Appendix 5b

Treasury Management Strategy 2018/19

1. Introduction

1.1 Treasury Management (TM) is about the management of the Council's cash flows to ensure it is adequately planned, with cash being available when it is needed. Surplus monies are invested in counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity and security initially before considering investment return.

1.2 The TM function also manages the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, requiring longer term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.3 The Council has adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. CIPFA consulted on changes to the Code in 2017, but has yet to publish a revised Code.

1.4 In addition, the Department for Communities and Local Government (CLG) has also issued revised Guidance on Local Authority Investments in March 2010 that requires the Council to approve an investment strategy before the start of each financial year.

1.5 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Guidance.

1.6 The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

1.7 In accordance with the CLG Guidance, the Council will be asked to approve a revised Treasury Management Strategy Statement should the assumptions on which this report is based change significantly. Such circumstances would include, for example, a large unexpected change in interest rates, or in the Council's capital programme or in the level of its investment balance.

2. External Context

2.1 The information relating to the overall global position of the UK financial markets is provided by Arlingclose, who were appointed as the Council's Treasury Advisors in July 2017. Arlingclose continue to update the Council with information including on-going market activity surrounding inflation, interest rates and the banking sector.

2.2 **Economic background**: The major external influence on the Council's treasury management strategy for 2018/19 will be the UK's progress in negotiating its exit from the European Union and agreeing future trading arrangements. The domestic economy has remained relatively robust since the surprise outcome of the 2016 referendum, but there are indications that uncertainty over the future is now weighing on growth. Transitional arrangements may prevent a cliff-edge, but will also extend the period of uncertainty for several years. Economic growth is therefore forecast to remain sluggish throughout 2018/19.

2.3 Consumer price inflation reached 3.0% in September 2017 as the post-referendum devaluation of sterling continued to feed through to imports. Unemployment continued to fall and the Bank of England's Monetary Policy Committee judged that the extent of spare capacity in the economy seemed limited and the pace at which the economy can grow without generating inflationary pressure had fallen over recent years. With its inflation-control mandate in mind, the Bank of England's Monetary Policy Committee raised official interest rates to 0.5% in November 2017.

2.4 In contrast, the US economy is performing well and the Federal Reserve is raising interest rates in regular steps to remove some of the emergency monetary stimulus it has provided for the past decade. The European Central Bank is yet to raise rates, but has started to taper its quantitative easing programme, signalling some confidence in the Eurozone economy.

2.5 **Credit outlook:** High profile bank failures in Italy and Portugal have reinforced concerns over the health of the European banking sector. Sluggish economies and fines for pre-crisis behaviour continue to weigh on bank profits, and any future economic slowdown will exacerbate concerns in this regard.

2.6 Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the European Union, Switzerland and USA, while Australia and Canada are progressing with their own plans. In addition, the largest UK banks will ringfence their retail banking functions into separate legal entities during 2018. There remains some uncertainty over how these changes will impact upon the credit strength of the residual legal entities.

2.7 The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Council; returns from cash deposits however remain very low.

2.8 **Interest rate forecast**: The Council's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.50% during 2018/19, following the rise from the historic low of 0.25%. The Monetary Policy Committee re-emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

2.9 Future expectations for higher short term interest rates are subdued and on-going decisions remain data dependant and negotiations on exiting the EU cast a shadow over monetary policy decisions. The risks to Arlingclose's forecast are broadly balanced on both sides. The Arlingclose central case is for gilt yields to remain broadly stable across the medium term. Upward movement will be limited, although the UK government's seemingly deteriorating fiscal stance is an upside risk.

2.10 A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix 1.

2.11 For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.40% which is based on Arlingclose's forecast for the 3 month LIBID rate with downside risk. No new long term borrowing has been assumed.

3. Local Context

3.1 As at 23 November 2017, the total debt portfolio of the Council (including HRA debt) was £464.797m offset by investments of £86.225m resulting in an overall net debt position of £378.58m. This is set out in further detail at Appendix 2.

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

3.3 Table 1 below outlines the current position as at 31 March 2017 from analysing the balance sheet and forecasts futures changes in these sums.

Table 1: Balance Sheet Summary and Forecast

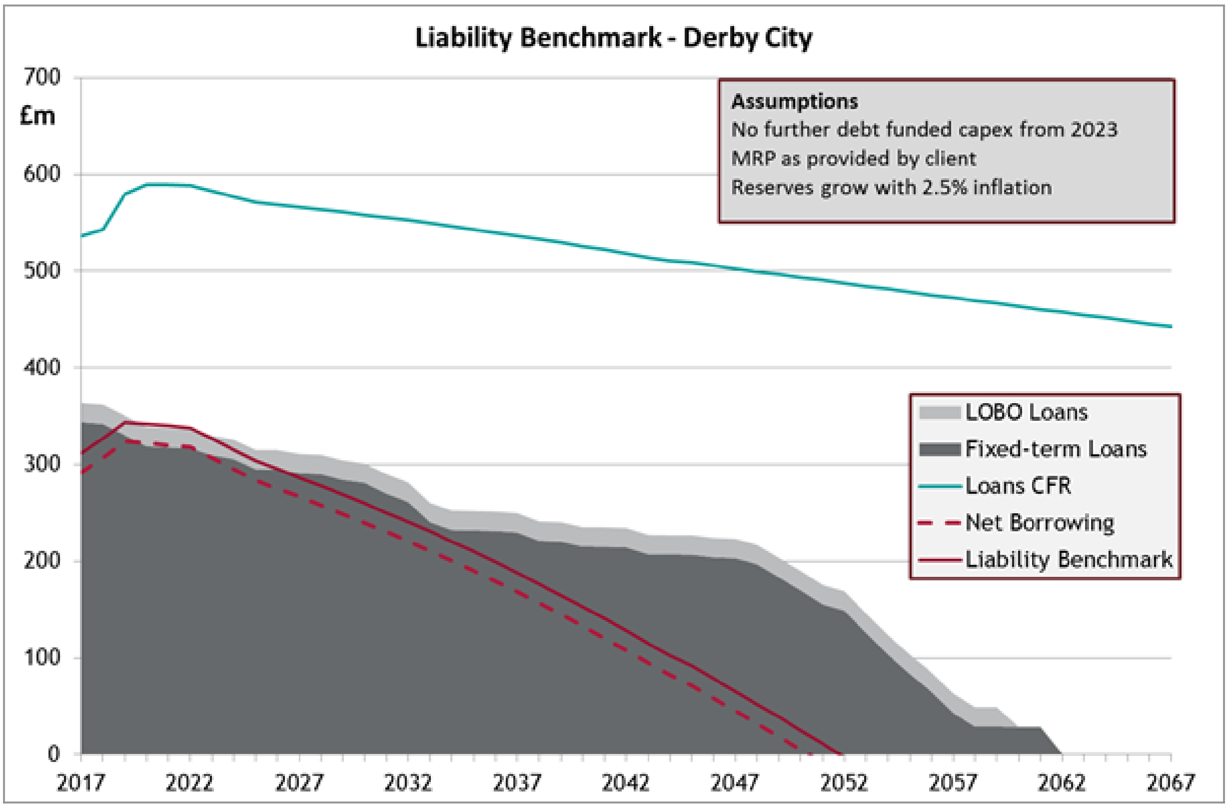
	31.3.17 Actual £m	31.3.18 Estimate £m	31.3.19 Forecast £m	31.3.20 Forecast £m	31.3.21 Forecast £m
General Fund CFR	407.5	413.7	450.3	460.8	460.6
HRA CFR	230.9	230.9	230.9	230.9	230.9
Total CFR	**638.4**	**644.6**	**681.20**	**691.7**	**691.5**
Less: Other debt liabilities	-102.0	-102.0	-102.0	-102.0	-102.0
Borrowing CFR	**536.4**	**542.6**	**579.2**	**589.7**	**589.5**
Less: External borrowing	-363.8	-361.9	-350.4	-338.8	-337.7
Internal (over) borrowing	**172.6**	**180.7**	**228.8**	**250.9**	**251.8**
Less: Usable reserves	-202.1	-193.3	-202.9	-210.1	-211.8
Less: Working capital	-42.5	-42.5	-52.5	-57.5	-57.5
Investments (or New borrowing)	**72.0**	**55.1**	**26.6**	**16.8**	**17.5**

3.4 The Council has an increasing CFR due to the future planned unfunded capital programme, however it is forecast that this can continue be met internally through usable reserves, working capital and reducing investments in 2018/19. By 2019/20 investment levels are forecast to fall just below the estimated minimal level to meet our liquidity needs and we may have a potential need to borrow in 2019/20.

3.5 CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2018/19.

3.6 To assist with its long-term treasury management strategy, the Authority and its advisers have created a liability benchmark, which forecasts the Authority's need to borrow over a 50 year period. Following on from the medium-term forecasts in table 1 above, the benchmark assumes the following from 2017/18 to 2020/21:

- capital expenditure funded by borrowing of £70m
- minimum revenue provision on new capital expenditure based on the Council's MRP policy
- increase in reserves of £9.6m
- existing loans of £26.1m being repaid
- increase in working capital if £15m
- income, expenditure and reserves all increase by 2.5% inflation a year.



3.7 The gap between the loan CFR and external borrowing represents internal borrowing. The gap between net borrowing and external borrowing represents the level of investments held. The liability benchmark takes into account a level of cash required to meet our liquidity needs, represented by the gap between net borrowing and the liability benchmark. If the liability benchmark rises above external borrowing this shows a need to borrow. In 2019/20 this forecast shows a small potential need to borrow, this will continue to be kept under review as assumptions are updated.

4. Treasury Management Strategy - Annual Borrowing Strategy

4.1 The Council currently holds £362.598m of loans, a small decrease since the 31 March 2017, due to principal being repaid in year on annuity loans and the repayment of one small PWLB loan. The balance sheet forecast in table 1 shows that the Council does not expect to need to borrow in 2018/19. The Council may however borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £868m.

4.2 The Council's chief consideration when borrowing money will be to strike an appropriate balance in terms of risk between securing low interest costs and achieving cost certainty over the period which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

4.3 The Council's borrowing strategy is also designed to address the key issue of affordability, especially given current restrictions to local authority funding, without comprising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

4.4 By doing so, the Council is able to reduce net borrowing costs and reduce overall treasury risk. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Our Treasury Advisors will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2018/19 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

4.5 The Council may arrange forward starting loans during 2018/19, where the interest rate is fixed in advance, but the cash is received later. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

4.6 The Council may borrow short-term loans (normally for up to one month) to manage cash flows.

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

- Public Works Loan Board (PWLB) and any successor body
- UK Local Authorities
- Any institution approved for investments (see below)
- Any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds (except our local Derbyshire CC Pension Fund)
- Capital market bond investors
- Transport for London
- Special purpose companies created to enable local authority bond issues (Municipal Bonds Agency)

4.8 In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- Operating and finance leases
- Hire purchase
- Private Finance Initiative
- Sale and leaseback

4.9 The Council has previously raised the majority of its longer term borrowing from the PWLB. The Council continues to investigate other sources of financing and re-financing, both long and short term which may be available at more favourable rates and returns. These include:

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

4.11 **LOBOs:** The Council holds £20m of LOBO (Lender's Option Borrower's Option) loans from the Royal Bank of Scotland. These are loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. The options on the existing LOBO's are not due until 2020/21. The Council will take the option to repay LOBO loans at no cost if it has the opportunity to do so. New LOBO's should not be entered into.

4.12 **Short-term and Variable Rate loans**: These loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

4.13 **Debt Rescheduling:** The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

4.14 **Capital Market/Bond Funding**: There are different structures that can be obtained through the capital markets. Such as deferred bonds, CPI linked bonds, fixed rate bonds. This borrowing option would be evaluated with the support of the Treasury Advisors and would be the subject of a separate report to Cabinet.

4.15 The following includes issues that will be considered prior to undertaking any external borrowing:

- affordability
- maturity profile of existing debt
- interest rate and refinancing risk
- borrowing source
- internal cash balances
- borrowing need.

5. Treasury Management Strategy - Investment Strategy

5.1 At 23 November 2017, the Council held £86m of invested funds in counterparties and institutions, as advised by our Treasury Advisors. In the past 12 months, the Council's investment balance has ranged between £70m and £112m, and similar levels are expected to be maintained in the forthcoming year.

5.2 Both the CIPFA Code and the CLG Guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest interest return or yield. The Councils objective when investing money is to strike a balance between risk and return , minimising the risk of incurring losses from defaults and the risk of receiving low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

5.3 **Negative interest rates:** If the UK enters into a recession in 2018/19, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

5.4 **Strategy:** Given the increasing risk and very low returns from short-term unsecured bank investments, the majority of the Council's surplus cash is currently invested in short- fixed term deposits with other Local Authorities, as they are not subject to bail-in, and there is an insignificant risk of insolvency. Short term money market funds are also used as these diversify risk and there is minimal use of unsecured bank deposits. The Council aims to further diversify into more secure and higher yielding asset classes during 2018/19. This is especially the case for the estimated £10m that is available for longer-term investments. This diversification will represent a substantial change in strategy over the coming year.

5.5 Recommended Counterparties: The Council may invest its surplus funds with any of the counterparty types in table 2 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 2: Approved investment counterparties and limits

Credit rating	Banks unsecured	Banks Secured	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£5m 5 years	£10m 20 years	£10m 50 years	£5m 20 years	£5m 20 years
AA+	£5m 5 years	£10m 10 years	£10m 25 years	£5m 10 years	£5m 10 years
AA	£5m 4 years	£10m 5 years	£10m 15 years	£5m 5 years	£5m 10 years
AA-	£5m 3 years	£10m 4 years	£10m 10 years	£5m 4 years	£5m 10 years
A+	£5m 2 years	£10m 3 years	£5m 5 years	£5m 3 years	£5m 5 years
A	£5m 13 months	£10m 2 years	£5m 5 years	£5m 2 years	£5m 5 years
A-	£5m 6 months	£10m 13 months	£5m 5 years	£5m 13 months	£5m 5 years
None	£1m 6 months	n/a	£10m 25 years	£1m 5 years	£5m 5 years
Pooled funds	The lower of 0.5% of the fund size or £8m				

This table must be read in conjunction with the notes below

5.6 **Operational bank accounts**: The Council's operational bank account is currently provided by Lloyds Bank. The maximum balance held in the operational bank account will be £15m for ease of operation due to the inclusion of Derby Homes balances.

5.7 **Credit rating:** Investment limits are set by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account. Types of investments are detailed in Appendix 3.

5.8 **Risk Assessment and Credit Ratings:** Credit ratings are obtained and monitored by the Council's Treasury Advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

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

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

5.9 **Other Information on the Security of Investments**: The Council recognise that credit ratings should not be the sole determinant of the quality of an institution. Full regard will therefore be given to other available information on the credit quality of the organisations, in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

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

5.11 **Specified Investments** The CLG Guidance defines specified investments as those:

- denominated in pound sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
    - the UK Government,
    - a UK local authority, parish council or community council, or
    - a body or investment scheme of “high credit quality”.

The Council defines “high credit quality” organisations and securities as those having a credit rating of [A-] or higher that are domiciled in the UK or a foreign country with a sovereign rating of [AA+] or higher.

5.12 **Non –Specified Investments:** Any investment not meeting the definition of a specified investment is classed as a non-specified investment. The Council does not intend to make any investments denominated in foreign currencies, however if opportunities arise these will be evaluated. The Council does not intent to make any investments that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will be limited to long term investments i.e. those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in table 3 below.

Table 3: Non-Specified Investment Limits

	Cash limit
Total long-term investments	£30m
Total investments without credit ratings or rated below [A-]	£0m
Total investments (except pooled funds) with institutions domiciled in foreign countries rated below [AA+]	£10m
Total non-specified investments	£40m

5.13 **Investment Limits**: The Council’s revenue reserves available to cover investment losses are forecast to be £101m on 31st March 2018. In order that no more than 10% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £10m. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers’ nominee accounts, foreign countries and industry sectors as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

5.14 **Table 4 – Investment Limits**

Provider	Cash Limit
The Councils Banking Provider - Lloyds	£15m
Any single organisation, except the UK Central Government (excluding the operational bank)	£10m
UK Central Government	Unlimited
Any group of organisations under the same ownership	£10m per group
Any group of pooled funds under the same management	£20m per manager
Negotiable instruments held in a brokers nominee account	£20m per Broker
Foreign Countries	£10m per Country
Registered Providers	£20m in total
Unsecured investments with Building societies	£10m in total
Loans to unrated companies	£10m in total
Money Market Funds (MMF)	50% of total

5.15 It should be noted that although Table 4 shows the maximum amount that can be held in any counterparty or group (apart from Lloyds Bank) to be agreed as part of the strategy, this may change throughout the year based on the advice of our Treasury Advisors.

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

5.17 **Non-Treasury Investments:** Although not classed as treasury management activities and therefore not covered by the CIPFA Code or the CLG Guidance, the Council may also purchase property for investment purposes and may also make loans and investments for service purposes, for example loans to local businesses and Council subsidiaries, or as equity investments. Such loans and investments will be subject to the Council's normal approval processes for revenue and capital expenditure and need not comply with this treasury management strategy.

6. Treasury Management Strategy - Other Items

There are a number of additional items that the Council is obliged by CIPFA or CLG to include in its Treasury Management Strategy.

6.1 **Policy on use of Financial Derivatives**

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

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

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

6.4 **Policy on Apportioning Interest to the HRA** On 1st April 2012, the Council notionally split each of its existing long-term loans into General Fund and HRA pools. During 2017/18 a review has been undertaken. The allocation of loans to the HRA was below the HRA Capital Financing Requirement, meaning the HRA is under borrowed. This represents a loan from the general fund to the HRA. The rate of interest charged for the under borrowing is to be the average rate of interest of the general fund notional loans. The HRA currently receives interest on the average value of its reserves; the interest rate this is based on is to be the 1 month UK Government Treasury Bill interest rate to reflect a credit risk free return. Investments are credit risk free to the HRA because if any credit losses are made on investments, the credit loss cannot be charged to the HRA, they would be a general fund charge.

6.5 **Investment Training**: The needs of the Councils treasury management staff for training in investment management are assessed every half yearly as part of the managing individual performance process, and additionally when the responsibilities of individual members of staff change.

6.6 Staff attend training courses, seminars and conferences provided by our Treasury Advisors and CIPFA.

6.7 **Investment advisers:** The Council has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled by the contract with the Advisors and the Council's Contract Procedure Rules.

6.8 **Investment of Money Borrowed in Advance of Need**: The Council may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

6.9 The total amount borrowed will not exceed the authorised borrowing limit of £868m. If money is borrowed in advance of need, the maximum period between borrowing and expenditure is expected to be two years, although the Council is not required to link particular loans with particular items of expenditure.

6.10 In determining whether borrowing will be undertaken in advance of need the Council will:

- ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio, which supports the need to take funding in advance of need;
- ensure the cost of carry has been considered;
- evaluate the economic reasons that might result in a decision to borrow in advance of need;
- consider the impact of increased counterparty risk when increasing investment levels as a result of borrowing in advance of need;
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use;
- Consider whether other borrowing structures could be utilised in order to fix funding rates for future funding, but have future drawdown dates (i.e. deferred funding structures).

6.11 **Financial Implications**

The budget for investment income in 2018/19 is £0.166m, based on an average investment portfolio of £41.5m at an interest rate of 0.40%. The total budget for debt interest paid in 2018/19 is £15.534m, based on an average debt portfolio of £356m and residual transferred debt. £10.534m of this debt interest is charged to the HRA based on the average HRA debt of £230.869m. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

7. Treasury Management Indicators

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

7.2 **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	Target
Portfolio average credit score	3.00

7.3 **Maturity Structure of Borrowing:** This shows the amount of fixed rate borrowing maturing in each period, expressed as a percentage of total fixed rate borrowing. This indicator is designed to be a control over having large amounts of fixed rate debt falling to be replaced at the same time, exposing the Council to refinancing risk.

The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Maturity structure of fixed rate borrowing	Existing level at 01/04/18 (%)	Upper Limit for 2018/19 %
under 12 months	2.95	10
under 24 months	5.95	20
under 5 years	13.54	30
under 10 years	19.48	50
under 20 years	38.38	70
under 30 years	44.78	80
under 40 years	91.83	95
under 50 years	100.00	100
50 years and above	0.00	0

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

7.4 **Principal Sums Invested for Periods Longer than 364 days:** This indicator is designed to protect the liquidity of investments, ensuring that large proportions of the cash reserves are not invested for long periods. It controls the Councils exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond 364 days will be £30m.

7.5 **Interest Rate Exposure Indicator:** This indicator is set to control the Council's exposure to interest rate risk. Its shows an upper limit for fixed and variable rate borrowing expressed as a percentage of net principal borrowed. Fixed rate borrowing provides certainty for future interest costs, regardless of movements in interest rates. A high level of variable rate debt presents a risk from increases in interest rates.

	Upper limit %
Interest Rate Exposure - Fixed	100
Interest Rate Exposure -Variable	20

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole of the financial year. Instruments that mature in the financial year are classed as variable.

7.6 In addition to the local treasury management indicators the Council is required under the prudential code to set and monitor against the prudential indicators. As these are mainly concerned with the capital programme and borrowing the prudential indicators were set and reported within the capital budget report 2018/19 – 2020/21.

8. Other options considered for the Treasury Management Strategy

8.1 The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Finance, having consulted the Cabinet Member for Finance, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed in Table 5.

Table 5 - Other Treasury Management Options considered

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

Appendix 1

Arlingclose Economic & Interest Rate Forecast November 2017

Underlying assumptions:

- In a 7-2 vote, the MPC increased Bank Rate in line with market expectations to 0.5%. Dovish accompanying rhetoric prompted investors to lower the expected future path for interest rates. The minutes re-emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

- Further potential movement in Bank Rate is reliant on economic data and the likely outcome of the EU negotiations. Policymakers have downwardly assessed the supply capacity of the UK economy, suggesting inflationary growth is more likely. However, the MPC will be wary of raising rates much further amid low business and household confidence.

- The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. While recent economic data has improved, it has done so from a low base: UK Q3 2017 GDP growth was 0.4%, after a 0.3% expansion in Q2.

- Household consumption growth, the driver of recent UK GDP growth, has softened following a contraction in real wages, despite both saving rates and consumer credit volumes indicating that some households continue to spend in the absence of wage growth. Policymakers have expressed concern about the continued expansion of consumer credit; any action taken will further dampen household spending.

- Some data has held up better than expected, with unemployment continuing to decline and house prices remaining relatively resilient. However, both of these factors can also be seen in a negative light, displaying the structural lack of investment in the UK economy post financial crisis. Weaker long term growth may prompt deterioration in the UK's fiscal position.

- The depreciation in sterling may assist the economy to rebalance away from spending. Export volumes will increase, helped by a stronger Eurozone economic expansion.

- Near-term global growth prospects have continued to improve and broaden, and expectations of inflation are subdued. Central banks are moving to reduce the level of monetary stimulus.

- Geo-political risks remains elevated and helps to anchor safe-haven flows into the UK government bond (gilt) market.

Forecast:

- The MPC has increased Bank Rate, largely to meet expectations they themselves created. Future expectations for higher short term interest rates are subdued. On-going decisions remain data dependant and negotiations on exiting the EU cast a shadow over monetary policy decisions.

- Our central case for Bank Rate is 0.5% over the medium term. The risks to the forecast are broadly balanced on both sides.

- The Arlingclose central case is for gilt yields to remain broadly stable across the medium term. Upward movement will be limited, although the UK government's seemingly deteriorating fiscal stance is an upside risk.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.19**
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**
Downside risk	0.00	0.00	0.00	0.00	0.00	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	**-0.15**
3-month LIBID rate														
Upside risk	0.10	0.10	0.10	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.22**
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**
Downside risk	-0.10	-0.10	-0.15	-0.15	-0.15	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	**-0.20**
1-yr LIBID rate														
Upside risk	0.15	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	**0.27**
Arlingclose Central Case	**0.70**	**0.70**	**0.70**	**0.70**	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	**0.77**
Downside risk	-0.15	-0.20	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.15	-0.15	**-0.26**
5-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	**0.32**
Arlingclose Central Case	**0.75**	**0.75**	**0.80**	**0.80**	**0.80**	**0.85**	**0.90**	**0.90**	**0.95**	**0.95**	**1.00**	**1.05**	**1.10**	**0.89**
Downside risk	-0.20	-0.20	-0.25	-0.25	-0.25	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	**-0.33**
10-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	**0.32**
Arlingclose Central Case	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.30**	**1.30**	**1.35**	**1.40**	**1.45**	**1.50**	**1.55**	**1.55**	**1.36**
Downside risk	-0.20	-0.25	-0.25	-0.25	-0.25	-0.30	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	**-0.33**
20-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	**0.32**
Arlingclose Central Case	**1.85**	**1.85**	**1.85**	**1.85**	**1.85**	**1.90**	**1.90**	**1.95**	**1.95**	**2.00**	**2.05**	**2.05**	**2.05**	**1.93**
Downside risk	-0.20	-0.30	-0.25	-0.25	-0.30	-0.35	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	**-0.38**
50-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	**0.32**
Arlingclose Central Case	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**	**1.75**	**1.80**	**1.85**	**1.90**	**1.95**	**1.95**	**1.95**	**1.95**	**1.82**
Downside risk	-0.30	-0.30	-0.25	-0.25	-0.30	-0.35	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	**-0.39**

Appendix 2

Current Debt and Investment Portfolio Position 23 November 2017

	£000
External Borrowing:	
- Fixed Rate PWLB	304,877
- Fixed Rate Market (LOBO's)	20,000
- Other Local Authorities	35,000
- Other loans	2,721
Other Long-term Liabilities:	
- Transferred Debt from other Local Authorities	2,931
- PFI Financing	98,442
- Finance Leases	826
Total Gross External Debt	**464,797**
Treasury Investments:	
- Local Authority Fixed Term Deposits	(46,000)
- Money Market Funds	(39,336)
- Unsecured Banks	(888)
Total Treasury Investments	**(86,225)**
Total Net External Debt	**378,572**

Appendix 3

Definitions of Types of Permitted Investments

Banks Unsecured: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

Banks Secured: Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

Corporates: Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made either following an external credit assessment or to a maximum of £1m per company as part of a diversified pool in order to spread the risk widely.

Registered Providers: Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services; they retain a high likelihood of receiving government support if needed.

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

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.