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Folkestone
Hythe & Romney Marsh
Shepway District Council
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Report Number **C/17/78**

To: Cabinet
Date: 28 February 2018
Status: Key Decision
Head of Service: Charlotte Spendley, Head of Finance
Cabinet Member: Malcolm Dearden, Finance

Subject: **TREASURY MANAGEMENT STRATEGY STATEMENT, PRUDENTIAL INDICATORS AND MINIMUM REVENUE PROVISION STATEMENT FOR 2018/19**

SUMMARY: This report sets out the proposed strategy for treasury management for 2018/19 including the Annual Investment Strategy and Treasury Management Indicators to be approved by full Council. This report also sets out both the Prudential Indicators for capital expenditure and the Minimum Revenue Provision Statement for 2018/19 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 Council must also have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities when carrying out its duties under Part 1 of the Local Government Act 2003.
c) The Financial Procedure Rules requires the Council to receive an annual plan and strategy for treasury management in advance of the financial year.
d) The Council is required to approve an Annual Investment Strategy for the forthcoming year.
e) The Council is required to approve a Minimum Revenue Provision statement for 2018/19 in advance of the start of the financial year.

RECOMMENDATIONS:

1. **To receive and note Report C/17/78.**
2. **To recommend to Council that the strategy for treasury management in 2018/19 set out in the report is adopted.**
3. **To recommend to Council that the 2018/19 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.**
5. **To recommend to Council the approval of the Prudential Indicators for capital and borrowing set out in the appendix 3 to this report.**
6. **To recommend to Council the approval of the Minimum Revenue Provision (MRP) Policy Statement for 2018/19 set out in appendix 4 to this 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. In December 2017 CIPFA issued a revised Code of Practice and it is no longer a requirement for the Authority to adopt this as it now has to have regard to it by law.

1.2 In addition, the former Department for Communities and Local Government (now the Ministry of Housing, Communities and Local Government, MHCLG) 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. The MHCLG has recently consulted over proposed changes to their Guidance and, at the time of writing, the outcome of this is not known. Should there be any material changes required to the Treasury Management Strategy Statement (TMSS) for 2018-19 arising from changes to the MHCLG Guidance then it is likely a revised TMSS will be submitted to full Council for approval later in the 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 MHCLG 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 MHCLG 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, Biggins Wood 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 This report also sets out both the Prudential Indicators for capital expenditure and the Minimum Revenue Provision Statement for 2018/19 to be approved by full Council.

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

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

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

2.2 Credit Outlook

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

2.2.2 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. In addition, the largest UK banks will ringfence their retail banking functions into separate legal entities during 2018. There remains some uncertainty over how these changes will impact upon the credit strength of the residual legal entities.

2.2.3 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 remain very low.

2.3 Interest Rate Forecast

2.3.1 The Authority's treasury adviser Arlingclose's central case is for UK Bank Rate to rise in May 2018 from its current level of 0.50% to 0.75% with a further increase forecast for later in the year to 1.0%. Arlingclose also anticipate another rise in the Bank Rate to 1.25% by mid-2019. Arlingclose's advice reflects comments from the Monetary Policy Committee at its meeting in February 2018 regarding private sector earnings growth and its impact on inflation together with slightly improved growth prospects.

2.3.2 The Arlingclose central case is for gilt yields to remain broadly stable across the medium term. Upward movement will be limited, although the UK government's seemingly deteriorating fiscal stance is an upside risk. Overall, the risk to Arlingclose's forecasts is weighted on the downside reflecting concerns about the impact of the exit from the European Union on UK growth in particular.

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 budget, it has been assumed that new investments will be made at an average rate of 0.83%. No new long-term loans have been anticipated in the budget.

3. THE COUNCIL'S FORECAST BORROWING AND INVESTMENT POSITION

3.1 On 31 December 2017 the Authority held £57.9m of borrowing and £50.9m 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

	31.3.17 Actual £m	**31.3.18 Estimate £m**	**31.3.19 Forecast £m**	**31.3.20 Forecast £m**	**31.3.21 Forecast £m**
General Fund CFR	18.5	19.1	25.2	37.5	37.9
HRA CFR	47.4	47.4	47.4	49.6	52.5
Total CFR	**65.9**	**66.5**	**72.6**	**87.1**	**90.4**
Less: External borrowing	59.5	57.8	55.9	68.2	75.1
Internal borrowing	**6.4**	**8.7**	**16.7**	**18.9**	**15.4**
Less: Usable reserves	(37.2)	(29.4)	(26.9)	(20.6)	(17.1)
Less: Working capital	(3.5)	(3.5)	(3.5)	(3.5)	(3.5)
Investments	**(34.3)**	**(24.2)**	**(13.7)**	**(5.2)**	**(5.2)**

3.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The 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 2018/19 and information taken from the latest approved Medium Term Financial Strategy for 2019/20 and 2020/21. The table includes assumptions regarding proposals for additional capital investment in the council's housing and regeneration company, Oportunitas Limited, and the Princes Parade leisure and housing development. In both cases, these schemes will be subject to further reports to Members for approval.

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 2018/19.

4. BORROWING STRATEGY

4.1 The Authority currently holds £57.9 million of loans, a reduction of £1.6 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 2018/19. The Authority may however borrow to pre-fund future years' requirements, providing this does not exceed the proposed authorised limit for borrowing of £90 million for 2018/19.

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 2018/19 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 2018/19, 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. During 2017, the Authority's investment balance has ranged between £33 and £56 million with the average being £45 million. The average investment balance held is expected to reduce to around £39 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 2018/19, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

5.3 Strategy

5.3.1 Given the increasing risk and very low returns from short-term unsecured bank investments, the Authority aims to further diversify into more secure and/or higher yielding asset classes during 2018/19. This is especially the case for the estimated £23m 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 and money market funds. This diversification will represent a continuation of the new strategy adopted in 2017/18.

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 2018

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates	Registered Providers
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
None	£1m 6 months	n/a	£5m 25 years	£50,000 5 years	£3m 5 years
Pooled funds	£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.

5.4.10 **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 end of day balances will therefore be kept below £500,000 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.

5.5 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 MHCLG 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

	Cash limit
Total long-term investments	£23m
Total investments without credit ratings or rated below A- (except UK Government and local authorities)	£15m
Total non-specified investments	£38m

5.9 Investment Limits

5.9.1 The Authority’s revenue reserves available to cover investment losses are forecast to be £15 million 31st March 2018. In order that no more than 35% 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

	Cash limit
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.

5.11 Non-Treasury Investments

5.11.1 Although not classed as treasury management activities in terms of investment for cash flow management, the Authority may also purchase property for investment purposes, such as the land at Otterpool Park, and may also make loans and investments for service purposes, for example as equity investments and loans to the Authority's subsidiary, Oportunitas Limited.

5.11.2 Such loans and investments will be subject to the Authority's normal approval processes for revenue and capital expenditure and need not comply with the specific requirements of this treasury management strategy.

5.11.3 The Authority's existing non-treasury investments are summarised as part of Appendix 2.

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.

	Target
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.

	Target
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:

	2018/19	**2019/20**	**2020/21**
Upper limit on fixed interest rate exposure	£66m	£73m	£75m
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:

	Upper	**Lower**
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:

	2018/19	2019/20	2020/21
Limit on principal invested beyond year end	£23m	£18m	£13m

7. OTHER ITEMS

7.1 There are a number of additional items that the Authority is obliged by CIPFA or MHCLG 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 £90 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 based on information at budget setting time is estimated to be:

£'000	2017/18 Estimate	*2017/18* *Latest Projection*	2018/19 Estimate	Variance 2017/18 to 2018/19
Revenue Budgets	£'000	£'000	£'000	£'000
Interest on Borrowing	**2,114**	*2,114*	**2,049**	**(65)**
HRA Element	**(1,676)**	*(1,676)*	**(1,597)**	**79**
GF Borrowing Cost	**438**	*438*	**452**	**14**
Investment income	**(357)**	*(418)*	**(534)**	**(177)**
HRA Element	**52**	*44*	**75**	**23**
GF Investment income	**(305)**	*(374)*	**(459)**	**(154)**
Net Cost (GF)	**133**	*64*	**(7)**	**(140)**

8.2 The main reasons for the projected net reduction in General Fund borrowing costs of £140k from the 2017/18 estimate to the 2018/19 estimate are:

		£'000
i)	Increase in investment income from projected higher cash reserves and balances in 2018/19 compared to 2017/18	(50)
ii)	Increase in investment income from forecast higher average returns in 2018/19 compared to 2017/18 planned to be achieved from further diversification into pooled products providing the opportunity for enhanced returns over longer periods	(127)
iii)	Reduction in interest payable on borrowing due to maturing loans falling out	(65)
iv)	Adjustments in charges between the General Fund and HRA	102
Net reduction in costs to General Fund		**(140)**

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.

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

10. THE CAPITAL PRUDENTIAL INDICATORS 2018/19 TO 2020/21

10.1 The Local Government Act 2003 requires local authorities to adopt the CIPFA Prudential Code and to produce prudential indicators. The Code promotes the freedom of a local authority to determine locally what it needs to borrow to finance its future capital spending. However, the Code requires the Council to have regard to the following matters when arriving at its decisions:

i. affordability – eg implications for Council Tax and housing rents,
ii. prudence and sustainability – eg implications for external borrowing,
iii. value for money – eg options appraisal,
iv. stewardship of assets – eg asset management planning
v. service objectives, and
vi. practicality – eg achievability of the medium term financial plan.

10.2 The Council is asked to approve the prudential indicators set out in **appendix 3** for the period up to 2020/21. Each indicator either summarises the expected activity or introduces limits upon the activity, and reflects the outcome of the council's underlying capital appraisal system and approved capital programme.

The Prudential Code requires the Authority to monitor the prudential indicators each year.

11. MINIMUM REVENUE PROVISION (MRP) POLICY STATEMENT 2018/19

11.1 The council is required to pay off an element of the accumulated General Fund capital spend financed by borrowing each year through a revenue charge (the Minimum Revenue Provision), although it is also allowed to undertake additional voluntary payments where it is seen to be in its best interests to do so.

11.2 Regulations have been issued by the MHCLG which require full Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils to replace the existing Regulations, so long as there is a prudent provision. The Council is asked to approve the MRP Statement shown in **appendix 4** to be applicable for 2018/19.

12. RISK MANAGEMENT ISSUES

12.1 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.

12.2 Specific risks to be addressed are as follows:

PERCEIVED RISK	SERIOUSNESS	LIKELIHOOD	PREVENTATIVE ACTION
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	Medium	Low	A limit is placed on the value of principal exposed to changes

value of investment capital)			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	Medium	Cash flows are calculated monthly and regular projections are made to identify changes to the council's funding requirements. Prudential borrowing to support capital expenditure can be used for schemes expected to provide a financial benefit to the council. Otherwise only realised capital receipts are used to fund the approved capital programme. There may be some slippage in capital expenditure between years and the impact will be monitored.

13. LEGAL/FINANCIAL AND OTHER CONTROLS/POLICY MATTERS

13.1 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.

13.2 Finance Officer's Comments (LW)

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

14. 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

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

Arlingclose's Treasury Management Strategy Statement Template 2018/19

Appendicies
Appendix 1 – Arlingclose Economic and Interest Rate Forecast
Appendix 2 - Existing Investment & Debt Portfolio Position
Appendix 3 – Capital Prudential Indicators 2018/19 to 2020/21
Appendix 4 – Minimum Revenue Provision Policy Statement 2018/19

Appendix 1 – Arlingclose Economic & Interest Rate Forecast February 2018

Underlying assumptions:

- The MPC has raised expectations for further rises in Bank Rate, both sooner and to a higher level than previously anticipated by markets. Reiterating the view of the UK economy's impaired supply capacity and survey data of higher private sector earnings growth, meaning inflationary outcomes are more likely, the MPC also revised the UK's economic growth prospects slightly higher due to the pull of global economic momentum.
- Significantly, the MPC also decided to shorten the forecast horizon over which inflation will be brought back to the CPI target.
- The MPC believes that soft domestic consumption will recover as the inflationary impact of weaker sterling fades. Their projections assume that households and companies base their decisions on a smooth adjustment to the new trading relationship with the EU.
- However, the additional moves made by the Bank to intentionally raise interest rate expectations suggests a wider strategy. By moving quickly and creating the conditions for monetary tightening, monetary policy will be a more effective weapon should downside Brexit risks crystallise.
- Our view is that the UK economy still faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. While recent economic data has improved, it has done so from a low base: UK Q4 2017 GDP growth was 0.5%, after a 0.4% expansion in Q2. Household consumption growth has softened, despite high employment and low saving rates. Housing markets are soft**. Nevertheless, we cannot disregard the MPC's forceful intent and signal in the *February Inflation* Report and accompanying commentary.**
- The depreciation in sterling is assisting the economy to rebalance away from spending. Export volumes have increased, helped by a stronger global and Eurozone economic expansions.
- Near-term global growth prospects have continued to improve and broaden, and expectations of inflation are subdued. Central banks are moving to reduce the level of monetary stimulus.
- Over the near term, Arlingclose must forecast the MPC's actions rather than the expected level of monetary policy given our assessment of the UK economy. There is clear momentum on the MPC for higher Bank Rate and this is likely to crystallise from May 2018.
- The MPC has heightened expectations of more increases in bank Rate and at a quicker pace despite only modest changes in inflation and growth forecasts, based on the bank's perceptions of impaired supply capacity and a desire to bring inflation back to target more quickly.
- Our central case is for Bank Rate to rise twice in 2018 and once more in the first half of 2019. The risks are weighted to the downside.

- Gilt yields have risen but remain historically low; current yields already incorporate higher Bank Rate expectations, so we expect little further upward movement.

	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-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	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.08**
Downside risk	0.00	-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.58**
3-month LIBID rate														
Upside risk	0.00	0.05	0.10	0.10	0.20	0.20	0.25	0.25	0.30	0.35	0.35	0.35	0.35	**0.22**
Arlingclose Central Case	**0.50**	**0.75**	**0.85**	**1.00**	**1.10**	**1.35**	**1.35**	**1.35**	**1.35**	**1.30**	**1.30**	**1.30**	**1.30**	**1.14**
Downside risk	0.00	-0.25	-0.30	-0.40	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.57**
1-yr LIBID rate														
Upside risk	0.05	0.10	0.20	0.20	0.30	0.30	0.35	0.35	0.40	0.50	0.50	0.50	0.50	**0.33**
Arlingclose Central Case	**0.70**	**0.95**	**1.10**	**1.30**	**1.40**	**1.65**	**1.65**	**1.60**	**1.55**	**1.50**	**1.50**	**1.50**	**1.50**	**1.38**
Downside risk	0.00	-0.25	-0.30	-0.40	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.57**
5-yr gilt yield														
Upside risk	0.20	0.20	0.20	0.20	0.20	0.25	0.35	0.40	0.40	0.40	0.40	0.40	0.40	**0.31**
Arlingclose Central Case	**1.15**	**1.35**	**1.40**	**1.50**	**1.55**	**1.60**	**1.65**	**1.70**	**1.70**	**1.70**	**1.65**	**1.65**	**1.65**	**1.56**
Downside risk	-0.10	-0.30	-0.35	-0.45	-0.50	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	**-0.50**
10-yr gilt yield														
Upside risk	0.15	0.20	0.20	0.20	0.25	0.25	0.35	0.35	0.40	0.40	0.40	0.40	0.40	**0.30**
Arlingclose Central Case	**1.65**	**1.80**	**1.85**	**1.90**	**2.00**	**2.05**	**2.10**	**2.15**	**2.15**	**2.15**	**2.05**	**2.05**	**2.05**	**2.00**
Downside risk	-0.10	-0.30	-0.35	-0.45	-0.50	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	**-0.50**
20-yr gilt yield														
Upside risk	0.15	0.20	0.20	0.20	0.25	0.25	0.35	0.35	0.40	0.40	0.40	0.40	0.40	**0.30**
Arlingclose Central Case	**2.00**	**2.10**	**2.15**	**2.15**	**2.20**	**2.25**	**2.25**	**2.20**	**2.15**	**2.20**	**2.20**	**2.20**	**2.20**	**2.17**
Downside risk	-0.10	-0.30	-0.35	-0.45	-0.50	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	**-0.50**
50-yr gilt yield														
Upside risk	0.15	0.20	0.20	0.20	0.25	0.25	0.35	0.35	0.40	0.40	0.40	0.40	0.40	**0.30**
Arlingclose Central Case	**1.80**	**1.95**	**2.00**	**2.00**	**2.05**	**2.10**	**2.10**	**2.05**	**2.00**	**2.05**	**2.05**	**2.05**	**2.05**	**2.02**
Downside risk	-0.10	-0.30	-0.35	-0.45	-0.50	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	**-0.50**

Appendix 2 – Existing Investment & Debt Portfolio Position

	Actual Portfolio at 31 December 2017 £m	Average Rate %
External Borrowing:		
Public Works Loan Board	57.4	3.65
Local Authorities	0.5	2.32
Total External Borrowing	**57.9**	**3.64**
Investments:		
Banks (unsecured)	6.0	0.68
Covered bonds (secured)	7.3	0.63
Local Authorities	13.0	0.59
Money Market Funds	14.4	0.37
Pooled Funds	10.4	2.75
Total Investments	**51.1**	**0.98**
Net Debt	**6.8**	

Non-Treasury Investments		
Investment Property	7.8	2.60
Shares in Subsidiaries	0.5	0.00
Loans in Subsidiaries	3.1	4.88
Total	**11.4**	**3.10**