REPORT TITLE: TREASURY MANAGEMENT STRATEGY 2017/18

CABINET

8 FEBRUARY 2017

THE OVERVIEW AND SCRUTINY COMMITTEE

13 FEBRUARY 2017

PORTFOLIO HOLDER: CLLR STEPHEN GODFREY (PORTFOLIO HOLDER FOR FINANCE)

REPORT OF HEAD OF FINANCE

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WARD(S): ALL WARDS

PURPOSE

This report sets out the proposed Treasury Management Strategy, the Annual Investment Strategy, the Prudential Indicators and the Minimum Revenue Provision Policy Statement for the Council for 2016/17.

The Treasury Management training offered to all Members in November provided an update on Treasury Management considerations which are reflected in this Strategy.

RECOMMENDATIONS: to Cabinet and Council:

1. That the Treasury Management Strategy Statement (TMSS) 2017/18 as set out in this report be approved and implemented from the date of the Council meeting, and also the following individual items as included in the TMS:

   - Annual Borrowing Strategy 2017/18 (see paragraph 12);
   - Annual Investment Strategy 2017/18 (see paragraph 13);
   - Prudential Indicators 2017/18 to 2019/20 (see Annex C);
   - Minimum Revenue Provision (MRP) Policy Statement (see Annex D).

2. Note that the Treasury Management Strategy be kept under regular review to take account of any changes in the current global economic situation.

To the Overview and Scrutiny Committee:

1. That the Committee considers whether it wishes to make any observations or recommendations to Council on the report.

IMPLICATIONS:

1 COMMUNITY STRATEGY OUTCOME

1.1 Treasury management is part of being an Efficient and Effective Council.

2 FINANCIAL IMPLICATIONS

2.1 Effective treasury management ensures both the financial security and liquidity of the Council.

3 LEGAL AND PROCUREMENT IMPLICATIONS

3.1 None

4 WORKFORCE IMPLICATIONS

4.1 None

5 PROPERTY AND ASSET IMPLICATIONS

5.1 None

6 CONSULTATION AND EQUALITY IMPACT ASSESSMENT

6.1 None

7 RISK MANAGEMENT

7.1 The main risks covered are:

- Credit Risk: the possibility that the counterparty to a financial asset will fail to meet its contractual obligations, causing a loss to the Council.
- Liquidity Risk: the possibility that the Council might not have the cash available to make contracted payments on time.

- Market Risk: the possibility that an unplanned financial loss will materialise because of changes in market variables such as interest rates or equity prices
- Reputational Risk: the possibility that decisions taken will impact on the reputation of the Council

Risk	**Mitigation and opportunities**
Credit Risk	
A counterparty to a financial asset will fail to meet its contractual obligations, causing a loss to the Council	The Council manages credit risk by ensuring that investments are only placed with organisations of high credit quality as set out in the Treasury Management Strategy. These include commercial entities with a minimum long-term credit rating of BBB+, the UK government, other local authorities and organisations without credit ratings upon which the Council has received independent investment advice. Recognising that credit ratings are imperfect predictors of default, the Council has regard to other measures including credit default swap and equity prices when selecting commercial organisations for investment. A limit of £7 million of the total portfolio is placed on the amount of money that can be invested with a single counterparty (other than the UK government). The Council also sets limits on investments in certain sectors. No more than £25 million can be invested for a period longer than one year. The Council's maximum exposure to credit risk in relation to its investments in banks, building societies cannot be assessed generally as the risk of any institution failing to make interest payments or repay the principal sum will be specific to each individual institution. Recent experience has shown that it is rare for such entities to be unable to meet their commitments. A risk of irrecoverability applies to all of the Council's deposits, but there was no evidence that this was likely to crystallise. The credit quality of the Council's investments is enhanced by collateral held in the form of covered bonds collateralised by UK residential mortgages. The collateral significantly reduces the likelihood of the Council suffering a credit loss on these investments.

Risk	Mitigation and Opportunities
Liquidity Risk	
The Council might not have the cash available to make contracted payments on time.	The Council has ready access to borrowing at favourable rates from the Public Works Loan Board and other local authorities, and at higher rates from banks and building societies. There is no perceived risk that the Council will be unable to raise finance to meet its commitments. It is however exposed to the risk that it will need to refinance a significant proportion of its borrowing at a time of unfavourably high interest rates. This risk is managed by maintaining a spread of fixed rate loans and ensuring that a significant proportion does not mature in any one financial year. More accurate and immediate cash flow forecasting can help improve the return on investments through more active treasury management activity
Market Risk	*Split between Interest Rate and Price Risk as set out below*
Interest Rate Risk	The Council is exposed to risk in terms of its exposure to interest rate movements on its borrowings and investments. Movements in interest rates have a complex impact on the authority. For instance, a rise in: • Borrowings at variable rates – the interest expense will rise • Borrowings at fixed rates – the fair value of the liabilities borrowings will fall • Investments at variable rates – the interest income credited will rise • Investments at fixed rates – the fair value of the assets will fall. Investments classed as “loans and receivables” and loans borrowed are not carried at fair value, so changes in their fair value will have no impact on Comprehensive Income and Expenditure. However, changes in interest payable and receivable on variable rate borrowings and investments will be posted to the Surplus or Deficit on the Provision of Services. Movements in the fair value of fixed rate investments classed as “available for sale” will be reflected in Other Comprehensive Income and Expenditure.

	The Treasury Management Strategy aims to mitigate these risks by setting upper limits on its net exposures to fixed and variable interest rates. The entire net principal borrowed (i.e. debt net of investments) is exposed to fixed rates. The Council's investments with less than one year to maturity; floating rate notes held with more than one year to maturity; and pooled property are classed as being held at variable rates and exposed to interest rate risk. If all interest rates had been 1.0% higher (with all other variables held constant) the financial effect would be: • Increase interest receivable on variable rate investment (£411,000) • Impact on the surplus or deficit on the Provision of Services (£411,000) • Decrease in fair value of available for sale financial assets £21,000 • Impact on Comprehensive Income and Expenditure £21,000 The approximate impact of a 1.0% fall in interest rates would be as above but with the movements reversed.
Price Risk	The market prices of the Council's fixed rate bond investments are governed by prevailing interest rates and the market risk associated with these instruments is managed alongside interest rate risk. The Council's investment in a pooled property fund is subject to the risk of falling commercial property prices. The risk is limited by the Council's investment strategy. A fall in commercial property prices would result in a charge to Other Comprehensive Income and Expenditure – this would have no impact on the General Fund until the investment was sold.
Reputational Risk	When managing treasury and investment activity the Council is mindful of the reputational risk attached to the decision making process. By taking a diversified strategy with strong controls the Council also seeks to demonstrate prudent management of public monies. The application of this strategy and the monitoring of its application by the Audit Committee seek to protect the liquidity and financial sustainability of the Council, and hence it's reputation.

8 SUPPORTING INFORMATION:

Introduction

8.1 Winchester City Council follows the Department for Communities and Local Government (CLG) revised Guidance on Local Authority Investments issued in March 2010, approving an investment strategy before the start of each financial year. In February 2012 the Council 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 Council to approve a treasury management strategy; the investment strategy is embedded within this document.

8.2 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.

8.3 Treasury management is focussed on the liquidity of the Council and is tailored to ensure that the Council is in a position to meet all of its financial commitments in a timely manner. Investment management concerns itself with more long term returns, balancing the risks and rewards implicit in those returns, ensuring that all such investments are within the Council's risk tolerances, including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's Treasury Management Strategy.

8.4 With effect from September 2014 Hampshire County Council (HCC) and Winchester City Council (WCC) established arrangements for the joint discharge of functions under Section (101)(1) and (5) of the Local Government Act 1972 and Section 9EA and 9EB Local Government Act 2000. Under this arrangement HCC's Investments and Borrowing Team provide a Treasury Service which includes the management of WCC's cash balances and the investment of surplus cash or sourcing of short-term borrowing in accordance with the agreed Treasury Management Strategy Statement.

9 External Context

9.1 The following paragraphs explain the economic and financial background against which the Treasury Management Strategy is being set.

Economic background

9.2 The major external influence on the Council'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.

9.3 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.

9.4 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 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.

Credit outlook

9.5 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 Council; returns from cash deposits however continue to fall.

Interest rate forecast

9.6 The Council'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. A 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.

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

10 **Balance Sheet Summary and Forecast**

10.1 On 31 December 2016 the Council held £156.7m of borrowing and £61.5m of investments. This is set out in further detail at Appendix B. Forecast changes in these sums are shown in the balance sheet analysis in Table 1 below.

Table 1: Balance Sheet Summary and Forecast

	31/03/16 Actual £m	**31/03/17 Estimate £m**	**31/03/18 Forecast £m**	**31/03/19 Forecast £m**	**31/03/20 Forecast £m**
General Fund CFR	5.4	8.0	28.6	41.3	74.7
HRA CFR	157.4	165.2	166.3	168.0	168.5
Total CFR	**162.8**	**173.2**	**194.9**	**209.3**	**243.2**
Less: Other debt liabilities *	-1.2	-0.8	-0.5	-0.2	-2.4
Borrowing CFR	**161.6**	**172.4**	**194.4**	**209.1**	**240.8**
Less: External borrowing **	-156.7	-156.7	-156.7	-156.7	-156.7
Internal (over) borrowing	**4.9**	**15.7**	**37.7**	**52.4**	**84.1**
Less: GF Usable reserves	-29.0	-27.3	-22.7	-16.3	-14.8
Less: HRA Usable reserves	-10.6	-16.4	-13.1	-13.1	-7.0
Less: Working capital	-8.4	-8.4	-8.4	-8.4	-8.4
Resources for investments	**-48.0**	**-52.1**	**-44.2**	**-37.8**	**-30.2**
New borrowing or (investments)	**-43.1**	**-36.4**	**-6.5**	**14.6**	**53.9**

* 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

10.2 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.

10.3 The Council has a forecast increasing CFR due to the planned capital programme over the coming years, and the Council's reserves will gradually reduce over the same period. If the capital programme is delivered as planned, this will require the Council to take out new borrowing during the forecast period.

10.4 CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2017/18.

11 Borrowing Strategy

11.1 The Council currently holds £156.7m of loans, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in Table 1 shows that the Council does not expect to need to borrow in 2017/18. The Council may however borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £200.9m.

Objectives

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

Strategy

11.3 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, if the Council does need to borrow, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

11.4 By internally borrowing, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal and 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.

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

Sources

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

- Public Works Loan Board (PWLB) and any successor body
- UK local authorities
- 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 Hampshire Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

11.7 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

11.8 The Council has previously raised all 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, which may be available at more favourable rates.

Short-term and Variable Rate loans

11.9 These loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators at section 14 of this strategy.

Debt Rescheduling

11.10 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. The Council 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.

12 **Investment Strategy**

12.1 The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £43.3 and £73.9 million.

Objectives

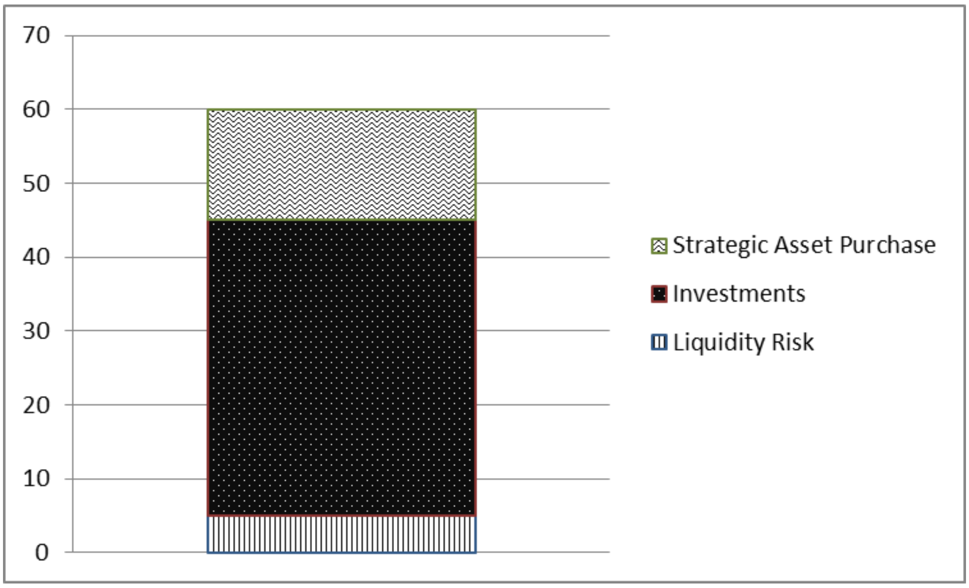
12.2 Both the CIPFA Code and the CLG Guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Negative Interest Rates

12.3 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.

Strategy

12.4 Given the increasing risk and falling returns from short-term unsecured bank investments, the Council aims to further diversify into more secure and/or higher yielding asset classes during 2017/18. This is especially the case for the estimated £25m that is available for longer-term investment. Approximately 50% (increased from 36% last year) of the Council's surplus cash is invested so that it is not subject to bail-in risk, as it is invested in local authorities, corporate bonds, pooled property and equity funds, and secured bank bonds. Whilst the remaining cash is subject to bail-in risk, 15% is held in short-term notice accounts which produce a significant return commensurate with the bail-in risk, 48% is held in overnight money markets funds which are subject to a reduced risk of bail-in, 26% is held in certificates of deposit which can be sold on the secondary market, and the remaining 11% of cash subject to bail-in risk is held in overnight bank call accounts for liquidity purposes (86% of which is held in a call account which produces a significant return commensurate with the bail-in risk). Further detail is provided at Appendix B. This diversification will represent a continuation of the new strategy adopted in 2015/16.



Investment Limits

12.5 Given the impact of the Bank Reform Act, Bank Recovery and Resolution Directive, and the recast Deposit Guarantee Schemes Directive, which have increased the credit risk that unsecured bank investments could be 'bailed-in', the following investments limits are proposed to mitigate the risk whilst allowing sufficient flexibility to manage the Council's investment balances.

Table 2: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£7m each
UK Central Government	Unlimited
Any group of organisations under the same ownership	£7m per group
Any group of pooled funds under the same management	£7m per manager
Registered Providers	£6m in total
Money Market Funds	£50% in total

Approved Counterparties

12.6 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 Unsecured**	**Registered Providers Secured**
UK Govt	n/a	n/a	£ Unlimited 30 years	n/a	n/a	n/a
AAA	£3.5m 5 years	£7m 20 years	£7m 30 years	£3.5m 20 years	£3.5m 20 years	£3.5m 25 years
AA+	£3.5m 5 years	£7m 10 years	£7m 25 years	£3.5m 10 years	£3.5m 10 years	£3.5m 10 years
AA	£3.5m 4 years	£7m 5 years	£7m 15 years	£3.5m 5 years	£3.5m 10 years	£3.5m 10 years
AA-	£3.5m 3 years	£7m 4 years	£7m 10 years	£3.5m 4 years	£3.5m 10 years	£3.5m 10 years
A+	£3.5m 2 years	£7m 3 years	£3.5m 5 years	£3.5m 3 years	£3.5m 5 years	£3.5m 5 years
A	£3.5m 13 months	£7m 2 years	£3.5m 5 years	£3.5m 2 years	£3.5m 5 years	£3.5m 5 years
A-	£3.5m 6 months	£7m 13 months	£3.5m 5 years	£3.5m 13 months	£3.5m 5 years	£3.5m 5 years
BBB+	£1m 100 days	£3.5m 6 months	£3.5m 2 years	£1m 6 months	£3.5m 2 years	£3.5m 2 years
None	£1m 6 months	n/a	£3.5m 25 years	n/a	£3.5m 5 years	£3.5m 25 years
Pooled funds	£7m per fund					

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

Credit Rating

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

Banks Unsecured

12.9 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.

Banks Secured

12.10 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.

Government

12.11 Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 30 years.

Corporates

12.12 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.

Registered Providers

12.13 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.

Pooled Funds

12.14 Shares 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.

12.15 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. Depending on the type of pooled fund invested in, it may have to be classified as capital expenditure. 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.

Risk Assessment and Credit Ratings

12.16 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.

12.17 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 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.

Other Information on the Security of Investments

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

12.19 Based on the available information and the advice of the Council's advisers, Arlingclose, the investment limits shown in Tables 2 and 3 may be reduced, and investing with certain counterparties may be suspended as necessary.

12.20 If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council'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.

Specified Investments

12.21 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".

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

Non-specified Investments

12.23 Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any investments denominated in foreign currencies. 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), pooled funds that the Council intends to hold as long-term investments (for more than one year) and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in Table 4 below.

Table 4: Non-Specified Investment Limits

	Cash limit
Total long-term investments	£25m
Total investments without credit ratings or rated below A- (excluding investments with other local authorities)	£25m
Total non-Sterling investments	£0m
Total investments in foreign countries rated below AA+	£0m
Total non-specified investments	£35m

* Total non-specified investments are a limit in its own right, and is not meant to equal the aggregate of the limits for total long-term investments, and investments without credit ratings or rated below A-.

12.24 Although the total long-term investments limit is greater than the expected investment balance at 31 March 2018, as shown in Table 1, this limit has been set to allow for current long-term investments to mature, as well as to allow flexibility if capital expenditure is experienced to be slower than forecast.

Liquidity Management

12.25 The Council has due regard for its future cash flows when determining the maximum period for which funds may prudently be committed. Historic cash flows are analysed in addition to significant future cash movements, such as payroll, grant income and council tax precept. Limits on long-term investments are set by reference to the Council’s medium term financial position (summarised in Table 1) and forecast short-term balances.

13 **Treasury Management Indicators**

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

Interest Rate Exposures

13.2 This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of principal borrowed or invested will be:

Table 5: Interest Rate Exposures

	2017/18	2018/19	2019/20
Upper limit on fixed interest rate investment exposure	£25m	£25m	£25m
Upper limit on variable interest rate investment exposure	£100m	£100m	£100m
Upper limit on fixed interest rate borrowing exposure	£201.5m	£215.3m	£254.1m
Upper limit on variable interest rate borrowing exposure	£201.5m	£215.3m	£254.1m

13.3 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

13.4 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:

Table 6: Maturity Structure of Borrowing

	Upper	Lower
Under 12 months	25%	0%
12 months and within 24 months	25%	0%
24 months and within 5 years	25%	0%
5 years and within 10 years	25%	0%
10 years and within 20 years	50%	0%
20 years and within 30 years	50%	0%
30 years and within 40 years	75%	0%
40 years and above	100%	0%

Principal Sums Invested for Periods Longer than 364 days

13.5 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:

Table 7: Principle Sums Invested for Periods Longer than 364 days

	2017/18	**2018/19**	**2019/20**
Limit on principal invested beyond year end	£25m	£25m	£25m

14 **Other Items**

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

Policy on Use of Financial Derivatives

14.2 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).

14.3 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.

14.4 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.

Policy on Apportioning Interest to the HRA

14.5 The Council has adopted the "two pool approach" whereby each of its long-term loans are split 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. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. This balance will be measured each month and interest transferred between the General Fund and HRA applying the following rates:

- The PWLB 3 month variable loan rate is applied to a deficit balance
- The risk free Debt Management Office rate is applied to a surplus balance.

Investment Training

14.6 The needs of the County Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

14.7 Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, and other appropriate organisations.

14.8 CIPFA's Code of Practice requires that the Council ensures that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities. All Members were invited to a workshop presented by Arlingclose on 29 November 2016, which gave an update of treasury matters. A further Arlingclose workshop has been planned for 29 November 2017.

Investment Advisers

14.9 The Council has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled through quarterly review meetings with Arlingclose.

Investment of Money Borrowed in Advance of Need

14.10 The Council may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks. The total amount borrowed will not exceed the authorised borrowing limit of £200.9 million.

15 BACKGROUND DOCUMENTS:-

Previous Committee Reports:-

15.1 CAB2766 - Treasury Management Strategy 2016/17 – 18 February 2016

Other Background Documents:-

15.2 None

16 **APPENDICES:**

Appendix A – Arlingclose Economic & Interest Rate Forecast November 2016
Appendix B – Existing Investment & Debt Portfolio Position at 31 December 2016
Appendix C – Prudential Indicators 2017/18
Appendix D – Annual Minimum Revenue Provision Statement 2017/18

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	Ave
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**

Existing Investment & Debt Portfolio Position at 31 December 2016

Investments Duration to maturity	**Overnight**	**<1 year**	**>1 year**	**Total**	**Average rate/yield**	**Average life**
	£m	**£m**	**£m**	**£m**	**%**	**(years)**
Subject to bail-in risk						
Bank call accounts	3.5	0.0	0.0	3.5	0.54	0.0
Bank notice accounts	0.0	4.5	0.0	4.5	0.73	0.2
Certificates of deposit[1]	0.0	8.0	0.0	8.0	0.42	0.1
Money market funds[2]	15.0	0.0	0.0	15.0	0.27	0.0
	18.5	**12.5**	**0.0**	**31.0**	**0.41**	**0.1**
Exempt from bail-in risk						
Covered floating rate notes	0.0	6.5	4.0	10.5	0.66	1.0
Covered fixed bonds	0.0	0.0	1.0	1.0	1.30	1.3
Corporate fixed bonds	0.0	2.0	0.0	2.0	0.45	0.3
Local authorities	0.0	14.0	0.0	14.0	0.62	0.5
	0.0	**22.5**	**5.0**	**27.5**	**0.65**	**0.7**
Targeting higher yields						
Pooled property funds[3]	0.0	0.0	2.0	2.0	5.23	n/a
Pooled equity funds[4]	0.0	0.0	1.0	1.0	n/a	n/a
	0.0	**0.0**	**3.0**	**3.0**	**5.23**	**n/a**
Total	**18.5**	**35.0**	**8.0**	**61.5**	**0.68**	**0.4**

	£m	**%**
External borrowing:		
PWLB Fixed Rate	(156.7)	(3.30)
Total Gross External Debt	**(156.7)**	**(3.30)**
Investments	**61.5**	**0.68**
Net (Debt) / Investments	**(95.2)**	

[1] Certificates of deposit are financial instruments that have the ability of being sold on the secondary market.
[2] Money market funds have a reduced risk of bail-in due to the portfolio of investments each fund is invested in.
[3] The average rate/yield provided for the pooled property fund is the average income return per annum for the past five years.
[4] The Council invested in the pooled equity funds part-way through the year, and the average income return for the investment period, annualised, does not provide a true reflection of income return expected, therefore a more accurate income return will be provided at the next reporting date.

PRUDENTIAL INDICATORS 2017/18

The Local Government Act 2003 requires the Council to have regard to the Chartered Institute of Public Finance and Accountancy's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Estimates of Capital Expenditure

The Council's planned capital expenditure and financing may be summarised as follows. Further detail is provided in the capital programme.

Capital Expenditure and Financing	**2016/17 Revised £m**	**2017/18 Estimate £m**	**2018/19 Estimate £m**	**2019/20 Estimate £m**
General Fund	5.8	26.9	24.4	41.7
HRA	22.3	25.3	16.6	16.0
Total Expenditure	**28.1**	**52.2**	**41.0**	**57.7**
Capital Receipts	1.5	7.2	8.0	4.0
Grants & Contributions	3.8	4.6	6.2	9.0
Reserves	7.0	8.9	7.6	7.9
Revenue	4.9	9.5	4.3	4.6
Borrowing	10.9	22.0	14.9	32.2
Total Financing	**28.1**	**52.2**	**41.0**	**57.7**

Estimates of Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	**31/03/17 Revised £m**	**31/03/18 Estimate £m**	**31/03/19 Estimate £m**	**31/03/20 Estimate £m**
General Fund	8.0	28.6	41.3	74.7
HRA	165.2	166.3	168.0	168.5
Total CFR	**173.2**	**194.9**	**209.3**	**243.2**

The CFR is forecast to rise over the next three years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

Gross Debt and the Capital Financing Requirement

In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	**31/03/17 Revised £m**	**31/03/18 Estimate £m**	**31/03/19 Estimate £m**	**31/03/20 Estimate £m**
Borrowing	-156.7	-156.7	-171.3	-210.6
Finance leases	-0.8	-0.5	-0.2	-2.4
Total Debt	**-157.5**	**-157.2**	**-171.5**	**-213.0**

Total debt is expected to remain below the CFR during the forecast period

Operational Boundary for External Debt

The operational boundary is based on the Council's estimate of most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the Council's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary	**2016/17 Revised £m**	**2017/18 Estimate £m**	**2018/19 Estimate £m**	**2019/20 Estimate £m**
Borrowing	177.2	198.4	212.4	249.6
Other long-term liabilities	0.8	0.5	0.2	2.4
Total Debt	**178.0**	**198.9**	**212.6**	**252.0**

Authorised Limit for External Debt

The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	**2016/17 Limit £m**	**2017/18 Limit £m**	**2018/19 Limit £m**	**2019/20 Limit £m**
Borrowing	179.5	200.9	215.0	251.1
Other long-term liabilities	1.0	0.6	0.3	3.0
Total Debt	**180.5**	**201.5**	**215.3**	**254.1**

Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**2016/17 Revised %**	**2017/18 Estimate %**	**2018/19 Estimate %**	**2019/20 Estimate %**
General Fund	-0.49	-0.85	0.07	2.80
HRA	17.93	17.93	17.54	17.28

The Ratio of Financing Costs to Net Revenue Stream is negative in the first two years as interest receivable is forecast to exceed interest payable and Minimum Revenue Provision (the statutory provision for repayment of debt; see Appendix D).

Incremental Impact of Capital Investment Decisions

This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax and housing rent levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme proposed.

Incremental Impact of Capital Investment Decisions	**2017/18 Estimate £**	**2018/19 Estimate £**	**2019/20 Estimate £**
General Fund - increase in annual band D Council Tax	4.50	38.26	59.36
HRA - increase in average weekly rents	8.47	-6.17	-1.29

Adoption of the CIPFA Treasury Management Code

The Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition in February 2012.

ANNUAL MINIMUM REVENUE PROVISION STATEMENT 2017/18

The DCLG Guidance requires the Council to approve an Annual Minimum Revenue Provision (MRP) Statement each year. The DCLG Guidance provided four options for calculating a prudent amount of MRP and this Council opted for option 3: the Asset Life Method.

The Asset Life Method determines that MRP will be calculated on the basis of charging the unfinanced capital expenditure over the expected useful life of the relevant assets based on either an equal instalment method or an annuity method, starting in the year after the asset becomes operational; MRP on purchases of freehold land will be charged over 50 years; and MRP on expenditure not related to fixed assets but which has been capitalised by regulation or direction will be charged over 20 years.

Leases brought on Balance Sheet under International Financial Reporting Standards (IFRS) based Accounting Code of Practice will match the annual principal repayment for the associated deferred liability.

No MRP will be charged in respect of the Housing Revenue Account.

The Head of Finance recommends the approval of the above MRP Policy statement for use in 2017/18.

	31/03/2017 Estimated CFR £m	**2017/18 Estimated MRP £**
Unsupported capital expenditure after 31.03.2008	7.2	129,000
Finance leases and Private Finance Initiative	0.8	321,000
Total General Fund	**8.0**	**450,000**
Assets in the Housing Revenue Account	165.2	-
Total Housing Revenue Account	**165.2**	**-**
Total	**173.2**	**450,000**