



EXECUTIVE BOARD DECISION

REPORT OF: Executive Member for Resources

LEAD OFFICERS: **DIRECTOR OF FINANCE & CUSTOMER SERVICES**

DATE: **14th MARCH 2019**

PORTFOLIO/S AFFECTED: Resources

WARD/S AFFECTED: All

KEY DECISION: YES NO

SUBJECT: TREASURY MANAGEMENT STRATEGY REPORT 2019/20

1. EXECUTIVE SUMMARY

1.1 Treasury risk management is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the Treasury Management Code) which requires the Council to approve a Treasury Management Strategy before the start of each financial year. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

2. RECOMMENDATIONS

That the Executive Board:

2.1 approves the proposed Treasury Management Strategy for 2019/20, detailed in Appendix 1, including the proposed Treasury Management Indicators.

3. BACKGROUND

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

3.2 Investments held for service purposes or for commercial profit are considered in the Capital Strategy report, approved by Finance Council in February 2019.

4. RATIONALE

4.1 The Council is required to approve a Treasury Management Strategy before the start of each

financial year. It must also set Treasury and Prudential Indicators and a policy for determining a “prudent” level of Minimum Revenue Provision for repayment of debt which is consistent with the Council’s Medium Term Financial Strategy (MTFS). Treasury Management Strategy.

5. KEY ISSUES

5.1 Working within the regulatory and professional frameworks, the Council considers and agrees an annual Treasury Management Strategy before the start of each year. This is followed up with a mid-year Strategy Review, considered alongside the Annual Outturn Report, summarising the position for the previous financial year. The key requirements for the Council are to maintain its two investment priorities, the security of capital and the liquidity of investments.

6. POLICY IMPLICATIONS

6.1 The policy implications arising from the Treasury Management Strategy are contained within the overall Budget Strategy of the Council.

7. FINANCIAL IMPLICATIONS

7.1 The financial implications arising from the Treasury Management Strategy are also contained within the overall Budget Strategy of the Council..

8. LEGAL IMPLICATIONS

8.1 Under the Local Government Act 2003, the Council is required to have regard to CIPFA’s *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*.

9. RESOURCE IMPLICATIONS

9.1 None as a direct consequence of this report.

10. EQUALITY AND HEALTH IMPLICATIONS

Please select one of the options below. Where appropriate please include the hyperlink to the EIA.

Option 1 Equality Impact Assessment (EIA) not required – the EIA checklist has been completed.

Option 2 In determining this matter the Executive Member needs to consider the EIA associated with this item in advance of making the decision.

Option 3 In determining this matter the Executive Board Members need to consider the EIA associated with this item in advance of making the decision.

10. CONSULTATIONS

10.1 The issues raised in this report have been discussed previously with Audit and Governance Committee and the Treasury Management Group.

11. STATEMENT OF COMPLIANCE

11.1 The recommendations are made further to advice from the Monitoring Officer and the Section 151 Officer has confirmed that they do not incur unlawful expenditure. They are also compliant with equality legislation and an equality analysis and impact assessment has been considered. The recommendations reflect the core principles of good governance set out in the Council's Code of Corporate Governance.

12. DECLARATION OF INTEREST

All Declarations of Interest of any Executive Member consulted and note of any dispensation granted by the Chief Executive will be recorded and published if applicable

VERSION:	1.0
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CONTACT OFFICER:	Ron Turvey, Deputy Finance Manager
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DATE:	28 th February 2019
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BACKGROUND PAPER:	None
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TREASURY MANAGEMENT STRATEGY 2019/20

1 Introduction

- 1.1 The Authority both borrows and invests substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's Treasury Management Strategy.
- 1.2 Treasury risk management for local authorities is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires each authority to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.
- 1.3 Investments held for service purposes or for commercial profit are considered in a different report, the Capital Strategy.
- 1.4 In previous years, the Council's Prudential Indicators (to assess and measure the affordability, sustainability and prudence of its capital investment plans) and Minimum Revenue Provision (MRP) Policy were incorporated within the Treasury Management Strategy approved by Finance Council. These are now included with the Capital Strategy considered by Finance Council, and the Treasury Management Strategy (and mid-year review and outturn reporting) will now be considered by Executive Board.
- 1.5 Should the assumptions on which this report is based change significantly, it may be necessary to seek approval to a revised Treasury Management Strategy. Such circumstances could include, for example, a large unexpected change in interest rates, or in the Authority's capital programme or in the level of investments made or borrowing required.

2 Economic Context, Credit Outlook and Interest Rates

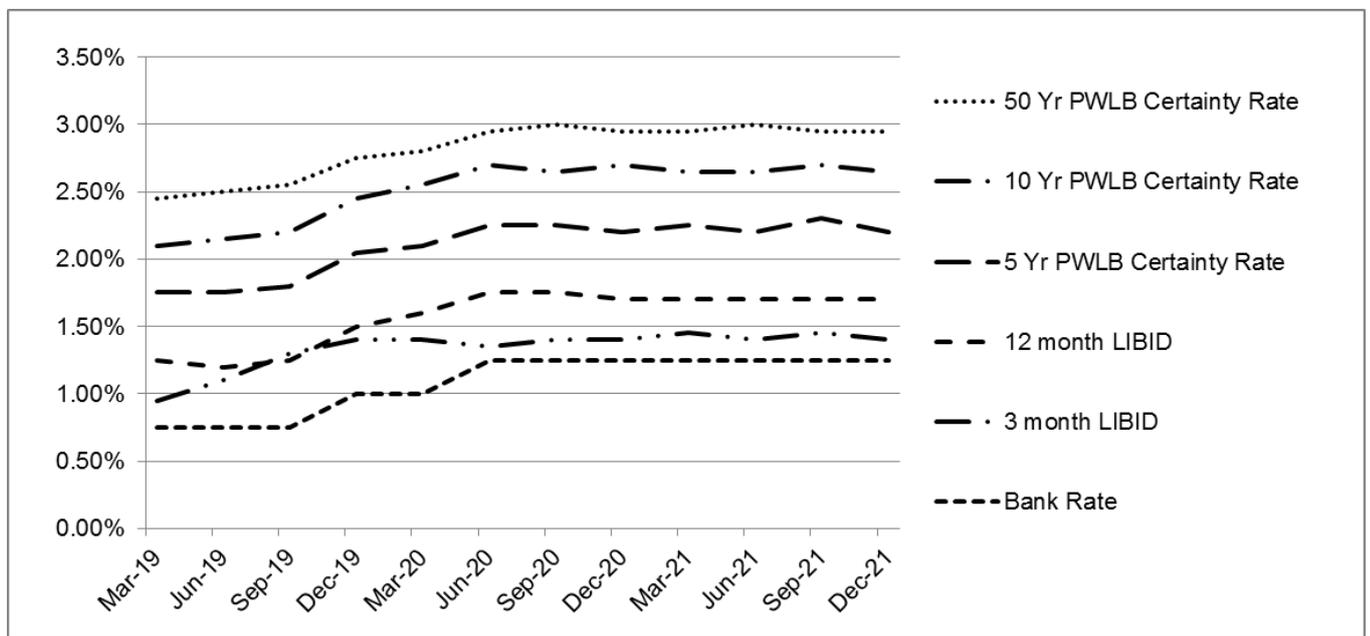
- 2.1 The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2019/20. Transitional arrangements, if agreed, may prevent a cliff-edge, but may also extend the period of uncertainty for several years.
- 2.2 Inflation, as measured by the Consumer Price Inflation (CPI) Index, fell to 2.1% in December and is expected to decline slightly in the short run before rising again after the effect of the recent fall in petrol prices unwinds. Unemployment rates remain low, and real wages have started to increase, but any economic slowdown could impact heavily on consumer spending.
- 2.3 The UK's annual GDP growth has fallen, and is now well below trend. However, providing the UK's exit from the EU is relatively smooth, the Bank of England, in its February Inflation Report, expects annual GDP growth to recover to 2% by the end of its forecast period.
- 2.4 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 Authority's treasury management strategy for 2019/20. Transitional arrangements, if agreed, may prevent a cliff-edge, but may also extend the period of uncertainty for several years.

- 2.5 Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no change to monetary policy has been made since. However, the Bank expects that should the economy continue to grow in line with forecasts, further increases in Bank Rate may be required. The Bank's Monetary Policy Committee (M.P.C.) continues to reiterate that any further increases will be at a gradual pace and limited in extent.
- 2.6 The US economy continued to grow, though at a slower rate by the end of 2018. The US Federal Reserve has continued to increase interest rates, but concerns over the sluggish growth, and storm clouds over potential world trade wars suggest that future increases in US interest rates will be slower than previously anticipated.
- 2.7 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.
- 2.8 The Bank of England released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.
- 2.9 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.
- 2.10 Following on from the August increase in Bank Rate to 0.75%, the Authority's treasury management adviser Arlingclose projects two more 0.25% hikes by June 2020 to take official UK interest rates to 1.25%. The MPC has maintained expectations for slow and steady rate rises, because though it favours a tight monetary policy, it 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 a higher Bank Rate will afford a more effective policy weapon should downside Brexit risks crystallise.
- 2.11 The Council's latest interest rate forecast, reflecting advice from Arlingclose, is shown below.

The PWLB rates relate to potential long term borrowing, and the LIBID (London Interbank Bid Rate) to short term borrowing and investment.

This is a realistic view of potential rates, however it must be recognised that there is significant uncertainty and risks to both the upside and downside. 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.

As such, the risks to the interest rate forecast are considered firmly to the downside.



For the purpose of setting the budget for 2019/20, it was assumed that:

- any new investments would be at low rates, averaging around 0.6%,
- short-term borrowing would be available at an average of around 1.25% and
- new long-term loans would be available, if required, at rates below 2.0%.

3 Borrowing Strategy

3.1 At the end of December 2018 the Council held around £315 M of borrowing:

	£M
Short Term Debt – maturing 18/19	60.0
Short Term Debt – maturing 19/20	18.0
Long Term Debt	156.0
Lancashire County Council (LCC) Debt	15.0
Debt re PFI arrangements	66.0
	315.0
This was offset by investments of:	62.5
Net borrowing (gross borrowing less investment)	252.5
If LCC and PFI debt are excluded, net borrowing	171.5

The investment level was unusually high because the Council took advantage of low PWLB interest rates in early December to take £35 M of new long term debt, while already holding short term loans covering its liquidity needs. The level of investments will fall sharply, as short term debt is repaid before the end of the financial year.

3.2 The Council's CFR (Capital Financing Requirement) is the key measure of the Council's borrowing **need** in the long term. It is

the accumulated need to borrow **to finance capital spend** (not funded from grants, etc.)

LESS the accumulated Minimum Revenue Provision (MRP) charges already made - councils must make a prudent MRP charge in their accounts, to finance their debt -

LESS any capital receipts applied to finance outstanding debt.

The CFR tends to increase if capital spend financed from borrowing exceeds MRP.

3.3 Forecast changes in CFR and borrowing needs are shown in the table below

	31.3.18 Actual £m	31.3.19 Estimate £m	31.3.20 Forecast £m	31.3.21 Forecast £m	31.3.22 Forecast £m
General Fund CFR	299.9	302.3	310.6	303.5	295.1
Less: CFR re Other debt liabilities *	-85.9	-85.4	-84.8	-84.3	-83.7
Loans CFR	214.0	216.9	225.8	219.2	211.4
Less: External borrowing **	-125.3	-154.9	-150.4	-145.7	-141.3
Internal borrowing	88.7	62.0	75.4	73.5	70.1
Less: Usable reserves ***	-41.0	-33.0	-29.7	-27.7	-27.7
Plus/Minus: Working capital	3.6	-2.7	-9.0	-10.9	-12.8
Remaining Net borrowing NEED	51.3	26.3	36.7	34.9	29.6

Net borrowing NEED addressed by	
Short Term borrowing	85.0 43.0
Treasury Investments	-33.7 -12.7

- * CFR regarding PFI liabilities and transferred debt that form part of the Council's total debt
- ** only loans to which the Council is committed over the longer term
- *** includes schools balances and grants received in advance of need

The Council's usable reserves and working capital allow less borrowing to be taken than would otherwise be required. This is sometimes termed internal borrowing.

The Council's "Loans CFR" initially increases, due to the levels of prudential borrowing under its Capital Programme plans. Thereafter, unless the level of prudential borrowing is increased beyond current plans, it will start to fall in later years, as the level of MRP being made would then be larger than the increase in CFR resulting from additional spend financed from borrowing.

- 3.4 CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that total debt should be lower than the highest forecast CFR over the next three years. The Council expects to comply with this recommendation during 2019/20.
- 3.5 The authority will continue to need to take borrowing in support of funding its capital programme. The 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.
- 3.6 Given the significant cuts to public expenditure and in particular to local government funding, the proposed 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 lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead. By doing so, the Council can reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.
- 3.7 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 Authority with

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

3.8 It had been the case that the Council had only taken short term borrowing for a number of years, with a view to minimising interest costs. It was always recognised, however, that it would be necessary to at some time to start to take some longer term borrowing, to address interest costs in the future, and to avoid becoming overly reliant on continuously rolling over short term debt. A significant tranche of long term borrowing was taken in December 2018, and the authority will continue to maintain a flexible approach to borrowing.

3.9 One alternative option is that 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.

3.10 In addition, the Council may take further short term loans to cover cash flow requirements.

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

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except the Lancashire County Council Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

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

- leasing
- hire purchase
- Private Finance Initiative
- sale and leaseback

The Authority has previously raised much 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.

3.12 Debt Rescheduling The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Authority may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

3.13 The Council still has £13 M of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. These options may be exercised during 2019/20; whilst it is unlikely that the options will be exercised in the current low interest rate environment, there remains an element of refinancing risk. The Authority may take the option to repay LOBO loans at no cost if it has the opportunity to do so. It is not currently expected that the Council will take any further

LOBO loans - however in order to allow for some flexibility, the Council will limit its total exposure to LOBO loans to £25 M.

3.14 The UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. Blackburn with Darwen BC was one of a number of local authorities investing in the Agency to help to establish it. It plans to issue bonds on the capital markets and lend the proceeds to local authorities.

This would be a more complicated source of finance than the PWLB for two reasons:

- (a) borrowing authorities may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans and
- (b) there will be a lead time of several months between committing to borrow and knowing the interest rate payable.

Any decision to borrow from the Municipal Bonds Agency will be subject to a separate report to Executive Board.

4 Investment Strategy

4.1 On a day to day basis the Council can hold significant surplus funds representing income received in advance of expenditure requirements, in addition to balances and reserves held. In the past 12 months, the Council's investment balance has ranged from £15 to £65 million, reflecting in particular the profiles of capital spending, grant funding, short term borrowing levels and long term debt repayments.

4.2 Both the CIPFA Code and the MHCLG 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 low investment income.

4.3 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.

4.4 The Council uses a cash flow model to determine the period for which funds may prudently be committed. The forecast is compiled on a prudent basis, to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Furthermore, a prudent level of funds is maintained in 'instant access' investments, to cover most likely eventualities. However to mitigate risk further, it is possible to borrow funds to cover short-term needs.

4.5 The Council's surplus cash is currently invested in short-term unsecured bank deposits, building society deposits and money market funds, along with fixed term deposits with other local authorities and the Debt Management Office (DMO). Given the increasing risk and continued low returns from short-term unsecured bank investments, the Council will consider the options to diversify into more secure and/or higher yielding asset classes during 2019/20, particularly if it finds itself with funds to invest for longer.

4.6 In order to prioritise the security of investments, the Council sets limits on the amounts placed with different institutions and as to the duration of the investment. This is to maintain a

diversified investment portfolio and to align amounts and durations of investments to the perceived risks associated with different counterparties.

- 4.7 When deteriorating financial market conditions give cause for concern, the Council will further restrict its investments to those institutions of higher credit worthiness and reduce the duration of its investments to seek to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Authority's cash balances, then the surplus will be deposited with the UK Government (via the DMO or invested in government treasury bills for example) or with other local authorities. This may reduce the level of investment income earned, but will protect the principal sum invested.
- 4.8 The Council uses credit ratings from all the three main rating agencies (Fitch Ratings Ltd, Moody's Investors Service Ltd and Standard & Poor's Financial Services LLC) to assess the risk of loss of investments. The lowest available credit rating will be used to determine credit quality. In order to make the limits straightforward to manage, limits are based on the Long-term ratings, as these ratings are those that address credit risk directly. Long-term ratings are expressed on a scale from AAA (the highest quality) through to D (indicating default). Ratings of BBB- and above are described as investment grade.

The ratings are obtained and monitored by the Council's Treasury Advisers, Arlingclose, who will notify the Council of changes as they occur.

- 4.9 Credit ratings are a significant factor in assessing the creditworthiness of organisations however the Council understands that they are not perfect predictors of investment default. Full regard will be given to other available information on the credit quality of banks and building societies, including credit default swap prices, financial statements, information on potential government support and other market information. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the specified criteria.
- 4.10 Investment limits are applied at the point at which new investments are made. They are set at cautious levels, allowing for the fact that circumstances may change while investments run their course

It is proposed that if the investment criteria for a counterparty are no longer met, then:

- no new investments will be made,
- any existing investments that can be recalled at no cost will be recalled and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

- 4.11 Where a credit rating agency announces that it is actively reviewing an organisation's credit ratings with a view to downgrading, and as a result it is likely to fall below the specified minimum criteria, then no further investments other than into instant access accounts will be made 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.

Where a credit rating agency awards a different rating to a particular class of investment instrument as opposed to the credit rating of the counter-party as a whole, the Council will base its investment decisions on the instrument credit rating rather than the counterparty credit rating.

4.12 Investment Criteria for 2019/20

The proposed criteria are at essentially the same levels as were agreed for last year. The distinctions previously applied in MHCLG Investment Guidance between Specified and Non-Specified Investments have changed, so those categories are no longer reflected in the proposed limits. It is proposed that the Council may invest its surplus funds with any of the counterparty types in the table immediately below, subject to the cash and time limits shown AND to other limits also set out successively below.

Approved Investment Counterparties	Cash limit	Time limit
Banks and Building Societies – Secured		
long-term credit ratings no lower than AA (or equivalent)	£5M each	364 days
long-term credit ratings no lower than AA- (or equivalent)	£4M each	364 days
long-term credit ratings no lower than A- (or equivalent)	£3M each	364 days
Banks and Building Societies – Unsecured		
long-term credit ratings no lower than AA (or equivalent)	£5M each	9 months
long-term credit ratings no lower than AA- (or equivalent)	£4M each	6 months
long-term credit ratings no lower than A- (or equivalent)	£3M each	4 months
The Council's current account banker - provided long term credit rating no lower than BBB- (or equivalent)	£3M	next day
Corporates or Registered Providers with long-term credit ratings no lower than A- (or equivalent)	£3M each	4 months
Unrated institutions , such as some building societies	£1M each	4 months
Company Shares where no direct service benefit arising, for the prudent management of its financial affairs	£100,000	n/a
Pooled funds (incl. money market funds)		
long-term credit ratings no lower than A- (or equivalent)	£5M each	n/a
unrated or long-term credit ratings under A- (or equivalent)	£4M each	n/a
UK Government	no limit	364 days
Other Government with long-term-credit ratings no lower than A- (or equivalent)	£5M each	364 days
UK Local Authorities* (irrespective of credit rating)	£5M each	364 days
* as defined in the Local Government Act 2003		

Other Investment Limits	Cash limit
Any single organisation, except the UK Central Government	£5M each
UK Central Government	unlimited
Any group of organisations under the same ownership	Group or overall limit same as would be set for parent company
Foreign countries - limited to those with sovereign credit rating of AA + or better (from all agencies)	£5M each
UK investments will not be limited by the UK's sovereign credit rating	
Foreign investment limits will not apply to investment in pooled funds which may be domiciled overseas. Sovereign credit rating criteria and foreign country limits will also not apply to investments in multilateral development banks (e.g. the European Investment Bank and the World Bank).	
Registered providers and registered social landlords	£5M in total
Unsecured investments with building societies	£6M in total
Money market funds	£16M in total

4.13 Secured and Unsecured Investments

Unsecured Investments include 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.

Unsecured investments with banks rated below A- (but no lower than BBB-) will be restricted to overnight deposits with the Council's Current Account bank, if applicable. A high level of monitoring of the credit-worthiness of the Current Account banker will be maintained if its ratings fall this low and this option will not be taken up if there are serious concerns.

In addition to investment balances, the Council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be monitored and minimised, so far as practicable. 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 Authority maintaining operational continuity.

Secured Investments include covered bonds and other collateralised arrangements with banks and building societies. Such investments are secured on the bank's assets, which limits potential losses in the unlikely event of insolvency and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits.

4.14 Investment in Other Government, Corporate and Registered Providers

Other Government – this covers 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.

Corporates – this covers 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 – this covers 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 government and, as providers of public services, they retain a likelihood of receiving government support if needed.

4.15 Unrated Institutions

To allow the option to invest in the Municipal Bonds Agency, and to continue to retain the option to invest in other unrated counterparties, it is proposed to set the limits as set out in 4.12 above.

4.16 Pooled Funds (including Money Market Funds)

Pooled Fund investments are investments 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.

The regulatory environment for pooled funds has changed how money market funds operate. The Council has had regular advice from its Treasury Adviser on the risk position for pooled funds, as the proposals have been enacted, and will continue to monitor the position for such funds.

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.

Pooled funds whose value changes with market prices, and/or have a notice period, will only be used for longer investment periods.

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

4.17 Strategy for 2019/20

Cash flow surpluses can be considered as falling into three categories -

- (a) **Short-term funds** that are required to meet cash flows occurring in the next month or so, and for which the preservation of capital and liquidity is therefore of paramount importance. Generating investment returns is of limited concern here, although should not be ignored. Instant access AAA-rated money market funds and bank deposit accounts will be the main methods used to manage short-term cash.

- (b) **Medium-term funds** that may be required in the next one to twelve months will be managed concentrating on security, with less importance attached to liquidity but a slightly higher emphasis on yield. The majority of investments in this period will be in the form of fixed term deposits with banks and building societies. A spread of counterparties and maturity dates will be maintained to maximise the diversification of credit and interest rate risks.
- (c) **Long-term funds** that are not required to meet any liquidity need and can be invested with a greater emphasis on achieving higher returns. Security remains fundamental however, as any losses from defaults will impact on the total return. Liquidity is of lesser concern, although it should still be possible to sell investments with due notice if large cash commitments arise unexpectedly. This is where a wider range of instruments, including structured deposits, certificates of deposit, gilts and corporate bonds could be used to diversify the portfolio.

The overall Investment Strategy will be to prioritise security of funds and maintain a mix of short-term (largely instant access) and medium-term investments to generate investment income as market conditions permit. There are currently no long-term investments by the Council. If there are sufficient funds at a future date, the Council will consider its options for optimising returns and making more long-term investments.

With short-term interest rates still significantly lower than long-term rates, due consideration will also be given to continuing to use surplus funds to defer making long-term borrowing or even make early repayments of long-term borrowing. In addition to the savings on the interest rate differential, this strategy will also reduce the Council's exposure to credit risk and interest rate risk. In the context of the borrowing strategy, it is likely that most investments will continue to be in instant access and short term deposits, to manage the Council's liquidity.

The counterparty limits set out above, do allow for a wider range of investment opportunities to be taken up than have been used by the Council to date. Should the circumstances arise under which this would be appropriate, this would allow an increased diversification of the overall portfolio and in some instances, increase the security of investments made. The take up of any new investment opportunities will be closely managed by TMG, following advice given by the Council's Treasury Management Advisers.

5 Budget Implications

5.1 Excluding PFI costs (which are offset by Government grant funding), the budget for debt interest payable in 2019/20 is £6.8 million (including the interest element of payments to LCC for debt managed on our behalf), reflecting

- (a) £6.3 million interest payable, at an average interest rate of around 3.8%, on the long-term debt portfolio (forecast to average £167 million over the year),
- (b) up to £0.5 million for short-term borrowing, at interest rates averaging 1.25%.

Projected investment income in 2019/20 is around £100,000, based on an average investment portfolio of circa £16 million, and interest rates averaging 0.6%.

If actual levels of investments and borrowing and/or actual interest rates differ from those forecast, performance against budget will be correspondingly different.

6 Using Derivatives

- 6.1 A derivative is a financial instrument whose value is derived from changes in the value of an asset or an index. Local authorities (including this Council) have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. deals agreed for future dates) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans).

Section 1 of the Localism Act 2011 included a general power of competence that removes the uncertain legal position over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). The CIPFA Code requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

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 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.

- 6.2 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.

7 Treasury Management Indicators

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

Refinancing Risk - Maturity Structure of Borrowing

This indicator is set to control the Council's exposure to refinancing risk - i.e. to prevent too much debt maturing at any one time, with a risk the Council will have to refinance at the rates then prevailing. The limits for up to 24 months continue to be relaxed to allow for a higher level of short term borrowing.

The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper	Lower
Under 12 months	50%	0%
12 months and within 24 months	20%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	30%	0%
10 years and above	95%	25%

This indicator applies to the financial years 2019/20, 2020/21, and 2021/22, from the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment. Where there is a prospect that a LOBO may be called, this has been reflected in setting these limits.

Principal Sums Invested for Periods Longer than 364 Days

The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2019/20 £M	2020/21 £M	2021/22 £M
Limit on principal invested beyond year end	7.0	5.0	3.0

The Indicators above are "standard" Treasury Management Indicators that are generally adopted by local authorities, in line with individual circumstances. These indicators have not directly addressed the key treasury priorities of Security and Liquidity, though these issues are already closely tracked throughout the year. However, working in conjunction with the Council's Treasury Advisers, options for the formal monitoring of performance in regard to these priorities remain under consideration.

Interest Rate Risk

CIPFA has withdrawn the previous recommendation for standard indicators for Upper Limits on Fixed and Variable Interest Rate Risk. Nonetheless, this Council recognises that it must have regard to the risk that fluctuations in interest rates could create an unexpected burden on its finances, and will therefore continue to monitor its exposure to Fixed and Variable Interest Rate Risk. In addition, without setting a formal limit, this Council will also monitor, on an ongoing basis, the potential impact of a 1% change in interest rates on its current borrowing and investment portfolio.

The upper limits on fixed and variable rate interest rate exposures, expressed as an amount of net principal borrowed will be:

	2019/20 £M	2020/21 £M	2021/22 £M
Upper limit on Fixed Interest rate exposures	233.9	227.7	220.2
Upper limit on Variable Interest rate exposures	102.8	100.0	96.6

8 Other Matters

Markets in Financial Instruments Directive (MiFID)

The Authority has opted up to professional client status with its providers of financial services, including advisers, brokers and some fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Authority's treasury management activities, the Director of Finance and Customer Services believes this to be the most appropriate status.

9 Other Options Considered

The MHCLG Investment Guidance and the CIPFA Code of Practice do not prescribe any particular treasury management strategy for local authorities to adopt.

Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Reduced risk of losses from credit related defaults
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs will be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long term costs will be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs will be less certain

The Director of Finance and Customer Services, having consulted with the Executive Member for Resources, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness.