

This Report will be made public on 10 January 2017

**Folkestone**

Hythe & Romney Marsh  
Shepway District Council



Report Number **C/16/98**

**To: Cabinet**  
**Date: 18 January 2017**  
**Status: Key Decision**  
**Head of Service: Pat Main, Interim Head of Finance**  
**Cabinet Member: Councillor Susan Carey, Finance**

**Subject: TREASURY MANAGEMENT STRATEGY STATEMENT 2017/18  
INCLUDING TREASURY MANAGEMENT INDICATORS**

**SUMMARY:** This report sets out the proposed strategy for treasury management for 2017/18 including the Annual Investment Strategy and Treasury Management Indicators to be approved by full Council.

**REASONS FOR RECOMMENDATION:**

Cabinet is asked to agree the recommendations set out below because:-

- a) The Council must have regard to both CIPFA's Code of Practice for Treasury Management in the Public Services and the CLG's Guidance on Local Authority Investments when carrying out its duties under Part 1 of the Local Government Act 2003.
- b) The Financial Procedure Rules requires the Council to receive an annual plan and strategy for treasury management in advance of the financial year.
- c) The Council is required to approve an Annual Investment Strategy for the forthcoming year.

**RECOMMENDATIONS:**

1. To receive and note Report C/16/98.
2. To recommend to Council that the strategy for treasury management in 2017/18 set out in the report is adopted.

- 3. To recommend to Council that the 2017/18 Annual Investment Strategy set out in the report is adopted.**
- 4. To recommend to Council the approval of the treasury management indicators set out in the report.**

## **1. INTRODUCTION**

- 1.1 In February 2012 the Authority 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 Authority to approve a treasury management strategy before the start of each financial year.
- 1.2 In addition, the Department for Communities and Local Government (CLG) issued revised *Guidance on Local Authority Investments* in March 2010 that requires the Authority to approve an investment strategy before the start of each financial year.
- 1.3 This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to both the CIPFA Code and the CLG Guidance.
- 1.4 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 risk are therefore central to the Authority's treasury management strategy.
- 1.5 In accordance with the CLG Guidance, the Authority will be asked to approve a revised Treasury Management Strategy Statement (TMSS) should the assumptions on which this report is based change significantly. Such circumstances would include, for example, a large unexpected change in interest rates, or in the Authority's capital programme or in the level of its investment balance.
- 1.6 The Authority's major capital investment initiatives, such as Otterpool Park, Princes Parade and other asset investment initiatives, remain to be reported in detail to Members for approval. When approved, these initiatives are likely to require the TMSS to be revised.
- 1.7 The Prudential Indicators for capital expenditure, including borrowing limits, are considered separately by Cabinet in a report on the Update to the Medium Term Capital Programme.

## **2. ECONOMIC OUTLOOK AND PROSPECT FOR INTEREST RATES**

(Commentary supplied by the council's Treasury Adviser, Arlingclose)

### **2.1 Economic Background**

- 2.1.1 The major external influence on the Authority's treasury management strategy for 2017/18 will be the UK's progress in negotiating a smooth exit from the European Union. Financial markets, wrong-footed by the referendum outcome, have since been weighed down by uncertainty over whether leaving the Union also means leaving the single market. Negotiations are expected to start once the UK formally triggers exit in early 2017 and last for at least two years. Uncertainty over future economic prospects will therefore remain throughout 2017/18.
- 2.1.2 The fall and continuing weakness in sterling and the near doubling in the price of oil in 2016 have combined to drive inflation expectations higher. The Bank of

England is forecasting that Consumer Price Inflation will breach its 2% target in 2017, the first time since late 2013, but the Bank is expected to look through inflation overshoots over the course of 2017 when setting interest rates so as to avoid derailing the economy.

- 2.1.3 Initial post-referendum economic data showed that the feared collapse in business and consumer confidence had not immediately led to lower GDP growth. However, the prospect of a leaving the single market has dented business confidence and resulted in a delay in new business investment and, unless counteracted by higher public spending or retail sales, will weaken economic growth in 2017/18.
- 2.1.4 Looking overseas, with the US economy and its labour market showing steady improvement, the Federal Reserve raised interest rates by 0.25% in December 2016 and projected three more 0.25% increases in 2017. The Eurozone meanwhile has continued to struggle with very low inflation and lack of momentum in growth, and the European Central Bank has left the door open for further quantitative easing.
- 2.1.5 The impact of political risk on financial markets remains significant over the next year. General elections in France, Germany and Italy scheduled in 2017 all have the potential to impact on financial markets.

## **2.2 Credit Outlook**

- 2.2.1 Markets have expressed concern over the financial viability of a number of European banks recently. Sluggish economies and continuing fines for pre-crisis behaviour have weighed on bank profits, and any future slowdown will exacerbate concerns in this regard.
- 2.2.2 Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the European Union, Switzerland and USA, while Australia and Canada are progressing with their own plans. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however continue to fall.

## **2.3 Interest Rate Forecast**

- 2.3.1 Arlingclose's central case is for UK Bank Rate to remain at 0.25% during 2017/18. The Bank of England has, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further falls in the Bank Rate look less likely. Negative Bank Rate is currently perceived by some policymakers to be counterproductive but, although a low probability, cannot be entirely ruled out in the medium term, particularly if the UK enters recession as a result of concerns over leaving the European Union.

- 2.3.2 Gilt yields have risen sharply in the second half of 2016 but remain at low levels. The Arlingclose central case is for yields to decline when the government triggers Article 50. Long-term economic fundamentals remain weak, and the quantitative easing (QE) stimulus provided by central banks globally has only delayed the fallout from the build-up of public and private sector debt. The Bank of England has defended QE as a monetary policy tool, and further QE in support of the UK economy in 2017/18 remains a possibility, to keep long-term interest rates low.
- 2.3.3 A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix 1.
- 2.3.4 For the purpose of setting the 2017/18 budget, it has been assumed that new investments will be made at an average rate of 0.37%. No new long-term loans have been anticipated in the budget.

### 3. THE COUNCIL'S FORECAST BORROWING AND INVESTMENT POSITION

- 3.1 On 30 November 2016 the Authority held £60m of borrowing and £45.8m of investments. This is set out in further detail at Appendix 2. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

**Table 1: Balance Sheet Summary and Forecast**

	<b>31.3.16 Actual £m</b>	<b>31.3.17 Estimate £m</b>	<b>31.3.18 Forecast £m</b>	<b>31.3.19 Forecast £m</b>	<b>31.3.20 Forecast £m</b>
General Fund CFR	17.8	17.4	17.0	16.6	16.2
HRA CFR	47.4	47.4	47.5	49.6	52.5
<b>Total CFR</b>	<b>65.2</b>	<b>64.8</b>	<b>64.5</b>	<b>66.2</b>	<b>68.7</b>
Less: External borrowing	60.1	59.5	57.8	55.9	54.8
<b>Internal borrowing</b>	<b>5.1</b>	<b>5.3</b>	<b>6.7</b>	<b>10.3</b>	<b>13.9</b>
Less: Usable reserves	-32.4	-25.0	-24.0	-21.2	-19.0
Less: Working capital	-4.3	-4.3	-4.3	-4.3	-4.3
<b>Investments</b>	<b>31.6</b>	<b>24.0</b>	<b>21.6</b>	<b>15.2</b>	<b>9.4</b>

- 3.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.
- 3.3 The movement in table 1 is based on the projected outturn for the current financial year, the draft revenue and capital budgets being proposed for 2017/18 and information taken from the latest approved Medium Term Financial Strategy for 2018/19 and 2019/20.

3.4 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 2017/18.

#### **4. BORROWING STRATEGY**

4.1 The Authority currently holds £60.0 million of loans, a small reduction of £0.1 million on the previous year, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 1 shows that the Authority currently does not expect to need to borrow in 2017/18. The Authority may however borrow to pre-fund future years' requirements, providing this does not exceed the proposed authorised limit for borrowing of £69.9 million for 2017/18.

#### **4.2 Objectives**

4.2.1 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**

4.3.1 Given the significant reductions 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.

4.3.2 By doing so, the Authority is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of both internal and 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 modestly. Arlingclose will assist the Authority with this 'cost of carry' and breakeven analysis. Its output may determine whether the Authority borrows additional sums at long-term fixed rates in 2017/18 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

4.3.3 Alternatively, the Authority may arrange forward starting loans during 2017/18, 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.

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

## **4.4 Sources of Borrowing**

4.4.1 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
- UK public and private sector pension funds (except the Kent County Council Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

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

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

4.4.3 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.

## **4.5 Short-term and Variable Rate Loans**

4.5.1 These loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

## **4.6 Debt Rescheduling**

4.6.1 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.

## **5. INVESTMENT STRATEGY**

5.1 The Authority holds significant 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 ranged between £32 and £54 million. The maximum investment balance held is expected to reduce to between £45 and £50 million in the coming year as the council uses its reserves to meet its approved capital expenditure plans in particular.

## 5.2 Objectives

5.2.1 Both the CIPFA Code and the CLG Guidance require 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. Where balances are expected to be invested for more than one year, the Authority will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

5.2.2 **Negative Interest Rates** - If the UK enters into a recession in 2017/18, 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.

## 5.3 Strategy

5.3.1 Given the increasing risk and falling returns from short-term unsecured bank investments, the Authority aims to further diversify into more secure and/or higher yielding asset classes during 2017/18. This is especially the case for the estimated £21m that is available for longer-term investment. A significant proportion of the Authority's surplus cash is currently invested in short-term unsecured bank deposits, certificates of deposit and money market funds. This diversification will represent a change in strategy over the coming year.

## 5.4 Approved Counterparties

5.4.1 The Authority 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. On the advice of Arlingclose, the corporate and registered providers are proposed to be added to the Authority's counterparty types for the first time.

**Table 2: Approved Investment Counterparties and Limits for New Investments effective from 1 April 2017**

<b>Credit Rating</b>	<b>Banks Unsecured</b>	<b>Banks Secured</b>	<b>Government</b>	<b>Corporates</b>	<b>Registered Providers</b>
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£3m 5 years	£5m 20 years	£5m 50 years	£3m 20 years	£3m 20 years
AA+	£3m 5 years	£5m 10 years	£5m 25 years	£3m 10 years	£3m 10 years
AA	£3m 4 years	£5m 5 years	£5m 15 years	£3m 5 years	£3m 10 years



AA-	£3m 3 years	£5m 4 years	£5m 10 years	£3m 4 years	£3m 10 years
A+	£3m 2 years	£5m 3 years	£5m 5 years	£3m 3 years	£3m 5 years
A	£3m 13 months	£5m 2 years	£5m 5 years	£3m 2 years	£3m 5 years
A-	£3m 6 months	£5m 13 months	£5m 5 years	£3m 13 months	£3m 5 years
BBB+	£3m 100 days	£3m 6 months	£3m 2 years	£1.5m 6 months	£1.5m 2 years
None	£1m 6 months	n/a	£5m 25 years	£50,000 5 years	£3m 5 years
<b>Pooled funds</b>	£5m per fund				

This table must be read in conjunction with the notes below

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

5.4.3 **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.

5.4.4 **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.

5.4.5 **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.

5.4.6 **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.

- 5.4.7 **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 the likelihood of receiving government support if needed.
- 5.4.8 **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.
- 5.4.9 Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority 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 Authority's investment objectives will be monitored regularly.

## 5.5 Risk Assessment and Credit Ratings

5.5.1 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.

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

## 5.6 Other Information on the Security of Investments

5.6.1 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 and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

5.6.2 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.

## **5.7 Specified Investments**

5.7.1 The CLG Guidance defines specified investments as those:

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

5.7.2 The Authority 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.

## **5.8 Non-specified Investments**

5.8.1 Any investment not meeting the definition of a specified investment is classed as non-specified. The Authority does not intend to make any 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 3: Non-Specified Investment Limits**

	<b>Cash limit</b>
Total long-term investments	£20m
Total investments without credit ratings or rated below A-	£15m
Total non-specified investments	£35m

## 5.9 Investment Limits

5.9.1 The Authority's revenue reserves available to cover investment losses are forecast to be £11 million 31st March 2017. In order that no more than 50% 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. 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 4: Investment Limits**

	<b>Cash limit</b>
Any single organisation, except the UK Central Government	£5m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£5m per group
Any group of pooled funds under the same management	£10m per manager
Negotiable instruments held in a broker's nominee account	£10m per broker
Foreign countries	£5m per country
Registered Providers	£10m in total
Unsecured investments with Building Societies	£5m in total
Loans to unrated corporates	£5m in total
Money Market Funds	£25m in total

## 5.10 Liquidity Management

5.10.1 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. TREASURY MANAGEMENT INDICATORS

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

6.2 **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.

	<b>Target</b>
Portfolio average credit rating	A

6.3 **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 three month period, without additional borrowing.

	<b>Target</b>
Total cash available within 3 months	£5m

6.4 **Interest Rate Exposures** - This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed will be:

	<b>2017/18</b>	<b>2018/19</b>	<b>2019/20</b>
Upper limit on fixed interest rate exposure	£63m	£66m	£68m
Upper limit on variable interest rate exposure	£0m	£0m	£0m

6.5 Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

6.6 **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 fixed rate borrowing will be:

	<b>Upper</b>	<b>Lower</b>
Under 12 months	30%	0%
12 months and within 24 months	40%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	80%	0%
10 years and above	100%	0%

6.7 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.

6.8 **Principal Sums Invested for Periods Longer than 364 days** - 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:

	<b>2017/18</b>	<b>2018/19</b>	<b>2019/20</b>
Limit on principal invested beyond year end	£20m	£15m	£10m

## 7. OTHER ITEMS

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

### 7.2 Policy on Use of Financial Derivatives

7.2.1 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).

7.2.2 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.

- 7.2.3 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.

### **7.3 Policy on Apportioning Interest to the HRA**

- 7.3.1 On 1st April 2012, the Authority notionally split each of its existing long-term loans into General Fund and HRA pools. In the future, new long-term loans borrowed 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, adjusted for credit risk.

### **7.4 Investment Training**

- 7.4.1 The needs of the Authority's treasury management staff for training in investment management are assessed as part of the regular staff appraisal process, and additionally when the responsibilities of individual members of staff change.
- 7.4.2 Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to undertake studying for relevant professional qualifications.

### **7.5 Investment Advisers**

- 7.5.1 The Authority appointed Arlingclose Limited as treasury management advisers with effect from 1 April 2016 on an initial three year contract with a provision for a further two year extension and receives specific advice on investment, debt and capital finance issues. The quality of this service is monitored by the council's treasury management staff with reference to the agreed specification and particular attention is given to the timeliness and relevance of the information received.

### **7.6 Investment of Money Borrowed in Advance of Need**

- 7.6.1 The Authority 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 Authority 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 Authority's overall management of its treasury risks.

- 7.6.2 The total amount borrowed will not exceed the authorised borrowing limit of £69.9 million. The maximum period between borrowing and expenditure is expected to be two years, although the Authority is not required to link particular loans with particular items of expenditure.

## 8. FINANCIAL IMPLICATIONS

- 8.1 The net revenue cost of the council's treasury management borrowing and investment activity is estimated to be:

£'000	2016/17 Estimate	2016/17 Latest Projection	2017/18 Estimate	Variance 2016/17 to 2017/18
<b>Revenue Budgets</b>	£'000	£'000	£'000	£'000
Interest on Borrowing	<b>2,225</b>	2,223	<b>2,114</b>	<b>(111)</b>
HRA Element	<b>(1,737)</b>	(1,737)	<b>(1,676)</b>	<b>61</b>
GF Borrowing Cost	<b>488</b>	486	<b>438</b>	<b>(50)</b>
Investment income	<b>(538)</b>	(494)	<b>(357)</b>	<b>181</b>
HRA Element	<b>106</b>	72	<b>52</b>	<b>(54)</b>
GF Investment income	<b>(432)</b>	(422)	<b>(305)</b>	<b>127</b>
<b>Net Cost (GF)</b>	<b>56</b>	64	<b>133</b>	<b>77</b>

- 8.2 The main reasons for the projected net increase in General Fund borrowing costs of £77k from the 2016/17 estimate to the 2017/18 estimate are:

	£'000
i) Reduction in investment income from lower cash reserves and balances in 2017/18 compared to 2016/17	103
ii) Reduction in investment income from forecast lower average returns in 2017/18 compared to 2016/17	78
iii) Reduction in interest payable on borrowing due to maturing loans falling out	(111)
iv) Adjustments in charges between the General Fund and HRA	7
<b>Net increase in costs to General Fund</b>	<b>77</b>



## 9. OTHER OPTIONS CONSIDERED

9.1 The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Corporate Director for Organisational Change, 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.

<b>Alternative</b>	<b>Impact on income and expenditure</b>	<b>Impact on risk management</b>
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

## 10. RISK MANAGEMENT ISSUES

10.1 Inherently treasury management is concerned with the management of risk, e.g. interest rate risk, market risk, credit risk and liquidity risk. The strategies in this Report are developed to minimise the impact of risk changes whilst at the same time providing a framework for the council to reduce its net interest costs.

10.2 Specific risks to be addressed are as follows:

<b>PERCEIVED RISK</b>	<b>SERIOUSNESS</b>	<b>LIKELIHOOD</b>	<b>PREVENTATIVE ACTION</b>
Interest Rate Risk (rates moving significantly different to expectations)	High	Medium	Rate rises would be beneficial but if rates fall the council would need to consider further fixed rate investments or debt rescheduling to mitigate impact.
Market Risk (adverse market fluctuations affect value of investment capital)	Medium	Low	A limit is placed on the value of principal exposed to changes in market value.
Credit Risk  (risk to repayment of Capital)	High	Medium	The council's investment criteria restricts counterparties to those of the highest quality and security.
Liquidity Risk  (risk that cash will not be available when needed)	Medium	Medium	Council's investment portfolio structured to reflect future liquidity needs. Temporary borrowing is also available to meet short term liquidity issues.
Changes to the Capital Programme and/or revenue streams	High	Low-Medium	Cash flows are calculated monthly and regular projections are made to identify changes to the council's funding

			<p>requirements.</p> <p>Prudential borrowing to support capital expenditure can be used for schemes expected to provide a financial benefit to the council.</p> <p>Otherwise only realised capital receipts are used to fund the approved capital programme.</p> <p>There may be some slippage in capital expenditure between years and the impact will be monitored.</p>
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## **11. LEGAL/FINANCIAL AND OTHER CONTROLS/POLICY MATTERS**

### **11.1 Legal Officer's Comments (DK)**

There are no legal implications arising directly out of this report. Part 1 of the Local Government Act 2003 gives the Council the power to borrow and to invest for any purpose relevant to its functions or for the purposes of the prudent management of its financial affairs. It also requires the Council to act prudently when carrying out these activities, including an obligation to determine and keep under review how much money it can borrow. In addition, the Council is required by the Local Government Finance Act 1992 to produce a balanced budget. The Council must bear in mind its fiduciary duties to local tax payers and its continuing obligation to ensure it has funding to perform relevant statutory undertakings it has to comply with

### **11.2 Finance Officer's Comments (LW)**

The report has been prepared by Financial Services and the relevant financial implications are contained within it.

## **12. CONTACT OFFICER AND BACKGROUND DOCUMENTS**

Councillors with any questions arising out of this report should contact the following officers prior to the meeting:

*Lee Walker – Group Accountant*

*Tel: 01303 853593 Email: [lee.walker@shepway.gov.uk](mailto:lee.walker@shepway.gov.uk)*

The following background documents have been relied upon in the preparation of this report:

Arlingclose's Treasury Management Strategy Statement Template 2017/18

Appendices

Appendix 1 – Arlingclose Economic and Interest Rate Forecast

Appendix 2 - Existing Investment & Debt Portfolio Position

## Appendix 1 – Arlingclose Economic & Interest Rate Forecast November 2016

### Underlying assumptions:

- The medium term outlook for the UK economy is dominated by the negotiations to leave the EU. The long-term position of the UK economy will be largely dependent on the agreements the government is able to secure with the EU and other countries.
- The global environment is also riddled with uncertainty, with repercussions for financial market volatility and long-term interest rates. Donald Trump's victory in the US general election and Brexit are symptomatic of the popular disaffection with globalisation trends. The potential rise in protectionism could dampen global growth prospects and therefore inflation. Financial market volatility will remain the norm for some time.
- However, following significant global fiscal and monetary stimulus, the short term outlook for the global economy is somewhat brighter than earlier in the year. US fiscal stimulus is also a possibility following Trump's victory.
- Recent data present a more positive picture for the post-Referendum UK economy than predicted due to continued strong household spending.
- Over the medium term, economic and political uncertainty will likely dampen investment intentions and tighten credit availability, prompting lower activity levels and potentially a rise in unemployment.
- The currency-led rise in CPI inflation (currently 1.0% year/year) will continue, breaching the target in 2017, which will act to slow real growth in household spending due to a sharp decline in real wage growth.
- The depreciation in sterling will, however, assist the economy to rebalance away from spending. The negative contribution from net trade to GDP growth is likely to diminish, largely due to weaker domestic demand. Export volumes will increase marginally.
- Given the pressure on household spending and business investment, the rise in inflation is highly unlikely to prompt monetary tightening by the Bank of England, with policymakers looking through import-led CPI spikes to the negative effects of Brexit on economic activity and, ultimately, inflation.
- Bank of England policymakers have, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further monetary loosening looks less likely.



## Appendix 2 – Existing Investment & Debt Portfolio Position

	<b>Actual Portfolio at 30 November 2016 £m</b>	<b>Average Rate %</b>
<b>External Borrowing:</b>		
Public Works Loan Board	58.9	3.73
Local Authorities	1.1	1.10
<b>Total External Borrowing</b>	<b>60.0</b>	<b>3.70</b>
<b>Investments:</b>		
Banks (unsecured)	19.5	0.81
Covered bonds (secured)	2.0	0.46
Local Authorities	8.0	0.97
Money Market Funds	11.2	0.32
Pooled Funds - CCLA LA Property Fund	5.1	4.83
<b>Total Investments</b>	<b>45.8</b>	<b>1.15</b>
<b>Net Debt</b>	<b>14.2</b>	