This Report will be made public on 14 January 2020

Report Number **C/19/59**

To: **Cabinet**
Date: **22 January 2020**
Status: **Key Decision**
Head of service: **Charlotte Spendley, Director of Corporate Services**
Cabinet Member: **Councillor David Monk – Leader and Portfolio Holder for Finance**

Subject: **TREASURY MANAGEMENT STRATEGY STATEMENT 2020/21**

SUMMARY: This report sets out the proposed strategy for treasury management for 2020/21 including Treasury Management Indicators.

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

a) The Council must have regard to CIPFA's Code of Practice for Treasury Management in the Public Services when carrying out its duties under Part 1 of the Local Government Act 2003, including approving an annual Treasury Management Strategy Statement in advance of the financial year.
b) The Council's Financial Procedure Rules require an annual plan and strategy for treasury management to be approved in advance of the financial year.

RECOMMENDATIONS:

1. **To receive and note Report C/19/59.**
2. **To approve the strategy for treasury management in 2020/21 set out in the report is adopted.**
3. **To approve the Treasury Management Indicators for 2020/21 set out in the report.**

1. INTRODUCTION

1.1 Treasury management is the management of the authority's cash flows, borrowing and investments, and the associated risks. The authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the authority's treasury management strategy and its prudent financial management.

1.2 Treasury risk management at the authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires the authority to approve a treasury management strategy before the start of each financial year. This report fulfils the authority's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code. The authority's own Financial Procedure Rules also require an annual plan and strategy for treasury management to be approved in advance of the each financial year.

1.3 Investments held for service purposes or for commercial profit are considered in a different report, the Investment Strategy which Cabinet is due to consider on 19 February 2020 ahead of it being submitted to full Council for approval on the same day.

2. ECONOMIC OUTLOOK AND PROSPECT FOR INTEREST RATES

(Based on commentary supplied by the council's Treasury Adviser, Arlingclose)

2.1 Economic Background

2.1.1 The UK's progress negotiating its exit from the European Union (EU), together with its future trading arrangements, will continue to be a major influence on the authority's treasury management strategy for 2020/21. The General Election has removed some uncertainty within the market, however following the expected Withdrawal Bill, uncertainties around the future trading relationship with the EU remain.

2.1.2 GDP growth rose by 0.4% in the third quarter of 2019 from -0.2% in the previous three months with the annual rate falling further below its trend rate to 1.1% from 1.2%. Services, construction and production added positively to growth, by 0.5%, 1.2% and 0.1% respectively, while agriculture recorded a fall of 0.1%. Looking ahead, the Bank of England's Monetary Policy Report (formerly the Quarterly Inflation Report) forecasts economic growth to pick up during 2020 as Brexit-related uncertainties dissipate and provide a boost to business investment helping GDP reach 1.6% in Q4 2020, 1.8% in Q4 2021 and 2.1% in Q4 2022.

2.1.3 The headline rate of UK Consumer Price Inflation remained the same in November 2019 at 1.5% year-on-year, the same as October 2019, however continuing to fall from highs of 2.1% in July and April 2019 as accommodation services and transport continued to contribute to a level of inflation below the BOE target of 2%. Labour market data continues to be positive. The official unemployment rate continues to hold at historic lows at 3.8%, its lowest level since 1975. The 3-month average annual growth rate for pay excluding bonuses rose to 3.5% in November 2019 providing some evidence that a shortage of labour is supporting wages. However, adjusting for inflation this means real wages were only up by 0.9% in October 2019 and only likely to have a moderate impact on household spending.

2.1.4 Domestic inflationary pressures have abated, as domestic gas and electricity price freezes have taken effect until 2020. The price of oil has fallen through the year, despite a rise in prices in December 2019. The limited inflationary pressure from real wages will likely keep inflation below the Bank of England target of 2%. The Bank of England maintained Bank Rate to 0.75% in December following a 7-2 vote by the Monetary Policy Committee. Despite keeping rates on hold, MPC members did confirm that if Brexit uncertainty drags on or global growth fails to recover, they are prepared to cut interest rates as required. Moreover, the downward revisions to some of the growth projections in the Monetary Policy Report suggest the Committee may now be less convinced of the need to increase rates even if there is a Brexit deal.

2.1.5 The US economy has continued to perform relatively well compared to other developed nations; however, the Federal Reserve has started to unwind its monetary tightening through 2019. The Federal Reserve has cut rates three times to 1.5% - 1.75%, to stimulate growth as GDP growth has started to fall (to 2.1%).

2.1.6 The fallout from the US-China trade war continues which, risks contributing to a slowdown in global economic activity in 2020. Recent suggestions have been an initial compromise and potential unwinding of tariffs; however, this can change quickly. Slow growth in Europe, combined with changes in leadership at the ECB and IMF has led to a change of stance in 2019. Quantitative easing has continued and been extended.

2.2 Credit Outlook

2.2.1 The recent Bank of England stress tests assessed all seven UK banking groups. The tests scenarios include deep simultaneous recessions in the UK and global economies that are more severe overall than the global financial crisis, combined with large falls in asset prices and a separate stress of misconduct costs. All seven banks passed the test on both a CET1 ratio and a leverage ratio basis. Major banks have steadily increased their capital for many years now. However, there are a number of shortcomings in the Bank's approach; timeliness as the results are over 11 months of out date when they are published, being based on end-2018 balance sheets; ringfencing, as the tests ignore the restrictions on transferring capital between ringfenced "retail" banks and non-ringfenced "investment" banks within the larger groups and;

coverage – the tests should be expanded to cover a wider range of UK banks and building societies.

2.2.2 The Bank of England will seek to address some of these issues in 2020, when Virgin Money/Clydesdale will be added to the testing group and separate tests will be included of ringfenced banks.

2.2.3 Looking forward, the potential for a "no-deal" Brexit and/or a global recession remain the major risks facing banks and building societies in 2020/21 and a cautious approach to bank deposits remains advisable.

2.3 Interest Rate Forecast

2.3.1 The authority's treasury management adviser Arlingclose is forecasting that Bank Rate will remain at 0.75% until the end of 2022. The risks to this forecast are deemed to be weighted to the downside with the need for greater clarity on Brexit and the continuing global economic slowdown. As already mentioned above, the MPC are less convinced of the need for an interest rate rise even with an orderly exit from the EU and successful trade negotiations between the two parties.

2.3.2 Gilt yields have risen but remain at low levels and only some very modest upward movement from current levels are expected based on Arlingclose's interest rate projections. The central case is for 10-year and 20-year gilt yields to rise to around 1.00% and 1.40% respectively over the time horizon, with broadly balanced risks to both the upside and downside. However, short-term volatility arising from both economic and political events over the period is a near certainty. Detailed interest rate forecasts for both investments and borrowing are shown in appendix 1 to this report.

2.3.3 For the purpose of setting the budget, it has been assumed that new treasury management investments will be made at an average rate of 0.75%, and that new long-term loans will be borrowed at an average rate of 2%.

3. THE COUNCIL'S FORECAST BORROWING AND INVESTMENT POSITION

3.1 On 31 December 2019 the authority held £56.4m of borrowing and £32.9m of investments. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance Sheet Summary and Forecast

	31.3.19 Actual £m	31.3.20 Estimate £m	31.3.21 Forecast £m	31.3.22 Forecast £m	31.3.23 Forecast £m
General Fund CFR	11.8	12.5	14.1	14.5	15.6
HRA CFR	47.4	47.4	47.4	47.4	49.5
Investments CFR	8.6	34.1	86.5	105.8	125.1
Total CFR	**67.8**	**94.0**	**148.0**	**167.7**	**190.2**
Less: External borrowing	56.4	54.8	53.5	52.2	47.2
Internal borrowing	**11.4**	**39.2**	**94.5**	**115.5**	**143.0**
Less: Usable reserves	(51.2)	(49.8)	(38.5)	(27.9)	(23.2)
Less: Working capital	(2.4)	(4.0)	(4.0)	(4.0)	(4.0)
Treasury Investments (-) or / New Borrowing (+)	**(42.2)**	**(14.6)**	**52.0**	**83.6**	**115.8**

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 2020/21, the proposed Medium Term Capital Progamme, the HRA Business Plan and information taken from the latest approved Medium Term Financial Strategy for 2021/22 and 2022/23. The authority has an increasing CFR arising from its planned capital investment and will therefore be required to borrow up to £116m over the forecast period.

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 2020/21.

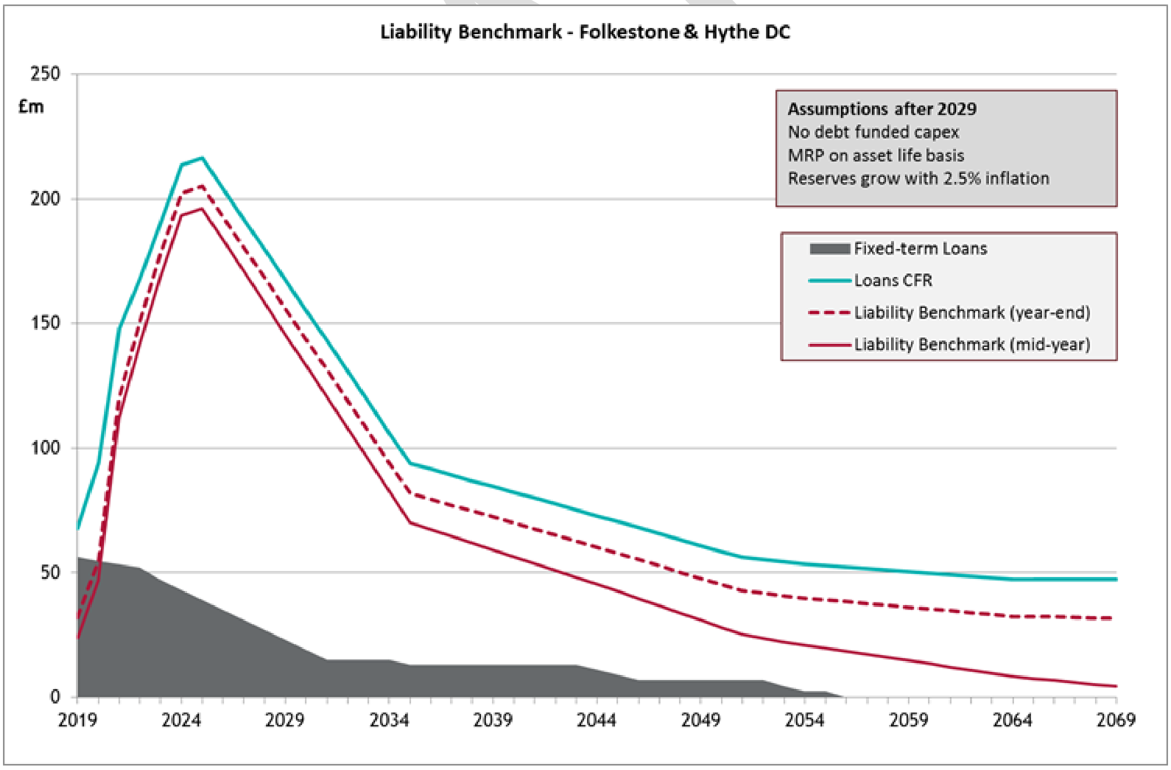
3.5 Liability Benchmark

3.5.1 To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as table 1 above, but that cash and investment balances are kept to a minimum level of £15m at each year-end, in line with strategic investment objectives.

Table 2: Liability benchmark

	31.3.19 Actual £m	31.3.20 Estimate £m	31.3.21 Forecast £m	31.3.22 Forecast £m	31.3.23 Forecast £m
CFR	67.8	94.0	148.0	167.7	190.2
Less: Usable reserves	(51.2)	(49.8)	(38.5)	(27.9)	(23.2)
Less: Working capital	(2.4)	(4.0)	(4.0)	(4.0)	(4.0)
Plus: Minimum investments	15.0	15.0	15.0	15.0	15.0
Liability Benchmark	**29.2**	**55.2**	**120.5**	**150.8**	**178.0**

3.5.2 Following on from the medium-term forecasts in table 2 above, the long-term liability benchmark assumes further capital expenditure funded by borrowing after 31 March 2023 for Otterpool Park and the HRA new build programme, minimum revenue provision on new capital expenditure based on asset life (except for Otterpool Park which assumes the borrowing to be repaid over 10 years), and income, expenditure and reserves all increasing by inflation of 2.5% a year. This is shown in the chart below:



4. BORROWING STRATEGY

4.1 The authority currently holds £56.4 million of loans as part of its strategy for funding previous years' capital programmes. The current loans are shown in appendix 2 to this report. The balance sheet forecast in table 1 shows that the authority expects to borrow up to £52m in 2020/21. The authority may however borrow to pre-fund future years' requirements, providing this does not exceed the proposed authorised limit for borrowing of £171 million for 2020/21. The authorised borrowing limit will be considered in more detail as one of the prudential indicators for capital expenditure which will be included in the Capital Strategy for 2020/21 report to Cabinet at its meeting on 19 February 2020 before going to full Council for approval on the same day.

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 2020/21 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

4.3.3 The authority has previously raised all of its long-term borrowing from the PWLB but the government increased PWLB rates by 1% in October 2019 making it now a relatively expensive option. The authority will now look to borrow any long-term loans from other sources including banks, pensions and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code.

4.3.4 Alternatively, the authority may arrange forward starting loans 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.

4.3.5 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
- any other UK public sector body
- 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:

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

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 interest rate exposure limits in the treasury management indicators below. Financial derivatives may be used to manage this interest rate risk (see section 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 2019/20 until 31 December, the authority's investment balance has ranged between £25 and £50 million with the average being £35 million. The average investment balance held is expected to reduce to around £25 million in the coming year as the council uses its reserves to meet its approved capital expenditure plans and also continues to use some of its cash balances in lieu of external borrowing (i.e. internal borrowing). The authority has about £15m invested in a range of professionally managed pooled property and diversified income funds. These are seen as longer term strategic investments which aim to provide returns in excess of inflation and have the potential for some limited capital growth, thereby helping to protect the value of the authority's cash reserves. Maintaining these pooled funds is seen as an important part of the authority's proposed investment strategy for

2020/21. The authority's current investment portfolio is shown in appendix 3 tot his report.

5.2 Objectives

5.2.1 The CIPFA Code requires the authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. 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 2020/21, 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 continue with its current strategy to diversify into more secure and/or higher yielding asset classes during 2020/21. This is especially the case for the estimated £27m that is available for longer-term investment. A significant but reducing proportion of the authority's surplus cash is currently invested in money market funds in particular, although this is likely to reduce further in 2020/21 as a result of the capital expenditure plans.

5.4 Business Models

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

5.5 Approved Counterparties

5.5.1 The authority may invest its surplus funds with any of the counterparty types in table 3 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 3: Approved Investment Counterparties and Limits for New Investments effective from 1 April 2020

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 and real estate investment trusts	£5m per fund or trust				

This table must be read in conjunction with the notes below

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

5.5.3 **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.

5.5.4 **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.

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

5.5.6 **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.

5.5.7 **Registered Providers -** Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are tightly regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

5.5.8 **Pooled Funds –** Shares or units 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.

5.5.9 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.

5.5.10 **Real estate investment trusts (REITS) -** Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties. Investments in REIT shares cannot be withdrawn but can be sold on the stock market to another investor.

5.5.11 **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.

5.6 Risk Assessment and Credit Ratings

5.6.1 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.

5.6.2 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.

5.7 Other Information on the Security of Investments

5.7.1 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 and analysis and advice from the authority's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the credit rating criteria.

5.7.2 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.

5.8 Investment Limits

5.8.1 The authority's revenue reserves available to cover investment losses are forecast to be £22 million 31st March 2020. In order that no more than 25% 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 and Registered Social Landlords	£10m in total
Unsecured investments with Building Societies	£5m in total
Loans to unrated corporates	£5m in total
Money Market Funds	£25m in total
Real estate investment trusts	£10m in total

5.9 Liquidity Management

5.9.1 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.

	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 of a 1% rise or fall in interest rates will be:

	Limit
Upper limit on one year revenue impact of a 1% **rise** in interest rates	£290,000
Upper limit on one year revenue impact of a 1% **fall** in interest rates	(£310,000)

6.5 The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates. The indicator also incorporates the impact of new borrowing forecast to support the authority's capital expenditure plans over the next 12 months.

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:

	2020/21	**2021/22**	**2022/23**
Limit on principal invested beyond year end	£15m	£5m	£5m

7. OTHER ITEMS

7.1 The CIPFA Code requires the authority to include the following 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.

7.2.4 In line with the CIPFA Code, the Authority will seek external advice and will consider that advice before entering into financial derivatives to ensure that it fully understands the implications.

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 Markets in Financial Instruments Directive

7.4.1 The authority has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the authority's treasury management activities, the Director of Corporate Services believes this to be the most appropriate status.

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	2019/20 Estimate	*2019/20 Latest Projection*	2020/21 Estimate	Variance 2019/20 to 2020/21
Revenue Budgets	£'000	£'000	£'000	£'000
Interest on Borrowing	**1,912**	*1,922*	**1,945**	**33**
HRA Element	**(1,569)**	*(1,569)*	**(1,547)**	**22**
GF Borrowing Cost	**343**	*353*	**398**	**55**
Investment income	**(713)**	*(764)*	**(635)**	**78**
HRA Element	**75**	*88*	**50**	**(25)**
GF Investment income	**(638)**	*(676)*	**(585)**	**53**
Net Cost (GF)	**(295)**	*(323)*	**(187)**	**108**

8.2 The main reason for the projected net increase in the General Fund borrowing cost of £108k in 2020/21 compared to 2019/20 is due to the impact of the borrowing being incurred to support the council's capital investment plans. It should be noted that the council is planning to adopt a capitalisation policy during 2019/20. This will mean the borrowing cost (interest) for qualifying assets being acquired or developed but not ready for use will be capitalised as a charge to the relevant capital scheme rather than be met by the General Fund. Only once the asset is ready to be used will the interest charge revert to being met by the General Fund. Notably, the interest cost for the additional £100m of prudential borrowing for the Otterpool Park scheme approved by full Council on 20 November 2019 is expected to be capitalised under this policy.

9. OTHER OPTIONS CONSIDERED

9.1 The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Director for Corporate Services, 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. 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:

PERCEIVED RISK	SERIOUSNESS	LIKELIHOOD	PREVENTATIVE ACTION
Interest Rate Risk (rates moving significantly different to expectations)	High	Medium	With an increasing borrowing requirement rising interest rates would be detrimental. The council would need to consider taking out fixed borrowing to help mitigate this risk and/or use further internal borrowing if resources are available. Falling interest rates would be broadly beneficial to the council given the increasing borrowing requirement.
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	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.

11. LEGAL/FINANCIAL AND OTHER CONTROLS/POLICY MATTERS

11.1 Legal Officer's Comments (Nicola Everden)

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. Generally the Council must take into account its fiduciary duties to local tax payers and its continuing obligation to ensure it has the funding required to perform its statutory undertakings.

11.2 Finance Officer's Comments (Lee Walker)

The report has been prepared by Finance 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 – Capital and Treasury Senior Specialist
Tel: 01303 853593 Email: lee.walker@folkestone-hythe.gov.uk

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

Arlingclose's Treasury Management Strategy Statement Template 2020/21
Appendicies
Appendix 1 – Arlingclose Interest Rate Forecast
Appendix 2 – Borrowing portfolio at 31 December 2019
Appendix 3 – Investment portfolio at 31 December 2019

Appendix 1 – Arlingclose Interest Rate Forecast December 2019

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.21**
Arlingclose Central Case	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**
Downside risk	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.73**
3-month money market rate														
Upside risk	0.10	0.10	0.25	0.25	0.25	0.25	0.25	0.25	0.30	0.30	0.30	0.30	0.30	**0.25**
Arlingclose Central Case	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**
Downside risk	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.73**
1yr money market rate														
Upside risk	0.10	0.20	0.20	0.20	0.20	0.20	0.20	0.25	0.30	0.30	0.30	0.30	0.30	**0.23**
Arlingclose Central Case	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**
Downside risk	-0.30	-0.50	-0.55	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	**-0.60**
5yr gilt yield														
Upside risk	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.45	0.45	0.45	**0.37**
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.55**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.57**
Downside risk	-0.35	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	**-0.56**
10yr gilt yield														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	**0.37**
Arlingclose Central Case	**0.75**	**0.75**	**0.80**	**0.80**	**0.85**	**0.85**	**0.90**	**0.90**	**0.95**	**0.95**	**1.00**	**1.00**	**1.00**	**0.88**
Downside risk	-0.40	-0.40	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	**-0.45**
20yr gilt yield														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	**0.37**
Arlingclose Central Case	**1.20**	**1.20**	**1.25**	**1.25**	**1.25**	**1.30**	**1.30**	**1.30**	**1.35**	**1.35**	**1.35**	**1.40**	**1.40**	**1.30**
Downside risk	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	**-0.45**
50yr gilt yield														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	**0.37**
Arlingclose Central Case	**1.20**	**1.20**	**1.25**	**1.25**	**1.25**	**1.30**	**1.30**	**1.30**	**1.35**	**1.35**	**1.35**	**1.40**	**1.40**	**1.30**
Downside risk	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	**-0.45**

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 1.80%

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

Appendix 2 – Borrowing Portfolio at 31 December 2019

Folkestone and Hythe District Council Itemised Borrowing at 31 December 2019

Lender	Loan No	Loan Type	Repayment Method	Interest Payment Frequency	Maturity Date	Principal Outstanding 31/03/2019	Movement	Principal Outstanding 31/12/2019	Interest Rate
						£	£	£	%
Public Works Loan Board	430141	Fixed	Annuity	Half Yearly	01/11/2033	4,010	-110	3,900	11.38
Public Works Loan Board	480111	Fixed	Maturity	Half Yearly	31/03/2023	1,000,000	0	1,000,000	6.63
Public Works Loan Board	488942	Fixed	Maturity	Half Yearly	07/08/2034	2,000,000	0	2,000,000	4.80
Public Works Loan Board	492233	Fixed	Maturity	Half Yearly	15/03/2054	2,000,000	0	2,000,000	4.05
Public Works Loan Board	493698	Fixed	Maturity	Half Yearly	07/08/2055	2,500,000	0	2,500,000	4.55
Public Works Loan Board	493914	Fixed	Maturity	Half Yearly	07/02/2053	2,500,000	0	2,500,000	4.55
Public Works Loan Board	494027	Fixed	Maturity	Half Yearly	15/03/2044	2,000,000	0	2,000,000	4.65
Public Works Loan Board	494028	Fixed	Maturity	Half Yearly	15/03/2045	2,000,000	0	2,000,000	4.65
Public Works Loan Board	494029	Fixed	Maturity	Half Yearly	15/03/2046	2,141,190	0	2,141,190	4.65
Public Works Loan Board	500536	Fixed	Maturity	Half Yearly	28/03/2023	4,000,000	0	4,000,000	2.56
Public Works Loan Board	500537	Fixed	Maturity	Half Yearly	28/03/2031	4,010,000	0	4,010,000	3.26
Public Works Loan Board	500538	Fixed	Maturity	Half Yearly	28/03/2028	4,000,000	0	4,000,000	3.08
Public Works Loan Board	500540	Fixed	Maturity	Half Yearly	28/03/2025	4,000,000	0	4,000,000	2.82
Public Works Loan Board	500541	Fixed	Maturity	Half Yearly	28/03/2029	4,000,000	0	4,000,000	3.15
Public Works Loan Board	500542	Fixed	Maturity	Half Yearly	28/03/2030	4,000,000	0	4,000,000	3.21
Public Works Loan Board	500543	Fixed	Maturity	Half Yearly	28/03/2027	4,000,000	0	4,000,000	3.01
Public Works Loan Board	500544	Fixed	Maturity	Half Yearly	28/03/2021	1,300,000	0	1,300,000	2.21
Public Works Loan Board	500545	Fixed	Maturity	Half Yearly	28/03/2022	1,300,000	0	1,300,000	2.40
Public Works Loan Board	500546	Fixed	Maturity	Half Yearly	28/03/2024	4,000,000	0	4,000,000	2.70
Public Works Loan Board	500547	Fixed	Maturity	Half Yearly	28/03/2020	1,100,000	0	1,100,000	1.99
Public Works Loan Board	500548	Fixed	Maturity	Half Yearly	28/03/2026	4,000,000	0	4,000,000	2.92
Total - Public Works Loan Board						55,855,200	-110	55,855,090	
Folkestone Town Council	n/a	Variable	Call Notice - 2 days	Half Yearly	n/a	500,000	0	500,000	0.50
Total - All Borrowing						**56,355,200**	**-110**	**56,355,090**	

Appendix 3 – Investment Portfolio at 31 December 2019

Category and Counterparty	Amount or Value £	Terms	Interest Rate or Yield %
Covered Bonds (Secured)			
Royal Bank of Scotland	1,000,257	Covered floating rate note to 15/05/2020	1.03
Royal Bank of Scotland	2,501,470	Covered floating rate note to 15/05/2020	1.03
Money Market Funds			
Aberdeen Standard MMF	4,740,000	No notice instant access	0.74
Goldman Sachs MMF	1,310,000	No notice instant access	0.68
Legal and General MMF	2,760,000	No notice instant access	0.72
Federated MMF	5,000,000	No notice instant access	0.73
Other Pooled Funds			
Commercial Property Funds			
CCLA Property Fund	5,432,067		4.38*
Multi-Asset Income Funds			
CCLA Diversified Income Fund	2,021,951		3.41
UBS Multi-Asset Income Fund	1,006,325		4.88
Kames Diversified Monthly Income Fund	3,589,046		5.27
Investec Diversified Income Fund	3,505,659		4.56
Total Investments	**32,866,775**		2.53
* Net of Fees			