READING BOROUGH COUNCIL

REPORT BY HEAD OF FINANCE

TO:	**AUDIT & GOVERNANCE COMMITTEE**		
DATE:	**28 JANUARY 2016**	**AGENDA ITEM:**	**6**
TITLE:	**DRAFT TREASURY STRATEGY & INVESTMENT STATEMENT FOR 2016/17**		
RESPONSIBLE COUNCILLOR:	**COUNCILLOR STEVENS**	**PORTFOLIO:**	**CHAIR OF AUDIT & GOVERNANCE**
SERVICE:	**ALL**	**WARDS:**	**BOROUGHWIDE**
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1. PURPOSE OF REPORT AND EXECUTIVE SUMMARY

1.1 CIPFA recommends that prior to Councils approving their Annual Treasury Strategy & Investment Statement, that it should be considered by the Council's Audit Committee as part of the overall governance arrangements.

1.2 The statement will in due course form part of the Council's overall budget proposals, presented as part of the Budget Report to Council in February.

1.3 This draft strategy may see some amendments to ensure it is consistent with the remainder of the budget proposals, but major change impacting 2015/16 is not anticipated. A short presentation will be made at the Committee to highlight key treasury management issues.

2. RECOMMENDED ACTION

2.1 That the committee considers the draft Treasury Strategy & Investment Statement for 2016/17.

3. POLICY CONTEXT

The Council is required to have a Treasury Strategy & Investment Statement in place in order to comply with legislative requirements and recommended professional practice, As the strategy is linked to the Council's overall budget strategy, it is formally considered and approved as part of the budget (as some of the prudential indicator limits are formally reserved to Council to set). This report enables Audit & Governance to consider the draft statement for 2016/17 (at Annex A) ahead of Cabinet & Council in February.

4. THE PROPOSAL

The draft Treasury Management Strategy Statement is attached in the Appendix. There will be a brief presentation at the Committee meeting to explain the key treasury issues the council is likely to face over the next year. There are a few gaps or things that may change in the draft as the budget proposal is yet to be finalised.

5. CONTRIBUTION TO STRATEGIC AIMS

Proper management of the Council's Treasury position helps support the overall achievement of the Council's financial objectives and service strategies.

6. COMMUNITY ENGAGEMENT AND INFORMATION

The Council does not directly consult with the community on this particular issue, though occasionally receives queries about its treasury activity to which an appropriate response is made.

7. EQUALITY IMPACT ASSESSMENT

An EIA is not relevant at this time.

8. LEGAL IMPLICATIONS

None, at this stage.

9. FINANCIAL IMPLICATIONS

As set out in the draft statement

10. BACKGROUND PAPERS

The statement has been prepared using a template provided by Arlingclose, adapted for Reading's needs.
CIPFA Treasury Management & Prudential Codes and guidance notes

Treasury Management Strategy Statement 2016/17

1. The Treasury Management Strategy Statement (TMSS) is an annual statement the Council is required to approve each year of our intended treasury activity, setting constraints under which that activity will (usually) operate. Given the technical nature of the subject, by way of introduction the statement is intended to explain

   - How the Council tries to minimise net borrowing costs over the medium term
   - How we ensure we have enough money available to meet our commitments
   - How we ensure reasonable security of money we have lent and invested
   - How we maintain an element of flexibility to respond to changes in interest rates
   - How we manage treasury risk overall.

1.1 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. DCLG guideline requires the Council to approve an investment strategy before the start of each financial year. This report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to both the CIPFA Code and the CLG Guidance.

1.2 The purpose of this TMSS is, therefore, to approve the:

   - Treasury Management Strategy for 2016/17
   - Annual Investment Strategy for 2016/17
   - Prudential Indicators for 2016/17, 2017/18 and 2018/19
   - MRP Statement (in connection with debt repayment)

1.3 The Council has both 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.

1.4 The TMSS has been prepared based on a template provided by Arlingclose, the Council's treasury management advisor.

2 External Context

2.1 **Economic background:** Domestic demand has grown robustly, supported by sustained real income growth and a gradual decline in private sector savings. Low oil and commodity prices were a notable feature of 2015, and contributed to annual CPI inflation falling to 0.1% in October. Wages are growing at 3% a year, and the unemployment rate has dropped to 5.4%. Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 3.5%. These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was an encouraging 2.3% a year in the third quarter of 2015. Although speeches by the Bank of England's Monetary Policy Committee (MPC) members sent signals that some were willing to countenance higher interest rates, the MPC held policy rates at 0.5% for the 81st consecutive month at its meeting in November 2015. Quantitative easing (QE) has been maintained at £375bn since July 2012.

2.2 The outcome of the UK general election, which was largely fought over the parties' approach to dealing with the deficit in the public finances, saw some big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

2.3 China's growth has slowed and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. US domestic growth has accelerated but the globally sensitive sectors of the US economy have slowed. Strong US labour market data and other economic indicators however suggest recent global turbulence has not knocked the American recovery off course. The Federal Reserve did not raise policy rates at its meetings in October and November, but the statements accompanying the policy decisions point have made a rate hike in December 2015 a real possibility. In contrast, the European Central Bank finally embarked on QE in 2015 to counter the perils of deflation.

2.4 **Credit outlook:** The varying fortunes of different parts of the global economy are reflected in market indicators of credit risk. UK Banks operating in the Far East and parts of mainland Europe have seen their perceived risk increase, while those with a more domestic focus continue to show improvement. The sale of most of the government's stake in Lloyds and the first sale of its shares in RBS have generally been seen as credit positive.

2.5 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 UK, USA and Germany. The rest of the European Union will follow suit in January 2016, while Australia, Canada and Switzerland are well advanced with their own plans. Meanwhile, changes to the UK Financial Services Compensation Scheme and similar European schemes in July 2015 mean that most private sector investors are now partially or fully exempt from contributing to a bail-in. 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 stubbornly low.

3 Interest rate forecast:

3.1 The Council's treasury advisor Arlingclose projects the first 0.25% increase in UK Bank Rate in the third quarter of 2016, rising by an average 0.5% a year thereafter, finally settling between 2% and 3% in several years' time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted towards the downside.

3.2 A shallow upward path for medium term gilts (government bond) yields is forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Arlingclose projects the 10 year gilt yield to rise from its current 2.0% level by around 0.3% a year. The uncertainties surrounding the timing of UK and US interest rate rises are likely to prompt short-term volatility in gilt yields.

3.3 A more detailed economic and interest rate forecast provided by Arlingclose is attached at ***Annex A***.

3.4 For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.4%, and that new borrowing will average around 2% (a mix of short term borrowing at under 1% and some longer term borrowing at 2-3.5%).

4. Local Context

4.1 At 31 December, the Council had £310.17m of borrowing and £36.8m of investments. This is set out in further detail at ***Appendix B***. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance Sheet Summary and Forecast

	31.3.15 Actual £m	31.3.16 Estimate £m	31.3.17 Forecast £m	31.3.18 Forecast £m	31.3.19 Forecast £m
General Fund CFR	248.2	278.6	309.2	307.6	303.5
HRA CFR	192.6	195.1	195	193.5	189.7
Total CFR	**440.8**	**473.7**	**504.2**	**501.1**	**493.2**
Less: Other debt liabilities *	34.1	33.1	32.2	31.3	30.4
Borrowing CFR	**406.7**	**440.6**	**472**	**469.8**	**462.8**
Less: External borrowing **	310.6	301.1	294.6	288.5	283.6
Maximum New External Borrowing Requirement.	**96.1**	**139.5**	**177.4**	**181.3**	**179.2**
Less: Other Cash Balances (Working capital & Earmarked Reserves)	133.1	130.0	125.0	115.0	115.0
(Cumulative Investments) / New borrowing requirement	**-37.0**	**9.5**	**52.4**	**66.3**	**64.2**

* finance leases, PFI liabilities and transferred debt that form part of the Council's total debt
** shows only loans to which the Council is committed and excludes optional refinancing

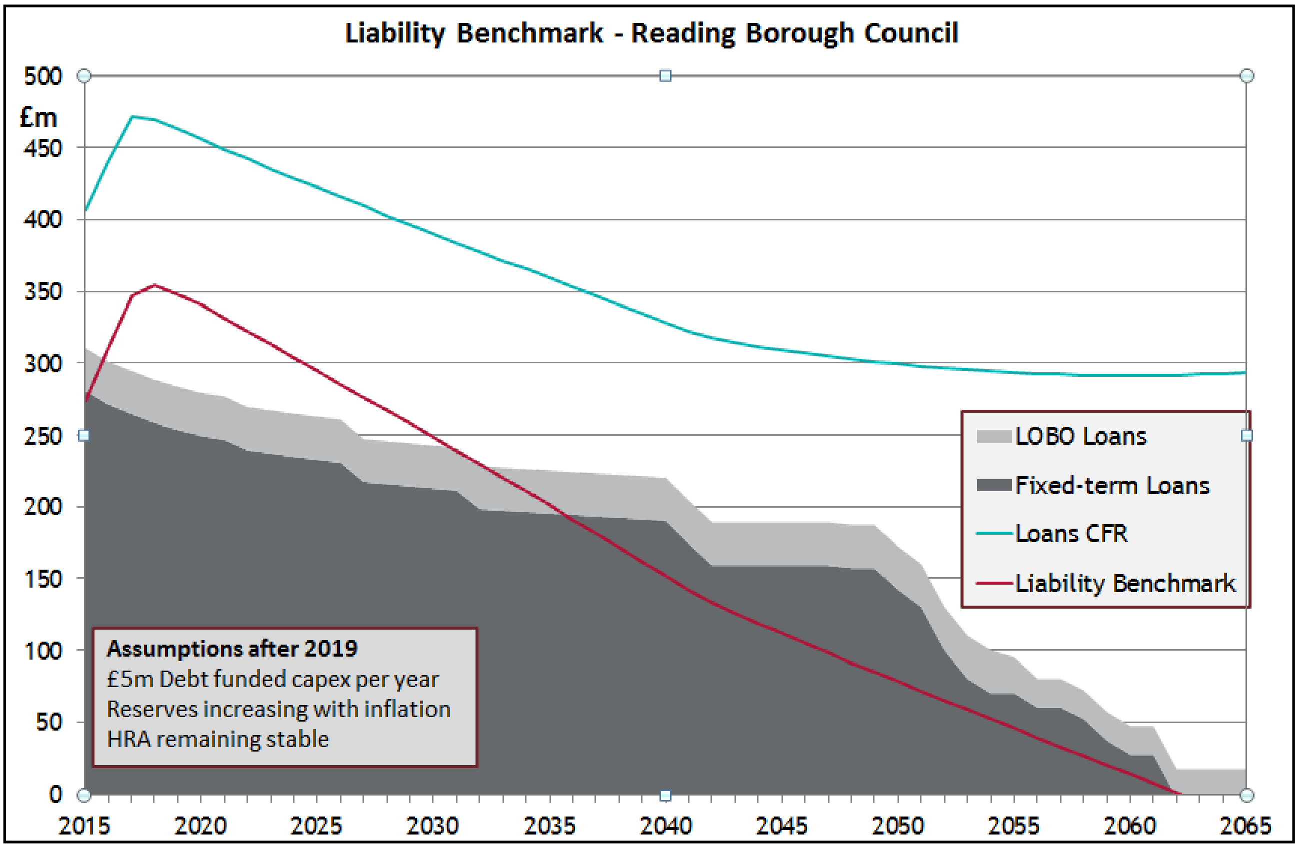
4.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, subject to holding a minimum liquid cash investment balance of around £10m.

4.3 The Council has an increasing CFR due to the capital programme, but reducing investments, and will therefore be required to borrow around £65m over the forecast period, and up to £50m of this will be required in 2016/17. Some additional borrowing may be needed in the last few days of 2015/16.

4.4 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. We will comply with this recommendation during 2016/17.

4.5 To assist with its long-term treasury management strategy, the Council and its advisers have created a liability benchmark, which forecasts the Council's need to borrow over a 50 year period. Following on from the current 3-4 year capital programme forecasts in table 1 above, the benchmark assumes

- capital expenditure funded by borrowing as set out in table in Section 2 of Annex C
- Minimum revenue provision on new capital expenditure based on an avevrage 25 year asset life
- Income, expenditure and reserves all increase by 2.5% inflation a year



4.6 The chart shows that we'll have an increasing borrowing requirement over the next 2-3 years, but from 4 years hence our borrowing needs will fall and by around 2030 be covered by exitsing long term loans. This implies that most of the borrowing we need to do should be of a relatively short term nature, subject to developments in the interest rate environment.

5 Borrowing Strategy

5.1 The Council currently holds £310.2 million of loans, a decrease of £6.5 million over the last year, reflecting our present strategy of funding the capital programme by using "internal borrowing" and reducing investments. However, the balance sheet forecast in table 1 (and our detailed treasury budget analysis) suggests we will need to borrow up to £50m towards the end of 2016/17. The Council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £400 million.

5.2 **Objectives:** The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

5.3 **Strategy:** Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the 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.

5.4 By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal / short-term 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. Arlingclose 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 2016/17 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

5.6 Alternatively, we may arrange forward starting loans during 2016/17, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

5.7 In addition, the Council may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages.

5.8 **Sources:** The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- UK Municipal Bonds Agency plc
- Any other special purpose companies created to enable local Council bond issues
- 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
- Capital market bond investors
- Any other party that establishes a presence in the LA market not covered by the above categories.

5.9 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

5.10 We have previously raised the majority of our long-term borrowing from the PWLB but continues to investigate other sources of finance, such as local Council loans and bank loans, that may be available at more favourable rates.

5.11 **LGA Bond Agency:** UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. With about 30 other authorities the Council was a founding investor in the company. During 2015/16 the Head of Finance has been working with two other local authority colleagues and the Agency's staff and advisors to develop the borrowing arrangements. That was completed just before Christmas, and a separate report will be coming forward to Policy Committee to explain those arrangements, and set out the final legal advice supporting the Agency structure. The Agency (which now has over 50 participating authorities) will issue bonds on the capital markets and lend the proceeds to local authorities. Borrowing authorities will be required to provide bond investors with a joint and several guarantee over the very small risk that other local Council borrowers default, and there will be a longer lead in time between deciding to borrow and concluding the deal, including knowing the interest rate payable.

5.12 **LOBOs:** The Council holds £30m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. £10m of these LOBOS have options during 2016/17, and although the Council understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Council will take the option to repay LOBO loans at no cost if it has the opportunity to do so. Total borrowing via LOBO loans will be limited to £50m. We also understand that because banking regulation has impacted how banks account for these loans, some LOBO lenders have been approaching local authorities offering early settlement terms. Should such an approach be received we will evaluate it with the assistance of Arlingclose as treasury advisor.

5.13 **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.

6 **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. The way the PWLB formula works makes this relatively unlikely to be pursued.

7 Investment Strategy

7.1 The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £26 and £61 million, and generally lower levels are expected to be maintained in the forthcoming year.

7.2 **Objectives:** 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 rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk receiving unsuitably low investment income.

7.3 **Strategy:** Given the increasing risk and continued low returns from short-term unsecured bank investments, the Council aims to further diversify into more secure and/or higher yielding asset classes during 2016/17. All of the Authorities surplus cash is currently invested in short-term unsecured bank deposits, call accounts and money market funds. At the end of 2014/15 our working capital was around £44m, and whilst this fluctuates during the year, a figure of this magnitude is not unusual. Last year we decided to invest some of this money CCLA's Property Fund, an investment vehicle designed solely for collective investments by local authorities in the UK property market. So far we have invested £12m (which is just under 2.5% of the fund (which now totals nationally over £500m). To date performance has been broadly as expected, though it will be a couple of years before the unit price has increased to the price we paid (because the fund has a bid-offer margin). Such investments are only be undertaken after taking treasury advice from Arlingclose and on the specific authority of the Head of Finance.

7.4 **Approved 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

Counterparty		Cash limit	Time limit †
Banks and other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:	AAA	£20m each	10 years*
	AA+		5 years*
	AA		4 years*
	AA-		3 years*
	A+		2 years
	A		1 year
	A-		
The Council's current account bank Lloyds Bank plc should circumstances arise when it does not meet the above criteria		£1m	next day***
UK Central Government (irrespective of credit rating)		unlimited	50 years**
UK Local Authorities (irrespective of credit rating)		£20m each	50 years**
UK Registered Providers of Social Housing whose lowest published long-term credit rating is A- or higher		£5m each	10 years**
UK Registered Providers of Social Housing whose lowest published long-term credit rating is BBB- or higher and those without credit ratings		£2m each	5 years
UK Building Societies without credit ratings		£10m each	1 year
Money market funds and other pooled funds (including the CCLA Property Fund)		Up to £20m each	n/a
Any other organisation, subject to an external credit assessment and specific advice from the Council's treasury management adviser		£5m each	3 months
		£1m each	1 year
		£100k each	5 years

† the time limit is doubled for investments that are secured on the borrower's assets
* but no longer than 2 years in fixed-term deposits and other illiquid instruments
** but no longer than 5 years in fixed-term deposits and other illiquid instruments
***this category is provided to enable overnight lending to the main banker – we do not expect Lloyds Bank to fall into this category.

Table 3: Current Counterparty List as at 31st December 2015{This table may need an update}

Country/ Domicile	Counterparty	Maximum Counterparty Limit %/£m	Maximum Group Limit (if applicable) %/£m	Maximum Maturity Limit (term deposits and instruments without a secondary market)	Maximum Maturity Limit (negotiable instrument)
UK	Clydesdale Bank (for banking & liquidity purposes only)		10%		
UK	Santander UK Plc (Banco Santander Group)	10		2 years	5 years
UK	Bank of Scotland (Lloyds Banking Group)	20	22.5%	2 years	5 years
UK	Lloyds TSB (Lloyds Banking Group)	20		2 years	5 years
UK	Barclays Bank Plc	20		2 years	5 years
UK	HSBC Bank Plc	20		2 years	5 years
UK	Nationwide Building Society	10		2 years	5 years
UK	NatWest (RBS Group)	0		2 years	5 years
UK	Royal Bank of Scotland (RBS Group)	0		2 years	5 years
UK	Standard Chartered Bank	10		2 years	5 years

2 years is the maximum approved duration for term deposits and illiquid investments (those without a secondary market), although in practice the Council may be investing on a shorter term basis depending on operational advice of the Council's treasury management adviser.

5 years is the maximum approved duration for negotiable instruments such as Certificates of Deposits, Medium Term Notes and Corporate Bonds, although in practice the Council may be investing for shorter periods depending on operational advice of the Council's treasury management adviser.

7.4 These tables must be read in conjunction with the notes below

7.5 **Credit Rating:** Investment decisions are made 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.

7.6 **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. Unsecured investment with banks rated BBB are restricted to overnight deposits at the Council's current account bank.

7.7 **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.

7.8 **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.

7.9 **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 as part of a diversified pool in order to spread the risk widely.

7.10 **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.

7.11 **Pooled Funds:** Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds 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.

7.12 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.

7.13 **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.

7.14 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.

7.15 **Other Information on the Security of Investments**: The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations, in which it invests, including credit default swap prices, financial statements, information on potential government support 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 for lending.

7.16 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.

7.17 **Ethical Policy**

During 2015, we agreed to include an ethical statement as part of our TMSS as follows;

The Council will not knowingly invest directly in businesses whose activities and practices pose a risk of serious harm to individuals or groups, or whose activities are inconsistent with the Council's mission and values. This would include institutions with material links to

- Human rights abuse (e.g. child labour, political oppression)
- Environmentally harmful activities (e.g. pollution, destruction of habitat, fossil fuels)
- Socially harmful activities (e.g. tobacco, gambling)

7.18 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:
  - UK Government,
  - a UK local Council, 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. For money market funds and other pooled funds "high credit quality" is defined as those having a credit rating of A- or higher.

7.19 **Non-specified Investments**: Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any treasury investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore 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 4: Non-Specified Investment Limits

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

7.19 **Investment Limits**: The Council's revenue reserves available to cover investment losses are forecast to be £[X] million on 31st March 2016. In order that excessive available reserves are not 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 normally be £12 million. (The Head of Finance may extend this for very short periods provided market conditions are stable to £20m to facilitate efficient treasury activity). A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

Table 5: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£12m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£12m per group
Any group of pooled funds under the same management	£12m per manager
Negotiable instruments held in a broker's nominee account	£5m per broker
Foreign countries	5m in total
Registered Providers	£5m in total
Unsecured investments with Building Societies	£5m in total
Loans to unrated corporates	5m in total
Money Market Funds	£10m each

8 Liquidity Management

8.1 The Council uses purpose-built (web-based) cash flow forecasting software to help determine the maximum period for which funds may prudently be committed. The forecast is compiled on a pessimistic basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast.

9 Treasury Management Indicators

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

9.1 **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	*6.0*

9.2 **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	Target
Total cash available within 3 months (above estimated cash flow requirements)	£10m

9.3 **Interest Rate Exposures**: This indicator is set to control the Council's exposure to interest rate risk. This Council calculates these limits on net principal outstanding sums, (i.e. fixed rate debt net of fixed rate investments, as percentage of fixed rate debt).

	2016/17	**2017/18**	**2018/19**
Upper limit on fixed interest rate exposure	120%	120%	120%
Upper limit on variable interest rate exposure	50%	50%	50%

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

9.4 **Maturity Structure of Borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Maturity Structure of Borrowing	Upper	Lower
Under 12 months	25%	0%
12 months and within 24 months	25%	0%
24 months and within 5 years	25%	0%
5 years and within 10 years	25%	0%
10 years and within 20 years	100%	40%
20 years and within 30 years	100%	
30 years and within 40 years	100%	
40 years and within 50 years	100%	
50 years and above	100%	

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.

9.5 **Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the Council's 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 the period end will be:

	2016/17	2017/18	2018/19
Limit on principal invested beyond year end	£20m	£15m	£15m

10 Policy on Use of Financial Derivatives

10.1 Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and 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).

10.2 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.

10.3 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.

11 **Policy on Apportioning Interest to the HRA:** Reform of the Housing Revenue Account Subsidy system was completed at the end of 2011/12, when we were required to pay DCLG £147.8m. Prior to 2012/13 we were required to recharge interest expenditure and income attributable to the HRA in accordance with Determinations issued by DCLG. The Council has adopted a policy that it will continue to manage its debt as a single pool using the same regime that applied prior to self-financing which will set out how interest charges attributable to the HRA will be determined, because self-financing did not result in a material change to the average interest rate paid.

11.1 The HRA also has a notional cash balance which may be positive or negative. This balance is measured each month and interest transferred between the General Fund and HRA at the net average rate earned by the Council on its portfolios of treasury investments and short-term borrowing

11.2 **Investment Training:** The needs of the Council's treasury management staff for training in investment management are assessed as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, and other appropriate organisations.

11.3 **Investment Advisers:** The Council has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. We have at least two meetings per annum with Arlingclose, and make contact whenever advice is needed.

11.4 **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.

11.5 The total amount borrowed will not exceed the authorised borrowing limit of £400 million. 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.

12 Financial Implications

12.1 The estimate for investment income in 2016/17 is £40k, based on an average investment portfolio of at least £10 million at an interest rate of 0.4%. The budget for debt interest paid in 2016/17 is £11 million, based on an average debt portfolio of £302.9 million at an average interest rate of 3.6%. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

13 Other Options Considered

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

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	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 Likely to be cost of premature repayments	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

Appendix A – Arlingclose Economic & Interest Rate Forecast December 2016

Underlying assumptions:

- The global economy is facing a period of slower growth, as China reorients slowly towards domestic demand. Lower demand for raw materials will depress growth in mainly developing countries where extraction is the primary industry and countries particularly reliant on exports will also face more challenging conditions.

- Countries with stronger domestic demand, such as the UK and US, will be able to weather a temporary global slowdown, helped by lower commodity prices. However, persistently slower growth will have economic repercussions for these countries.

- Additional US monetary policy tightening will be gradual and not pre-planned. The US economy will absorb the rise in interest rates without choking off growth.

- UK economic growth will slow further but remain within the long term trend range. Economic growth softened in Q3 2015 but remained reasonably robust at 2.3% year- on-year.

- Inflation is currently very low and will likely remain so over the next 12 months, on the back of low commodity prices and expectations that UK monetary policy will be tightened (strengthening sterling). The CPI rate will to rise towards the end of 2016.

- Domestic demand is key for UK growth. Household spending has been and will remain the key driver of GDP growth through 2016. Consumption will continue to be supported by real wage and disposable income growth.

- On the back of strong consumption, business investment has strengthened, which should drive some productivity growth. However the outlook for business investment may be tempered by the looming EU referendum, increasing uncertainties surrounding global growth and recent financial market shocks.

- Annual average earnings growth was 2.4% (including bonuses) in the three months to October. With low inflation, real earnings and income growth continue to run at relatively strong levels and could feed directly into unit labour costs and households' disposable income. Improving productivity growth should support pay growth in the medium term and may alleviate the wage pressure on companies. The development of wage growth is one of the factors being closely monitored by the MPC.

- Longer term rates will be tempered by international uncertainties and weaker global inflation pressures.

Forecast:

- We have maintained our projection for the first rise in Bank Rate in Q3 2016. Risks remain weighted to the downside. We project a slow rise in Bank Rate. The appropriate level for Bank Rate will be lower than the previous norm and will be between 2 and 3%.

- We project medium term gilt yields on a shallow upward path in the medium term, with interest rate and inflation expectations remaining subdued.

- The uncertainties surrounding UK and US monetary policy, and global growth weakness, are likely to continue to prompt short term volatility in gilt yields.

	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Average
Official Bank Rate														
Upside risk	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.31
Arlingclose Central Case	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.50**	**1.50**	**1.50**	**1.50**	**1.12**
Downside risk				-0.25	-0.50	-0.50	-0.75	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-0.73
3-month LIBID rate														
Upside risk	0.30	0.30	0.30	0.35	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.36
Arlingclose Central Case	**0.60**	**0.70**	**0.80**	**0.95**	**1.05**	**1.15**	**1.30**	**1.40**	**1.50**	**1.60**	**1.65**	**1.70**	**1.75**	**1.24**
Downside risk		-0.30	-0.45	-0.55	-0.65	-0.80	-0.90	-1.05	-1.10	-1.20	-1.20	-1.20	-1.20	-0.83
1-yr LIBID rate														
Upside risk	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.45	0.45	0.41
Arlingclose Central Case	**1.20**	**1.35**	**1.45**	**1.55**	**1.70**	**1.80**	**1.95**	**2.00**	**2.10**	**2.15**	**2.15**	**2.15**	**2.15**	**1.82**
Downside risk	-0.25	-0.35	-0.50	-0.60	-0.70	-0.85	-0.95	-1.10	-1.15	-1.25	-1.25	-1.25	-1.25	-0.88
5-yr gilt yield														
Upside risk	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.56
Arlingclose Central Case	**1.30**	**1.38**	**1.45**	**1.53**	**1.60**	**1.68**	**1.75**	**1.83**	**1.90**	**1.98**	**2.05**	**2.13**	**2.20**	**1.75**
Downside risk	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25	-1.25	-0.94
10-yr gilt yield														
Upside risk	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.56
Arlingclose Central Case	**1.90**	**1.95**	**2.00**	**2.05**	**2.10**	**2.15**	**2.20**	**2.25**	**2.30**	**2.35**	**2.40**	**2.45**	**2.50**	**2.20**
Downside risk	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25	-1.25	-0.94
20-yr gilt yield														
Upside risk	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.56
Arlingclose Central Case	**2.50**	**2.53**	**2.55**	**2.58**	**2.60**	**2.63**	**2.65**	**2.68**	**2.70**	**2.73**	**2.75**	**2.78**	**2.80**	**2.65**
Downside risk	-0.40	-0.50	-0.55	-0.65	-0.75	-0.85	-0.95	-1.05	-1.10	-1.15	-1.20	-1.20	-1.20	-0.89
50-yr gilt yield														
Upside risk	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.56
Arlingclose Central Case	**2.50**	**2.55**	**2.60**	**2.63**	**2.65**	**2.68**	**2.70**	**2.73**	**2.75**	**2.78**	**2.80**	**2.83**	**2.85**	**2.69**
Downside risk	-0.35	-0.45	-0.50	-0.60	-0.70	-0.80	-0.90	-1.00	-1.05	-1.10	-1.15	-1.15	-1.15	-0.84

Appendix B – Existing Investment & Debt Portfolio Position

	31/12/15 **Actual Portfolio** **£m**	31/12/15 **Average Rate** **%**
External Borrowing:		
PWLB – Fixed Rate	**275.3**	**3.61**
PWLB – Variable Rate	**4.8**	**0.77**
LOBO Loans	**30.0**	**3.80**
Total External Borrowing	**310.1**	**3.62**
Other Long Term Liabilities:		
PFI	33.5	
Finance Leases	0.9	
Total Gross External Debt	344.5	
Investments:		
Short-term investments	19.5	0.4
Fund Managers (Federated Cash Plus Fund)	5.0	0.6+
Pooled Funds (CCLA Property Fund)	12.0	3+
Total Investments	**36.5**	
Net Debt	**306**	