London Borough of Haringey

Treasury Management Strategy Statement 2019/20

1. Introduction

1.1. Treasury management is the management of the Authority's cash flows, borrowing and investments, and the associated risks. The Authority 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 financial risk are therefore central to the Authority's prudent financial management.

1.2. Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year. This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

1.3. Investments held for service purposes or for commercial profit are considered in section 6 of this report.

1.4. The single largest external variable that frames the context of the Council's treasury strategy for 2019/20 is Brexit. This strategy has been reviewed and updated in light of this, and provides the Council with the means and flexibility to deal with a range of eventualities or outcomes as necessary.

2. External Context – provided by the Council's appointed treasury advisor, Arlingclose

2.1. **Economic background:** The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2019/20.

2.2. UK Consumer Price Inflation (CPI) for October was up 2.4% year/year, slightly below the consensus forecast and broadly in line with the Bank of England's November Inflation Report. The most recent labour market data for October 2018 showed the unemployment rate edged up slightly to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pull on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level still likely to have little effect on consumer spending.

2.3. The rise in quarterly GDP growth to 0.6% in Q3 from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in Q1. At 1.5%, annual GDP growth continues to remain below trend. Looking ahead, the BoE, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

2.4. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy has been made since. However, the Bank expects that should the economy continue to evolve in line with its November forecast, further increases in Bank Rate will be required to return inflation to the 2% target. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.

2.5. While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2%-2.25% in September. Markets continue to expect one more rate rise in December, but expectations are fading that the further hikes previously expected in 2019 will materialise as concerns over trade wars drag on economic activity.

2.6. **Credit outlook:** The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ringfencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ringfenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.

2.7. The Bank of England released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

2.8. European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading here. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be very high if ever needed. The uncertainty caused by protracted negotiations between the UK and EU is weighing on the creditworthiness of both UK and European banks with substantial operations in both jurisdictions.

2.9. **Interest rate forecast:** Following the increase in Bank Rate to 0.75% in August 2018, the Authority's treasury management adviser Arlingclose is forecasting two more 0.25% hikes during 2019 to take official UK interest rates to 1.25%. The Bank of England's MPC has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

2.10. The UK economic environment remains relatively soft, despite seemingly strong labour market data. Arlingclose's view is that the economy still faces a challenging outlook as it exits the European Union and Eurozone growth softens. While assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity *(at the time of writing this commentary in mid-December)*. As such, the risks to the interest rate forecast are considered firmly to the downside.

2.11. Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on Arlingclose's interest rate projections, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.7% and 2.2% respectively over the interest rate forecast horizon, however volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.

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

2.13. For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 1.0%, and that new long-term loans will be borrowed at an average rate of 3.0%.

3. Local Context

3.1. On 31st December 2018, the Authority held £384.2m of borrowing and £56.9m of investments. Forecast changes to borrowing balances are shown in the balance sheet analysis in table 1 below.

3.2. Table 1: Balance sheet summary and forecast

	31.3.18 Actual £m	31.3.19 Estimate £m	31.3.20 Forecast £m	31.3.21 Forecast £m	31.3.22 Forecast £m
General Fund CFR	343.3	437.1	562.3	660.4	726.1
HRA CFR	248.7	248.9	260.1	310.7	485.0
Total CFR	**591.9**	**686.0**	**822.4**	**971.0**	**1,211.1**
Less: Other debt liabilities *	-34.0	-30.3	-26.5	-22.8	-19.0
Loans CFR	**557.9**	**655.7**	**795.9**	**948.3**	**1,192.1**
Less: External borrowing **	-365.4	-383.8	-357.7	-350.4	-340.4
Less: Internal borrowing	-192.6	-192.6	-182.1	-182.1	-182.1
New Borrowing Required (cumulative)	**-**	**79.4**	**256.1**	**415.8**	**669.6**

*finance leases and PFI liabilities and transferred debt form part of the Authority's total debt

** shows only loans to which the Authority is committed and excludes optional refinancing

3.3. The capital plans which underpin the borrowing requirement above are dealt with in the council's main budget report (in particular the Capital Strategy section). All of the Council's capital programme is robustly scrutinised and tested to ensure that the capital plans are affordable and prudent. The above shows the three year effects of the Council's capital programme, however all capital plans are assessed in their entirety (i.e. some schemes are for a greater than 3 year time frame).

3.4. The Council's HRA business plan is still developing in light of the debt cap removal, and as such, the HRA borrowing element is still under active review. The figures above represent the most up to date figures at the time of publication of this report, however, given the timing of other reports that form part of the Council's budget process, it may be the case that the HRA figures differ slightly from those published within the Council's main budget report, which will be the final figures.

3.5. 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 Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

3.6. The Authority has an increasing CFR due to the capital programme, but minimal investments and will therefore be required to borrow up to £670m over the forecast period.

3.7. CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Authority expects to comply with this recommendation during 2019/20.

4. **<u>Borrowing Strategy</u>**

4.1. The Authority currently holds £384 million of loans, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 1 shows that the Authority expects to borrow up to £256m by the end of 2019/20. The Authority may also borrow additional sums to externalise the extent of its existing internal borrowing to satisfy future years' borrowing requirements, providing this does not exceed the authorised limit for borrowing as set out in table 2 of this report.

4.2. **Objectives:** The Authority'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 Authority's long-term plans change is a secondary objective.

4.3. **Strategy:** Given the significant cuts to public expenditure and in particular to local government funding, the Authority'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. However, given the size of the Council's capital programme, and the need to diversify the Council's debt portfolio, long term borrowing will also be required during 2019/20, so the strategy will be to fulfil the Council's borrowing requirement with a mixture of long and short term borrowing.

4.4. By taking short term borrowing, the Authority is able to reduce net borrowing costs. The benefits of short term borrowing will be monitored regularly against the potential for incurring additional costs by deferring longer term borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Authority with this 'cost of carry' and breakeven analysis. Its output may determine to what extent the Authority borrows additional sums at long-term fixed rates in 2019/20 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

4.5. Alternatively, the Authority may arrange forward starting loans during 2019/20, 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.

4.6. In addition, the Authority may borrow short-term loans to cover unplanned cash flow shortages.

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

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except Haringey Pension Fund, and the London Collective Investment Vehicle)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

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

- leasing
- hire purchase
- Private Finance Initiative
- sale and leaseback

4.9. The Authority has previously raised the majority of its long-term borrowing from the PWLB but it continues to investigate other sources of finance, such as local authority loans and bank loans, that may be available at more favourable rates.

4.10. **LOBOs:** The Authority holds £125m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. £75m of these LOBOs have options during 2019/20, and although the Authority 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 repay LOBO loans with no penalty if it can, however, it recognises that lenders are highly unlikely to offer this while the interest rates on existing loans remain above prevailing rates.

4.11. Some LOBO lenders are now open to negotiating premature exit terms from LOBO loans via payment of a premium to the lender. Haringey Council's policy will be to exit LOBO agreements if the costs of replacing the loans, including all premium, transaction and funding costs, generate a material net revenue saving for the Council over the life of the loan in net present value terms, and all costs are consistent with Haringey's approved medium term financial strategy. Whether to repay a LOBO loan will be determined by the S151 Officer, in line with Haringey's constitution.

4.12. When loans are prematurely repaid, there is usually a premium payable to the lender, to compensate them for interest forgone at the contractual rate, where prevailing interest rates are lower. Haringey would need to refinance LOBOs by raising borrowing for both the original sum borrowed, and the premium payable to the lender. However, this type of arrangement can prove beneficial where interest savings exceed premium costs. Replacing LOBOs, that contain an option for lenders to increase the rate, with fixed rate debt will reduce refinancing and interest rate risk.

4.13. **Short-term and variable rate loans**: These loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below.

4.14. **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 Authority 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.

4.15. **Borrowing Limits:** The council's total borrowing limits are set out in the table below. The Authorised Limit sets the maximum level of external borrowing on a gross basis (i.e. not net of investments) and is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit). The Indicator separately identifies borrowing from other long term liabilities such as finance leases. The Authorised Limit has been set on the estimate of the most likely, prudent but not worst case scenario with sufficient headroom over and above this to allow for unusual cash movements.

4.16. The Operational Boundary links directly to the Council's estimates of the CFR and estimates of other cashflow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent but not worst case scenario but without the additional headroom included within the Authorised Limit. The Operational Boundary and Authorised Limit apply at the total level.

4.17. The Chief Finance Officer has delegated authority, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long-term liabilities. Decisions will be based on the outcome of financial option appraisals and best value considerations. Any movement between these separate limits will be reported to the next meeting of the Corporate Committee.

4.18. Table 2 Borrowing Limits

	2018/19 limit	2019/20 limit	2020/21 limit	2021/22 limit
	£m	£m	£m	£m
Authorised limit – borrowing	618.4	752.4	901.0	1,141.1
Authorised limit – PFI & leases	43.3	39.9	35.0	30.1
Authorised limit – total external debt	**661.6**	**792.3**	**936.0**	**1,171.2**
Operational boundary - borrowing	568.4	702.4	851.0	1,091.1
Operational boundary – PFI & leases	39.9	36.3	31.8	27.3
Operational boundary – total external debt	**608.3**	**738.7**	**882.9**	**1,118.4**

5. Investment Strategy - Treasury Investments

5.1. The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's investment balance has generally ranged between £10 and £50 million, and similar levels are expected to be maintained in the forthcoming year. It is a requirement of the Markets in Financial Instruments Directive II that the Council maintains an average investment balance of at least £10m, in order to remain professional client status (see also par 11.6)

5.2. **Objectives:** The CIPFA Code requires the Authority 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 Authority'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 of receiving unsuitably low investment income. Were balances to be invested for more than one year, the Authority would 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 2019/20, 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 Authority aims to maintain its policy of utilising highly creditworthy and highly liquid investments such as loans to other local authorities, AAA rated money market funds and the Debt Management Office (part of HM treasury).

5.5. **Business models:** Under the new IFRS 9 standard, the accounting for certain investments depends on the Authority's "business model" for managing them. The Authority aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

5.6. **Approved counterparties:** The Authority may invest its surplus funds with any of the counterparty types in table 3 below, subject to the cash limits (per counterparty) and the time limits shown.

5.7. Table 3: Approved investment counterparties and limits

Instrument	Country/ Domicile	Counterparty	Maximum Counterparty Limits £m	Maximum period of investment
Term Deposits	UK	Debt Management Account Deposit Facility (DMADF), Debt Management Office (DMO)	No limit	364 days
Gilts	UK	Debt Management Office (DMO)	No limit	364 days
Treasury Bills	UK	Debt Management Office (DMO)	No limit	364 days
Term Deposits/ Call Accounts	UK	Other UK Local Authorities	£5m per local authority	364 days
Term Deposits/ Call Accounts/ Certificates of Deposit/Covered Bonds	UK or AA+ Rated Country	Counterparties rated at least A- Long Term (or equivalent)	£5m per bank or banking group	364 days
Constant Net Asset Value Money Market Funds (MMFs)	UK/Ireland/ Luxembourg domiciled	AAA-rated Money Market Funds	£10m per MMF; Group limit £50m*	Instant Access

*These limits apply for both Haringey Council and Haringey pension Fund, so in practice, the limit is £5m per MMF and £25m group limit for the Council, and £25m for the fund.

5.8. **Credit rating:** Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. 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.

5.9. **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.

5.10. **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.

5.11. **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 generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

5.12. **Operational bank accounts:** The Authority may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £10m per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Authority maintaining operational continuity.

5.13. **Risk assessment and credit ratings**: Credit ratings are obtained and monitored by the Authority'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.

5.14. 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 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.

5.15. **Other information on the security of investments**: The Authority 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, reports in the quality financial press and analysis and advice from the Authority's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

5.16. 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 Authority 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 Authority'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.

5.17. **Investment limits**: The Authority's revenue reserves expressly available to cover investment losses are forecast to be £5 million on 31st March 2019. In order that no more than 100% 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 £5 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

5.18. **Liquidity management**: The Authority uses purpose-built cash flow forecasting software 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 Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Authority's medium-term financial plan and cash flow forecast.

6. <u>Investment Strategy – Non-Treasury Management Investments</u>

6.1. The Authority invests its money for three broad purposes:

- o because it has surplus cash as a result of its day-to-day activities, for example when income is received in advance of expenditure (known as **treasury management investments –** see section 5 of this report),
- o to support local public services by lending to or buying shares in other organisations (**service investments**), and
- o to earn investment income (known as **commercial investments** where this is the main purpose).

6.2. This section (section 6) is a new part of this report for 2019/20, meeting the requirements of statutory guidance issued by the government in January 2018, and focuses on the second and third of the above categories.

6.3. <u>Treasury Management Investments</u>

6.3.1. The Authority typically receives its income in cash (e.g. from taxes and grants) before it pays for its expenditure in cash (e.g. through payroll and invoices). It also holds reserves for future expenditure. These activities, plus the timing of borrowing decisions, lead to a cash surplus which is invested in accordance with guidance from the Chartered Institute of Public Finance and Accountancy. The balance of treasury management investments is expected to fluctuate between £10m and £50m during the 2019/20 financial year.

6.3.2. **Contribution:** The contribution that these investments make to the objectives of the Authority is to support effective treasury management activities.

6.3.3. **Further details:** Full details of the Authority's policies and its plan for 2019/20 for treasury management investments are covered in the previous section, section 5 of this report

6.4. **Service Investments:**

6.4.1. **Contribution:** The Council lends money to third parties such as its subsidiaries, local businesses, local charities, local residents and its employees to support local public services and stimulate local economic growth. These are often treated as capital expenditure and included within the Council's capital programme

6.4.2. **Security:** The main risk when making service loans is that the borrower will be unable to repay the principal lent and/or the interest due. In order to limit this risk, it will be ensured that any new loans made will remain proportionate to the size of the Authority. Balances as at 31.3.18 were as follows:

6.4.3. *Table 4: Loans for service purposes in £ millions*

Category of borrower	31.3.2018 actual		
	Balance owing	**Loss allowance**	**Net figure in accounts**
Subsidiaries	0.3	-0.3	0.0
Local businesses	4.5	0.0	4.5
Local charities	47.8	-43.5	4.3
Local residents	0.1	0.0	0.1
Employees	0.1	0.0	0.1
TOTAL	52.8	-43.8	9.0

6.4.4. The largest balance above relates to Alexandra Palace debts (shown under local charities). There is a large amount of historic debt that a provision was created for, however this has not been written off. The loans to local business include the opportunity investment fund, and a loan to a business who operates some of Haringey's leisure facilities.

6.4.5. Accounting standards require the Authority to set aside loss allowance for loans, reflecting the likelihood of non-payment. The figures for loans in the Authority's statement of accounts from 2018/19 onwards will be shown net of this loss allowance. However, the Authority makes every reasonable effort to collect the full sum lent and has appropriate credit control arrangements in place to recover overdue repayments.

6.4.6. **Risk assessment:** The Authority assesses the risk of loss before entering into and whilst holding service loans by weighing up the service outcomes any such loan could provide against the creditworthiness of the recipient. This is done on a case by case basis, given the low number of such arrangements. This forms part of the Council's capital programme, further details of which are in the Council's annual medium term financial strategy.

6.5. **Commercial Investments: Property**

6.5.1. **Contribution:** The Council holds properties which are classified as 'investment properties' in the Council's statement of accounts. These properties are all within the local area, and the revenue stream associated with these (net of the costs of maintaining the properties) forms part of the Council's annual budget, therefore contributing to the resources available to the Council to spend on local public services.

6.5.2. The value of investment properties disclosed in the 2017/18 statement of accounts was £66.9m.

7. Capacity, Skills, Culture and Advice

7.1. CIPFA's Treasury Management Code of Practice requires the Chief Financial Officer to ensure that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities.

7.2. Given the significant amounts of money involved, it is crucial members have the necessary knowledge to take treasury management decisions. Training sessions are arranged for members to keep their knowledge up to date.

7.3. 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, the Association of Corporate Treasurers and other appropriate organisations.

7.4. 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 reviewed by the Council's treasury management staff.

7.5. Appropriately skilled and experienced finance and legal staff members work with service departments to ensure that the risks associated with any projects they undertake, and compliance with regulation and statutory guidance are properly understood, and form a key consideration in any decision making process.

7.6. The Council's constitution has clearly defined roles and responsibilities for treasury management responsibilities, both for members, committees, and officers.

8. Investment Indicators

8.1. The Authority has set the following quantitative indicators to allow elected members and the public to assess the Authority's total risk exposure as a result of its investment decisions.

8.2. **Total risk exposure:** The first indicator shows the Authority's total exposure to potential investment losses.

8.3. *Table 5: Total investment exposure in £ millions*

Total investment exposure	31.03.2018 Actual	31.03.2019 Forecast	31.03.2020 Forecast
Treasury management investments	45.9	33.7	15.0
Service investments: Loans	9.0	8.6	8.3
Commercial investments: Property	66.9	66.9	66.9
TOTAL INVESTMENTS	121.8	109.2	90.2

8.4. **How investments are funded:** Government guidance is that these indicators should include how investments are funded. Since the Authority does not normally associate particular assets with particular liabilities, this guidance is difficult to comply with. However, the following investments could be described as being funded by borrowing. The remainder of the Authority's investments are funded by usable reserves and income received in advance of expenditure.

8.5. *Table 6: Investments funded by borrowing in £ millions*

Investments funded by borrowing	31.03.2018 Actual	31.03.2019 Forecast	31.03.2020 Forecast
Treasury management investments	0.0	0.0	0.0
Service investments:	5.9	6.1	6.4
Commercial investments: Property	43.8	47.3	51.6
TOTAL FUNDED BY BORROWING	49.7	53.4	58.0

8.6. **Rate of return received:** This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested. Note that due to the complex local government accounting framework, not all recorded gains and losses affect the revenue account in the year they are incurred.

8.7. *Table 7: Investment rate of return (net of all costs)*

Investments net rate of return	**2017/18 Actual**	**2018/19 Forecast**	**2019/20 Forecast**
Treasury management investments	0.25%	0.70%	1.00%
Service investments:	4.17%	4.17%	4.17%
Commercial investments: Property	0.72%	4.00%	4.00%
ALL INVESTMENTS	0.80%	3.00%	3.52%

9. **Treasury Management Indicators**

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

9.2. **Security:** The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating 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.

Credit risk indicator	**Target**
Portfolio average credit rating	*Above A-, score of 7 or lower*

9.3. **Liquidity:** The Authority 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 3 month period, without additional borrowing.

Liquidity risk indicator	**Target**
Total cash available within 3 months	£10m

9.4. **Interest rate exposures**: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	Limit
Upper limit on one-year revenue impact of a 1% rise in interest rates	£1m
Upper limit on one-year revenue impact of a 1% fall in interest rates	£1m

9.5. The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

9.6. **Maturity structure of borrowing:** This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	50%*	0%
12 months and within 24 months	40%	0%
24 months and within 5 years	40%	0%
5 years and within 10 years	40%	0%
10 years and within 20 years	40%	0%
20 years and within 30 years	40%	0%
30 years and within 40 years	50%	0%
40 years and within 50 years	50%	0%
50 years an above	40%	0%

*this has been revised from the previous year when the corresponding figure was 60%

9.7. 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.

9.8. **Total short term borrowing:** the Council has used short term borrowing (under 1 year in duration) from other local authorities extensively in recent years, as an alternative to longer term borrowing from PWLB, due to the lower interest rates, and corresponding revenue savings. Short term borrowing exposes the Council to refinancing risk: the risk that interest rates rise quickly over a short period of time, and are at significantly higher rates when loans mature and new borrowing has to be raised. With this in mind, the Authority will set a limit on the total amount of short term local authority borrowing, as a proportion of all borrowing.

Short term borrowing	Limit
Upper limit on short term borrowing from other local authorities as a percentage of total borrowing	30%

9.9. **Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the Authority'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:

Price risk indicator	2019/20	2020/21	2021/22
Limit on principal invested beyond year end	£10m	£10m	£10m

10. Minimum Revenue Provision Policy Statement

10.1. The Council's MRP policy has been reviewed and revised to better reflect the rules set out in the prudential code and government guidance around prudent provision for repayment of borrowed capital. The revised policy, which took effect from 1 April 2016, ensures that provision for capital repayment is made over a period that is commensurate with the period in which the asset purchased provides benefits.

General Fund MRP policy: borrowing before 2007/08

10.2. The Council will calculate MRP on historic debt based on the Capital Financing Requirement (CFR) as at 1 April 2007.

10.3. The Council will calculate the MRP charge based on 2% of that CFR, fixed at the same cash value so that the whole debt is repaid after 50 years in total.

10.4. The historic MRP policy for borrowing incurred before 2007/08 led to MRP charges that exceeded what prudence required during the period from 1 April 2007 to 31 March 2016. This resulted in a cumulative charge at 31 March 2016 that was in excess of what is considered prudent and appropriate under the current policy. To reflect the historic over-provision the Council will undertake an annual review to determine whether to make a realignment of MRP charged to the General Fund, using the policy set out above, to recognise the excess sum charged to that point.

10.5. The following conditions will apply to the annual review:

- Total MRP after applying realignment will not be less than zero in any financial year.
- The cumulative total of the MRP realignment will never exceed the amount of historical over-provision calculated to 31 March 2016.

General Fund MRP policy: prudential borrowing from 2007/08

10.6. For borrowing incurred on schemes described by the Government as Prudential Borrowing or Unsupported Borrowing, MRP will be calculated over the estimated remaining useful life applicable to the expenditure (usually the useful life of the asset it is financing) using the Annuity repayment method in accordance with Option 3 of the guidance.

10.7. This means that MRP will be calculated on an annuity basis (like many domestic mortgages) over the estimated life of the asset. Estimated life periods will be determined by the Section 151 Officer under delegated powers.

10.8. In accordance with the provisions in the guidance, MRP will be first charged in the financial year following the one in which the entire asset to which the charge relates, becomes fully operational.

10.9. Financial agreements such as loans, investments or where assets are to be acquired for future development (including where capital receipts are part of the business case), will not, at the discretion of the CFO, attract MRP. This discretion will be applied where it is reasonable to assume that the initial capital investment will be returned to the Council in full at maturity or over a defined period.

Concession Agreements

10.10. MRP in relation to concession agreements (e.g. PFI contracts) and finance leases are calculated on an asset life method using an annuity repayment profile, consistent with the method for all prudential borrowing since 2007/08. Estimated life periods will be determined under delegated powers.

10.11. The Section 151 Officer may approve that such debt repayment provision may be made from capital receipts or from revenue provision.

Finance Leases

10.12. For assets acquired by finance leases, including leases brought on Balance Sheet under the International Financial Reporting Standards (IFRS) based Accounting Code of Practice, MRP will be determined as being equal to the element of the rent or charge that goes to write down the balance sheet liability.

Statutory capitalisations

10.13. For expenditure which does not create a fixed asset, but is statutorily capitalised and subject to estimated life periods that are referred to in the guidance, these estimated periods will generally be adopted by the Council. However, the Council reserves the right to determine useful life periods and prudent MRP in exceptional circumstances where the recommendations of the guidance would not be appropriate.

10.14. Other methods to provide for debt repayment may occasionally be used in individual cases where this is consistent with the statutory duty to be prudent, at the discretion of the Section 151 Officer.

11. Related Matters

11.1. The CIPFA Code requires the Authority to include the following in its treasury management strategy.

11.2. **Financial Derivatives:** 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).

11.3. The Authority 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 Authority 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.

11.4. 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.

11.5. **Housing Revenue Account:** On 1st April 2012, the Authority notionally split each of its existing long-term loans into General Fund and HRA pools. From 2012 going forwards, new long-term loans borrowed have been, and will be assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged/ credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. This balance will be measured each month and interest transferred between the General Fund and HRA at the Authority's average interest rate on investments.

11.6. **Markets in Financial Instruments Directive**: The Authority has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Authority's treasury management activities, this is the most appropriate status.

12. Financial Implications

12.1. The budget for investment income in 2019/20 is £0.25 million, based on an average investment portfolio of £25 million at an interest rate of 1.0%. The budget for debt interest paid in 2019/20 is £17.4 million (£6.8 General Fund, £10.6m HRA), based on an average debt portfolio of £538.5 million at an average interest rate of 3.23%. If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different.

13. Other Options Considered

13.1. The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Finance (S151 Officer) 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 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	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 2018

Underlying assumptions:

- Our central interest rate forecasts are predicated on there being a transitionary period following the UK's official exit from the EU.

- The MPC has a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. We believe that MPC members consider that: 1) tight labour markets will prompt inflationary pressure in the future, 2) ultra-low interest rates result in other economic problems, and 3) higher Bank Rate will be a more effective policy weapon if downside risks to growth crystallise.

- Both our projected outlook and the increase in the magnitude of political and economic risks facing the UK economy means we maintain the significant downside risks to our forecasts, despite the potential for slightly stronger growth next year as business investment rebounds should the EU Withdrawal Agreement be approved. The potential for severe economic outcomes has increased following the poor reception of the Withdrawal Agreement by MPs. We expect the Bank of England to hold at or reduce interest rates from current levels if Brexit risks materialise.

- The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in the middle quarters of 2018, but more recent data suggests the economy slowed markedly in Q4. Our view is that the UK economy still faces a challenging outlook as the country exits the European Union and Eurozone economic growth softens.

- Cost pressures are easing but inflation is forecast to remain above the Bank's 2% target through most of the forecast period. Lower oil prices have reduced inflationary pressure, but the tight labour market and decline in the value of sterling means inflation may remain above target for longer than expected.

- Global economic growth is slowing. Despite slower growth, the European Central Bank is conditioning markets for the end of QE, the timing of the first rate hike (2019) and their path thereafter. More recent US data has placed pressure on the Federal Reserve to reduce the pace of monetary tightening – previous hikes and heightened expectations will, however, slow economic growth.

- Central bank actions and geopolitical risks have and will continue to produce significant volatility in financial markets, including bond markets.

Forecast:

- The MPC has maintained expectations of a slow rise in interest rates over the forecast horizon, but recent events around Brexit have dampened interest rate expectations. Our central case is for Bank Rate to rise twice in 2019, after the UK exits the EU. The risks are weighted to the downside.

- Gilt yields have remained at low levels. We expect some upward movement from current levels based on our central case that the UK will enter a transitionary period following its EU exit in March 2019. However, our projected weak economic outlook and volatility arising from both economic and political events will continue to offer borrowing opportunities.

	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.17**
Arlingclose Central Case	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.13**
Downside risk	0.00	-0.50	-0.75	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	**-0.85**
3-mth money market rate														
Upside risk	0.10	0.10	0.10	0.10	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	**0.17**
Arlingclose Central Case	**0.90**	**0.95**	**1.10**	**1.30**	**1.40**	**1.40**	**1.40**	**1.35**	**1.35**	**1.35**	**1.35**	**1.35**	**1.35**	**1.27**
Downside risk	-0.20	-0.45	-0.60	-0.80	-0.90	-0.90	-0.90	-0.85	-0.85	-0.85	-0.85	-0.85	-0.85	**-0.76**
1-yr money market rate														
Upside risk	0.20	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	**0.33**
Arlingclose Central Case	**1.15**	**1.25**	**1.35**	**1.50**	**1.70**	**1.60**	**1.50**	**1.40**	**1.35**	**1.35**	**1.35**	**1.35**	**1.35**	**1.40**
Downside risk	-0.35	-0.50	-0.60	-0.80	-0.90	-0.90	-0.90	-0.85	-0.85	-0.85	-0.85	-0.85	-0.85	**-0.77**
5-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.37**
Arlingclose Central Case	**1.15**	**1.25**	**1.35**	**1.50**	**1.50**	**1.40**	**1.35**	**1.35**	**1.30**	**1.30**	**1.30**	**1.30**	**1.30**	**1.33**
Downside risk	-0.50	-0.60	-0.65	-0.80	-0.80	-0.70	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	**-0.66**
10-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.37**
Arlingclose Central Case	**1.50**	**1.65**	**1.70**	**1.80**	**1.80**	**1.75**	**1.75**	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**
Downside risk	-0.55	-0.70	-0.70	-0.80	-0.80	-0.75	-0.75	-0.70	-0.70	-0.70	-0.70	-0.70	-0.70	**-0.71**
20-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.37**
Arlingclose Central Case	**2.00**	**2.10**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.20**	**2.18**
Downside risk	-0.60	-0.70	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.73**
50-yr gilt yield														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.37**
Arlingclose Central Case	**1.90**	**1.95**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**2.00**	**1.99**
Downside risk	-0.60	-0.70	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.73**

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%
PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%