**Appendix B**

## Treasury Management Strategy 2019/20 – 2021/22

1. The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the process, which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992.

2. The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice: the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management, as revised December 2017. This Council adopted the Code of Practice on Treasury Management in February 2010.

3. As a result of adopting the Code the Council also adopted a Treasury Management Policy Statement. This adoption is a requirement of one of the prudential indicators.

4. The policy requires an annual strategy to be reported to the Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year, and the Code of Practice requires a mid-year monitoring report.

5. This strategy covers:

   - The Council's current portfolio position
   - The Council's debt and investment projections;
   - The Council's estimates and limits on future debt levels;
   - The expected movement in interest rates;
   - The Council's borrowing and investment strategies;
   - Treasury performance indicators;
   - Specific limits on treasury activities;
   - Any local treasury issues.

## Current Portfolio Position

6. The overall treasury management portfolio as at 31 March 2018 and 15 January 2019 are shown below for both borrowing and investments:

| **Treasury Portfolio** | | | | |
|---|---|---|---|---|
| | Actual @ 31.3.2018 | | Current @ 15.1.19 | |
| **Treasury investments** | £'000 | *%* | £'000 | *%* |
| Banks | 23,554 | *30%* | 19,920 | *19%* |
| Building Societies – rated | - | - | 17,000 | *16%* |
| Building Societies – unrated | 10,000 | *13%* | 21,000 | *20%* |
| Local authorities | 45,000 | *57%* | 48,800 | *45%* |
| **Total treasury investments** | **78,554** | ***100%*** | **106,720** | ***100%*** |
| | | | | |
| **Treasury external borrowing** (PWLB) | **42,046** | ***100%*** | **57,186** | ***100%*** |

**Debt and Investment Projections 2019/20 – 2021/22**

7. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement – CFR), highlighting any over or under borrowing.

| £'000 | 2018/19 Revised | 2019/20 Estimated | 2020/21 Estimated | 2021/22 Estimated |
|---|---|---|---|---|
| Debt at 1 April | 42,046 | 57,022 | 73,919 | 82,646 |
| Expected change in debt | 14,976 | 16,897 | 8,727 | 8,623 |
| Other long-term liabilities (OLTL) | - | - | - | - |
| Expected change in OLTL | - | - | - | - |
| **Actual gross debt at 31 March** | **57,022** | **73,919** | **82,646** | **91,269** |
| **Capital Financing Requirement** | **63,979** | **80,572** | **88,990** | **97,298** |
| Under/(over) borrowing | (6,957) | (6,653) | (6,344) | (6,029) |

The under borrowing shown is due to: the internal borrowing used to fund the purchase of Sandown Industrial Park; the level of internal borrowing to be offset by funds set aside to repay the £1.5m PWLB loan.

Within the above figures, the level of debt relating to commercial activities / non-financial investment is:

| £'000 | 2018/19 Revised | 2019/20 Estimated | 2020/21 Estimated | 2021/22 Estimated |
|---|---|---|---|---|
| **External debt for commercial activities / non-financial investments, including Economic Regeneration** | | | | |
| Actual debt as at 31 Mar | 44,563 | 61,903 | 71,078 | 80,156 |
| *Proportion of total external debt (%)* | *78%* | *84%* | *86%* | *88%* |

8. The related impact of the above movements on the revenue budget are:

| £'000 | 2018/19 Revised | 2019/20 Estimated | 2020/21 Estimated | 2021/22 Estimated |
|---|---|---|---|---|
| **Revenue Budgets** Interest on Borrowing | 972 | 1,369 | 1,888 | 2,162 |
| Principal | 940 | 1,103 | 1,273 | 1,377 |
| General Fund Borrowing Costs | 1,912 | 2,472 | 3,161 | 3,539 |
| Investment Income | (1,000) | (1,000) | (1,100) | (1,150) |

**Limits to Borrowing Activity**

9. Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well-defined limits. The first of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2019/20 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

10. The Strategic Director & Deputy Chief Executive reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report. The gross / net debt indicator appears below.

| £'000 | 2018/19 Revised | 2019/20 Estimated | 2020/21 Estimated | 2021/22 Estimated |
|---|---|---|---|---|
| Gross Borrowing | 57,022 | 73,919 | 82,646 | 91,269 |
| Money Market Investments | (80,000) | (80,000) | (80,000) | (80,000) |
| **Net Borrowing/(Investments)** | **(22,978)** | **(6,081)** | **2,646** | **11,269** |
| CFR - Commercial activities / non-financial investment, including Economic Regeneration | 53,380 | 70,430 | 79,307 | 88,076 |
| CFR - Services | 10,599 | 10,142 | 9,683 | 9,222 |

**Operational Boundary**

11. This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

| Operational Boundary £'000 | 2018/19 Revised | 2019/20 Estimated | 2020/21 Estimated | 2021/22 Estimated |
|---|---|---|---|---|
| Debt – Commercial activities / non-financial investment, including Economic Regeneration | 54,000 | 71,000 | 80,000 | 89,000 |
| Debt – Services | 11,000 | 11,000 | 10,000 | 10,000 |
| Other Long Term liabilities | - | - | - | - |
| **Total** | **65,000** | **82,000** | **90,000** | **99,000** |

**Authorised Limit for External Debt**

12. A further key prudential indicator representing a control on the overall level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by full Council. It reflects the level of external debt, which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

13. The Authorised Limit is the statutory limit determined under section 3(1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although no control has yet been exercised.

14. The Council is asked to approve the following Authorised Limit:

| Authorised limit £'000 | 2018/19 Revised | 2019/20 Estimated | 2020/21 Estimated | 2021/22 Estimated |
|---|---|---|---|---|
| Debt – Commercial activities / non-financial investment, including Economic Regeneration | 89,000 | 89,000 | 90,000 | 90,000 |
| Debt – Services | 11,000 | 11,000 | 10,000 | 10,000 |
| Other long term liabilities | - | - | - | - |
| Total | **100,000** | **100,000** | **100,000** | **100,000** |

15. The Authorised Limit also allows for any potential overdraft position as this will be counted against the overall borrowing and short-term borrowing from the market should a need arise.

**Borrowing in Advance of Need**

16. The Council has some flexibility to borrow funds in a current year for use in future years. The Strategic Director & Deputy Chief Executive, in consultation with the Portfolio Holder for Resources, may do this under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. Whilst the Strategic Director & Deputy Chief Executive will adopt a cautious approach to any such borrowing, where there is a clear business case for doing so borrowing may be undertaken to fund the approved capital programme or to fund future debt maturities. Borrowing in advance will be made within the constraints that:

- It will be limited to no more than 50% of the expected increase in borrowing need (CFR) over the three-year planning period; and
- The Council would not normally look to borrow more than 12 months in advance of need.

17. Risks associated with any advance borrowing activity will be subject to appraisal in advance and subsequent reporting through the mid-year or annual reporting mechanism.

**Expected Movement in Interest Rates**

**Medium-Term Rate Estimates (averages)**

18. The following table gives the Link Asset Services view in January 2019 (net of 0.2% 'Certainty' discount):

| | | PWLB Rates | | | |
|---|---|---|---|---|---|
| | **Bank Rate (%)** | **5 years** | **10 years** | **25 years** | **50 years** |
| Mar 2019 | 0.75 | 1.90 | 2.30 | 2.70 | 2.50 |
| June 2019 | 1.00 | 2.00 | 2.40 | 2.80 | 2.60 |
| Sept 2019 | 1.00 | 2.00 | 2.40 | 2.90 | 2.70 |
| Dec 2019 | 1.00 | 2.10 | 2.50 | 2.90 | 2.70 |
| Mar 2020 | 1.25 | 2.10 | 2.60 | 3.00 | 2.80 |
| June 2020 | 1.25 | 2.20 | 2.70 | 3.10 | 2.90 |
| Sept 2020 | 1.25 | 2.30 | 2.70 | 3.10 | 2.90 |
| Dec 2020 | 1.50 | 2.30 | 2.80 | 3.20 | 3.00 |
| Mar 2021 | 1.50 | 2.40 | 2.80 | 3.20 | 3.00 |
| June 2021 | 1.75 | 2.40 | 2.90 | 3.30 | 3.10 |
| Sept 2021 | 1.75 | 2.50 | 2.90 | 3.30 | 3.10 |
| Dec 2021 | 1.75 | 2.60 | 3.00 | 3.40 | 3.20 |
| Mar 2022 | 2.00 | 2.60 | 3.00 | 3.40 | 3.20 |

19. The Monetary Policy Committee (MPC) delivered a 0.25% increase in Base Rate to 0.75% at its 2 August meeting, the first time the rate had exceeded 0.50% since April 2008. Growth was healthy around the time of the meeting but is expected to have weakened somewhat during the last quarter of 2018 from the robust 0.6% figure in quarter 3, given growth of 0.3% in the three months to November. At its November meeting, the MPC noted that the fiscal stimulus in the Chancellor's budget could increase inflationary pressures,

although it is considered unlikely the MPC will move on Base Rate before the March 2019 Brexit deadline. Assuming the UK and EU reach an agreement, Link consider the timing of the next increase in Base Rate will be May 2019, followed by increases in February and November 2020, and June 2021 before reaching 2.00% in February 2022. The Bank of England does not expect Base Rate to exceed 2.50% over the next decade.

20. The overall longer run future trend is for gilt yields, and consequently Public Works Loan Board (PWLB) rates, to rise, albeit gently. The last 25 years has been characterised by falling bond yields, with inflation falling to much lower levels than before, supported by the quantitative easing programme of government and other debt purchases after the financial crash of 2008. In response to this, investors moved into riskier assets seeking higher returns, which in turn led to a rise in equity values.

21. A reversal of this trend began in 2016 in the United States with a large increase in the US government deficit aimed at stimulating economic growth. The US Federal Reserve has repeatedly increased the Federal Funds rate to reach 2.50% in December 2018, to counter building inflationary pressure in an economy with very low unemployment. This, allied with its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing when they mature, saw the benchmark US 10-year bond Treasury yields rise above 3.2% towards the end of 2018. But as investors started to rebalance their portfolios away from riskier assets during 2018, this in turn contributed to falls in equity prices, helping push major indices to their worst yearly performance in a decade, and entering the new year, US 10-year bond yields have fallen back on fears of these interest rate rises creating a risk of recession.

22. Gilt yields, and hence PWLB rates, can be subject to levels of volatility periodically due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.

23. Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts (and MPC decisions), will be liable to further amendment depending on economic data and developments in financial markets over the next year. Geopolitical developments, especially in the EU, could also have a major impact.

**Borrowing Strategy 2019/20 – 2021/22**

24. The Council is currently in an under-borrowed position. This is a result of the Council using surplus cash balances to finance capital expenditure (instead of borrowing).

    A provisional capital allocation has been included in the 2019/20 to 2021/22 Capital Programme for potential Asset Investment or an agreed loan to the Housing Company, to give the Council the ability to obtain future loans from the PWLB at preferential interest rates (0.2% below normal rates – the ‘Certainty rate’). Borrowing will only be undertaken if required to fund investment, or asset development opportunities as they arise and will be subject to consideration of a business case then approved by Council on an individual basis.

    The Strategic Director & Deputy Chief Executive will decide whether to borrow externally or utilise surplus cash balances rather than investing them, based on loan and investment rates available.

**Investment Strategy 2019/20 – 2021/22**

25. 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 appearing elsewhere on the agenda.

26. The Council's investment policy has regard to the following: -
    - MHCLG's Guidance on Local Government Investments;
    - CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017;
    - CIPFA Treasury Management Guidance Notes 2018.

27. **Key Objectives** – The Council's investment strategy primary objectives are safeguarding the repayment of the principal and interest of its investments on-time first, and ensuring adequate liquidity second – the investment return being a third objective. Following the economic background above, the current investment climate has one over-riding risk consideration: counterparty security risk. As a result of these underlying concerns, officers are implementing an operational investment strategy which retains the tight controls which are already in place in the approved investment strategy.

28. **Risk Benchmarking** – A development in the revised Codes and the MHCLG Investment Guidance is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are requirements, although the application of these is more subjective in nature. Additional background in the approach taken is attached at Annexe 1.

29. These benchmarks are simple **guides** (to minimise risk) and so may be exceeded from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is for officers to monitor the current and trend position, and amend the operational strategy depending on any changes. If the benchmarks are exceeded, this will be reported with supporting reasons, in the Mid-Year or Annual Report.

30. **Security** – The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:

    - 0.25% historic risk of default when compared to the whole portfolio.

31. **Liquidity Management** – The Council monitors cash flow to determine the maximum period for which funds may be prudently committed. The forecast is compiled on a prudent basis, minimising the risk of the Council being forced to borrow on unfavourable terms to meet its short-term financial commitments.

    Limits on long-term investments are set with reference to the Council's medium-term financial plan and cash flow forecast.

    - Maximum at anytime bank overdraft - £nil.
    - Liquid short-term deposits of at least £2.0m available within a week's notice.
    - Weighted Average Life benchmark is expected to be under 1.0 years, with a maximum of 3.0 years.
    - Core investments are defined as the anticipated sums invested at the end of the financial year.
    - A core investment balance of approximately £80 million, although this amount may fluctuate due to cash flow reasons.

- Non-core investments may not have a final maturity date of more than 365 days.
- No more than 50% of core investments should have a remaining maturity date of more than 3 years at any one time.
- The Council will be able to allocate 100% of its investments to non-specified instruments.

32. **Yield** - Local measures of the yield benchmarks for Investments is the rate of returns above the 7-day London Interbank Bid (LIBID) rate.

33. In addition, the security benchmark for each individual year is:

| | 1 year | 2 years | 3 years | 4 years | 5 years |
|---|---|---|---|---|---|
| Maximum | 0.15% | 0.15% | 0.35% | 0.50% | 0.65% |

Note: This benchmark is an average risk of default measure, and does not constitute an expectation of a loss against a particular investment (see Annexe 1).

34. **Investment Counterparty Selection Criteria -** The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:

- It maintains a policy covering both the categories of investment types in which it will invest, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

35. A copy of the 2019/20, counterparty list is attached at Appendix C. The only change proposed from the 2018/19 list (Annexe 2) is to remove the specified funds from the Money Market Funds section as these are no longer available in the market.

36. The criteria differ from Specified and Non-Specified investments by providing an overall pool of counterparties considered high quality which the Council may use rather than defining investments.

37. The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits, within short or long-term categories. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with a CIPFA Treasury Management Panel recommendation in March 2011 and the CIPFA Treasury Management Code of Practice.

38. Credit rating information is supplied by our treasury consultants on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance, a negative rating watch applying to a counterparty at the

minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions.

39. The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments) is:

- **Banks 1 - Good Credit Quality** – the Council will only use banks which are UK clearing banks or UK subsidiaries of major overseas banks;
  ***and*** have, as a minimum, the following Fitch, Moody's and Standard & Poors credit ratings (where rated):

  i. for Short Term investment **– Fitch F2, Moody's P-2, S&P A-2**
  ii. for Long Term investment **– Fitch A-, Moody's A3, S&P A-**

- **Banks 2** – The Council's own banker: if rating falls below the above criteria, balances will be minimised in both monetary size and term.

- **Banks 3 –** UK Banks and their subsidiaries where the UK Government has a controlling interest.

- **Banks 4** – named Major Overseas Banks (sterling-denominated deposits only) which have, as a minimum, the following Fitch, Moody's and Standard & Poors credit ratings, in countries with equivalent or higher Sovereign ratings
  i. for Short Term investment – **Fitch F1, Moody's P-1, S&P A-1**
  ii. for Long Term investment – **Fitch A, Moody's A2, S&P A**

- **Building Societies** – these are large financial institutions and the Council's risk in investing in these is reduced where their total assets exceed £350 million. Limiting the amount and term of the investments also assists in managing risk. The Council will use:
  - Building Societies with total assets exceeding £350 million – limit £2 million for up to 1 year only; and
  - Building Societies which are also rated and meet the criteria set out above under 'Banks 1' will be subject to a higher limit of £5 million (Nationwide £10 million) for up to 2 years.

  Rated Building Societies which do not meet rating agency criteria under 'Banks 1' but which meet the 'total assets' threshold will remain valid counterparties provided they qualify as 'investment grade' as a minimum, subject to the £2 million limit and up to 1 year only.

- **UK Government** (including gilts and the Debt Management Account Deposit Facility)

- **Local authorities, Police and Fire authorities**

- **Money market funds –** Low Volatility Net Asset Value (LVNAV)

A limit of 100% will be applied to the use of Non-Specified investments.

40. **UK Banks – ring fencing** – The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), were required, by UK law, to separate core retail banking services from their investment and international banking activities by 1 January 2019. This is known as "ring-fencing", a regulatory initiative created in response to the global financial crisis which mandates the separation of retail and SME deposits from

investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and “riskier” activities are required to be housed in a separate entity, a non-ring-fenced bank (NRFB). This is intended to ensure that an entity’s core activities are not adversely affected by the acts or omissions of other members of its group.

41. While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

42. **Markets in Financial Instruments Directive II** (MiFID II) – The Markets in Financial Instruments Directive II (MIFID II) 2014/65/EU, changed the classification of local authorities to retail investors from 3 January 2018. Meeting the criteria for professional status, the Council applied to opt to up to ‘elective professional client’ status with its counterparties and brokers, although the Council has up to this time traded in instruments which fall outside the Directive.

43. **Sovereign ratings and Link Asset Services considerations** – Due care will be taken to consider the country, group and Link Asset Services assessment of potential risk of the Council’s investments. In part the country selection will be chosen by the credit rating of the Sovereign state in Banks 4 above. In addition:

- no more than £5 million will be placed with any non-UK Bank at any time, subject to a £15 million limit in the group;
- limits in place above will apply to Group companies; and
- Link Asset Services limits will be monitored regularly for appropriateness.

44. **Use of additional information other than credit ratings** – Additional requirements under the Code of Practice now require the Council to supplement credit rating information. Whilst the above criteria rely primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks, financial websites) will be applied to compare the relative security of differing investment counterparties.

45. **Investment Limits** – The Council sets additional criteria to cover the amount of moneys which will be invested with individual bodies. These are shown in the table below, applicable with effect from 1 April 2019:

| Category | Institution | Maximum Loan £m |
|---|---|---|
| 1 | Lloyds Bank | 20 |
| 2 | Major UK Clearing Banks and Subsidiaries | 15 (1) |
| 3 | UK Bank Subsidiaries of overseas banks | 20 (2) |
| 4 | Overseas Banks (sterling-denominated loans only) | 5 (3) |
| 5 | Nationwide Building Society | 10 |
| 6 | Other rated Building Societies | 5 |
| 7 | Rated Building Societies other than '6', meeting 'asset threshold (>£350m) and 'investment grade' | 2 |
| 7 | Non-credit rated Building Societies with assets >£350m | 2 |
| 8 | Local authorities | 5 |
| 9 | Money Market Funds (LVNAV) | 2 (4) |

(1) Per Clearing Bank (2) Within the Category (3) £15m in the group (4) £3m in the group

The current institutions approved for the purpose of lending the Council's internally managed surplus cash are detailed at Annexe 2.

46. **Time and Monetary Limits applying to Investments** – The time and monetary limits for institutions on the Council's Counterparty List appear below (these will cover both Specified and Non-Specified Investments):

| Category | Fitch (or equivalent) | | Money Limit | Time Limit |
|---|---|---|---|---|
| | Short Term | Long Term | | |
| 1 | F2 | A- | £20m | 5 yrs |
| 2 | F2 | A- | £15m | 5 yrs |
| 3 | F2 | A- | £20m in group | 2 yrs |
| 4 | F1 | A | £5m | 2 yrs |
| 5 | F2 | A- | £10m | 2 yrs |
| 6 | F2 | A- | £5m | 2 yrs |
| 7 | n/a | n/a | £2m | 1 yr |
| 8 * | n/a | n/a | £5m | 5 yrs |
| 9 | F1 | A | £3m in group | - |

* increased from 2 years

47. For completeness the criteria for defining Specified and Non-Specified investments are shown in Annexe 3.

48. In the normal course of the Council's cash flow operations it is expected that both Specified and Non-specified investments will be utilised for the control of liquidity as both categories allow for short-term investments.

49. The use of longer-term instruments (greater than one year from inception to repayment) will fall in the Non-Specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the longer-term investment limits.

50. **Economic Investment Considerations** - Investment returns are likely to remain low during 2019/20 but to be on a gently rising trend over the next few years. In the short term, rate movements will be determined by the nature of the UK's exit from the EU. The Council's investment decisions are based on comparisons between the rises priced into market rates compared with the advice provided by the Council's Treasury Management advisors (Link Asset Management).

51. The criteria for choosing counterparties set out above provide a sound approach to investment given the current market conditions. Whilst Members are asked to approve the base criteria above, the Strategic Director & Deputy Chief Executive may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval in the light of market information which may arise from time to time. Similarly, the investment term may also be restricted.

52. Examples of the implications of these restrictions would be the greater use of the Debt Management Account Deposit Facility (DMADF – a Government body which accepts local authority deposits), Money Market Funds, guaranteed deposit facilities and strongly rated institutions offered support by the UK Government.

**Sensitivity to Interest Rate Movements**

53. The Council accounts require disclosure of the impact of risks on the Council's treasury management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 0.5% increase/decrease in all interest rates to the estimated treasury management costs/income for next year. That element of the debt and investment portfolios, which are of a longer-term, fixed interest rate nature will not be affected by interest rate changes.

| **£'000** | **2019/20 Estimated + 0.5%** | **2019/20 Estimated - 0.5%** |
|---|---|---|
| **Revenue Budgets** | | |
| Interest on Borrowing | - | - |
| Net General Fund Borrowing Cost | - | - |
| Investment income | 256 | (256) |

**Treasury Management Limits on Activity**

54. There are four further treasury activity limits, which were previously prudential indicators. The purpose of these is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The indicators are:

- Upper limits on variable interest rate exposure – This identifies a maximum limit for variable interest rates based upon the debt position net of investments.

- Upper limits on fixed interest rate exposure.

- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

- Total principal funds invested for greater than 365 days – These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

55. The Council is asked to approve the following limits:

| | **2019/20** | **2020/21** | **2021/22** |
|---|---|---|---|
| **Interest rate Exposures** | **£'000** | **£'000** | **£'000** |
| | **Upper** | **Upper** | **Upper** |
| **Limits on fixed interest rates based on net investments** | 25,000 | 25,000 | 25,000 |
| **Limits on variable interest rates based on net investments** | 4,000 | 4,000 | 4,000 |
| ***Limits on fixed interest rates *:*** | | | |
| • ***Debt only*** | (100,000) | (100,000) | (100,000) |
| • ***Investments only*** | 125,000 | 125,000 | 125,000 |
| ***Limits on variable interest rates*** | | | |
| • ***Debt only*** | (1,000) | (1,000) | (1,000) |
| • ***Investments only*** | 5,000 | 5,000 | 5,000 |
| **Maximum principal sums invested > 365 days** | | | |
| Principal sums invested > 365 days | 35,000 | 35,000 | 35,000 |
| Current investments as at 15.1.19 >365 days maturing in each year | 4,000 | 23,800 | - |
| **Maturity Structure of fixed interest rate borrowing 2019/20** | | | |
| | **Lower (%)** | **Upper (%)** | |
| Under 12 months | 0 | 25 | |
| 12 months to 2 years | 0 | 25 | |
| 2 years to 5 years | 0 | 30 | |
| 5 years to 10 years | 0 | 30 | |
| 10 years and above | 25 | 90 | |

* including escalating deposits

**Performance Indicators**

56. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

- Debt/Borrowing - Average rate of borrowing for the year compared to average available
- Debt – Average rate movement year on year
- Investments – Internal returns above the 7-day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report.

## Treasury Management Advisors

57. The Council uses Link Asset Services (formerly Capita) as its treasury management advisors. They provide a range of services which include:

    - Technical support on treasury matters, capital finance issues and the drafting of Member reports;
    - Economic and interest rate analysis;
    - Debt services which includes advice on the timing of borrowing;
    - Debt rescheduling advice surrounding the existing portfolio;
    - Generic investment advice on interest rates, timing and investment instruments;
    - Credit ratings/market information service comprising the three main credit rating agencies.

58. Whilst the advisors provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the Council.

## Member and Officer Training

59. The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training programme for Members and Officers. Specific training sessions for Members was held in July 2018, with further training will take place in the next financial year.

60. The needs of the Council’s treasury management staff for training in investment management are assessed annually as part of the staff appraisals process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend seminars providing information on latest developments and emerging best practice.

## Security, Liquidity and Yield Benchmarking

**Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service**
Calculation of security and liquidity benchmarks represents a key strand of reporting to Members. These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons, in the Annual Treasury Report.

**Yield** – These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – Returns above the 7-day LIBID rate.

Security and liquidity benchmarks are intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Benchmarks for the cash type investments are shown below and form the basis of reporting in this area. In the other investment categories appropriate benchmarks are used where available.

**Liquidity** – This is defined as "having adequate, though not excessive, cash resources, borrowing arrangements, overdrafts or standby facilities to enable the Council at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

- Bank overdraft - £nil.
- Liquid short-term deposits of at least £2.0m available with a week's notice.

The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect the following benchmark is used:

- WAL benchmark is expected to be under 1.0 years, with a maximum of 3.0 years.

**Security** of investments – In the context of benchmarking, assessing security is a more subjective exercise. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard & Poors). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy.

The table beneath shows average defaults for differing periods of investment grade products for each Fitch long term rating category over the period 1990 to 2017 based on information from the three main credit rating agencies (figures in bold). Intermediate values are calculated on a straight-line basis in accordance with methodology suggested by our treasury advisors.

| **Long term rating** | **1 year** | **2 years** | **3 years** | **4 years** | **5 years** |
|---|---|---|---|---|---|
| **AAA** | **0.04%** | **0.10%** | **0.18%** | **0.27%** | **0.36%** |
| **AA** | **0.02%** | **0.04%** | **0.10%** | **0.17%** | **0.24%** |
| A+ | 0.04% | 0.11% | 0.22% | 0.34% | 0.47% |
| **A** | **0.05%** | **0.15%** | **0.28%** | **0.42%** | **0.59%** |
| A- | 0.09% | 0.25% | 0.44% | 0.67% | 0.91% |
| BBB+ | 0.12% | 0.35% | 0.60% | 0.91% | 1.23% |
| **BBB** | **0.16%** | **0.44%** | **0.77%** | **1.15%** | **1.55%** |

The Council's minimum long term Fitch rating criterion is 'A-', meaning the average expectation of default for a one year investment in a counterparty with a Fitch 'A-' long term rating would be ~0.09% of the total investment (e.g. for a £1m investment the average loss would be around £900). This is only an average – if there were any specific counterparty loss the amount would likely be higher - but these figures are used as a proxy benchmark to establish the risk across the portfolio. It should be noted that the authority historically has not suffered any such losses on its investments.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

- 0.25% historic risk of default when compared to the whole portfolio.

In addition, the security benchmark for each individual year is:

| | **1 year** | **2 years** | **3 years** | **4 years** | **5 years** |
|---|---|---|---|---|---|
| Maximum | 0.15% | 0.15% | 0.35% | 0.50% | 0.65% |

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and regularly reported to Members (Audit & Standards Committee) and in the Investment Annual Report. As this data is collated, trends and analysis will be reported. Where a counterparty is not credit rated, a proxy rating will be applied. Local Authorities are allocated a Fitch long-term rating of 'AA' ('very high investment grade') corresponding to the UK Sovereign rating as applied by our treasury advisors, and non-rated Building Societies 'BBB' ('good investment grade') in line with general practice, in the absence of contrary indications.

**Annexe 2**

**2018/19 Counterparty List - Approved Institutions for Lending Surplus Cash**

**Current Fitch short/long term credit ratings shown in brackets**

1. **Major UK Clearing Banks and Subsidiaries (£15m max. per Bank, except Lloyds Bank - £20m limit)**
    - Barclays Bank plc (F1/A)
    - HSBC Bank plc (F1+/AA-)
    - Lloyds Banking Group
        - Lloyds Bank (F1/A+)
        - Bank of Scotland (F1/A+)
    - Royal Bank of Scotland (F2/BBB+) *

2. **UK Bank Subsidiaries of Major Overseas Banks (£20m within category)**
    - Santander UK plc (F1/A) - owned by Banco Santander
    - Clydesdale Bank (F2/BBB+) * - owned by National Australia Bank

3. **Major Overseas Banks (£5m max. per Bank, £15m max. in category)**
    Counterparties having minimum rating F1/A, with equivalent or higher Sovereign rating:
    ***Australia (F1+/AAA)***
    - Australia & New Zealand Banking Corporation (F1+/AA-)
    - Commonwealth Bank (F1+/AA-)
    - National Australia Bank (F1+/AA-)

    ***Canada (F1+/AAA)***
    - Toronto-Dominion Bank (F1+/AA-)

    ***France (F1+/AA)***
    - Credit Industriel et Commercial (F1/A+)

    ***Germany (F1+/AAA)***
    - DZ Bank AG (F1+/AA-)
    - Landesbank Hessen-Thueringen (Helaba) (F1+/A+)

    ***Netherlands (F1+/AAA)***
    - Cooperatieve Rabobank UA (F1+/AA-)

4. **Building Societies**
    <u>Societies in top ten with credit ratings which meet our criteria</u>
    - Nationwide (F1/A+) (rank #1 by asset size) – £10m limit
    - Yorkshire (F1/A-) (rank #2) – £5m limit
    - Coventry (F1/A) (rank #3) – £5m limit
    - Skipton (F1/A-) (rank #4) – £5m limit **
    - Leeds (F1/A-) (rank #5) – £5m limit
    - Principality (F2/BBB+) (rank #6) – £5m limit *
    - Nottingham (F2/BBB+) (rank #9) – £5m limit ***

    <u>Building Societies by asset size (other than those shown above)</u>
    - Asset size exceeding £350m: Investment limit £2 million per Society for maximum 1 year

**5. UK Government Debt Management Office (unlimited investments)**

**6. All Local Authorities including Police & Fire Authorities (£5m max. per Authority)**

**7. Money Market Funds (Maximum £3 million in the group with £2 million per counterparty)**

Liquid MMFs with minimum rating F1/A which are open to Local Authorities.

**	short term only – long term rating below our 'A-' threshold*
***	short term only as Moody's long term rating currently below Fitch 'A-' equivalent*
****	rated by Moody's, so Fitch equivalent ratings shown - short term only (as ** above)*

## Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management

MHCLG issued Investment Guidance in 2018 and this forms the structure of the Council's policy below.

The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (as revised in 2017). This Council adopted the Code of Practice at the Council meeting on 24 February 2010 and will apply its principles to all investment activity. In accordance with the Code, the Strategic Director & Deputy Chief Executive has produced its treasury management practices (TMPs). This part, TMP 1(5), covering investment counterparty policy requires approval each year.

**Annual Investment Strategy** - The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments the Council will use. These are high security and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used, and a limit to the overall amount within various categories that can be held at any time.

The investment policy proposed for the Council is:

**Strategy Guidelines** – The main strategy guidelines are contained in the body of the treasury strategy statement.

**Specified Investments** – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council retains the right to demand repayment within 12 months. These are considered low risk assets where the possibility of loss of principal or investment income is minimal. These would include sterling investments (which are not defined as expenditure for capital control purposes) with:

a) The UK Government (such as the Debt Management Account Deposit Facility, UK Treasury Bills or a Gilt with less than one year to maturity).
b) Supranational bonds of less than one year's duration.
c) A local authority, parish council or community council.
d) Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category 9 this covers pooled investment vehicles, such as money market funds, with Fitch long-term rating A (or equivalent).
e) For category 3 this covers counterparties with a minimum Fitch short / long-term rating F2 / A- (as appropriate to the investment term) or equivalent.

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of moneys which will be invested in these bodies.

**Non-Specified Investments** – Non-Specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non-Specified investments would include any sterling investments with:

| | **Non-Specified Investment Category** | **Limit (£m)** |
|---|---|---|
| a. | **Supranational Bonds greater than 1 year to maturity**<br><br>**(a) Multilateral development bank bonds** - These are bonds defined as an international financial institution having as one of its objectives economic development, either generally or in any region of the world (e.g. European Investment Bank etc.).<br><br>**(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company [GEFCO])<br><br>The security of interest and principal on maturity is on a par with the Government and so very secure, and these bonds usually provide returns above equivalent gilt-edged securities. However, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity. | NIL |
| b. | **Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity. | NIL |
| c. | **The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.** | 20 |
| d. | **Building societies not meeting the basic security requirements under the specified investments**. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. | 2 |
| e. | Any **bank or building society** that has a minimum long term credit rating of 'A-' for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment). | 15 |
| f. | Any **major overseas bank** that has a minimum long term credit rating of 'A' for deposits with a maturity of greater than one year, in a country with an equivalent or higher Sovereign rating (including forward deals in excess of one year from inception to repayment). | 5 |
| g. | **Share capital or loan capital** in a body corporate **–** the use of these instruments will be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies. There is a higher risk of loss with these types of instruments. | NIL |
| h. | **Pooled property or bond funds –** The use of these instruments will normally be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies.<br><br>The key exception to this is an investment in the CCLA Local Authorities Property Fund. | NIL |

**The Monitoring of Investment Counterparties** - The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Link Asset Services as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading would not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Strategic Director & Deputy Chief Executive, and if required, new counterparties which meet the criteria will be added to the list, subject to the appropriate approval.

**Annexe 4**

## Treasury Management Scheme of Delegation

### (i) Cabinet/Council

- receiving and reviewing reports on treasury management policies and practice;
- approval of annual strategy;
- approval of capital strategy;
- receiving sufficient information to understand the authority's risk exposure;
- budget consideration and approval;
- approval of / amendments to, the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- approval of the division of responsibilities, and scheme of delegation;
- setting the overall external borrowing level.

### (ii) Audit & Standards Committee

- ensuring an adequate governance process is in place for approval, monitoring and ongoing risk management of non-financial investments and long term liabilities;
- reviewing the treasury management policy and procedures and making recommendations to Cabinet or Council;
- ensuring due diligence has been carried out on all treasury and non-financial investments appropriate to the authority's risk appetite;
- ensuring adequate information is received to understand the authority's risk exposure;
- receiving and reviewing regular monitoring and activity reports
- receiving and reviewing the mid-year and the full year activity reports

### (iii) The S151 (responsible) officer

- preparation of a capital strategy including Treasury Management Practices dealing with how non-financial investments are carried out and managed;
- ensuring the capital strategy is prudent, sustainable and affordable in the long term, and provides value for money;
- ensuring the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing;
- ensuring due diligence has been carried out on all treasury and non-financial investments
- ensuring the proportionality of all investments in relation to the authority's financial resources;
- ensuring an adequate governance process is in place for approval, monitoring and ongoing risk management of non-financial investments and long-term liabilities;
- ensuring Members are adequately informed to understand the authority's risk exposure;
- approving the selection of external service providers and agreeing terms of appointment;
- recommending the appointment of external service providers;
- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting treasury management policy reports;
- submitting budgets and budget variations;

- submitting a schedule of non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- making changes/amendments to the Council’s counterparty list providing they are within the overall approved counterparty criteria;
- placing investments for periods of greater than one year to maturity;
- ensuring the adequacy of internal audit, and liaising with external audit on Treasury Management;
- to authorise borrowing as and when the need arises in accordance with the Treasury Management Strategy.