TREASURY MANAGEMENT STRATEGY 2019/20

1. Treasury Management

(a) Introduction

This report considers the annual Treasury Management Strategy as required by the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management, updated in 2017, which the Council has adopted. This report also includes a number of Prudential and Treasury Management Indicators, which provide a framework for Councils to borrow prudently.

Revised reporting is required for the 2019/20 due to revisions of the MHCLG Investment Guidance, the MHCLG Minimum Revenue Provision (MRP) Guidance, the CIPFA Prudential Code and the CIPFA Treasury Management Code. The primary reporting changes include the introduction of a capital strategy, to provide a longer-term focus to the capital plans, and greater reporting requirements surrounding any commercial activity undertaken under the Localism Act 2011. The capital strategy is being reported separately.

The purpose of the Treasury Management Strategy is to ensure the Council has sufficient cash resources available to fund its expenditure in services on a day-to-day basis; and to maximise the returns from the investment of any surplus cash to help the Council's overall financial position. Treasury management also incorporates the borrowing strategy for funding the capital programme detailed in the borrowing strategy noted below.

Whilst any commercial initiatives or loans to third parties will impact on the treasury function, these activities are generally classed as non-treasury activities, (arising usually from capital expenditure),and are separate from the day to day treasury management activities.

The Strategy has been reviewed and the revised approach set out in this report takes account of what is happening in the financial markets, specifically in respect of returns on investments and the outlook for interest rates, as well as the wider economic situation and the continuing pressures on local government funding.

The Strategy draws together the approach to short-term cash deposits under one year, short to medium term investments under 3 years, medium term deposits for 3 to 5 years, and investments for over 5 years.

(b) Background

Preservation of capital continues to be an important factor, dominating the Council's strategy for placing its cash deposits. This is in accordance with MHCLG guidance on investments which notes that investment priorities should be security and liquidity, rather than yield.

The year ahead is likely, once again, to be characterised by difficulties in placing the Council's investments with relatively sound institutions at competitive interest rates. Finding a reasonable rate of return will continue to be challenging. Current returns range from 0.6% to 1.0% depending on the duration of the deposit, whilst the Bank of England forecasts that inflation will be above 2% during 2019.

The annual strategy covers the borrowing activities to be undertaken to finance the Capital Programme in 2019/20 together with the investment of the Council's cash balances which are expected to range between £40m and £80m during 2019/20. A significant proportion of these balances are earmarked Council Funds (eg the Insurance Reserve which protects the Council from the financial impact of catastrophic risks) and deposits made on behalf of schools.

The Council employs Link Asset Services (previously Capita Asset Services) as its external treasury management advisors and they have been consulted and support the proposals contained in this report.

The Treasury Management Strategy is underpinned by the Council being required under the Local Government Act 1992 to set a Council Tax sufficient to meet its spending commitments.

(c) Interest Rate Outlook

The Council's strategy for 2019/20 will be influenced by the outlook for interest rates and the credit-worthiness of banks and financial institutions. Bank Rate currently stands at 0.75% and most forecasters predict that bank rate will increase to 1.0% during 2019/20. Interest rate expectations, however, could alter due to Brexit.

Interest rates on long term loans from the Public Works Loan Board (PWLB) are currently around 2.6% and are expected to rise gradually to around 3% during 2019/20.

(d) Treasury Management Strategy for 2019/20

The MHCLG and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, (as managed by the treasury management team). Non-financial investments, essentially the purchase of income yielding assets, are covered in the Capital Strategy, (a separate report).

Given the continuing limited investment opportunities and low returns the Treasury Management Strategy for 2019/20 has been reviewed with the aim of seeking out a wider range of investments that may generate greater returns whilst balancing risk and liquidity.

The Council's cash balances, and projected sums available, fall into three broad categories:

- short-term cash deposits under one year, and short to medium term investments under three years (around £20m);
- medium-term deposits from three to five years (£15m); and
- investments over five years (£16m).
- The Council's credit rating criteria have also been re-examined to ensure that they remain appropriate.

There are two key elements of the Strategy for 2019/20: the investment of the Council's cash balances and the management of the Council's long term borrowings. Given the volatile nature of financial markets and the need to respond quickly it may be necessary to change the strategy, limits and indicators throughout the year. It is, therefore, proposed to delegate changes to the treasury management strategy, limits and indicators to the Section 151 Officer, the Director of Finance and Corporate Services, in consultation with the

Cabinet Member for Resources, where statutory guidance allows. Any such changes will be reported to Council at the next earliest opportunity.

Investments

As part of its strategy for achieving savings, the Council in 2017 made a prepayment of around £33m into the Pension Fund in order to produce annual savings of £0.5m. The saving is generated by the Pension Fund having a greater scope to achieve a higher return than that available on treasury deposits. This is the second three year prepayment cycle that the Council has made and as a result this reduces the available balances for investments during 2019/20. The balance of funds averaging around £40m-£60m will be managed internally by the oneSource treasury team, whose training needs are periodically reviewed. Cash flows, however, vary from month to month.

The Council's investment strategy for 2019/20 incorporates both the strategy for the Council's short-term cash flows and short-term deposits (less than one year) and the strategy for investing the Council's medium-term cash balances.

Deposits of less than one year are made both for the purpose of managing the Council's daily cash flows and for strategic reasons. Medium-term investments are made with cash balances that the Council does not need to use in the short to medium term. This core cash is unlikely to be required over the medium term as it relates to balance sheet items such as cash backed reserves.

The Council's strategy for 2019/20 has been developed to incorporate earnings from the short-term core cash, which will be invested for periods of up to one year, short to medium-term investments in liquid pooled investment vehicles with the potential to earn potentially higher returns than in fixed term deposits, medium-term investments in Diversified Growth Funds/Absolute Return pooled funds and medium-term to longer-term investments in pooled property funds. The strategy also proposes that the Council will continue to research higher yielding investment instruments using the experience and knowledge within the oneSource treasury team, and taking appropriate advice from the Council's treasury management adviser, to help protect the 'real value' of the council's cash balances.

The Council's treasury management operation has elected to be treated as an elective professional investor under the Markets in Financial Instruments Directive (MiFID II) which became operational from January 2018. This ensures that the Council can continue to earn the highest possible rates on its deposits.

The Council's treasury management strategy operates within guidance from the Ministry of Housing, Communities and Local Government (MHCLG) on local government investments. This guidance defines a prudent investment policy as having two objectives: achieving first of all security (protecting the capital sum from loss) and then liquidity (keeping the money readily available for expenditure when needed). The generation of yield is distinct from these prudential objectives.

(i) Security

The Council's credit-rating criteria has been amended in recent years to reflect regulatory changes in the banking sector which have led to changes in the ratings issued by the main credit rating agencies.

The regulatory changes introduced throughout the world are designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. The Council has chosen to apply the creditworthiness service provided by Link Asset Services which employs a sophisticated modelling approach utilising credit ratings from all of the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following:

- credit watches and credit outlooks from credit rating agencies;
- Credit Default Swap (CDS) spreads to give early warning of likely changes in credit ratings; and
- sovereign ratings to select counterparties from only the most creditworthy countries.

Link's modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used to determine the suggested duration for investments. The Council will therefore use counterparties who meet Link's credit-rating/overlay criteria. The use of these criteria for deposits with banks and building societies will meet the definition of "high" credit-ratings as required by the MHCLG guidance.

The Council's credit rating criteria for UK banks and building societies in 2019/20 will continue to limit deposits to those UK banks and building societies which have high credit ratings and will also allow for those which are partly/majority owned by the UK government.

When making deposits the Council will continue to operate a group limit with counterparties. This means that investments with NatWest/RBS, Bank of Scotland/Lloyds and other banking groups are controlled at a group level, which remain at £35m for all banking groups.

For lending to banks outside the United Kingdom the Council's revised credit-rating criteria will require that they meet the Link credit-rating matrix described above and that only banks that have a sovereign rating equivalent to the UK and above can be used. The countries that currently meet this criteria are (AAA rated) Australia, Canada, Denmark, Germany, Netherlands, Singapore, Sweden, Switzerland, (AA+ rated) Finland, U.S.A. and (AA rated) France. The limit for these banks will remain at £25m.

The Council will also continue to use Money Market Funds (MMFs), which provide lower interest returns but do provide a highly liquid, diversified investment via a highly credit-rated (AAA/Aaa) pooled investment vehicle.

The strategy also proposes that the Council may make investments in 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 Regulator of Social Housing. The duration of such investments, limited to £10m with each Registered Provider, will be subject to the Council taking appropriate advice prior to making any such investment. The strategy also continues to allow the Council to invest in un-rated bonds such as Solar Bonds. The Council will take appropriate advice prior to making such investments and undertake due diligence where required.

(ii) Liquidity

Current forecasts for investment returns during 2019/20 are based on very low levels - ranging from 0.6% to around 1%, dependent on counterparty and duration. The Council, therefore, has continued to examine areas where it might be possible to produce enhanced returns for its short-term cash balances (less than one year) within the Council's risk-return parameters. Since 2017/18 the Director of Finance and Corporate Services has considered it prudent to extend the maximum period for placing deposits with Nationwide Building Society, Santander UK, Lloyds Bank/Bank of Scotland and Barclays Bank to one year. Link's advice at times limits deposits with these four counterparties to 6 months but the Director of Finance and Corporate Services considers that these three institutions continue to play a key part in the UK banking sector and that this provides a degree of additional security to invest for slightly longer periods. It is proposed that this policy should be continued in 2019/20.

Given the projections for the Council's cash balances over the next three years it is important to maintain a degree of liquidity. Also, as opportunities to place investments for over one year are currently constrained due to low rates and a limited range of appropriate counterparties it is proposed that most fixed term investments made during 2019/20 will be for periods of less than one year.

Investments in pooled investment vehicles

Investments in pooled investment vehicles include deposits in credit rated funds, which count as specified investments and investments in non-credit rated funds which are categorised as non-specified investments. The different categorisation reflects the additional knowledge that the Council must consider before making deposits in non-specified funds. The Council continues to consider it appropriate to place money in non-specified funds and will take appropriate advice from its advisers when taking such decisions and in their subsequent monitoring.

The Director of Finance and Corporate Services has undertaken research to investigate alternative streams of income from the Council's treasury deposits that offer enhanced returns on a consistent basis over a medium-term timespan (three to five years).

In line with this policy the Council has, to date, placed £15m in pooled investment funds, namely Diversified Growth Funds / Absolute Return Funds which are used by the Council's Pension Fund. These funds have demonstrated an historical out-performance above the 7 Day LIBID used when forecasting interest earnings and aim to produce a positive return over time, regardless of the prevailing market conditions. Even when markets are falling sharply, these funds still have the potential to make money although there may be times when they underperform. These funds are different from traditional investments because they:

- seek consistently positive results by deploying techniques that are able to profit from both the ups and downs in financial markets, including stock prices;
- have a lower correlation to the pattern of returns from other asset classes;
- are not benchmarked against a specific index/sector; and
- invest in a broad base of investments including equities, bonds and derivatives.

The aim is to increase the return on the Council's treasury deposits within an acceptable level of risk and volatility.

Before making investments in pooled funds, and Diversified Growth Funds in particular, the Council discussed its strategy with Link who made the following comments on three funds that the Council was researching:

“Historically they (the three funds) have outperformed cash over the last 1, 3 and 5 years but this hasn’t been a consistent outperformance as during periods of financial uncertainty these funds may produce a volatile return. As a result, they may underperform their targeted benchmarks and the Authority should be comfortable that this may occur before any funds are placed.”

“…the Funds might not be appropriate for investors who plan to withdraw their money within five years, which is at the longer end of your time horizon. If the Authority is happy with the risk attached to these funds then they could be considered for inclusion in the Authority treasury cash investment portfolio.”

Advantages of investments in pooled funds, such as Diversified Growth Funds, include returns, which have shown enhanced returns over cash benchmarks over a three to five year period, whilst daily dealing allows quick access to funds should they be required.

During 2019/20 an evaluation of all the current pooled funds will be undertaken, particularly in the light of the announcement in November 2018 by the MHCLG, providing a temporary override to allow English local authorities time to adjust their portfolio of all pooled investments, by announcing a statutory override to delay implementation of IFRS 9 for five years commencing from 1 April 2018.

Drawbacks of these investments include the volatility of returns, and the potential of a capital loss does mean that there is potential for underachievement of interest earnings from time to time – because of this these funds will be subject to tighter monitoring and review. When making the decision to make these investments the Council agreed that any short-term volatility in the returns from these funds would be smoothed by use of the Financing Reserve thus avoiding any impact on the General Fund. It is proposed that this also continues to form part of the 2019/20 strategy but consideration will be given throughout the period to alternative investment strategies which may result in the sale of the investment.

Given the continuing pressures on the Council’s interest earnings, the Director of Finance and Corporate Services continues to investigate further opportunities for the investment of medium to longer-term balances. The Council has had discussions with Link to identify suitable pooled investment vehicles which have the potential to produce enhanced earnings above fixed rate deposits but which are also very liquid and would allow the Council to withdraw money if required for other purposes. These would typically be of a shorter duration than Diversified Growth / Absolute Return Funds, but still provide the potential to achieve stronger returns than cash deposits.

It is proposed that the strategy for 2019/20 will include investments in suitable pooled investment vehicles, commonly referred to as Ultra Short Dated Bond Funds or Short Dated Bond Funds. The Council will discuss any technical issues with its advisers to ensure that any appropriate funds meet all MHCLG investment criteria. Suitable funds may not be rated, or have credit-ratings below the AAA ratings associated with short-term money market funds reflecting the longer duration and the increased risk and potential volatility of return that such funds take when targeting enhanced performance. It is proposed that, where funds do have credit-ratings, a minimum credit-rating of AA be required for pooled funds in which the Council invests its short to medium-term cash. If money is placed in non-credit rated pooled funds for short to medium-term periods the Council will take appropriate advice prior to making any such investments.

During 2016/17 the Council invested £12.5m in pooled property funds. These investments, originally part of an allocation of up to £20m in such funds, followed a review of the Council's cash needs to determine the appropriate levels of medium to long-term investments in pooled property funds. This review was undertaken to ensure that the Council can maximise investment returns given the financial constraints we face whilst continuing to have sufficient funds available to run services. Advice was received that opportunities in such investments were now limited and accordingly the Council examined, and continues to examine appropriate investments in longer-term investment vehicles which may include investments in other categories of pooled funds.

The Council may also consider further investments in property, assets and other suitable potential investment opportunities which might count as capital expenditure, but will seek appropriate advice before making any decisions.

Other investments, including those made for more than one year

Investments for more than one year may also be made in deposits with banks and building societies who meet Link's credit-rating criteria. The Director of Finance and Corporate Services considers it appropriate that investments for up to three years may continue to be made with banks which are part/majority owned by the UK government. The Council's criteria since 2016/17 has authorised investments in bonds which do not have credit ratings, having taken appropriate advice, including from oneSource partners, and undertake due diligence where required. It is proposed that this continues to provide an option for the 2019/20 strategy.

It is proposed that for 2019/20 an upper limit of £50m at any one time should apply to the total of investments in non-specified investments which includes investments outstanding for more than one year and investments in pooled investment vehicles. This would also include investments in government gilt-edged stock and eurobonds.

The criteria for investments over one year, investments in un-rated bonds and in pooled investment vehicles are summarised in Appendix 1. These investments exclude loans to third parties (such as BexleyCo) for the purpose of capital expenditure which are not covered by this report.

The Council, therefore, continues to adopt a cautious approach to banking counterparties with whom it places money.

Borrowing

The Council's increasing focus on growth and regeneration in the Borough is reflected in the latest Capital Strategy and a step-change in the composition of its Capital Programme. Supporting the objectives of the Growth Strategy, opportunities to generate significant additional revenue income streams will be exploited and will include property development and investment both in and outside of the Borough, with in-Borough investment targeted to also boost the impact of the Growth Fund.

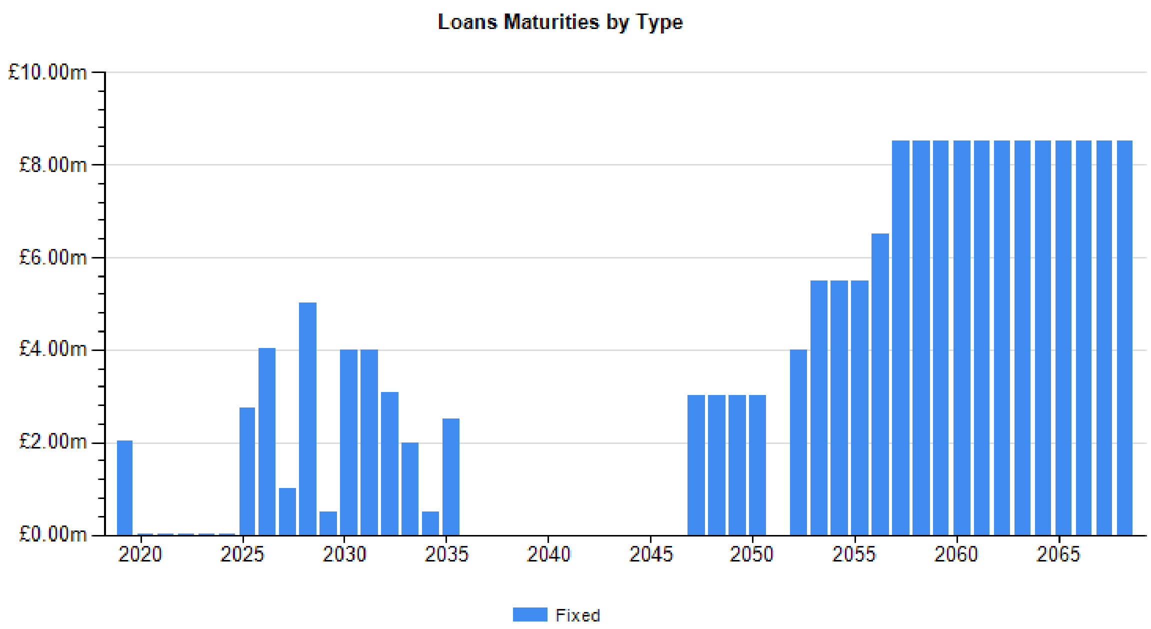
The scale of the investment required, taking advantage of potential opportunities and making a significant impact on the Council's revenue position, either in terms of increased income or reduced service costs, will require the Council to exploit its prudential borrowing powers.

A key aspect of this approach is the creation of the Council's arms-length development company – BexleyCo Ltd - which was incorporated in June 2017. Its objective is to support the delivery of the Council's Growth Strategy, with a focus on delivering new homes for local people, in sustainable localities, which respect the Borough's overall character and identity.

BexleyCo's business plan sets out an initial package of development schemes in the Borough that will require significant investment funding from the Council. This is included in the Council's latest Capital Programme and the impact is reflected in the borrowing limits over the next three years detailed in Appendix 1. The Council will look to borrow for the agreed capital programme at the best rates available within our stated borrowing limits.

The scope to repay and refinance debt is limited due to changes in PWLB redemption arrangements which introduced a penalty rate when prematurely repaying debt. Borrowing and repayment opportunities will be kept under review throughout 2019/20. Any new long-term borrowing is likely to take place at long maturities and be prudently spread to ensure that the Council does not face excessive re-financing demands in any one year.

The graph below shows the long-term nature of the Council's borrowing, with most borrowing maturing in the 30 to 50 year periods. It also demonstrates the spread of the Council's long-term debt which currently totals £173m



2. Prudential and Treasury Management Indicators

The Prudential Indicators which the Council is required to set are:

(i) Authorised limit for external debt. This is based on the Council's capital expenditure, financing and working capital requirements together with a contingency for unexpected events.

(ii) Operational limit (boundary) for external debt. This limit is based on the same estimates as the authorised limit without a contingency.

The Treasury Management Indicators which the Council is required to set are:

(iii) Repayment profile of borrowing.

(iv) Total amount invested for periods longer than 1 year.

Other prudential indicators relating to the capital programme are reported in the capital strategy report on this agenda. Appendix 1 provides figures for 2019/20 and the following two financial years where required.

Appendix 1

1. The Council's Credit Rating Criteria

The Council uses the credit-worthiness service provided by Link as the basis for all investment decisions with banks and building societies. This service uses both credit-rating information and market intelligence when determining with whom the Council places deposits. This information is monitored daily by Link and the Council's treasury staff.

2. Criteria for "specified" Investments up to 1 Year

The short-term ratings offered by the credit-rating agencies are their assessment of the financial institutions' ability to repay investments placed with them for periods of up to 1 year. The criteria used by the Council indicate that the institution has a strong capacity for timely repayment.

The criteria below will be used to define "high" credit ratings under the MHCLG guidance for investments of up to one year ("specified investments") and credit ratings are continually monitored. Limits are set for different types of organisations who borrow from local authorities and are based on the credit ratings (where appropriate) of each type of institution:

a) Local Authorities £35m limit per authority

b) UK banks and building societies who meet Link's criteria:

- Limit of £35m per insititution

c) Overseas banks who meet Link's criteria:

- Limit of £25m per institution. Such investments may only be placed with banks whose home country is rated AA or above.

d) Investments in Money Market Funds (investments in externally managed pooled funds) will be made with those which have Fitch/Standard & Poor's AAAmmf/AAAm ratings or Moody's Aaa-mf (which are the very highest ratings specifically assigned to Money Market Funds):

- Limit of £25m per fund for AAA/Aaa rated funds.

e) Investments in ultra-short dated bond pooled investment funds will be made with those which have, as a minimum Fitch/Standard & Poor's AA ratings or Moody's Aa rating.

- Limit of £10m for AA/Aa rated ultra-short dated bond pooled investment funds.

3. Criteria for "non-specified Investments"

(a) Investments over one year are defined as "non-specified investments" under the MHCLG guidance. The Council will make such investments with institutions who meet Link's criteria. Amounts that may be lent to such institutions are included in the limits in section 2 above.

The Council may also make investments over one year with UK banks which are part/majority owned by the UK government. Such investments may be made for periods of up to 3 years.

These longer term investments will be made in government gilt-edged stock and deposits with banks, building societies and UK local authorities who meet the long-term investment credit criteria.

(b) Investments may also be made in pooled investment vehicles, such as Short Dated Bond Funds, Diversified Growth Funds, Absolute Return Funds and Property Funds. Investments in such funds, which do not tend to have credit-ratings, shall be made with the view that the investments will be held for three to five year periods.

A limit of £10m will apply to the amount placed in each such fund.

(c) Investments may also be made in 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 Regulator of Social Housing.

A limit of £10m will apply to the amount placed in such loans and bonds issued by each such Registered Provider of Social Housing.

(d) Investments may also be made in un-rated bonds. The Council will take appropriate advice prior to making such investments and undertake due diligence where required.

A limit of £10m will apply to the amount placed in such un-rated bonds issued by each such provider.

Note:

From 1 January 2019, the largest UK banks must separate core retail banking from investment banking. This is known as ring-fencing. Ring-fencing was the central recommendation of the Independent Commission on Banking chaired by Sir John Vickers and was introduced through the Financial Services (Banking Reform) Act 2013.

Ring-fencing will support financial stability by making banking groups simpler and easier to ‘resolve’. This means that if either the ring-fenced or non ring-fenced part of the bank fails, it will be easier to manage the failure in an orderly way without the need for a government bail-out. As well as ensuring that UK taxpayers are not on the hook for bank failures, ring-fencing should mean fewer and less severe financial crises in the future, which will benefit the whole UK economy.

Appendix 2

Treasury Management and Prudential Indicators

(i) Prudential Indicators

PRUDENTIAL INDICATORS	2019/20 £m	2020/21 £m	2021/22 £m
Authorised limit for external debt			
• Borrowing	390	392	394
• Commercial Activities	132	132	132
• Other long term liabilities	45	45	45
Total	567	569	571
Operational limit (boundary) for external debt			
• Borrowing	319	319	319
• Commercial Activities	120	120	120
• Other long term liabilities	45	45	45
Total	484	484	484

(ii) Treasury Management Indicators

TREASURY MANAGEMENT INDICATORS	2019/20 £m	2020/21 £m	2021/22 £m
Upper limit for total amount invested for longer than 1 year	50	50	50

Repayment Profile of Borrowing (Fixed and variable rate)	Upper limit %	Lower limit %
Under 12 months	40	0
12 months and within 24 months	60	0
24 months and within 5 years	80	0
5 years and within 10 years	100	0
10 years and above	100	0

Note: The above repayment profile excludes short-term temporary borrowings