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ITEM Treasury Management Strategy Statement and Annual Investment Strategy 2018/19

Report of the Finance Portfolio Holder

Recommended:

1. **That the Treasury Management Strategy Statement and the Annual Investment Strategy for 2018/19 as set out in the report be approved.**
2. **That the Minimum Revenue Provision (MRP) policy be approved.**
3. **That the Prudential Indicators as set out in annex 1 be approved.**

Recommendation to Council

SUMMARY:

- This report presents the Treasury Management and Annual Investment Strategies of the Council and has been produced in accordance with the latest statutory requirements and relevant codes of practice.
- Borrowing costs are currently limited to the interest payable on short term borrowing which is used to even out the Council's cashflow throughout the year although prudential borrowing to cover the deficit in the capital programme is permitted in the strategy.
- The major objectives of the Treasury Management Strategy for 2018/19 are:
  - To manage effectively and control the risks associated with treasury management activities.
  - To invest prudently having regard to the security and liquidity of investments and the predictability of returns.
  - To aim to achieve the optimum return on investments commensurate with the proper levels of security, liquidity and protection of capital.
- This report identifies two separate occasions when the Treasury Management Strategy was breached. On both occasions the situation was recovered.

1 Introduction

1.1 Background

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the

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Council's low risk appetite, providing adequate liquidity before considering investment return.

The second main function of the treasury management service is the funding of cash which 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.

1.2 Reporting requirements

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

Prudential and treasury indicators and treasury strategy (this report) - The first, and most important report covers:
- the capital plans (including prudential indicators);
- a minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
- 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).

A mid year treasury management report – This will update Councillors with the progress of the capital programme, amending prudential indicators as necessary, and whether any policies require revision.

An annual treasury report – This provides details of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

Capital Strategy
In December 2017, CIPFA issued revised Prudential and Treasury Management Codes. As from 2019-20, all local authorities will be required to prepare an additional report, a Capital Strategy report, which is intended to provide the following:

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability

The aim of this report is to ensure that all elected members on the Council fully understand the overall strategy, governance procedures and risk appetite entailed by this Strategy.

The Capital Strategy will include capital expenditure, investments and liabilities and treasury management in sufficient detail to allow all members to

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understand how stewardship, value for money, prudence, sustainability and affordability will be secured.

1.3 **Treasury Management Strategy for 2018/19**

The strategy for 2018/19 covers two main areas:

Capital issues
- the capital plans and the prudential indicators;
- the MRP strategy.

Treasury management issues
- the current treasury position;
- treasury indicators which limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- the investment strategy;
- creditworthiness policy; and
- policy on use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the CIPFA Treasury Management Code and CLG Investment Guidance.

1.4 **Treasury Management Consultants**

The Council uses Link Asset Services as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon external service providers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the method by which their value will be assessed are properly agreed and documented, and are subject to regular review.

2 Treasury Management Strategy Statement

2.1 CIPFA defines treasury management as:

“The management of the local authority’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.”

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2.2 The 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.

2.3 The 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 within the context of effective risk management.

3 Breaches of the Treasury Management Strategy

3.1 During the current year there were two breaches of the Treasury Management Strategy.

3.2 One instance was due to the breaching of the investment group limit - this limit is set to £15m. Overnight the balance on the bank current account exceeded this limit and due to sickness there was no one available to authorise the transfer of funds. This was rectified the following day.

3.3 The second instance was due to an investment being made for a period longer than advised by our consultants. This investment is now within our advised limit.

4 Current Portfolio Position

The Council's treasury portfolio position at 31 December 2017 totalled £71.891M and there was no external borrowing. The entire portfolio was invested in fixed rate cash deposits with varying maturity profiles.

Investment Term	**£'000**
Callable on Demand	5,629
Callable Deposits (10 to 100 days' notice)	25,262
Investments maturing on or before 31 March 2018	14,000
Investments maturing between 1 April 2018 and 31 March 2019	10,000
Investments maturing after 31 March 2019	17,000
Total Investment Portfolio	**71,891**

5 Prudential Indicators, Treasury Limits and MRP Statement

<u>Prudential Indicators</u>

5.1 There are three key prudential indicators that are required to be reported each year. These relate to the affordability of capital expenditure and the impact that capital expenditure has on Council Tax. The prudential indicators and

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borrowing limits are shown in Annex 1 and are relevant for setting an integrated treasury management statement.

5.2 The first indicator is the ratio of financing costs to net revenue stream. This compares the Council's net investment income and borrowing expenditure as a ratio of the budget requirement. A negative figure shows that investment income is greater than borrowing costs.

5.3 The second indicator is the Capital Financing Requirement (CFR). This is the total amount by which the funding of capital expenditure is reliant on external borrowing.

5.4 Despite being debt-free the Council does not strictly comply with this limit because the Council's CFR is currently negative i.e. nil borrowing is greater than the negative CFR balance. This does not cause any operational issues or fetter any part of the Treasury Strategy, but is required to be highlighted as part of this report. For 2018/19 it is expected that the Council will use external borrowing to fund a large project therefore the CFR projections are reported in Annex 1.

5.5 The final indicator is the incremental impact that decisions to commit capital expenditure have on the level of Council Tax. This calculation is based on the amount of interest that is foregone by reducing the level of investments when capital expenditure is committed.

Borrowing Limits

5.6 The operational borrowing boundary is the limit beyond which external debt is not normally expected to exceed. For 2018/19 this is recommended to be set as £15M as shown in Annex 1.

5.7 The authorised limit for external debt is a further prudential indicator that provides a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

5.8 The prudential indicators and borrowing limits shown in Annex 1 are relevant for the purposes of setting an integrated treasury management strategy.

The Head of Finance reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the budget report.

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5.9 Minimum Revenue Provision Policy Statement

MRP is the statutory requirement to make a charge to the Council's General Fund to make provision for the repayment of the Council's past capital debt and other credit liabilities.

The scheme of MRP was set out in former regulations 27, 28 and 29 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003. This system was radically revised in 2008 by the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008, which shifted the emphasis from regulations to guidance. The key principle of the new system and accompanying guidance is that an authority's debt liability should be repaid over a similar period to that which the asset associated with the capital expenditure provides benefits or, in the case of borrowing supported by Revenue Support Grant, in-line with the period implicit in the determination of that grant. Local authorities are asked by the Secretary of State "to prepare an annual statement of their policy on making MRP for submission to their full Council".

The type of approach intended by the MRP guidance is clearly to enable local circumstances and discretion to play a part, as the guidance in general contains a set of recommendations rather than representing a prescriptive process. The guidance makes it clear that councils can follow an alternative approach, provided they still make a prudent provision.

Since 2003 the Council has had no external debt and so has not been required to make MRP. The Council is evaluating funding options to support its programme of capital expenditure and this may involve an element of borrowing. Where any borrowing is taken out this will follow the principles established in the Prudential Code of prudence, affordability and sustainability.

It is recommended that members approve the following MRP policy to be applied form 2018/19 onwards:

- In respect of capital expenditure incurred in 2018/19 and subsequent financial years the MRP policy will be to use the Asset Life Method. MRP will be charged based on the estimated life of the associated assets, calculated on an annuity basis.
- Repayments included in any annual finance leases will be applied as MRP in accordance with the terms of the agreement.

6 Prospects for interest rates

6.1 The Council has appointed Link Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Annex 2 draws together a number of current City forecasts for short term bank rate and longer fixed interest rates. The following summary gives the Link central view.

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Forecasted Bank Rate as at:

- 31 March 2018 – 0.50%
- 31 March 2019 – 0.75%
- 31 March 2020 – 1.00%
- 31 March 2021 – 1.25%

6.2 There are a number of factors that could affect the forecast changes to interest rates. A detailed view of the current economic background is contained within Annex 3 to this report.

7 Borrowing Strategy

7.1 The Council is currently debt free and has been since 2003.

7.2 The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is relatively high.

7.3 Before undertaking any borrowing the Head of Finance will;

- ensure the ongoing revenue liabilities to be created, and the implications for the future plans and budgets have been considered.
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow.
- consider the merits and demerits of alternative forms of funding and consider the alternative interest rate bases available, the most appropriate periods to fund and the repayment profiles to use.

7.4 **Sensitivity of the forecast –** In normal circumstances the main sensitivities of the forecast are likely to be the two scenarios noted below. Council officers, in conjunction with the treasury advisers, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change of interest rate forecast:

- If it were felt that there was a significant risk of a sharp fall in long and short term rates, e.g. due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed.
- If it were felt that there was a significant risk of a sharp rise in long and short term rates compared with that currently forecast, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

7.5 Against this background and the risks within the economic forecast, caution will be adopted with the 2018/19 treasury operations. The Head of Finance will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances, reporting any decisions at the next available opportunity.

7.6 Policy on borrowing in advance of need - the Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

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 debt portfolio which supports the need to take funding in advance of need.

7.7 Municipal Bond Agency – it is likely that the Municipal Bond Agency, currently in the process of being set up, will be offering loans to local authorities in the near future. It is also hoped that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). This Authority intends to make use of this new source of borrowing as and when appropriate.

8 Annual Investment Strategy

<u>Investment Policy</u>

8.1 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes (the CIPFA TM Code). The Council's investment priorities are (in order of importance): -

- The security of capital
- The liquidity of investments
- The return on investments

8.2 In accordance with guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council has clearly stipulated below the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings, watches and outlooks published by all three ratings agencies with a full understanding of what these reflect in the eyes of each agency. Link Asset Services monitors ratings on a real-time basis with any changes notified to Council automatically.

8.3 The borrowing of monies purely to invest or on lend and make a return is unlawful and this Council will not engage in such activity.

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8.4 Investment instruments identified for use in the financial year are classified as either ‘Specified’ or ‘Non-Specified’ investment categories. Counterparty limits will be as set through the Council’s Treasury Management Practices’ Schedules. The definitions of Specified and Non-Specified investments are shown below.

8.5 <u>Specified investments</u>

All such investments will be sterling denominated, with maturities up to maximum of 1 year, meeting the minimum rating criteria where applicable.

	Minimum Credit Criteria	**Limits**
Debt Management Agency Deposit Facility	--	No Limit
Term deposits – local authorities	--	No Limit
Term deposits / bonds – banks and building societies *	Per Link colour code (see para.8.9)	£15M total investment
Term deposits – banks backed by UK Government Guarantees **	--	£15M total investment
Money Market Funds	Long term AAA	£15M total investment
UK Government Gilts / Treasury Bills	UK Sovereign Rating	£15M total investment
Bonds issued by multilateral development banks	Long term AAA	£15M total investment
Bonds issued by a financial institution which is guaranteed by the UK government	UK Sovereign Rating	£15M total investment

* If forward deposits are to be made, the forward period plus the deal period will not exceed one year in aggregate.

** Subject to the maximum of any guarantee period in issue by the Government on the date the investment was made.

Whilst these requirements are in place to ensure the safety of the Council’s investments it does present an operational difficulty for managing short term (up to one week) funds as these types of accounts are only available from major banks.

The following criteria are proposed for investment accounts for balances held for up to seven days.

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	Minimum 'High' Credit Criteria	**Limits**
On Call accounts	Short-term F1, Long-term A Individual C, Support 1	£15M total investment
Term deposits – maximum of 7 days	Short-term F1, Long-term A Individual C, Support 1	£15M total investment

8.6 Non-Specified Investments

These are investments which do not meet the Specified Investment criteria. A maximum of 50% will be held in aggregate in non-specified investments with no more than £5M to be held with any one counterparty (excluding other local authorities).

Maturities in excess of 1 year

	Minimum Credit Criteria	**Max. maturity period**
Term deposits – local authorities	--	60 months
Term deposits - Banks	Per Link colour code	24 months
Fixed term callable deposits with variable rate and variable maturities	Per Link colour code (see para.8.9)	24 months
Certificates of deposits issued by banks	Short-term F1+, Long-term AA- Individual B, Support 2	24 months
UK Government Gilts	UK Sovereign Rating	60 months
Bonds issued by multilateral development banks	AAA	60 months
Bonds issued by a financial institution which is guaranteed by the UK government	AAA	60 months
Sovereign bond issues (i.e. other than the UK govt)	AAA	60 months

8.7 There may be occasions when the counterparty limit will be exceeded as a result of credit interest being applied to deposit balances. Where this occurs, it will be permitted without the need to immediately withdraw the amount by which the gross balance exceeds the counterparty limit.

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Creditworthiness Policy

8.8 This Council applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard & Poor's. The credit ratings of counterparties are supplemented with the following overlays: -

- Credit watches and credit outlooks from credit rating agencies
- Credit default swap (CDS) spreads to give early warning of likely changes in credit ratings
- Sovereign ratings to select counterparties from only the most creditworthy countries

8.9 This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to determine the duration for investments and are referred to as durational bands. The Council will therefore use counterparties within the following durational bands.

- Yellow 5 years
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi-nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days
- No Colour not to be used

8.10 These durational bands will have precedence over the credit criteria of all investments shown in paragraph 8.5. Should the recommended duration for any colour band change during the year, the investment strategy will allow the updated durations to be used.

8.11 This Council will not use the approach of using the lowest rating from all three rating agencies to determine creditworthy counterparties. The Link creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

8.12 All credit ratings will be monitored daily. The Council is alerted to changes to ratings of all three agencies through its use of the Link creditworthiness service.

- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use for new investments will be withdrawn immediately.

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- In addition to the use of Credit Ratings the Council will be advised of information in movements in Credit Default Swap spreads against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

8.13 Sole reliance will not be placed on the use of this external service. In addition the Council will also use market data and market information, information on government support for banks and the credit ratings of that government support.

Country risk

8.14 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch Ratings (or equivalent from other agencies if Fitch does not provide).

Investment Strategy

8.15 The Council will continue to manage its investment portfolio using internal resources.

8.16 A mid-year report on investment performance will be presented to the Overview and Scrutiny Committee. At the end of the financial year a report summarising investment activity will be presented to Cabinet as part of the Treasury Management Outturn.

8.17 The Council will avoid locking into longer term deals while investment rates are at historically low levels unless exceptionally attractive rates are available which make longer term deals worthwhile.

8.18 For 2018/19 it is suggested that the Council should budget for an investment return of 0.10% above base rate on investments placed during the financial year.

8.19 For its cash flow generated balances, the Council will seek to utilise its business reserve accounts and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

Role of the Section 151 Officer

8.20 The S151 officer is responsible for:

- Recommending treasury management policy / practices for approval, reviewing the same regularly, and monitoring compliance
- Submitting regular treasury management policy reports
- Submitting budgets and budget variations
- Receiving and reviewing management information reports

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- Reviewing the performance of the treasury management function
- Ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function
- Ensuring the adequacy of internal audit, and liaising with external audit

9 Risk Management

9.1 Whilst the protection of the authority's capital and the pursuit of reasonable returns are two vital features of effective treasury management, there is also a need to address other treasury risks. The main treasury management risks have been identified as;

- Liquidity Risk - The risk that cash will not be available when it is needed.
- Interest Rate Risk - The risk that changes in the rates of interest create an unexpected or unbudgeted burden on the Council's finances.
- Inflation Risk - The risk that growth in the authority's investment income does not keep pace with the effects of inflation on its expenditure.
- Credit Risk - The risk that a counterparty defaults on its obligations.
- Operational Risk - The risk of loss through fraud, error, corruption, system failure or other eventualities in treasury management dealings, and failure to maintain effective contingency management arrangements.

9.2 Techniques and procedures to manage these risks are in place and include:

- Reliable cash flow forecasting and monitoring;
- Access to reliable and informed sources of information concerning both economic developments and the likely future course of interest rates;
- Managing exposure to interest rates;
- A sound diversification policy for investments;
- Rigorous assessment of credit-worthiness of counterparties;
- Fidelity insurance;
- Suitable treasury management policies, including back-up measures for system failures and staff absences

9.3 Despite these measures, there is a risk of a financial institution collapsing and not repaying a loan to the authority. The current arrangements are designed to reflect this level of risk and reduce the authority's exposure. However, a residual risk remains, which cannot be fully mitigated, as the authority must undertake a level of Treasury Management activity with its cash surpluses.

10 Resource Implications

10.1 There are no direct resource implications arising from this report. However, the restrictions on the types of investment that can be used identified in this

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report will have an effect on the return on investments that the Council can expect to achieve in the year.

11 Equality Issues

11.1 An EQIA screening has been completed in accordance with the Council's EQIA methodology and no potential for unlawful discrimination or low level negative impact have been identified, therefore a full EQIA has not been carried out.

12 Consultations

12.1 The Council's treasury advisors, Link Asset Services, have been consulted in the preparation of this report.

13 Conclusion and reasons for recommendation

13.1 This report presents the Council's Treasury Management strategy for 2018/19. Whilst largely unchanged from the 2017/18 strategy, it sets out the criteria within which cash surpluses can be invested and how external borrowing will be managed should the Council choose to take on debt in the year.

13.2 The report and annexes show how the Council plans to minimise its risks to the current economic climate by stipulating creditworthiness requirements on lenders and limiting the maximum amount available to be invested at any one time.

Background Papers (Local Government Act 1972 Section 100D) None			
Confidentiality It is considered that this report does not contain exempt information within the meaning of Schedule 12A of the Local Government Act 1972, as amended, and can be made public.			
No of Annexes:	3	File Ref:	
(Portfolio: Finance) Councillor Giddings			
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Report to:	Cabinet	Date:	14 February 2018