CAB3133
CABINET

REPORT TITLE: TREASURY MANAGEMENT STRATEGY STATEMENT 2019/20

13 FEBRUARY 2019

REPORT OF PORTFOLIO HOLDER: Finance – Cllr. Guy Ashton

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WARD(S): ALL WARDS

PURPOSE

This report sets out the proposed Treasury Management Strategy Statement, including the Annual Investment Strategy for the Council for 2019/20.

RECOMMENDATIONS: to Cabinet and Council

1. That the Treasury Management Strategy Statement which includes the Annual Treasury Investment Strategy for 2019/20, (and the remainder of 2018/19) is approved; and
2. That authority is delegated to the Section 151 Officer, who in turn delegates to Hampshire County Council's Director of Corporate Resources, as agreed in the Service Level Agreement, to manage all Council investments (other than the high yield portfolio) and short term borrowing according to the Treasury Management Strategy Statement as appropriate.

IMPLICATIONS:

1 COUNCIL STRATEGY OUTCOME

1.1 Treasury management is an integral part of helping the deliver the Council Strategy and all of its outcomes.

2 FINANCIAL IMPLICATIONS

2.1 Effective treasury management ensures both the financial security and liquidity of the Council. The overall target return is a 1% yield which, with an average balance of £40m, would yield £400k p.a.

3 LEGAL AND PROCUREMENT IMPLICATIONS

3.1 The Council's Treasury Management Strategy Statement follows the latest codes of practice and the MHCLG and CIPFA guidance.

3.2 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 investment of surplus cash or sourcing of short-term borrowing in accordance with the agreed Treasury Management Strategy Statement.

4 WORKFORCE IMPLICATIONS

4.1 None

5 PROPERTY AND ASSET IMPLICATIONS

5.1 None

6 CONSULTATION AND COMMUNICATION

6.1 The Overview and Scrutiny Committee discussed the report at its meeting held on 4 February 2019. At the conclusion of questions and debate, the Committee agreed that there were no particular matters that it wished to raise for Cabinet to further consider.

7 ENVIRONMENTAL CONSIDERATIONS

7.1 None

8 EQUALITY IMPACT ASSESSEMENT

8.1 None

9 DATA PROTECTION IMPACT ASSESSMENT

9.1 None required

10 RISK MANAGEMENT

Risk	**Mitigation**	**Opportunities**
Returns from investments are too low	A diversified strategy that attempts to manage the balance between liquidity risk, credit risk and yield within the Council's risk appetite.	Returns 0.13% above budgeted levels
A counterparty fails	A diversified strategy that has relatively low levels of counter-party risk	
Cash is not available	A balanced portfolio of liquid and long term funds are held to ensure cash is available to utilise. The Council also mitigates this risk through cashflow forecasting	More accurate and immediate cashflow forecasting can help improve the return on investments through more active treasury management activity
Access to Money Market Funds (MMFs) may be restricted when the UK exits the EU	Invest in suitable alternatives	

11 SUPPORTING INFORMATION:

12 Summary

12.1 The Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) require authorities to determine the Treasury Management Strategy Statement (TMSS) before the start of each financial year.

12.2 As per the requirements of the Prudential Code, the Council adopts the CIPFA Treasury Management Code. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

13 Introduction

13.1 Treasury management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council has borrowed and invested sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the Council's prudent financial management.

13.2 Treasury risk management at the Council is conducted within the framework of the CIPFA Code which requires the Council to approve a TMSS before the start of each financial year. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

13.3 Investments held for service purposes or for commercial profit are considered in a different report, the Capital Investment Strategy.

13.4 Hampshire County Council's Investments & Borrowing Team has been contracted to manage the Council's treasury management balances since September 2014 but overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

14 External Context

Economic background

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

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

14.3 The rise in quarterly GDP growth to 0.6% in Quarter 3 from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in Quarter 1. At 1.5%, annual Gross Domestic Product growth continues to remain below trend. Looking ahead, the BoE, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

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

Credit outlook

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

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

Interest rate forecast

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

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

14.9 A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix 1.

15 Balance Sheet Summary and Forecast

15.1 On 30 November 2018, the Council held £156.7m of borrowing and £61.7m 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. One important policy change that will impact on the treasury strategy is the removal of the debt cap for the Housing Revenue Account (HRA). This will likely lead to an increased borrowing requirement for the HRA as the council explores opportunities to build more new homes over the period of the TMS.

Table 1: Balance sheet summary and forecast

	31/03/18 Actual £m	31/03/19 Estimate £m	31/03/20 Forecast £m	31/03/21 Forecast £m	31/03/22 Forecast £m
General Fund CFR	13.2	32.1	77.6	105.3	108.5
HRA CFR	164.0	164.0	172.0	187.5	196.5
Total CFR	**177.2**	**196.1**	**249.6**	**292.8**	**305.0**
Less: Other debt liabilities *	(0.5)	(0.2)			
Borrowing CFR	**176.7**	**195.9**	**249.6**	**292.8**	**305.0**
Less: External borrowing **	(156.7)	(156.7)	(156.7)	(156.7)	(156.7)
Internal (over) borrowing	**20.0**	**39.2**	**92.9**	**136.1**	**148.3**
Less: GF Usable reserves	(33.7)	(27.8)	(19.9)	(17.4)	(14.8)
Less: HRA Usable reserves	(16.7)	(17.4)	(10.5)	(7.2)	(10.4)
Less: Working capital	(8.6)	(8.6)	(8.6)	(8.6)	(8.6)
Resources for investments	**(59.0)**	**(53.8)**	**(39.0)**	**(33.2)**	**(33.8)**
New borrowing or (investments)	**(39.0)**	**(14.6)**	**53.9**	**102.9**	**114.5**

* 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

15.2 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.

15.3 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 external borrowing from 2019/20.

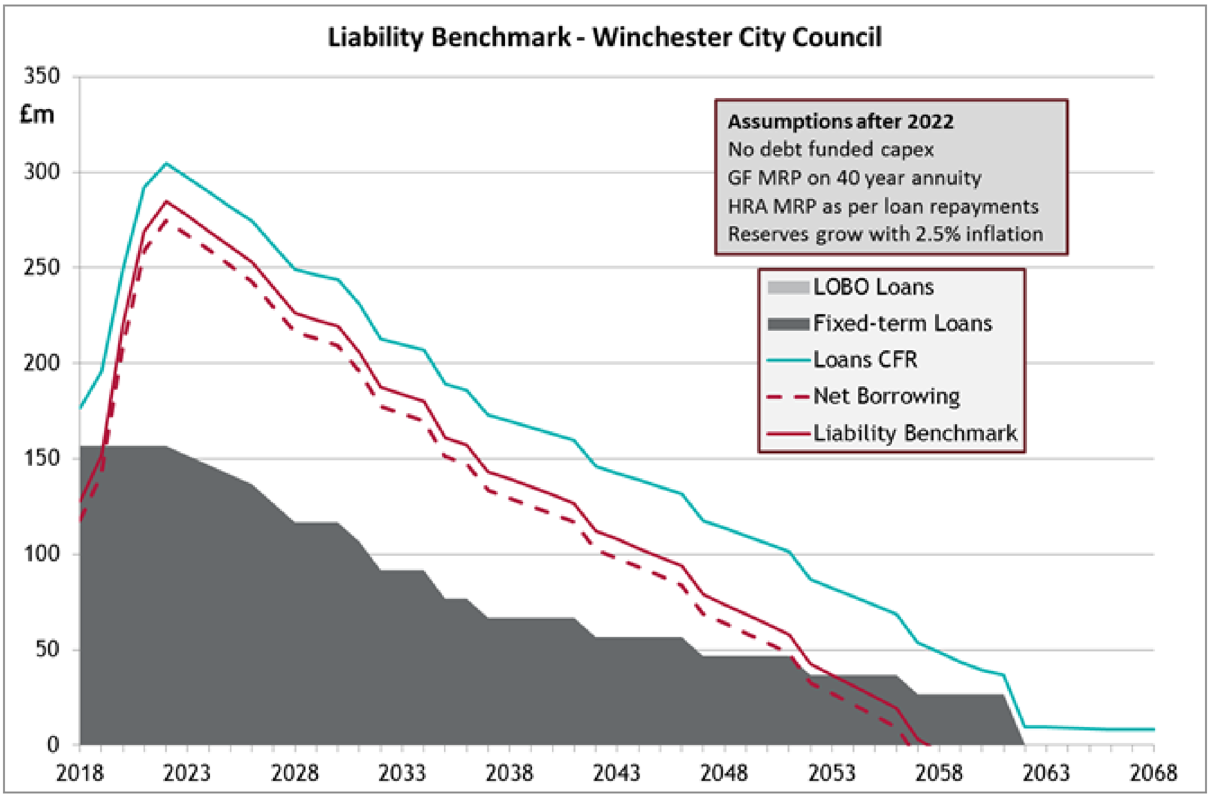
15.4 CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2019/20.

Liability benchmark

15.5 To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as Table 1 above but that cash and investment balances are kept to a minimum level of £10m at each year-end to maintain sufficient liquidity but minimise credit risk.

Table 2: Liability benchmark

	31/03/18 Actual £m	**31/03/19 Estimate £m**	**31/03/20 Forecast £m**	**31/03/21 Forecast £m**	**31/03/22 Forecast £m**
Total CFR	177.2	196.1	249.6	292.8	305.0
Less: Total usable reserves	-50.4	-45.2	-30.4	-24.6	-25.2
Less: Working capital	-8.6	-8.6	-8.6	-8.6	-8.6
Plus: Minimum investments	10	10	10	10	10
Liability benchmark	**128.2**	**152.3**	**220.6**	**269.6**	**281.2**



15.6 At the start of the period, 31st March 2017, the Council had a Loans CFR of £177m, fixed term loans of £157m and a liability benchmark of £139m. The difference of £20m between the CFR and fixed term loans is internal borrowing and is where the Council has used its own resources to fund capital expenditure.

15.7 The liability benchmark is the lowest level of debt the Council could hold if it used all of its balances, reserves and cash flow surpluses.

15.8 The forward projection using the Council capital programme forecasts suggest that capital expenditure funded by borrowing of around £109m will occur over the next three financial years as evidenced by the rising CFR and where the liability benchmark increases above the debt portfolio is where the Council will need to take on additional external borrowing to fund this expenditure. It is anticipated that to keep debt at a minimum level, a maximum of £125m of additional debt would need to be taken out. Any debt should be taken on an amortising basis to match the shape of the liability benchmark.

16 <u>Borrowing Strategy</u>

16.1 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 expects to borrow up to £53.9m in 2019/20. The Council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £284.3m.

Objectives

16.2 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

16.3 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, when the Council does 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.

16.4 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. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2019/20 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

16.5 Alternatively the Council may arrange forward-starting loans during 2019/20, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

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

Sources of borrowing

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

- Public Works Loan Board (PWLB) and any successor body
- Any other UK public sector 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 Hampshire Pension Fund)

- Capital market bond investors

- UK Municipal Bonds Agency plc and other special purpose companies created to enable local Council bond issues

Other sources of debt finance

16.8 In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- Leasing

- Hire purchase

- Private Finance Initiative

- Sale and leaseback

16.9 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, that may be available at more favourable rates.

Short-term and variable rate loans

16.10 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 the interest rate exposure limits in the treasury management indicators at Section 17 of this TMSS.

Debt rescheduling

16.11 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.

17 Investment Strategy

17.1 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 £38.7m and £72.5m.

Objectives

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

Negative interest rates

17.3 If the UK enters into a recession in 2019/20, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Strategy

17.4 Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to further diversify into more secure and/or higher yielding asset classes during 2019/20. This is especially the case for the estimated £15m that is available for longer-term investment. At 30 November 2018 approximately 50% of the Council's surplus cash was invested so that it is not subject to bail-in risk (decreased from 63% last year due to the requirement of extra liquidity to fund the forthcoming land purchase), as it was invested in local authorities, pooled property funds, corporate bonds and secured bank bonds. Whilst the remaining cash is subject to bail-in risk, 66% is held in cash plus funds and overnight money market funds which are subject to a reduced risk of bail in, 16% is held in certificates of deposit which can be sold on the secondary market, 10% is held in maturing notice accounts (which once available, these funds will be placed in more secure/higher yielding investments) and the remaining 8% of cash subject to bail-in risk is held in overnight bank call accounts for liquidity purposes. Further detail is provided at Appendix 2. This diversification represents a continuation of the new strategy adopted in 2015/16.

17.5 The Council's investment in a pooled property fund allows the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. The fund, which is operated on a variable net asset value (VNAV) basis, offers diversification of investment risk, coupled with the services of a professional fund manager; also offers enhanced returns over the longer term but is more volatile in the short-term. The Council's pooled fund investment is in the fund's distributing share class which pays out the income generated.

17.6 Although money can be redeemed from the pooled fund at short notice, the Council's intention is to hold it for at least the medium term. Its performance and suitability in meeting the Council's investment objectives are monitored regularly and discussed with Arlingclose.

17.7 As shown in Appendix 2, without this allocation the weighted average return of the Council's cash investments would have been 0.81%; the allocation to high yielding investments has added 0.28% (£0.17m based on the cash balance at

30 November 2018) to the average interest rate earned by the remainder of the portfolio.

Investment limits

17.8 The maximum that will be lent to any one organisation (other than the UK Government) will be £7 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, and investments in pooled funds, as they would not count against a limit for any single foreign country, since the risk is diversified over many countries.

Table 3: 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
Money Market Funds	50% in total

Approved counterparties

17.9 The Council may invest its surplus funds with any of the counterparty types in Table 4 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 4: Approved investment counterparties and limits

Credit rating	**Banks unsecured**	**Banks secured**	**Government**	**Corporates**
UK Govt	n/a	n/a	£ Unlimited 30 years	n/a
AAA	£3.5m 5 years	£7m 20 years	£7m 50 years	£3.5m 20 years
AA+	£3.5m 5 years	£7m 10 years	£7m 25 years	£3.5m 10 years
AA	£3.5m 4 years	£7m 5 years	£7m 15 years	£3.5m 5 years
AA-	£3.5m 3 years	£7m 4 years	£7m 10 years	£3.5m 4 years
A+	£3.5m 2 years	£7m 3 years	£3.5m 5 years	£3.5m 3 years
A	£3.5m 13 months	£7m 2 years	£3.5m 5 years	£3.5m 2 years
A-	£3.5m 6 months	£7m 13 months	£3.5m 5 years	£3.5m 13 months

None	£1m 6 months	n/a	£7m 25 years	£3.5m 10 years
Pooled funds	£7m per fund			

This table must be read in conjunction with the notes below

Credit rating

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

Banks unsecured

17.11 Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

Banks secured

17.12 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

17.13 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

17.14 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.

17.15 Where a counterparty does not have a credit rating and to ensure there is a clear process for external scrutiny specifically around these alternative investments, the governance structure detailed below was approved in the Treasury Management Mid-Year Review 2017/18 in order for the Council to consider such investment opportunities in a timely manner and ensure that there has been effective scrutiny over the proposed decisions. The S151 officer will consult with this group on these types of investment prior to making the final decision.

Option
- Alternative Investment identified by the Finance Manager (Capital & Treasury)
- Considered with the s151 officer

Due Dilligence
- Officers commission due diligence report from external advisor / organisation
- Information to also include identification of option against other current or potential investment opportunities

TIG*
- Treasury Investment Group (TIG) considers the option
- Recommend / reject option to s151 officer
- s151 officer to make final decision

* The TIG (Treasury Investment Group) includes the following officer and member roles:

- Finance Manager (Capital & Treasury)
- Portfolio Holder (Finance)
- One other Cabinet member
- Chair of the Audit Committee
- Shadow Portfolio Holder (Finance)
- S151 officer

<u>Pooled funds</u>

17.16 Shares or units 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.

17.17 Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.

Real estate investment trusts

17.18 Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer terms, but are more volatile especially as the share price reflects changing demands for the shares as well as changes in the value of the underlying properties. Given the increased volatility as a result of supply and demand the Council will not invest in REITs.

Operational bank accounts

17.19 The Council may incur operational exposures, for example through current accounts, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept low. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

Risk assessment and credit ratings

17.20 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.

17.21 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

17.22 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 and analysis and advice from the Council's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the above criteria.

17.23 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 Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available 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.

18 Treasury Management Indicators

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

Interest rate exposures

18.2 The following indicator shows the sensitivity of the Council's current investments and borrowing to a change in interest rates.

Table 5: Interest rate risk indicator

	30 November 2018	**Impact of +/-1% interest rate change**
Sums subject to variable interest rates		
Investment	£48.2m	+/-£0.48m
Borrowing	(£0.0m)	+/-£0.0m

Maturity structure of borrowing

18.3 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: Refinancing rate risk indicator

	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	30%	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 within 50 years	100%	0%

18.4 Time periods start of the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal sums invested for periods longer than a year

18.5 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 total principal sum invested to final maturities beyond the period end will be:

Table 7: Price risk indicator

	2019/20	2020/21	2021/22
Limit on principal invested beyond year end	£15m	£15m	£10m

19 Prudential Indicators – Borrowing

Gross Debt and the Capital Financing Requirement

19.1 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.

Table 8: Debt

	31.03.18 Revised £m	31.03.19 Estimate £m	31.03.20 Estimate £m	31.03.21 Estimate £m
Borrowing	(156.7)	**(156.7)**	(156.7)	(156.7)
New borrowing	-	**-**	(53.9)	(102.9)
Finance leases	(0.5)	**(0.2)**	-	-
Total Debt	**(157.2)**	**(156.9)**	**(210.6)**	**(259.6)**

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

Operational Boundary for External Debt

19.3 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.

Table 9: Operational Boundary				
	2017/18 Revised £m	**2018/19 Estimate £m**	**2019/20 Estimate £m**	**2020/21 Estimate £m**
Borrowing	195.3	**213.7**	266.9	310.1
Other long-term liabilities	0.5	**0.2**	-	-
Total Debt	**195.8**	**213.9**	**266.9**	**310.1**

Authorised Limit for External Debt

19.4 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.

Table 10: Authorised Limit

	2017/18 Limit £m	2018/19 Limit £m	2019/20 Limit £m	2020/21 Limit £m
Borrowing	212.4	**231.0**	284.3	327.5
Other long-term liabilities	0.6	**0.3**	-	-
Total Debt	**213.0**	**231.0**	**284.3**	**327.5**

20 Related Matters

20.1 The CIPFA Code requires the Council to include the following in its treasury management strategy.

Financial derivatives

20.2 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).

20.3 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.

20.4 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.

Housing Revenue Account

20.5 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

20.6 The needs of the 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.

20.7 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.

20.8 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 27 November 2018, which gave an update of treasury matters. A further Arlingclose workshop has been planned for November 2019.

Investment advisers

20.9 Hampshire County Council has appointed Arlingclose Limited as treasury management advisers for all Councils under the arrangement, 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

20.10 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 £284.3m.

Markets in Financial Instruments Directive

20.11 The Council has opted up to professional client status with its providers of financial services, including advisers, brokers and fund managers, allowing it access to a greater range of services but with out the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the s151 Officer believes this to be the most appropriate status.

BACKGROUND DOCUMENTS:-

Previous Committee Reports:-

AUD119: Treasury Management Practices, 22 June 2015

CAB3013: Treasury Management Strategy 2018-19, 14 February 2018

CAB3064: Treasury Management Outturn 2017/18, 18 July 2018

AUD223: Treasury Management Mid-Year Monitoring Report 2018/19, 29 November 2018

Other Background Documents:-

None

APPENDICES:

Appendix A – Arlingclose Economic & Interest Rate Forecasts October 2018

Appendix B - Existing Investment & Debt Portfolio Position at 30 November 2018

Appendix A – Arlingclose Economic & Interest Rate Forecast October 2018

Underlying assumptions:

- The MPC left Bank Rate unchanged at the September meeting, after voting unanimously to increase Bank Rate to 0.75% in August.

- Our projected outlook for the UK economy means we maintain the significant downside risks to our interest rate forecast. The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2% remains well below the long term average. Our view is that the UK economy still faces a challenging outlook as the country exits the European Union and Eurozone economic growth softens.

- Cost pressures were projected to ease but have risen more recently and are forecast to remain above the Bank's 2% target through most of the forecast period. The rising price of oil and tight labour market means inflation may remain above target for longer than expected. This means that strong real income growth is unlikely in the near future.

- The MPC has a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. We believe that MPC members consider both that: 1) ultra-low interest rates result in other economic problems, and 2) higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise and cuts are required.

- The global economy appears to be slowing, particularly the Eurozone and China, where the effects of the trade war has been keenly felt. Despite slower growth, the European Central Bank is adopting a more strident tone in conditioning markets for the end of QE, the timing of the first rate hike (2019) and their path thereafter. Meanwhile, European political issues, mostly lately with Italy, continue.

- The US economy is expanding more rapidly. The Federal Reserve has tightened monetary policy by raising interest rates to the current 2%-2.25% range; further rate hikes are likely, which will start to slow economic growth. Central bank actions and geopolitical risks have and will continue to produce significant volatility in financial markets, including bond markets.

Forecast:

- The MPC has maintained expectations of a slow rise in interest rates over the forecast horizon. Our central case is for Bank Rate is to rise twice in 2019. The risks are weighted to the downside.

- Gilt yields have remained at low levels. We expect some upward movement from current levels based on our interest rate projections, the strength of the US economy and the ECB's forward guidance on higher rates. However, volatility arising from both economic and political events will continue to offer borrowing opportunities.

	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.17**
Arlingclose Central Case	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.17**
Downside risk	0.00	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	**0.65**
3-mth money market rate														
Upside risk	0.10	0.10	0.10	0.10	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	**0.17**
Arlingclose Central Case	**0.80**	**1.00**	**1.10**	**1.20**	**1.30**	**1.30**	**1.25**	**1.20**	**1.20**	**1.20**	**1.20**	**1.20**	**1.20**	**1.17**
Downside risk	0.20	0.50	0.60	0.70	0.80	0.80	0.75	0.75	0.75	0.75	0.75	0.75	0.75	**0.68**
1-yr money market rate														
Upside risk	0.20	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	**0.33**
Arlingclose Central Case	**1.05**	**1.25**	**1.35**	**1.40**	**1.50**	**1.45**	**1.40**	**1.40**	**1.40**	**1.40**	**1.40**	**1.40**	**1.40**	**1.37**
Downside risk	0.35	0.50	0.60	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	**0.69**
5-yr gilt yield														
Upside risk	0.15	0.20	0.25	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	**0.32**
Arlingclose Central Case	**1.15**	**1.20**	**1.25**	**1.35**	**1.40**	**1.40**	**1.35**	**1.35**	**1.30**	**1.30**	**1.30**	**1.30**	**1.30**	**1.30**
Downside risk	0.30	0.35	0.45	0.50	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	**0.54**
10-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	**0.32**
Arlingclose Central Case	**1.60**	**1.65**	**1.65**	**1.70**	**1.75**	**1.75**	**1.75**	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**
Downside risk	0.30	0.45	0.50	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	**0.55**
20-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	**0.32**
Arlingclose Central Case	**1.90**	**1.95**	**1.95**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**1.98**
Downside risk	0.30	0.40	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	**0.43**
50-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	**0.32**
Arlingclose Central Case	**1.80**	**1.85**	**1.85**	**1.90**	**1.90**	**1.90**	**1.90**	**1.90**	**1.90**	**1.90**	**1.90**	**1.90**	**1.90**	**1.88**
Downside risk	0.30	0.40	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	**0.43**

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%
PWLB Local Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%

Appendix B - Existing Investment & Debt Portfolio Position at 30 November 2018

Investment Position (Treasury Investments)

	30/09/2018 Balance £m	Movement £m	30/11/2018 Balance £m	30/11/2018 Rate %	30/11/2018 WAM* years
Short term investments					
Banks and Building Societies:					
- Unsecured	9.8	0.8	10.6	0.74	0.16
- Secured	4.0	2.0	6.0	0.87	0.17
Money Market Funds	17.1	2.1	19.2	0.72	0.01
Cash Plus Funds	1.0	-	1.0	0.53	n/a
Local Authorities	1.5	-	1.5	0.65	0.13
Corporate Bonds	4.9	-	4.9	0.69	0.04
	38.4	**4.8**	**43.2**	**0.74**	**0.08**
Long term investments					
Banks and Building Societies:					
- Secured	7.0	-	7.0	1.08	2.54
Local Authorities	6.5	-	6.5	1.06	1.52
	13.5	**-**	**13.5**	**1.07**	**2.05**
High yield investments					
Pooled Property Funds**	5.0	-	5.0	4.26	n/a
	5.0	**-**	**5.0**	**4.26**	**n/a**
TOTAL INVESTMENTS	**56.9**	**4.8**	**61.7**	**1.09**	**0.55**

* Weighted average maturity

** The rate provided for pooled property fund investments is reflective of the average of the most recent dividend return as at 30 November 2018

Treasury Management position

	30/11/2018 Balance £m	30/11/2018 Rate %
External borrowing:		
PWLB Fixed Rate	(156.7)	(3.30)
Total Gross External Debt	**(156.7)**	**(3.30)**
Investments	**61.7**	**1.09**
Net (Debt) / Investments	**(95.0)**	