APPENDIX B

TREASURY MANAGEMENT STRATEGY

Strategic Implications

1. This report relates to all of the objectives in the Council's Corporate Plan 2015-2025 as it supports the Council's ability to fund capital and revenue projects and services. The approach recommended continues to build on the Council's previous success in this respect with corporate risk managed carefully as detailed in the report and appendices.

Background

2. Treasury Management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council 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 Council's prudent financial management.

3. Treasury risk management at the Council 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 Council 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.

4. Investments held for service and commercial purposes are considered in a different report, the Investment Strategy – Appendix C

External Context – Economic Background

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

6. The rise in quarterly GDP growth to 0.6% in Q3 from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in Q1. At 1.5%, annual GDP growth continues to remain below trend. Looking ahead, the BoE, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

7. UK Consumer Price Inflation (CPI) for October was up 2.4% year/year, slightly below the consensus forecast and broadly in line with the Bank of England's November Inflation Report. The most recent labour market data for October

2018 showed the unemployment rate edged up slightly to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily. Adjusted for inflation, real wages grew by 1.0%, a level likely to have only a moderate effect on consumer spending.

8. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have 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.

9. While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2%-2.25% in September. Markets continue to expect one more rate rise in December, but expectations are fading that the further rises previously expected in 2019 will materialise as concerns over trade wars drag on economic activity.

Credit Outlook

10. The big four UK Banking Groups have now divided their retail and investment banking divisions into separate legal entities under ring-fencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ring-fenced 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 ring-fenced banks generally being better rated than their non-ring-fenced counterparts.

11. 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.

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

Interest Rate Forecast

13. 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% rises during the 2019 calendar year 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 move towards tighter monetary policy but seems reluctant to push interest rate expectations too strongly. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

14. The UK economic environment remains relatively soft, despite seemingly strong labour market data. Arlingclose’s view is that the economy still faces a challenging outlook as it exits the European Union and Eurozone growth softens. Whilst 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.

15. 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.

16. A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix B4.

17. For the purpose of setting the budget, it will be assumed that new long-term loans will be borrowed at an average rate of 3.00%.

Local Context

18. On 31 December 2018 the Council held £423m of borrowing and £21m of treasury investments, shown in table 1 below:

Table 1 – Existing Borrowing and Treasury Investment Position

	Dec-18 Actual Portfolio £m	Dec-18 Average Rate %
External Borrowing:		
Public Works Loan Board	52.5	2.33
Local authorities	370.5	0.78
LOBO loans from banks	-	-
Total External Borrowing	**423**	**0.98**
Other Long Term Liabilities:		
PFI	-	-
Finance Leases	-	-
Transferred Debt	-	-
Total Gross External Borrowing	**423**	**0.98**
Investments:		
Banks & building societies (unsecured)	1	0.55
Money Market Funds	10	0.75
Pooled Funds	10	4.5
Total Investments	**21**	**2.53**
Net Borrowing	**402**	**-**

19. Forecast changes in these sums are shown in the balance sheet analysis in table 2 below.

Table 2: Balance Sheet Summary and Forecast

	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	393	489	554	572	583
Less: External borrowing	(359)	(455)	(520)	(538)	(549)
Internal (over) borrowing	**34**	**34**	**34**	**34**	**34**
Less: Usable reserves	(24)	(24)	(24)	(24)	(24)
Less: Working capital	0	0	0	0	0
Net Investments (CCLA)	**10**	**10**	**10**	**10**	**10**

20. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

21. The Council has an increasing CFR due to the capital programme, but minimal investments and therefore borrowing will increase up to £549m over the forecast period.

22. CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total borrowing should be lower than its highest forecast CFR over the next three years. Table 2 (above), shows that the Authority expects to comply with this recommendation during 2019/20.

Borrowing Strategy

23. The Council currently holds £423m of loans, an increase of £64m since 31 March 2018, as part of its Strategy for funding previous years' capital programmes. The balance sheet forecast in table 2 shows that the Council expects to borrow up to £520m in 2019/20. The Council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £554m. This limit is reviewed monthly as part of the Community Investment Programme and any change in limits will be reported.

24. The Council's main 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.

25. Given the significant cuts to public expenditure and in particular to local government funding, the Council's Borrowing Strategy continues to address the key issue of affordability without compromising the longer-term stability of the borrowing portfolio. With short-term interest rates currently much lower than long-term rates, it is more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

26. By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of short-term borrowing will continue to 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 Council borrows additional sums at long-term fixed rates in 2019/20 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

27. Alternatively, the Authority 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.

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

Sources of Borrowing

29. 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
- 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 borrowing liabilities:

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

30. The Council has previously raised all of its long-term borrowing from the PWLB but it continues to investigate other sources of finance, such as local authority loans and bank loans that may be available at more favourable rates.

Other sources of borrowing may include:

- **Municipal Bond 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 Cabinet.

- **Short-term and variable rate loans**: These loans leave the Council 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.

- **Borrowing 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 Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

Treasury Investments Strategy

31. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2018/19, the Council's investment balance has ranged between £0m and £53m, and similar levels are expected to be maintained in the forthcoming year.

32. The CIPFA Code requires the Council to invest its funds prudently and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council 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.

33. 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.

34. Given the increasing risk and very low returns from short-term unsecured bank investments, the Council shall assess diversification into more secure and/or higher yielding asset classes during 2019/20. The majority of the Council's surplus cash is currently invested in short-term unsecured bank deposits, and money market funds.

35. 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.

36. The Council may invest its surplus funds with any of the counterparty types in table 3 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 3 – Approved Counterparties

Credit rating	Banks unsecured	Banks secured	Government
UK Govt	n/a	n/a	£unlimited 50 years
AAA	£10m 30 days	£10m 30 days	£10m 364 days
AA+	£10m 30 days	£10m 30 days	£10m 364 days
AA	£10m 30 days	£10m 30 days	£10m 364 days
AA-	£10m 30 days	£10m 30 days	£10m 364 days
A+	£10m 30 days	£10m 30 days	£10m 364 days
A	£10m 30 days	£10m 30 days	£10m 364 days
A-	£10m 30 days	£10m 30 days	£10m 364 days
None	n/a	n/a	£10m 364 days
Pooled funds		£10m across all Pooled Funds, and £10m per MMF	

37. The limits for 2019/20 have risen from £7.5m to £10m per counterparty. This is in light of recent large purchases causing these limits to be breached. In order to mitigate risk, whilst the monetary limit has risen, the length of time these investments can be made for has been reduced from 100 days to 30 days to limit the Council's exposure. Government lending has also risen to £10m, but the length of time has stayed constant at 364 days, due to the added security government deposits give.

38. 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.

39. 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.

40. 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.

41. 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.

42. 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 (MMF) 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.

43. 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.

44. 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 either following an external credit assessment. There are currently no intentions to invest in Corporates during 2019/20.

45. 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. There are currently no intentions to invest in Registered Providers during 2019/20.

46. Real Estate Investment Trusts (REITs): Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties. There are currently no intentions to invest in Registered Providers during 2019/20.

47. Operational Bank Accounts: The Council may incur operational exposures, for example though 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 £10m per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

48. 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.

49. 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 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.

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

51. In order to limit the risk of loss, a group of Banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on Fund Managers, 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 4 – Investment limits per group

Investment Limits	**Cash limit**
UK Central Government	unlimited
Any group of organisations under the same ownership	£10m
Any group of pooled funds under the same management	£10m
Foreign countries	£10m
Unsecured investments with building societies	£10m
Money market funds	£10m

52. The Council uses purpose-built cash flow forecasting spreadsheets 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 Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

53. In the absence of any explicit legal power to do so, the Council will not use standalone financial derivatives (such as swaps, forwards, futures and options). Derivatives embedded into loans and investments, including pooled funds and forward starting transactions, may be used, and the risks that they present will be managed in line with the overall Treasury Risk Management Strategy.

54. The Council has opted up to professional client 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 Council's Treasury Management activities, the Chief Financial Officer believes this to be the most appropriate status.

Financial Implications

55. The budget for investment income in 2019/20 is £458k, based on an average investment portfolio of £17.5m. The budget for borrowing interest paid in 2019/20 is £4.5m, based on an average borrowing portfolio of £492m. 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

56. The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer, having consulted the Treasury Management Review Group, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. 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	Lower chance of losses from credit related defaults, but any such losses may be greater
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, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Borrowing 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 may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Borrowing interest costs will initially be lower	Increases in borrowing interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on borrowing 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 may be less certain