# TREASURY MANAGEMENT POLICY STATEMENT INCLUDING:

- **TREASURY MANAGEMENT STRATEGY**
- **ANNUAL INVESTMENT STRATEGY 2019/20**

**Portsmouth City Council**
**Director of Finance and Information Technology (Section 151 Officer)**

## TREASURY MANAGEMENT POLICY STATEMENT 2018/19

## 1 BACKGROUND

1.1 This Council defines its Treasury Management activities as "the management of the organisation's investments and cash flows, its banking, money market and capital market transactions, the effective control of the risks associated with those activities, and the pursuit of optimum performance consistent with those risks."

1.2 This Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

1.3 This Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance management techniques, within the context of effective risk management.

1.4 The City Council's treasury management activities are governed by various codes of practice and guidance that the Council must have regard to under the Local Government Act 2003. The main codes and guidance that the Council must have regard to are:

- Treasury Management in the Public Services Code of Practice published by the Chartered Institute of Public Finance and Accountancy (CIPFA) which sets out the key principles and practices to be followed.

- The Prudential Code for Capital Finance in Local Authorities published by CIPFA which governs borrowing by local authorities.

- The Guidance on Local Government Investments published by the Ministry of Housing Communities and Local Government which governs local authorities investment activities and stipulates that investment priorities should be security (protecting the capital sum from loss) and liquidity (keeping money readily available for expenditure when needed), rather than yield.

## 2 REPORTING ARRANGEMENTS

### 2.1 General Background

The Council has a duty to prepare 3 interrelated but distinct strategies as follows:

- Capital Strategy - covering future capital expenditure, and its implications for borrowing, providing for the repayment of debt and investing
- Treasury Management Strategy - covering how borrowing and investments are to be organised and setting boundaries within which these activities will be undertaken
- Annual Investment Strategy - covering the types of cash investments that the Council may enter into including limits on activity

This Treasury Management Policy deals with the Treasury Management Strategy and the Annual Investment Strategy. The Capital Strategy will be reported separately.

### 2.2 Capital Strategy

The Chartered Institute of Public Finance and Accountancy (CIPFA) revised 2017 Prudential and Treasury Management Codes require, for 2019-20, all local authorities to prepare an additional report, a capital strategy report providing a high-level long term overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services, and an overview of how the associated risk is managed

The aim of this capital strategy is to ensure that all elected members on the full council fully understand the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite.

This Capital Strategy is reported separately from the Treasury Management Strategy Statement; non-treasury investments will be reported through the former. This ensures the separation of the core treasury function under security, liquidity and yield principles, and the policy and commercialism investments usually driven by expenditure on an asset. The capital strategy will show:

- The corporate governance arrangements for these types of activities;
- The expected income, costs and resulting contribution;
- The debt related to the activity and the associated interest costs;
- The payback period (minimum revenue provision (MRP) policy for debt repayment);
- The risks associated with each activity (see Appendix A)

If any non-treasury investment sustains a loss in a financial year , the strategy and revenue implications will be reported through the same procedure as the capital strategy.

2.2 Treasury Management Strategy

The Council is currently required to receive and approve, as a minimum, three main treasury reports each year, which incorporate a variety of policies, estimates and actuals.

**a. Treasury management policy statement** (this report) - The first, and most important report is forward looking and covers:

- the treasury management strategy, (how the investments and borrowings are to be organised), including treasury indicators; and
- an investment strategy, (the parameters on how investments are to be managed).

**b. A mid-year treasury management report** – This is primarily a progress report and will update members on the current position, amending prudential indicators and policies as necessary.

**c. An annual treasury management outturn report** – This is a backward looking review document and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

**Scrutiny**

The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Governance and Audit and Standards Committee. The Governance and Audit and Standards Committee also receives quarterly treasury management monitoring reports.

## 3 CAPITAL EXPENDITURE, BORROWING LIMITS AND THE PRUDENTIAL CODE

### 3.1 Capital Expenditure

The capital programme approved by the City Council on 12th February 2019 can be summarised in table A as follows:

| **Table A** | **2017/18 Actual** £m | **2018/19 Revised Estimate** £m | **2019/20 Estimate** £m | **2020/21 Estimate** £m | **2021/22 Estimate** £m | **2022/23 Estimate** £m | **2023/24 Estimate** £m |
|---|---|---|---|---|---|---|---|
| Investment Properties | 13 | 32 | 23 | - | - | - | - |
| Other Non - Housing Revenue Account (HRA) | 71 | 100 | 169 | 123 | 29 | 23 | 18 |
| **Sub - Total** | **84** | **132** | **192** | **123** | **29** | **23** | **18** |
| Housing Revenue Account (HRA) | 38 | 35 | 33 | 33 | 28 | 30 | 32 |
| **Total** | **122** | **167** | **225** | **156** | **57** | **53** | **50** |
| **Element financed from borrowing** | **53** | **66** | **53** | **28** | **9** | **2** | **-** |

Capital expenditure on commercial activities / non-financial investments including investment properties is entirely financed from borrowing.

## 3.2 Borrowing Limits

The Prudential Code requires the City Council to approve an authorised limit and an operational boundary for external debt together with other prudential indicators designed to ensure that the capital investment plans are affordable, prudent and sustainable. These were approved by the City Council on 12th February 2019.

i) Authorised Limit

The authorised limit for external debt is the maximum amount of debt which the authority may legally have outstanding at any time. The Authorised Limit includes headroom to enable the Council to take advantage of unexpected movements in interest rates and to accommodate any short-term debt or unusual cash movements that could arise during the year

| | £m |
|---|---|
| Borrowing | 675 |
| Other Long Term Credit Liabilities | 62 |
| | 737 |

ii) Operational Boundary

The Operational Boundary is based on the probable external debt during the course of the year. It is not a limit, but acts as a warning mechanism to prevent the authorised limit (above) being breached.

| | £m |
|---|---|
| Borrowing | 645 |
| Other Long Term Credit Liabilities | 62 |
| | 707 |

## 3.3 Ratio of Financing Costs to Net Revenue Stream

Financing costs are largely fixed. Therefore the higher the ratio of financing costs to net revenue stream, the less flexibility there is to amend the Council's overall budgets.

| **Table B** | **2017/18 Actual** | **2018/19 Revised Estimate** | **2019/20 Estimate** | **2020/21 Estimate** | **2021/22 Estimate** | **2022/23 Estimate** | **2023/24 Estimate** |
|---|---|---|---|---|---|---|---|
| Non - Housing Revenue Account (HRA) | 12.4% | 10.9% | 12.3% | 14.1% | 15.1% | 14.7% | 13.4% |
| Housing Revenue Account (HRA) | 7.2% | 7.2% | 7.6% | 7.5% | 7.3% | 7.0% | 6.7% |

The ratio of financing costs to net revenue stream for non-Housing Revenue Account (HRA) activity includes Investment Properties that have the following ratios representing the proportion of income from the investment properties that is required to cover the associated debt financing costs.

| **Table C** | **2017/18 Actual** | **2018/19 Revised Estimate** | **2019/20 Estimate** | **2020/21 Estimate** | **2021/22 Estimate** | **2022/23 Estimate** | **2023/24 Estimate** |
|---|---|---|---|---|---|---|---|
| Investment Properties | 34.1% | 34.8% | 34.8% | 33.2% | 33.2% | 33.2% | 33.2% |

## 3.4 The Council's Underlying Borrowing Need (Capital Financing Requirement)

The capital financing requirement (CFR) is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council’s indebtedness and so its underlying borrowing need. Any capital expenditure above, which has not immediately been paid for through a revenue or capital resource, will increase the CFR.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the indebtedness in line with each assets life, and so charges the economic consumption of capital assets as they are used.

The CFR includes any other long-term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility by the PFI lease provider and so the Council is not required to separately borrow for these schemes. The Council currently has £68m of such schemes within the CFR.

| **Table D** | **2017/18** £m | **2018/19** £m | **2019/20** £m | **2020/21** £m | **2021/22** £m | **2022/23** £m | **2023/24** £m |
|---|---|---|---|---|---|---|---|
| Commercial activities / non-financial investments including investment properties | 117 | 149 | 172 | 172 | 172 | 172 | 172 |
| Non - Housing Revenue Account (HRA) | 291 | 314 | 333 | 352 | 356 | 353 | 350 |
| **Sub - Total** | **408** | **463** | **505** | **524** | **528** | **525** | **522** |
| Housing Revenue Account (HRA) | 167 | 174 | 180 | 183 | 180 | 177 | 174 |
| **Total Capital Financing Requirement (CFR)** | **575** | **637** | **685** | **707** | **708** | **702** | **696** |
| **Movement** | **48** | **62** | **48** | **22** | **1** | **(6)** | **(6)** |

The movement in the CFR is analysed in the table below.

| **Table E** | **2017/18** £m | **2018/19** £m | **2019/20** £m | **2020/21** £m | **2021/22** £m | **2022/23** £m | **2023/24** £m |
|---|---|---|---|---|---|---|---|
| Capital expenditure financed by borrowing from table above | 53 | 66 | 53 | 28 | 9 | 2 | - |
| Less Minimum revenue provision (MRP) | (5) | (4) | (5) | (6) | (8) | (8) | (6) |
| **Movement in CFR** | **48** | **62** | **48** | **22** | **1** | **(6)** | **(6)** |

3.5 Gross Debt and the Capital Financing Requirement

In order to ensure that over the medium term, debt will only be for a capital purpose, CIPFA's Prudential Code which the City Council is legally obliged to have regard to requires the City Council to ensure that debt does not, except in the short term, exceed the total of capital financing requirement (CFR). The CFR measures the Council's underlying need to borrow. If in any year there is a reduction in the capital financing requirement, this reduction is ignored in estimating the cumulative increase in the capital financing requirement which is used for the comparison with gross external debt. The Council's forecast gross debt is shown in the table below.

| **Table F** | **2018/19** £m | **2019/20** £m | **2020/21** £m | **2021/22** £m | **2022/23** £m | **2023/24** £m |
|---|---|---|---|---|---|---|
| Borrowing | 553 | 544 | 536 | 528 | 520 | 512 |
| Finance leases | 1 | 1 | 1 | 1 | 1 | 1 |
| Service Concessions (including Private Finance Initiative schemes) | 65 | 62 | 56 | 50 | 45 | 42 |
| **Total Gross debt** | **619** | **607** | **593** | **579** | **566** | **555** |
| | | | | | | |
| **Capital Financing Requirement (CFR):** | | | | | | |
| Opening CFR in 2018/19 | 575 | | | | | |
| Change in CFR in 2018/19 | 62 | | | | | |
| Closing CFR in 2018/19 | 637 | | | | | |
| Cumulative increase in CFR in future years | | 48 | 70 | 71 | 71 | 71 |
| **Closing CFR** | **637** | **685** | **707** | **708** | **708** | **708** |
| **Borrowing Under / (Over) the CFR** | **18** | **78** | **114** | **129** | **142** | **153** |

The Council's gross debt exceeded its estimated CFR, ie. it was over borrowed, in 2017/18 by £55m. This is primarily due taking advantage of low interest rates in 2016/17 and also to less commercial property being acquired in 2016/17 than had been anticipated. It is planned to finance £66m of capital expenditure from borrowing in 2018/19 including the purchase of £32m of commercial property. This should leave the Council under borrowed by £18m at the end of 2018/19.

## 4 TREASURY MANAGEMENT POLICY STATEMENT

4.1 The prime objective of the Treasury Management function is the effective management and control of risk associated with the activities described in paragraph 1.1. The key risks associated with the Council's treasury management operations are:

- Credit risk – ie. that the local authority is not repaid, with due interest in full, on the day repayment is due.

- Liquidity risk – ie. that cash will not be available when it is needed, or that the ineffective management of liquidity creates additional, unbudgeted costs.

- Interest rate risk – ie. that the authority fails to get good value for its cash dealings (both when borrowing and investing) and the risk that interest costs incurred are in excess of those for which the authority has budgeted.

- Inflation risk, ie. the chance that cash flows from an investment won't be worth as much in future because of changes in purchasing power due to inflation.

- Exchange rate risk - the risk that fluctuations in foreign exchange rates create an unexpected or unbudgeted burden on the organisation's finances, against which the organisation has failed to protect itself adequately.

- Maturity (or refinancing risk) – This relates to the authority's borrowing or capital financing activities, and is the risk that the authority is unable to repay or replace its maturing funding arrangements on appropriate terms.

- Procedures (or systems) risk – ie. that a treasury process, human or otherwise, will fail and planned actions are not carried out through fraud, error or corruption.

4.2 It is recommended that the Director of Finance and Information Technology (Section 151 Officer) and officers nominated by him have delegated authority to (**recommendation 3.1c)**:

(i) invest surplus funds in accordance with the approved Annual Investment Strategy;

(ii) borrow to finance short term cash deficits and capital payments from any reputable source within the authorised limit for external debt of £737m approved by the City Council on 12 February 2019;

(iii) Release the over provision of MRP back into General Fund balances over a prudent period by reducing the MRP in future years;

(v) to buy and sell foreign currency, and to purchase hedging instruments including forward purchases, forward options and foreign exchange rate swaps to mitigate the foreign exchange risks associated with some contracts that are either priced in foreign currencies or where the price is indexed against foreign currency exchange rates.

## 5 TREASURY MANAGEMENT STRATEGY FOR 2019/20

5.1 Objectives

The budget for net interest and debt repayment costs for 2019/20 is £24.8m. The Treasury Management policy will therefore form a cornerstone of the Medium Term Resource Strategy.

Risk appetite statements are contained in the Capital Strategy. Lending and Borrowing will be undertaken in line with these risk appetite statements which are reproduced in Appendix A.

Specific objectives to be achieved in 2019/20 are:

(a) Borrowing

- To minimise the revenue costs of debt
- To manage the City Council's debt maturity profile to ensure that no single financial year exposes the authority to a substantial borrowing requirement when interest rates may be relatively high
- To match the City Council's debt maturity profile to the provision of funds to repay debt if this can be achieved without significant cost
- To effect funding in any one year at the cheapest long term cost commensurate with future risk
- To forecast future interest rates and borrow accordingly (i.e. short term and/or variable when rates are 'high', long term and fixed when rates are 'low').
- To monitor and review the level of variable interest rate loans in order to take greater advantage of interest rate movements
- To reschedule debt in order to take advantage of potential savings as interest rates change or to even the maturity profile.

(b) Lending

- To ensure the security of lending (the maximisation of returns remains a secondary consideration)
- To make returns in excess of inflation on the Council's long term core cash
- To maintain £10m in instant access accounts
- To make funds available to Council's subsidiaries
- To make funds available for the provision of housing in the greater Portsmouth area on a commercial basis
- To make funds available for the regeneration of Hampshire on a commercial basis
- To manage the Council's investment maturity profile to ensure that no single month exposes the authority to a substantial re-investment requirement when interest rates may be relatively low to the extent that this can be managed without compromising the security of lending.

5.2 Gross and Net Debt

5.2.1 The borrowing and investment projections for the Council are as follows:

| **Table G** | **2017/18** £m | **2018/19** £m | **2019/20** £m | **2020/21** £m | **2021/22** £m | **2022/23** £m | **2023/24** £m |
|---|---|---|---|---|---|---|---|
| Gross Debt at 31 March* | 561 | 553 | 544 | 536 | 528 | 520 | 512 |
| Investments at 31 March | (419) | (326) | (255) | (194) | (137) | (49) | (23) |
| **Estimated Net Debt** | **142** | **227** | **289** | **342** | **391** | **471** | **489** |

***** The gross debt shown above includes the following amounts relating to commercial activities / non-financial investments:

| **Table H** | **2017/18** | **2018/19** | **2019/20** | **2020/21** | **2021/22** | **2022/23** | **2023/24** |
|---|---|---|---|---|---|---|---|
| **External debt for Investment Properties** | | | | | | | |
| Gross Debt at 31 March | £117m | £149m | £172m | £172m | £172m | £172m | £172m |
| Percentage of total external debt | 21% | 27% | 32% | 32% | 33% | 33% | 34% |

5.2.2 The current high level of investments has arisen from the Council's earmarked reserves and borrowing in advance of need to take advantage of low borrowing rates thus securing cheap funding for the Council's capital programme. The current high level of investments does increase the Council’s exposure to credit risk, ie. the risk that an approved borrower defaults on the Council’s investment. In the interim period when investments are high in advance of capital expenditure being incurred, there is also a short term risk that the rates (and therefore the cost) at which money has been borrowed will be greater than the rates at which those loans can be invested. However the Council's treasury management investments are expected to decline in 2019/20 as funds are used to invest in commercial properties and other capital schemes.

## 5.3 Interest Rates

### 5.3.1 Interest Rate Forecasts

No treasury consultants are currently employed by the City Council to advise on the borrowing strategy. However, the City Council does employ Link Asset Services to provide an economic and interest rate forecasting service and maintains daily contact with the London Money Market.

Table I

| Link Asset Services Interest Rate View | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank Rate View | 0.75% | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% | 1.75% | 2.00% |
| 3 Month LIBID | 0.70% | 0.80% | 1.00% | 1.10% | 1.20% | 1.40% | 1.50% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% |
| 6 Month LIBID | 0.80% | 0.90% | 1.20% | 1.30% | 1.40% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% |
| 12 Month LIBID | 1.00% | 1.10% | 1.40% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% | 2.30% | 2.40% |
| 5yr PWLB Rate | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% |
| 10yr PWLB Rate | 2.20% | 2.30% | 2.40% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.00% |
| 25yr PWLB Rate | 2.70% | 2.80% | 2.90% | 3.00% | 3.10% | 3.20% | 3.20% | 3.30% | 3.40% | 3.40% | 3.50% | 3.50% | 3.60% |
| 50yr PWLB Rate | 2.50% | 2.60% | 2.70% | 2.80% | 2.90% | 3.00% | 3.00% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% |

2018 was a year which started with weak growth of only +0.1% in quarter 1. However, quarter 2 rebounded to +0.4% followed by quarter 3 being exceptionally strong at +0.6%. Quarter 4 though, was depressed by the cumulative weight of Brexit uncertainty and came in at only +0.2%. Growth is likely to continue being weak until the Brexit issues are resolved.

The above forecasts are based on a major assumption that Parliament and the EU agree an orderly Brexit, either by 29 March or soon after. At their 7 February meeting, the Monetary Policy Committee (MPC) of the Bank of England repeated their well-worn phrase that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the financial crash; indeed they have given a figure for this of around 2.5% in ten years' time but have declined to give a medium term forecast. However, with so much uncertainty around Brexit, the next move could be up or down, even if there was a disorderly Brexit. While it would be expected that Bank Rate could be cut if there was a significant fall in GDP growth as a result of a disorderly Brexit, so as to provide a stimulus to growth, they could also *raise* Bank Rate in the same scenario if there was a boost to inflation from increases in import prices, devaluation of sterling, and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor could provide fiscal stimulus to boost growth.

The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. However, over about the last 25 years, we have been through a period of falling bond yields as inflation subsided to, and then stabilised at, much lower levels than before, and supported by central banks implementing substantial quantitative easing purchases of government and other debt after the financial crash of 2008. Quantitative easing, conversely, also caused a rise in equity values as investors searched for higher returns and purchased riskier assets. In 2016, we saw the start of a reversal of this trend with a sharp rise in bond yields after the US Presidential election in November 2016, with yields then rising further as a result of the big increase in the US government deficit aimed at stimulating even stronger economic growth. That policy change also created concerns around a significant rise in inflationary pressures in an economy which was already running at remarkably low levels of unemployment. Unsurprisingly, the Federal Reserve has continued on its series of robust responses to combat its perception of rising inflationary pressures by repeatedly increasing the Fed rate to reach 2.25 – 2.50% in December 2018. It has also continued its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing, when they mature. We have, therefore, seen US 10 year bond Treasury yields rise above 3.2% during October 2018 and also seen investors causing a sharp fall in equity prices as they sold out of holding riskier assets. However, US 10 year bond yields have subsequently fallen back on fears that the Federal Reserve could be too aggressive in raising interest rates and was going to cause a recession. More recent comments by the Federal Reserve have indicated that the chances of more than one further increase after the December increase have considerably diminished and that there is some doubt around even one more increase. Equity prices have been very volatile on alternating good and bad news over this period.

Rising bond yields in the US have also caused some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure has been dampened by how strong or weak the prospects for economic growth and rising inflation are in each country, and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

From time to time, gilt yields, and therefore Public Works Loans Board (PWLB) rates, can be subject to exceptional levels of volatility 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.

Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

Further background information and risks to the interest rate forecasts are contained in Appendix B.

5.3.2 Borrowing Rates

Borrowing interest rates have been volatile so far in 2018/19 and while they were on a rising trend during the first half of the year, they have fallen significantly since then.

There will remain a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

5.3.3 Borrowing Strategy

The Council has established a net borrowing requirement in its capital strategy. This is the Council's underlying need to borrow as measured by its Capital Financing Requirement (CFR) less its cash back reserves which could be used to internally fund capital expenditure financed from borrowing for a limited period. This is considered to represent a neutral treasury management position and is shown below.

| **Table J** | **2018/19**<br>£m | **2019/20**<br>£m | **2020/21**<br>£m | **2021/22**<br>£m |
|---|---|---|---|---|
| Net Loans Requirement | 293 | 403 | 515 | 573 |
| Borrowing (excluding finance leases, PFI schemes & transferred debt) | 552 | 544 | 536 | 527 |
| Amount of Borrowing (Over) / Under Net Loans Requirement | (259) | (141) | (21) | 46 |

The Council may undertake borrowing in 2019/20 in order to full fill its net loans requirement in future years, but borrowing is not expected to exceed the CFR. This is particularly likely if it was felt that there was a significant risk of a much sharper rise in long and short term rates than that currently forecast, perhaps arising from an acceleration in the rate of increase in central rates in the USA and UK, an increase in world economic activity, or a sudden increase in inflation risks. Regard would also be given to the possibility that interest rates may not increase as forecast in the longer term.

Any decisions will be reported to the appropriate decision making body at the next available opportunity.

5.3.3 Investment Rates

Investment returns are likely to remain low during 2019/20 but are expected to be on a gently rising trend over the next few years.

5.4 Volatility of Budgets

The budget for interest payments and receipts is based on both the level of cash balances available and the interest rate forecasts contained in paragraph 4.3. Any deviation of interest rates from these forecasts will give rise to budget variances.

The Council is exposed to interest rate fluctuations through the need to invest up to £147m of surplus cash in the short term.

The Council currently has substantial sums of cash invested in the short term, and if interest rates fall below the budget forecast, investment income will be less than that budgeted. For example, if short-term interest rates fall to 0.5% below the budget forecast, the income from the Council’s investments will be £0.7m below budget in 2019/20. Conversely, if short-term interest rates rise to 0.5% above the budget forecast, income from the Council’s investments will exceed the budget by £0.7m in 2019/20.

5.5 Limits on total principal sums invested for periods longer than 365 days

Under the Treasury Management Code it is necessary to specify limits on the amount of long term investments, ie. investments exceeding 365 days that have maturities beyond year end.

Investing long term at fixed rates provides certainty of income and reduces the risk of interest rates falling. At the current time, investing long term allows higher yields to be obtained, although it would be prudent to maintain opportunities to invest when interest rates are higher. There are regular fluctuations in the Council's cash balances which can amount to £75m. In addition cash balances are expected to be at their lowest at the end of the financial year as tax receipts are lower in March. On this basis the following limits will be placed on total principal sums invested for periods longer than 365 days:

31/3/2019 = £264m
31/3/2020 = £205m
31/3/2021 = £144m
31/3/2022 = £117m

5.6 Limits for the maturity structure of borrowing

The Government has issued guidance on making provision for the repayment of General Fund debt which the Council is legally obliged to have regard to. The City Council is required to begin to make provision for the repayment of debt in advance of most of the Council’s debt falling due for repayment. Therefore the City Council is required to provide for the repayment of debt well in advance of it becoming due. This is illustrated in the table below. This means that it is necessary to invest the funds set aside for the repayment of debt with its attendant credit and interest rate risks (see paragraph 3.1). The City Council could reschedule its debt, but unless certain market conditions exist at the time, premium payments have to be made to lenders (see paragraph 4.11).

CIPFA’s Treasury Management in the Public Services Code of Practice which the City Council is legally obliged to have regard to requires local authorities to set upper and lower limits for the maturity structure of their borrowing.

It is recommended that the upper limit should be set high enough to allow for debt to be rescheduled into earlier years and for any new borrowing to mature over a shorter period than that taken out in the past. The high upper limit for debt maturing in over 40 years' time reflects existing borrowing as the upper limit cannot be set lower than the existing maturity profile.

It is recommended that the lower limit be set at 0%.

85% of the Council's borrowing is fixed rate with the remaining 15% borrowed at variable rates. In order to ensure a reasonably even maturity profile (paragraph 4.1(a)), it is recommended that the council will set upper and lower limits for the maturity structure of its borrowings as follows.

Amount of fixed rate borrowing maturing in each period as a percentage of total projected borrowing that is fixed rate.

| **Table K** | **Weighted Average Interest Rate** | **Loan Debt Maturity 31 March 2019** | **Underlying Loans Minimum Revenue Provision (MRP)** | **% By Which Loan Debt Maturity is Over / (Under) Loans MRP** | **Lower limit** | **Upper limit** |
|---|---|---|---|---|---|---|
| Under 12 months | 3.24% | 1% | 1% | 0% | 0% | 10% |
| 12 months and within 24 months | 3.24% | 1% | 2% | (1%) | 0% | 10% |
| 24 months and within 5 years | 3.24% | 4% | 8% | (4%) | 0% | 10% |
| 5 years and within 10 years | 3.22% | 7% | 13% | (6%) | 0% | 20% |
| 10 years and within 20 years | 3.25% | 24% | 27% | (3%) | 0% | 30% |
| 20 years and within 30 years | 3.75% | 7% | 27% | (20%) | 0% | 30% |
| 30 years and within 40 years | 4.48% | 31% | 22% | 9% | 0% | 40% |
| 40 years and within 50 years | 3.32% | 25% | 0% | 25% | 0% | 40% |

Amount of variable rate borrowing maturing in each period as a percentage of total projected borrowing that is variable rate.

| **Table L** | **Weighted Average Interest Rate** | **Loan Debt Maturity 31 March 2019** | **Underlying Loans Minimum Revenue Provision (MRP)** | **% By Which Loan Debt Maturity is Over / (Under) Loans MRP** | **Lower limit** | **Upper limit** |
|---|---|---|---|---|---|---|
| Under 12 months | 1.05% | 2% | 1% | 1% | 0% | 10% |
| 12 months and within 24 months | 1.05% | 2% | 2% | 0% | 0% | 10% |
| 24 months and within 5 years | 1.05% | 6% | 8% | (2%) | 0% | 10% |
| 5 years and within 10 years | 1.05% | 10% | 13% | (3%) | 0% | 20% |
| 10 years and within 20 years | 1.05% | 22% | 27% | (5%) | 0% | 30% |
| 20 years and within 30 years | 1.05% | 23% | 27% | (4%) | 0% | 30% |
| 30 years and within 40 years | 1.05% | 21% | 22% | (1%) | 0% | 30% |
| 40 years and within 50 years | 4.65% | 14% | 0% | 14% | 0% | 30% |

The current maturity pattern contained in Appendix C is well within these limits.

5.7 Debt Rescheduling

5.7.1 Most of the City Council’s long term external debt has been borrowed at fixed interest rates ranging from 1.97% to 5.01%. 56% of the Council’s fixed rate debt matures in over 30 years' time. Appendix C shows the long term loans maturity pattern. Therefore debt rescheduling could be beneficial in evening out the debt maturity profile.

5.7.2 In the event that it were decided to further reschedule debt, account will need to be taken of premium payments to the Public Works Loans Board (PWLB). These are payments to compensate the PWLB for any losses that they may incur.

5.7.3 The Housing Revenue Account (HRA) will be responsible for its proportion of the premium due for early redemption of debt, based on the percentage of debt attributable to the HRA at the start of the financial year. The premiums would be charged to the General Fund and the HRA. Regulations allow the City Council to spread the cost of the premiums over a number of years, during which the accounts would benefit from reduced external interest rates.

4.7.4 The Director of Finance and Information Technology (Section 151 Officer) will continue to monitor the Council’s debt and will undertake further rescheduling if it would be beneficial.

5.8 Treasury Management Indicators

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management in the Public Services Code of Practice requires the Council to approve a number of treasury management indicators which set the limits within which the Council's treasury management activities will be undertaken. These are contained in the Treasury Management Strategy above and are summarised in Appendix D (**Recommendation 3.1a)**

## 6 APPROVED METHODS OF RAISING CAPITAL FINANCE

6.1 The following list specifies the various types of borrowing instruments which are available: -

| | Variable | Fixed |
|---|---|---|
| PWLB | Y | Y |
| Market Long-term | Y | Y |
| Municipal Bonds Agency | | Y |
| Market Temporary | Y | Y |
| Overdraft | Y | |
| Negotiable Bonds | Y | |
| Internal (capital receipts & revenue balances) | Y | Y |
| Commercial Paper | Y | Y |
| Medium Term Notes | Y | Y |
| Leasing | Y | Y |
| Bills & Local Bonds | Y | Y |

6.2 The main methods of raising capital finance used by the City Council are discussed in greater detail within Section 6 of this policy. Other methods are not generally used because of the perceived risk or because administrative costs are high, such as in the case of Local Bonds.

6.3 Local authorities are not required to conform to the Money Laundering Regulations stipulated in the Financial Services Acts. However, these principles where practical will be applied when arranging future money market borrowing to ensure that funds are not obtained from potentially unscrupulous sources.

## 7 APPROVED SOURCES OF BORROWING

7.1 Further information on some of the main borrowing instruments used by the City Council is set out below: -

(a) Public Works Loans Board (PWLB)

The main source of longer term borrowing for the City Council for many years has been from the Government through the Public Works Loans Board. The PWLB offers fixed rate loans from 1 year to 50 years at varying rates with different methods of repayment.

Alternatively the PWLB offers variable rate loans for 1 to 10 years, where the interest rate varies at 1, 3 or 6 month intervals. These loans can be replaced by fixed rate loans before maturity at an opportune time to the authority.

(b) Money Market Loans – Long Term

Loans for 1 to 70 years are available through the London Money Market although, depending of the type of loan being arranged, the rates of interest offered may not match those available from the PWLB, especially for Equal Instalment of Principal loans (E.I.P. loans). Any loans to be taken are evaluated to ensure that the interest rate is the lowest the City Council could obtain.

Loans offered by the money market are often LOBO (Lenders Option, Borrowers Option) loans. This enables the authority to take advantage of low fixed interest for a number of years before an agreed variable rate comes into force. At the time when the interest rate becomes variable, the lender has the option to increase the rate charged every 6 months (or any other agreed review period). The borrower has the option to repay the loan with no penalties if the interest rate is increased on any of the review dates.

(c) Bonds

Bonds may be suitable for raising sums in excess of around £150m. The interest payable on bonds may be less than that charged by the PWLB, but considerable upfront fees would be incurred. To obtain the best interest rate, the Council would need to obtain a credit rating which would need to be maintained. This would incur a further upfront fee and an annual maintenance fee.

Because such a large amount needs to be borrowed to attract investors and also to reduce the upfront fees and negate the need for an individual credit rating a pooled issuance with other local authorities may be more viable.

(d) Municipal Bonds Agency (MBA)

A municipal bonds agency has been established by the Local Government Association (LGA) to enable local authorities to undertake long term borrowing at lower rates than those offered by the PWLB. The MBA is expected to issue its first bond and advance its first loans to local authorities. The MBA has yet to issue its first bond. Loans will be advanced on fixed dates determined by the municipal bonds agency. Loans will be repayable at maturity with the duration of the loan being fixed by the MBA.

(e) Money Market Loans – Temporary (Loans up to 365 days)

The use of temporary borrowing through the London Money Market forms an important part of the strategy. The authorised limit for external debt in 2019/20 of £737m set by the City Council on 12 February 2019 must not be exceeded. It is not anticipated that the City Council will need to use the temporary borrowing facility in 2018/19.

(f) Overdraft

An overdraft limit of £2m has been agreed with the Barclays Bank plc. Interest on the overdraft is charged at 1% above base rate. The City Council does not anticipate that short-term borrowing will generally be necessary during 2019/20 as it currently holds sufficient funds to enable the authority's cash flow to be managed without the need to borrow. However, the overdraft facility may be used when there are unforeseen payments and funds placed on temporary deposit cannot be called back in time.

(g) Internal Funds

Internal funds include all revenue reserves and other specific reserves maintained by the City Council, including the minimum revenue provision which is available to either repay debt or to be used instead of new borrowing. The cash held in respect of internal funds such as earmarked reserves can be borrowed in the short term to finance capital expenditure or the repayment of debt, thus delaying the need to borrow externally.

## 8. APPORTIONMENT OF BORROWING COSTS TO THE HOUSING REVENUE ACCOUNT (HRA)

8.1 The Council will continue to operate with a single loans pool and apportion costs according to locally established principles. The principles upon which the apportionment of borrowing costs should be based are as follows:

- The apportionment is broadly equitable between the HRA and the General Fund, and is detrimental to neither;
- The loans portfolio is managed in the best interests of the whole authority;
- The costs and benefits of over and under borrowing above or below the capital financing requirement (CFR) are equitably shared between the General Fund and the HRA.

## 9 ANNUAL INVESTMENT STRATEGY

9.1 The Government has also issued guidance on investments. The guidance requires the City Council to adopt an Annual Investment Strategy. This is contained within paragraphs 10 to 16 below. The requirements of the Ministry of Housing, Communities and Local Government are in addition to the requirements of the Chartered Institute of Public Finance and Accountancy's Treasury Management in Public Services: Code of Practice.

9.2 During the year the Council may be asked to approve a revised strategy if there are investment issues which the full Council might wish to have brought to their attention.

9.3 The guidance defines a prudent policy as having two objectives:

- achieving first of all security (protecting the capital sum from loss);
- liquidity (keeping the money readily available for expenditure when needed).

Only when proper levels of security and liquidity have been secured should yield be taken into account.

9.4 Investment activities will also take account of the risk appetite statement contained in the Capital Strategy approved by the Cabinet and City Council (reproduced in Appendix A).

9.5 Investment strategies usually rely on credit ratings and both the current and recommended Investment Strategies are based on credit ratings. Although the recommended Investment Strategy is based on credit ratings other sources of information will be taken into account prior to placing deposits such as information in the quality financial press and credit default swaps (CDS) prices.

9.6 CDS are a financial instrument for swapping the risk of debt default. The buyer of a credit default swap pays a premium for effectively insuring against a debt default. He receives a lump sum payment if the debt instrument is defaulted. The seller of a credit default swap receives monthly payments from the buyer. If the debt instrument defaults they have to pay an agreed amount to the buyer of the credit default swap.

9.7 Investments will be made with reference to the core balance and cash flow requirements and the outlook for short and medium term interest rates (i.e. rates for investments up to 6 years). Greater returns are usually obtainable by investing for longer periods. While most cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed. As a general rule:

- If it is thought that Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or variable.

- Conversely, if it is thought that Bank Rate is likely to fall within that time period, consideration will be given to locking in higher rates currently obtainable, for longer periods.

9.8 The Council is forecast to have at least £87m of core surplus cash after internal borrowing has been taken into account until 2021/22. The Council must be mindful that some of this principal could be lost in real terms if investment returns do not exceed inflation. It is proposed that this cash be placed in long term investments that carry greater risk than the Council's shorter term investments.

9.9 The Council may invest these sums in:

- subsidiary companies;
- companies that support the local economy such as Hampshire Community Bnk;
- pooled investment vehicles such as corporate bond funds, equity funds, property funds, and multi asset funds

9.10 Some of these funds may be externally managed.

9.11 The Council may also invest in lower risk structured investment products that follow financial markets, such as equity markets, where movements in prices may diminish the capital sum invested. These investments, and indeed any other investment, could also be diminished if the counter party defaults. Although the Council only invests in counter parties offering good credit quality, the credit quality of an investment counter party can decline during the life of the investment. This is particularly the case with long term investments.

9.12 The Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Local Authority Accounting requires movements in the market value of pooled investments and some structured investment products to be charged to General Fund balances. The Government has made regulations to mitigate the effect of movements in the market value of pooled investments for at least five years, but there are no mitigating regulations for movements in the market value of structured products. This means that there will be less money to fund the Council's services in the event of the market value of some structured investments diminishing.

## 10. INVESTMENT CONSULTANTS

10.1 The City Council currently employs consultants to provide the following information:

- Interest rate forecasts
- Credit ratings
- CDS prices

## 11. SPECIFIED INVESTMENTS

11.1 The Government requires the Council to identify investments offering high security and high liquidity. These are the most secure investments and there is no overall limit on the amount that can be held. Specified investments will be made with the minimum of procedural formalities. They must be made in sterling and have a maximum duration of 365 days. Specified investments must not involve the acquisition of share capital in any corporate body.

11.2 Credit rating information is available to the financial market through three main credit rating bodies ie. Moody's, Fitch, and Standard and Poor. Short and long term credit ratings are provided by all three agencies. Long term credit ratings are explained in Appendix E.

11.3 The grades of short and long term credit rating are as follows with the best credit ratings at the top. The credit ratings that meet the City Council's investment criteria for specified investments are shaded.

| Fitch | | Moody's | | Standard & Poor's | |
|---|---|---|---|---|---|
| Short Term | Long Term | Short Term | Long Term | Short Term | Long Term |
| F1+ | AAA | P-1 | Aaa | A-1+ | AAA |
| | AA+ | | Aa1 | | AA+ |
| | AA | | Aa2 | | AA |
| | AA- | | Aa3 | | AA- |
| F1 | A+ | | A1 | A-1 | A+ |
| | A | P-2 | A2 | | A |
| | A- | | A3 | A-2 | A- |
| F2 | BBB+ | P-3 | Baa1 | A3 | BBB+ |
| | BBB | | Baa2 | | BBB |
| F3 | BBB- | | Baa3 | | BBB- |

11.4 It is recommended that specified investments should only be placed with institutions that have a long term credit rating of at least A- from at least two rating agencies except enhanced money market funds and registered social landlords for which a single credit rating will be required.

11.5 Industry practice is for enhanced money market funds to have a single credit rating, but such funds are well diversified. The Council will only invest in enhanced money market funds with a credit rating of at least AA-. These funds will be treated as category 6 (A+) (see paragraph 10.17) investments to reflect the increased risk of relying on a single credit rating (as opposed to category 4 if two ratings had been obtained).

11.6 Most registered social landlords (RSLs) are only rated by a single agency. However RSLs are regulated by the Homes and Communities Agency (HCA) which rates the financial viability of RSLs. Investments will only be placed with RSLs that have a financial viability rating of V1 from the HCA.

11.7 In addition to rating financial institutions the rating agencies also rate governments. These are known as sovereign credit ratings. The evolving regulatory environment, in tandem with the rating agencies' new methodologies also means that sovereign ratings are now of lesser importance in the assessment process with the new regulatory environment attempting to break the link between sovereign support and domestic financial institutions. However sovereign credit ratings are also dependent on a government's ability to raise taxes and thus also give an indication of the state of a nation's general economy. Investments will only be placed with institutions based in either the United Kingdom or states with an AA credit rating.

11.8 When an institution or state has differing ratings from different agencies, the average rating will be used to assess its suitability. Those institutions that have not been rated by a particular agency will not be discarded because of the lack of ratings.

11.9 It is proposed that investments be allowed in government bodies, banks including supranational banks, building societies, money market funds, enhanced money market funds, RSLs, universities and corporate bonds that meet the Council's investment criteria.

11.10 Money market funds are well diversified funds that invest in high quality very short term instruments enabling investors to have instant access to their funds. These funds do have a low level of volatility in their net asset value which could theoretically result in a small loss of capital. Enhanced money market funds, also known as short dated investment funds, are also well diversified funds investing in high quality counter parties, but for longer periods, and require a few days' notice of withdrawals. Industry practice is for enhanced money market funds to have a single credit rating. Although there may be small variations in the net asset value, the Government has made regulations that prevent variations in the value of pooled funds, including money market funds, from being charged to revenue prior to such investments being disposed of.

11.11 Corporate bonds are tradable loan instruments issued by commercial companies. Credit ratings measure the risk of default, ie. the risk of not receiving principal and interest when it is due, across these institutions in a way that allows them to be compared. However, other measures of credit risk such as CDS prices are not available for all institutions including most building societies, RSLs, universities and commercial companies.

11.12 There are over 30 registered social landlords (RSLs) with a single or double A credit rating. RSLs often have a single credit rating from one agency, but are subject to Government regulation. The Homes and Communities Agency (HCA) assigns a viability rating to larger RSLs with in excess of 1,000 dwellings as follows:

V1 - the RSL meets the HCA's financial viability standard and has the capacity to mitigate its exposures effectively

V2 - the RSL meets the HCA's viability requirements but need to manage material financial exposures to support continued compliance

V3 - the RSL does not meet the HCA's viability requirements. There are issues of serious regulatory concern and in agreement with the HCA; the RSL is working to improve its position

V4 - the RSL does not meet the HCA's viability requirements. There are issues of serious regulatory concern and the RSL is subject to regulatory intervention or enforcement action

However an RSL's debts are not guaranteed by the Government.

11.13 Building societies also operate under a separate legal regime to banks, which limits the amount of lending not secured on residential property and limits the amount of wholesale funding. When a building society has got into financial difficulties in the past it has always been taken over by another building society without its creditors losing any of their money. For these reasons building societies are placed in a category one notch above other institutions with the same credit rating.

11.14 Lending to universities will be permitted**.** A number of universities have credit ratings and are as secure as a commercial company with a similar credit rating.

11.15 The Council's direct investments will be limited to senior debt. Subordinated corporate bonds are sometimes issued by financial institutions and commercial companies. Subordinated corporate bonds offer higher yields, but in the event of an institution defaulting, senior debtors are repaid before subordinated debtors. Because of this, subordinated bonds often have a lower credit rating than senior debt issued by the same institution.

11.16 There are structured investment products available that pay enhanced returns provided that neither of the specified stock market indices such as the FTSE 100 and Eurostoxx 50 decline by more than 50% over 6 years and repay the capital invested if the worst performing index does not fall by more than 60%. The Director of Finance and Information Technology (Section 151 Officer) may invest the Council's funds in structured investment products which follow the developed stock markets or other financial markets that do not fully protect the Council's capital invested. These products are effectively bank deposits where the return is determined by stock market performance. As such they are subject to credit risk if the issuer defaults. Variations in the market value of some structured investment produces will be credited or debited to General Fund balances under new accounting standards. The Government has not made regulations to prevent the General Fund balances being affected by variations in the market value of these investments.

11.17 The approved counter parties for specified investments are divided into eight categories as follows:

| | Maximum Investment in a Single Organisation |
|---|---|
| Category 1<br>United Kingdom Government including the Debt Management Office Deposit Facility | Unlimited investments for up to 6 years |
| Category 2<br>Local authorities in England, Scotland and Wales | £30m for up to 6 years |
| Category 3<br>RSLs with a single long term credit rating of Aa- | £30m for up to 10 years |
| Category 4<br>Banks, corporate bonds and universities with a short term credit rating of F1+ and a long term rating of AA-.<br>Building societies with a short term credit rating of F1 and a long term rating of A+.<br>Aaa rated money market funds | £26m for up to 6 years |
| Category 5<br>RSLs with a single long term credit rating of A- | £20m for up 10 years |
| Category 6<br>Banks, corporate bonds and universities with a short term credit rating of F1 and a long term rating of A+.<br>Building societies with a short term credit rating of F1 and a long term rating of A.<br>Enhanced money market funds with a single AA credit rating | £20m for up to 6 years. |
| Category 7<br>Banks, corporate bonds and universities with a short term credit rating of F1 and a long term rating of A.<br>Building societies with a short term credit rating of F1 and a long term rating of A-. | £15m for up to 6 years |
| Category 8<br>Banks, corporate bonds and universities with a short term credit rating of F1 and a long term rating of A-. | £10m for up to 6 years |

11.18 A list of financial institutions currently meeting the Councils investment criteria is contained in Appendix F. There are too many RSLs, universities and companies issuing corporate bonds to include in the list.

11.19 Investing in counter parties that do not meet the Council's credit criteria if the investment is secured against assets that do meet the Council's investment criteria will increase the number of counter parties the Council can invest in and may increase investment returns. Although this will increase the risk of defaults, it should not increase the risk of investment losses provided that the contracts are properly drawn up and the assets offered as security pass to the Council.

11.20 Sometimes institutions issue covered bonds which are secured against assets held by that institution. These assets may be loans that the institution has made to local authorities or loans made to other financial institutions that have a higher credit rating. If the institution that issued the covered bond defaults the specified assets will pass the City Council. Investments will be permitted in covered bonds that are secured against local authority debt or covered bonds that have a credit rating that meets the Council's investment criteria even if the counter party itself does not meet the Council's credit criteria.

11.21 Repo / reverse repo is accepted as a form of collateralised lending and should be based on the GMRA 2000 (Global Master Repo Agreement). A repo is a form of secured borrowing where readily saleable collateral, normally gilts or treasury bills are placed with the lender. If the borrower fails to repay the loan the lender keeps the collateral that has been deposited. A reverse repo is the equivalent form of secured lending. Therefore whilst the borrower would have a repo, the Council would have a reverse repo. Should the counter party not meet our senior unsecured rating then a 102% collateralisation would be required. The acceptable collateral is as follows:

- Index linked gilts
- Conventional gilts
- UK treasury bills

11.22 Credit ratings be reviewed weekly and that any institution whose lowest credit rating falls below the criteria for category 8 in paragraph 10.16 be removed from the list of specified investments.

11.23 Institutions that are placed on negative watch or negative outlook by the credit rating agencies will be reassigned to a lower category.

## 12. NON-SPECIFIED INVESTMENTS

12.1 The Government's Guidance requires that other less secure types of investment be identified and that a limit be set on the overall amount that may be held in such investments at any time in the year. Non-specified investments are investments that are not secure, ie. do not have an "A" credit rating or are not liquid, ie. have a maturity in excess of 365 days. Investments that are not denominated in sterling would also be non-specified investments due to exchange rate risks.

12.2 In order to reduce the risks associated with placing funds with a relatively small number of counter parties and to improve returns further investment categories have been established for non-specified investments that do not meet the criteria for specified investments.

<u>Category 9 - £50m</u>

Category 9 will consist of investments in pooled investment vehicles including equity funds, property funds, and multi asset funds.

These investment vehicles have the potential to generate returns in excess of inflation and thus maintain the value of the principal invested in real terms. The Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Local Authority Accounting requires movements in the market value of pooled investments to be charged to General Fund balances after a statutory transition period of 5 years.

<u>Category 10 - £30m</u>

Category 10 will consist of investments in subsidiary companies. In particular, funds could be invested to facilitate the establishment of a subsidiary company to develop housing in the greater Portsmouth area on a commercial basis.

<u>Category 11 - £11m for 2 years</u>
Short Term – F2 (or equivalent from Fitch, Moody's and Standard & Poor)
Long Term – BBB or better (or equivalent from Fitch, Moody's and Standard and Poor)

Category 11 will consist of rated building societies that meet these criteria.

Category 12 - £7m for 365 days

Short Term – F2 (or equivalent from Fitch, Moody’s and Standard & Poor)
Long Term – BBB+ or better (or equivalent from Fitch, Moody’s and Standard and Poor)

Investing up to 365 days in investments with a long term credit rating of BBB+ / Baa1 and a short term credit rating of at least F2 / P-3 / A3 would diversify the portfolio by enabling investments to be made in more commercial companies such as British Telecom. The risk of an investment defaulting is driven by the credit quality of the investment counter party and the duration of the investment, ie. the amount of time that credit quality can deteriorate over. An investment counter party rated BBB+ is more likely to default than an investment counter party rated A-. However an 18 month investment is more likely to default than a 12 month investment. Therefore a 12 month investment rated BBB+ can offer a lower probability of default than an 18 month investment rated A-. Therefore investing up to 365 days in investments rated BBB+ would diversify the portfolio by enabling investments to be made in more commercial companies without increasing the risk of default. Category 11 will consist of institutions that meet the above criteria.

Category 13 - £8m

Long Term – BBB or better (or equivalent from Fitch, Moody’s and Standard and Poor)

Further diversification could be achieved by investment in a corporate bond fund. Investing in a corporate bond fund where the average credit rating of the underlying investments is BBB+. Such funds could include underlying investments with BBB- credit ratings although each investment would amount to no more than 4% of the fund. If one of the underlying investments did default the Council's holding in the fund could be worth less than what it paid into the fund, ie. the Council could make a loss. It is therefore recommended that total investments in such funds will be restricted to £8m.

Category 13 will consist of corporate bonds bought on the Council's behalf by professional fund managers who will target an average credit rating of at least BBB+ for the corporate bond fund. The average credit rating of the corporate bond fund may fall to BBB if there was a downgrade to a single issue or a broad downgrade. We would not want the fund manager to be a forced seller in this situation. If this situation arises a strategy will be agreed with the fund manager to return the average rating of the portfolio to BBB+.

Category 14 - £6m for 2 years

Many smaller building societies that have been more conservative in their lending approach do not have credit ratings. An analysis of building society accounts suggests that many of those without credit ratings are in a better financial position than some of the larger ones who do hold credit ratings.

Category 14 consists of the unrated building societies in the strongest financial position.

The limits on these building societies are less than £6m to take account of their small size in terms of assets.

| Stronger Unrated Building Societies | |
|---|---|
| **Building Society** | **Limit** |
| Newcastle | £6.0m |
| Progressive | £6.0m |
| Leek United | £5.2m |
| Ipswich | £3.2m |
| Marsden | £2.4m |
| Melton Mowbray | £2.3m |
| Market Harborough | £2.1m |
| Scottish | £2.1m |
| Hanley Economic | £2.0m |
| Dudley | £2.0m |
| Tipton & Coseley | £1.8m |

Category 15 - £6m for 365 days

Category 15 consists of the unrated building societies that are in a strong financial position.

The limits on some building societies are less than £6m to take account of their small size in terms of assets.

| Unrated Building Societies in a Strong Financial Condition | |
|---|---|
| **Building Society** | **Limit** |
| Cumberland | £6.0m |
| The Family | £6.0m |
| Saffron* | £5.1m |
| Newbury | £5.0m |
| Furness | £4.5m |
| Hinkley & Rugby | £3.7m |
| Darlington # | £2.9m |

* Saffron Building Society

In 2018/19 Saffron Building Society was placed in category 14 (formerly category 13) amongst the strongest unrated building societies.

The total assets of the Building Society have since fallen by £94m from £1,114m to £1,020m. This is a result of a decision by the Building Society to use some of its assets to upgrade its IT systems. The lending limits for unrated building societies are set at 0.5% of total assets. As a result of this the lending limit for the Building Society has been reduced by £0.5m from £5.6m to £5.1m. As a consequence of this the revised limit for Saffron Building Society has been exceeded by £0.5m. This situation will persist until 16 April 2019 when a £2.8m loan matures.

As the total assets of the Building Society have decreased, the percentage of total assets that are liquid has fallen by 6.97% from 22.40% to 15.43% which is inconsistent with a category 14 counter party considered suitable for investments of up to 2 years duration. Consequently the Building Society has been reassigned to category 14 which is only considered suitable for investments of up to 365 days. On 6 April 2018 the City Council invested £2.8m with the Building Society for 2 years.

# Darlington Building Society

In 2018/19 Darlington Building Society was placed in category 14 (formerly category 13) amongst the strongest unrated building societies.

The liquid assets ratio of the Building Society has fallen by 4.65% from 20.77% to 16.12%. This is a result of a decision by the management of the Building Society to management down its liquidity in order to improve efficiency. As the minimum liquid asset ratio for category 14 has been set at 16.48% the Building Society has been downgraded to category 15. The effect of this is to reduce the maximum term for future investments from 2 years to 365 days. On 23 April 2018 the City Council invested £1.2m with the Building Society for 2 years.

Monmouthshire Building Society

In 2018/19 Monmouthshire met the criteria to be placed in category 14 (formerly category 13) and was eligible for the Council to invest in.

Building societies have reduced their dependence on wholesale funding overall. Monmouthshire Building Society has also reduced its dependence on wholesale funding, but by less than the average for building societies. As the Building Society is no longer in line with its peers, the Council will not place any further investments with this building society. The Council currently has £5.3m invested with the Building Society which matures on 12 April 2019.

Category 16 - £10m for up to 10 years

Purchasing bonds in Hampshire Community Bnk (HCB) would contribute to the regeneration of Hampshire and offer interest of up to 3.5%. Investing in HCB carries greater risk than the other approved investments contained in the Council's Annual Investment Strategy as HCB is a new entity that is in the process of developing its business, and currently has neither a banking license nor a credit rating. However HCB will be able to offer assets as security to cover a corporate bond. These assets would consist of good performing loans secured against tangible assets. The loan assets offered as security would pass to the Council in the event of HCB defaulting.

Category 15 will consist of bonds issued by Hampshire Community Bnk secured against good quality assets owned by the bank.

12.3 Money Lodged on Behalf of MMD (Shipping Services) Ltd

The Council’s treasury management operation is exposed to the Council’s subsidiary company MMD (Shipping Services) Ltd. The Council has £550,000 lodged with Lloyds Bank to guarantee MMD’s banking limits.

12.4 Contracts Denominated in Foreign Currencies

The Council sometimes enters into contracts denominated in foreign currencies. Such contracts normally relate to civil engineering schemes at the port. It can be beneficial to buy Euros early to fund these projects and avoid the associated currency risk.

## 12.5 Limit on Non Specified Investments

Non-specified investments will in aggregate be limited to the following:

| | £ |
|---|---|
| Pooled investment funds | 50m |
| Building societies with a BBB credit rating and unrated building societies | 77m |
| Corporate bonds with a BBB+ credit rating | 32m |
| Externally managed corporate bond funds with an average credit rating of BBB | 8m |
| Investments in subsidiary companies including funds lodged to guarantee the banking limits of MMD (Shipping Services) Ltd. | 30m |
| Long term investments | 264m |
| Investments in foreign currencies to hedge against contracts priced or indexed against foreign currencies | 4m |
| Hampshire Community Bnk bonds | 10m |
| **Total** | **475m** |

## 13. MAXIMUM LEVEL OF INVESTMENT IN INDIVIDUAL ORGANISATIONS

13.1 The Government's Guidance does not require a limit to be placed on the amount that can be placed in any one investment. However in order to minimise risk further, the total amount that can be directly invested with any organisation at any time will be limited as follows:

| | Maximum Investment in Single Organisation |
|---|---|
| Category 1 | Unlimited |
| Category 2 | £30m for up to 6 years |
| Category 3 | £30m for up to 10 years |
| Category 4 | £26m for up to 6 years |
| Category 5 | £20m for up to 10 years |
| Category 6 | £20m for up to 6 years |
| Category 7 | £15m for up to 6 years |
| Category 8 | £10m for up to 6 years |
| Category 9 | £50m with an indefinite duration (although these investments may be sold) |
| Category 10 | £30m with an indefinite duration |
| Category 11 | £10m for up to 2 years |
| Category 12 | £7m for up to 365 days |
| Category 13 | £8m with an indefinite duration (although these investments may be sold) |
| Category 14 | £6m for up to 2 years |
| Category 15 | £6m for up to 365 days |
| Category 16 | £10m for 10 years |

13.2 AA money market funds offer security and same day access. By aggregating investments they can also invest in financial institutions that may not be interested in the relatively small sums that the Council can invest. Although AA money market funds are well diversified in their investments, there is a risk that more than one fund could have investments with the same bank or that the Council may also have invested funds in the same bank as a money market fund. Therefore it is proposed that the Council should aim to have no more than £80m invested in money market funds.

13.3 Most building society lending is secured against residential properties. If property prices fall there may be inadequate security to support building societies lending giving rise to a systemic risk.

13.4 As RSL's offer one principal service and their assets principally consist of residential properties, excessive investments in RSLs would also expose the Council to a systemic risk.

13.5 Excessive investments in investment products tracking equity, property or other markets could also expose the Council to a systemic risk.

13.6 In order to minimise systemic credit risk in any sector the following limits will be applied:

| | |
|---|---|
| Money market funds | £80m |
| Building societies | £155m |
| Registered Social Landlords | £80m |
| Investments tracking the equity, property or other markets | £70m |

13.7 In order to minimise systemic credit risk in any region it is recommended that the following limits be applied to the geographic areas where investments can be made in foreign countries.

13.8 The following limits be applied:

| | |
|---|---|
| Asia & Australia | £80m |
| Americas | £80m |
| Eurozone | £60m |
| Continental Europe outside the Eurozone | £60m |

13.9 The limits above only apply to direct investments. The City Council's exposure to any institution, sector or region may exceed the limits stated above through indirect investments via money market funds. Money market funds employ specialist staff to assess counter party risks and all investments made by money market funds are short-term.

## 14. LIQUIDITY OF INVESTMENTS

14.1 The Council's cash flow forecast for the current year is updated daily. In addition, the Council maintains a long term cash flow forecast that extends to 2037/38. These forecast are used to determine the maximum period for which funds may be prudently committed, ie. the City Council's core cash. The City Council maintains at least £10m invested on an instant access basis to ensure that unforeseen cash flows can be financed.

## 15. INVESTMENT OF MONEY BORROWED IN ADVANCE OF NEED

15.1 Section 12 of the Local Government Act 2003 gives a local authority the power to invest for "any purpose relevant to its functions under any enactment or for the prudent management of its financial affairs". While the speculative procedure of borrowing purely to invest at a profit is clearly unlawful, there is no legal obstacle to the temporary investment of funds borrowed for the purpose of funding capital expenditure incurred in the reasonably near future.

15.2 Borrowing in advance of need may enable the City Council to obtain cheaper loans than those available at the time when expenditure is incurred, although the consequent investment of funds borrowed in advance of need does expose the City Council to credit risk. The interest payable on funds borrowed in advance of need is likely to exceed the interest earned on the investment of those funds in the current economic climate. The Council may determine to borrow in advance of need in circumstances where it is reasonably expected that the total cost of borrowing over the whole life of the loan in present value terms is lower by borrowing in advance of need.

15.3 The Council's gross debt exceeded its CFR by £55m, ie. it was over borrowed, at 31 March 2018, but is expected to fall below its CFR by the end of 2018/19 leaving the Council under borrowed.

## 16. TRAINING OF INVESTMENT STAFF

16.1 The Finance Manager (Technical & Financial Planning) manages the treasury function and is a qualified Chartered Public Finance Accountant and holds the Association of Corporate Treasurers Certificate in Treasury Management. The Finance Manager (Technical & Financial Planning) is assisted by the Treasury Manager who is a qualified Chartered Certified Accountant and also holds the Association of Corporate Treasurers Certificate in Treasury Management. The City Council is also a member of CIPFA's Treasury Management Network which provides training events throughout the year. Additional training for investment staff is provided as required.

## 17. DELEGATED POWERS

17.1 Once the Treasury Policy has been approved, the Director of Finance and Information Technology (Section 151 Officer) has delegated powers under the constitution of the City Council, to make all executive decisions on borrowing, investments or financing.

It is recommended that Chief Executive, the Leader of the City Council and the Chair of the Governance and Audit and Standards Committee be informed of any variances from the Treasury Management Policy when they become apparent, and that the Leader of the City Council be consulted on remedial action (**recommendation 3.1(d)** of the Treasury Management Policy Report considered by the Cabinet on 12 March 2019 and the City Council on 19 March 2019).

## 18. TREASURY SYSTEMS AND DOCUMENTATION

18.1 Once the Policy Statement has been approved by the Council, the documentation of the Treasury Systems will be updated so that all employees involved in Treasury Management are clear on the procedures to be followed and the limits applied to their particular activities.

18.2 The Treasury Management Practices document covers the following topics: -

- risk management
- performance measurement
- decision making and analysis
- approved instruments, methods and techniques
- organisation, clarity and segregation of responsibilities, and dealing arrangements
- reporting requirements and management information arrangements
- budgeting, accounting and audit arrangements
- cash and cash flow management
- money laundering
- training and qualifications
- use of external service providers
- corporate governance