

## **Treasury Management Strategy Statement 2019/20**

### **Introduction**

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

Treasury risk management at the Authority 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 the Authority 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.

Investments held for service purposes or for commercial profit are considered in Appendix C to this report, the Investment Strategy.

### **External Context**

**Economic background:** 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.

Following the Bank of England'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 continues to reiterate that any further increases will be at a gradual pace and limited in extent.

**Interest rate forecast:** Following the increase in Bank Rate to 0.75% in August 2018, the Authority's treasury management adviser Arlingclose is forecasting two more 0.25% hikes during 2019 to take official UK interest rates to 1.25%. The Bank of England'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.

Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on Arlingclose's interest rate projections, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.7% and 2.2% respectively over the interest rate forecast horizon, however volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.

For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.93%, and any new long term loans will be subject to analysis to determine the most cost effective source of borrowing.

### **Local Context**

On 31<sup>st</sup> December 2018, the Authority held £130.9m of borrowing and £60.0m of investments. This is set out in further detail at page 9. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance sheet summary and forecast

|                           | <b>31.3.18<br/>Actual<br/>£000</b> | <b>31.3.19<br/>Estimate<br/>£000</b> | <b>31.3.20<br/>Forecast<br/>£000</b> | <b>31.3.21<br/>Forecast<br/>£000</b> | <b>31.3.22<br/>Forecast<br/>£000</b> |
|---------------------------|------------------------------------|--------------------------------------|--------------------------------------|--------------------------------------|--------------------------------------|
| General Fund CFR          | 15,143                             | 18,842                               | 20,033                               | 18,329                               | 17,987                               |
| HRA CFR                   | 132,343                            | 130,358                              | 128,403                              | 126,477                              | 124,579                              |
| <b>Total CFR</b>          | <b>147,486</b>                     | <b>149,200</b>                       | <b>148,436</b>                       | <b>144,806</b>                       | <b>142,566</b>                       |
| Less: External borrowing  | -<br>131,303                       | -129,336                             | -127,341                             | -125,373                             | -123,433                             |
| <b>Internal borrowing</b> | <b>16,183</b>                      | <b>19,864</b>                        | <b>21,095</b>                        | <b>19,433</b>                        | <b>19,133</b>                        |
| Less: Usable reserves     | -51,440                            | -50,318                              | -48,590                              | -46,672                              | -46,438                              |
| Less: Working capital     | -11,103                            | -15,183                              | -16,470                              | -13,747                              | -10,760                              |
| <b>Investments</b>        | <b>46,360</b>                      | <b>45,637</b>                        | <b>43,965</b>                        | <b>40,986</b>                        | <b>38,065</b>                        |

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 Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

The Authorities General Fund CFR increases in the financial years to 2019/20 due to the capital programme. It then reduces in subsequent years as forecast capital receipts will be used to repay prudential borrowing. The Authority has a reducing HRA CFR. Investments are forecast to remain at £46m by 31/3/19 but will fall in subsequent years as useable reserves are utilised to finance the HRA capital and General Fund revenue budget.

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

## **Borrowing Strategy**

The Authority currently holds £129 million of loans, a decrease of £2 million on the previous year, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 1 shows that the Authority does not expect to need to borrow in 2019/20. The Authority may however borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing.

**Objectives:** The Authority's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Authority's long-term plans change is a secondary objective.

**Strategy:** Given the significant cuts to public expenditure and in particular to local government funding, the Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much 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 Authority is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal 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.

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

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

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments (see below)

- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except Derbyshire Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

**Other sources of debt finance:** 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 the majority of its long-term borrowing from the PWLB but it continues to investigate other sources of finance, such as local authority loans and bank loans, that may be available at more favourable rates.

**Municipal Bonds Agency:** UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a joint and several guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

**Short-term and variable rate loans:** These loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below.

**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.

### **Investment Strategy**

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's investment balance has ranged between £46 and £64 million, and similar levels are expected to be maintained in the forthcoming year.

**Objectives:** The CIPFA Code requires the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Authority will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

**Negative interest rates:** 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:** Given the increasing risk and very low returns from short-term unsecured bank investments, the Authority aims to further diversify into more secure and/or higher yielding asset classes during 2019/20. This is especially the case for the estimated £10m that is available for longer-term investment. A reducing proportion of the Authority's surplus cash remains

invested in short-term unsecured bank deposits, certificates of deposit and money market funds. This diversification will represent a change in strategy over the coming year.

**Business models:** Under the new IFRS 9 standard, the accounting for certain investments depends on the Authority’s “business model” for managing them. The Authority aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

**Approved counterparties:** The Authority may invest its surplus funds with any of the counterparty types in table 2 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 2: Approved investment counterparties and limits

| <b>Credit rating</b> | <b>Banks &amp; Building Societies</b> | <b>Local Authorities</b> | <b>Government</b>       | <b>Corporates</b> | <b>Registered Providers</b> |
|----------------------|---------------------------------------|--------------------------|-------------------------|-------------------|-----------------------------|
| UK Govt              | n/a                                   | n/a                      | £ Unlimited<br>50 years | n/a               | n/a                         |
| AAA                  | £5m<br>2 years                        | n/a                      | £5m<br>50 years         | £5m<br>2 years    | £5m<br>2 years              |
| AA+                  | £5m<br>2 years                        | n/a                      | £5m<br>25 years         | £5m<br>2 years    | £5m<br>2 years              |
| AA                   | £5m<br>2years                         | n/a                      | £5m<br>15 years         | £5m<br>2 years    | £5m<br>2 years              |
| AA-                  | £5m<br>2 years                        | n/a                      | £5m<br>10 years         | £5m<br>2 years    | £5m<br>2 years              |
| A+                   | £5m<br>2 years                        | n/a                      | £5m<br>5 years          | £5m<br>2 years    | £5m<br>2 years              |
| A                    | £5m<br>13 months                      | n/a                      | £5m<br>5 years          | £5m<br>13 months  | £5m<br>13 months            |
| A-                   | £5m<br>6 months                       | n/a                      | £5m<br>5 years          | £5m<br>6 months   | £5m<br>6 months             |
| None                 | n/a                                   | £5m<br>2 years           | £5m<br>5 years          | n/a               | n/a                         |
| <b>Pooled funds</b>  |                                       | £12m per fund            |                         |                   |                             |

This table must be read in conjunction with the notes below

**Credit rating:** 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:** 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:** 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:** 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 generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

**Corporates:** Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made as part of a diversified pool in order to spread the risk widely.

**Registered providers:** Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are tightly regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

**Pooled funds:** Shares or units in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Bond, equity, multi-asset 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.

**Operational bank accounts:** The Authority may incur operational exposures, for example through current accounts, collection accounts and merchant acquiring services, 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 below £50,000 per bank. 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.

**Risk assessment and credit ratings:** Credit ratings are obtained and monitored by the Authority's treasury advisers, who will notify changes in

ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

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

Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as “rating watch negative” or “credit watch negative”) so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

**Other information on the security of investments:** The Authority understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the Authority’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 otherwise meet the above criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Authority will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Authority’s cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example,

or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

**Investment limits:** The maximum that will be lent to any one organisation (other than the UK Government) will be £5 million. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

Table 3: Investment limits

|   | <b>Cash limit</b> |
|---|-------------------|
| Any single organisation, except the UK Central Government | £5m each          |
| UK Central Government                                     | unlimited         |
| Any group of organisations under the same ownership       | £7.5m per group   |
| Any group of pooled funds under the same management       | £12m per manager  |
| Negotiable instruments held in a broker's nominee account | £15m per broker   |
| Foreign countries   | £10m per country  |
| Registered providers and registered social landlords      | £10m in total     |
| Unsecured investments with building societies             | £5m in total      |
| Loans to unrated corporates                               | £2m in total      |
| Money market funds  | £30m in total     |

**Liquidity management:** The Authority uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Authority's medium-term financial plan and cash flow forecast.

## **Treasury Management Indicators**

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

**Interest rate exposures:** This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

| <b>Interest rate risk indicator</b>  | <b>Limit</b> |
|--|--------------|
| Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates | £150,000     |
| Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates | £100,000     |

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

**Maturity structure of borrowing:** This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

| <b>Refinancing rate risk indicator</b> | <b>Upper limit</b> | <b>Lower limit</b> |
|--|--------------------|--------------------|
| Under 12 months                        | 10%                | 0%                 |
| 12 months and within 24 months         | 10%                | 0%                 |
| 24 months and within 5 years           | 10%                | 0%                 |
| 5 years and within 10 years            | 25%                | 0%                 |
| 10 years and within 25 years           | 50%                | 20%                |
| 25 years and above                     | 70%                | 20%                |

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

**Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

| <b>Price risk indicator</b>                 | <b>2019/20</b> | <b>2020/21</b> | <b>2021/22</b> |
|---|----------------|----------------|----------------|
| Limit on principal invested beyond year end | £10m           | £10m           | £10m           |

## **Related Matters**

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

**Financial Derivatives:** Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

The Authority will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Authority is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

**Housing Revenue Account:** On 1st April 2012, the Authority notionally split each of its existing long-term loans 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 annually and interest transferred between the General Fund and HRA at the Authority's average interest rate on investments, adjusted for credit risk.

**Markets in Financial Instruments Directive:** The Authority has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and 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 Resources believes this to be the most appropriate status.

### **Financial Implications**

The budget for investment income in 2019/20 is £0.4 million, based on an average investment portfolio of £45 million at an interest rate of 0.93%. For the General Fund the budget for debt interest paid in 2019/20 is £180k, based on an average debt portfolio of £3.1 million at an average interest rate of 5.8%. For the HRA the budget for debt interest paid in 2019/20 is £4.3 million, based on an average debt portfolio of £127 million at an average interest rate of 3.8%. If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different.

### **Other Options Considered**

The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Finance and Resources believes that the above strategy represents an appropriate balance between risk management and cost effectiveness.

## Existing Investment & Debt Portfolio Position

|   | <b>31/12/18<br/>Actual<br/>Portfolio<br/>£m</b> | <b>31/12/18<br/>Average<br/>Rate<br/>%</b> |
|---|---|--|
| <b>External borrowing:</b>                |   |  |
| Public Works Loan Board                   | 130.8   | 3.84                                       |
| <b>Total external borrowing</b>           | <b>130.8</b>                                    | <b>3.84</b>                                |
| <b>Treasury investments:</b>              |   |  |
| Banks & building societies<br>(unsecured) | 20.1<br>20.0                                    | 0.77<br>0.88                               |
| Government (incl. local<br>authorities)   | 6.5   | 0.75                                       |
| Money Market Funds                        | 13.4  | 0.92                                       |
| Cash Plus Funds                           | <b>60.0</b>                                     | <b>0.84</b>                                |
| <b>Total treasury investments</b>         |   |  |
| <b>Net debt</b>                           | <b>70.8</b>                                     |  |