Poor returns on investments could lead to a reduction in income required to support the revenue budget.

13.2. The limits proposed in this report in respect to counterparties and investments are the overall limits for agreement by Council. However from time to time these may be tightened temporarily by the Executive Head of Finance in consultation with the portfolio holder for Resources to reflect increased uncertainty and increase in perceived risk in financial institutions and the economy. This will usually be at the cost of lower returns.

13.3. The investments ratings provided by credit ratings agencies are only a guide and do not give 100% security. There is always a risk that an institution may be unable to repay its loans whatever the credit rating.

14. **Consultation**

14.1. The Council's treasury advisors have been consulted on the treasury strategy.

15. **Officer Comments**

15.1. Included within the paper.

Annexes	Annex A – Arlingclose Economic and Interest Rate Forecast November 2016 Annex B – 2017/18 Other Items - Treasury Management Strategy Annex C – 2017/18 Treasury Management Indicators Annex D – Investments as at 31 December 2016 Annex E – Existing Investment and Debt Portfolio Annex F – Minimum Revenue Policy (MRP) Statement
Background Papers	CIPFA Code of Practice: Treasury Management in the Public Services – 2011 Edition
Author/Contact Details	Nahidah Cuthbert 01276 707260 nahidah.cuthbert@surreyheath.gov.uk
Head of Service	Kelvin Menon - Executive Head of Finance

Consultations, Implications and Issues Addressed

Resources	**Required**	**Consulted**
Revenue	✓	
Capital		
Human Resources		
Asset Management		
IT		
Other Issues	**Required**	**Consulted**
Corporate Objectives & Key Priorities	✓	
Policy Framework		
Legal		
Governance		
Sustainability		
Risk Management		
Equalities Impact Assessment		
Community Safety		
Human Rights		
Consultation		
P R & Marketing		

Annex A

Arlingclose Economic & Interest Rate Forecast November 2016

Underlying assumptions:

- The medium term outlook for the UK economy is dominated by the negotiations to leave the EU. The long-term position of the UK economy will be largely dependent on the agreements the government is able to secure with the EU and other countries.
- The global environment is also riddled with uncertainty, with repercussions for financial market volatility and long-term interest rates. Donald Trump's victory in the US general election and Brexit are symptomatic of the popular disaffection with globalisation trends. The potential rise in protectionism could dampen global growth prospects and therefore inflation. Financial market volatility will remain the norm for some time.
- However, following significant global fiscal and monetary stimulus, the short term outlook for the global economy is somewhat brighter than earlier in the year. US fiscal stimulus is also a possibility following Trump's victory.
- Recent data present a more positive picture for the post-Referendum UK economy than predicted due to continued strong household spending.
- Over the medium term, economic and political uncertainty will likely dampen investment intentions and tighten credit availability, prompting lower activity levels and potentially a rise in unemployment.
- The currency-led rise in CPI inflation (currently 1.0% year/year) will continue, breaching the target in 2017, which will act to slow real growth in household spending due to a sharp decline in real wage growth.
- The depreciation in sterling will, however, assist the economy to rebalance away from spending. The negative contribution from net trade to GDP growth is likely to diminish, largely due to weaker domestic demand. Export volumes will increase marginally.
- Given the pressure on household spending and business investment, the rise in inflation is highly unlikely to prompt monetary tightening by the Bank of England, with policymakers looking through import-led CPI spikes to the negative effects of Brexit on economic activity and, ultimately, inflation.
- Bank of England policymakers have, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further monetary loosening looks less likely.

Forecast:

- Globally, the outlook is uncertain and risks remain weighted to the downside. The UK domestic outlook is uncertain, but likely to be weaker in the short term than previously expected.
- The likely path for Bank Rate is weighted to the downside. The Arlingclose central case is for Bank Rate to remain at 0.25%, but there is a 25% possibility of a drop to close to zero, with a very small chance of a reduction below zero.
- 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.

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Average
Official Bank Rate														

Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	**0.12**
Arlingclose Central Case	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Downside risk	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	**0.40**
3-month LIBID rate														
Upside risk	0.05	0.05	0.10	0.10	0.10	0.15	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.18**
Arlingclose Central Case	**0.25**	**0.25**	**0.25**	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**0.30**	**0.29**
Downside risk	0.20	0.25	0.25	0.25	0.30	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.34**
1-yr LIBID rate														
Upside risk	0.10	0.10	0.15	0.15	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	**0.23**
Arlingclose Central Case	**0.60**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.60**	**0.70**	**0.85**	**0.90**	**0.90**	**0.90**	**0.65**
Downside risk	0.10	0.15	0.15	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	**0.24**
5-yr gilt yield														
Upside risk	0.25	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.39**
Arlingclose Central Case	**0.50**	**0.40**	**0.35**	**0.35**	**0.35**	**0.40**	**0.40**	**0.40**	**0.45**	**0.50**	**0.55**	**0.60**	**0.65**	**0.45**
Downside risk	0.30	0.45	0.45	0.45	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	**0.47**
10-yr gilt yield														
Upside risk	0.30	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.39**
Arlingclose Central Case	**1.15**	**0.95**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.90**	**0.95**	**1.00**	**1.05**	**1.10**	**1.15**	**0.96**
Downside risk	0.30	0.45	0.45	0.45	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	**0.47**
20-yr gilt yield														
Upside risk	0.25	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.39**

Arlingclose Central Case	**1.70**	**1.50**	**1.40**	**1.40**	**1.40**	**1.40**	**1.40**	**1.45**	**1.50**	**1.55**	**1.60**	**1.65**	**1.70**	**1.75**
Downside risk	0.40	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	**0.57**
50-yr gilt yield														
Upside risk	0.25	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.39**
Arlingclose Central Case	**1.60**	**1.40**	**1.30**	**1.30**	**1.30**	**1.30**	**1.30**	**1.35**	**1.40**	**1.45**	**1.50**	**1.55**	**1.60**	**1.41**
Downside risk	0.40	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	**0.57**

Annex B

<u>Other Items</u>

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

1. **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.
2. **Investment Training:** The needs of the Council's treasury management staff for training in investment management are assessed 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.
3. **Investment Advisers:** The Council has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues
4. **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 Authority 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 Authority's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £167 million. The maximum period between borrowing and expenditure is expected to be two years, although the Authority is not required to link particular loans with particular items of expenditure.

5. **Other Options Considered**

The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer, having consulted the Portfolio Member, 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
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

Annex C

Treasury Management Indicators for 2017/18

1. The Council measures its exposures to treasury management risks using the following indicators. The Council is asked to approve the following indicators:
2. Security: average credit rating
   The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the weighted average credit rating of its investment portfolio.

	Target
Portfolio average credit rating	A

   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. For the purpose of this indicator, unrated building societies are assigned an indicative rating of BBB, and unrated local authorities are assumed to hold AA+ rating.

3. Liquidity: cash available within three months
   The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	Target
Total cash available within 3 months	£5m

4. Interest Rate Exposures:
   This indicator is set to control the Authority'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 exposure	£167m	£167m	£167m
Upper limit on variable interest rate exposure	£167m	£167m	£167m

   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.
5. Maturity Structure of Borrowing**:**
   This indicator is set to control the Authority'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	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 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.

6. Principal Sums Invested for Periods Longer than 364 days**:**
The purpose of this indicator is to control the Authority'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:

	2017/18	2018/19	2019/20
Limit on principal invested beyond year end	£15m	£15m	£15m

Annex D

INVESTMENTS as at 31st December 2016

	£
Lloyds Bank Call Account	600,000
Goldman Sachs Bank	2,000,000
National Counties Building Society	2,000,000
Nationwide Building Society	2,000,000
Total Building Society	**6,600,000**
Debt Management Office	3,000,000
Total Banks, Building Societies and DMO	**9,600,000**
Glasgow City Council	2,000,000
Greater London Authority	2,000,000
The London Borough of Islington	2,000,000
Total Local Authorities	**6,000,000**
AAA Rated MM Fund - Aberdeen (SWIP)	2,987,703
AAA Rated MM Fund - Insight	1,013,090
AAA Rated MM Fund - Standard Life (Ignis)	3,000,000
AAA Rated MM Fund - Blackrock	2,900,000
Total Money Market Funds	**9,900,793**
CCLA Property Fund	2,050,498
M & G Investments - Global Dividend Fund	1,140,155
M & G Investments - Strategic Corp Bond Fund	2,032,011
Threadneedle - Global Equity Income Fund	1,183,752
Threadneedle - Strategic Bond Fund	1,974,796
Total Longer Term Investments	**8,381,212**
Total Invested (excluding the NatWest SIBA)	**33,882,006**
NatWest SIBA	996,109
NatWest International Account	616,910
Total Invested (including NatWest SIBA)	**£35,495,025**

Annex E

Existing Investment & Debt Portfolio Position

	31-Dec-16 Actual Portfolio £m	31-Dec-16 Average Rate %
External Borrowing:		
Public Works Loan Board - Long Term	16	2.9%
Local authorities - Short Term	115	0.3%
Total Gross External Debt	**131**	**0.6%**
Investments:		
Banks & Building societies	8	0.2%
Government (incl. local authorities)	9	0.6%
Money Market Funds	10	0.5%
Other Pooled Funds	8	3.8%
Total Investments	**35**	**1.2%**
Net Debt	**95**	**0.4%**

Annex F

Minimum Revenue Policy (MRP) Statement

1. The Secretary of State under section 21(1A) of the Local Government Act 2003 issued guidance on the calculation of MRP in February 2008 with 2008/09 being the first year of operation. The Council has assessed its method of MRP and is satisfied that the guidelines for its annual amount of MRP set out within this policy statement will result in its making the prudent provision that is required by the guidance.

2. For capital expenditure incurred and funded through borrowing the Council will calculate MRP using the asset life method as summarised in the table below. MRP will be based on the estimated life of the assets purchased by unsupported borrowing.

Estimated economic lives of assets Asset Class	**Estimated economic life**
Land and heritage assets	50 years
Buildings for services	40 years
Vehicles and Plant	10 years
IT equipment and software	5 years
Investment property	50 years
Property for regeneration	0% until development complete

3. The Council will aim to minimise the impact of MRP on the General Fund by funding assets with a longer economic life from borrowing in the first instance.

4. In accordance with provisions in the guidance MRP will be charged in the year following the date an asset becomes operational.

5. The Council reserves the right to determine alternative MRP approaches in particular cases in the interests of making prudent provision where this is material, taking in to account local circumstances, including specific project timetables and revenue earning profiles.

6. The forecast MRP is shown in the table below:

	2016/17	**2017/18**	**2018/19**	**2019/20**
	£m	£m	£m	£m
Forecast MRP	0.2	1.4	1.7	1.7