Report to Audit Committee

Date of meeting 13 December 2017

By the Director of Corporate Resources

DECISION REQUIRED

Not exempt

Treasury Management Strategy 2018/19

Executive Summary

This report is a statutory requirement setting the strategy for treasury management and specific treasury management indicators for the financial year 2018/19. The strategy is set against the context of the projected interest rates and the Council's capital spend.

The new strategy leaves investment criteria and limits largely unchanged as investments are expected to fall and some borrowing is envisaged. CIPFA and the DCLG are reviewing and consulting on the regulatory background to this strategy that may change it significantly. The results of this are expected in the next few months but are not yet finalised, so this report is based on the existing regulations.

Recommendations

The Committee is recommended to recommend that the full Council:

i) approve the Treasury Management Strategy for 2018/19.

ii) approve the Treasury Management Indicators for 2018/19.

Reasons for Recommendations

i) The Council has adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year.

ii) The Department for Communities and Local Government (DCLG) issued revised guidance on local authority investments in March 2010 that requires the Council to approve an investment strategy before the start of each financial year.

Background Paper
"Medium Term Financial Strategy 2018/19 to 2021/22" – Cabinet 23 November 2017

Consultation: Arlingclose Limited
Wards affected: All
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Background Information

1 Introduction

The purpose of this report

1.1 The Council has significant investments and borrowing which bring with them financial risks including the loss of invested funds and the revenue effect of changing interest rates. It therefore requires an overall strategy as well as sets of practices and procedures to identify, monitor and control those risks. There is a body of statute and other regulation that lays down what a strategy should do. This report sets out a Treasury Management Strategy for 2018/19 that fulfils the legal requirement and provides a workable framework for day-to-day operations.

2 Background

Economic background

2.1 The Council's Treasury Management Strategy must take account of expectations for the economy and specifically the finance sector. The Council receives advice on this from Arlingclose Ltd and Appendix A is a commentary by them on the economic background, the outlook for creditworthiness and interest rates.

2.2 The forecast for the Bank Rate is that it remains at 0.50%. For the purpose of the budget any new investments are estimated to be on or about the Bank Rate.

2.3 The treasury management environment remains difficult with yields and quality counterparties remaining reduced in the aftermath of the financial crisis of 2008 with no return to pre-crisis rates envisaged in the medium term. Governments and regulators have put in place measures prompted by the crisis that restrict any government bail-out of individual financial institutions exposing the Council to participate in a bail-in if has invested in an affected institution.

Statutory background

2.4 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the Department for Communities and Local Government (DCLG) Guidance that requires the Council to approve an investment strategy before the start of each financial year.

2.5 The regulatory background is complicated by the current revision by both CIPFA and DCLG of their codes and guidance on treasury management and prudential indicators. The Council must have regard to both sets of codes and guidance. The expectation is that the final CIPFA codes will only be available in late December and DCLG guidance in late January. These dates are not guaranteed and the timing relative to the Council's meetings dealing with 2018/19 is problematic. The background to possible changes to the regulations is further explained in Appendix B. The Director of Corporate Resources will monitor the situation and bring an updated strategy to the Council if needed.

Relevant Council policy

2.6 In February 2012 the Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition (the CIPFA Code) which requires the Council to approve a Treasury Management Strategy before the start of each financial year.

2.7 The existing Treasury Management Strategy 2017/18 was approved by the Council on 15 February 2017 having been approved by this Committee on 4 January 2017.

3 Current and Position and Projection

3.1 The Council's treasury portfolio at the end of November 2017 was:

	Principal £m	Average Interest Rate %
Call accounts	0.8	0.05
Money Market Funds	22.9	0.51
Short-term deposits	3.0	0.45
Long-term deposits	5.8	1.58
Pooled Funds	15.9	3.90
Total Investments	**48.4**	**1.74**
Long-term PWLB loans	4.0	3.38
Short term borrowing	0	0
Total Borrowing	**4.0**	**3.38**
Net Investments	**45.1**	**1.59**

3.2 The current cash balances are reducing from the high levels of last year. Last year the comparative figure for total net investments was £48m. However, bearing in mind the spend on the Forum Retail Units it is healthier than we might have expected. At the time of the purchase there was some temporary short term borrowing to ensure the £15m of cash was available for the purchase but that has since been repaid. That said the rest of 2017/18 should see significant outflows as the capital spend on the Bridge Leisure centre and the new waste and recycling fleet add to the usual net outflow of cash in the latter end of a financial year as tax income slows while precept and other outflows do not reduce to the same degree.

3.3 The table shows that pooled funds, other than money market funds, which were a new introduction for 2016/17, have produced a step up in yields. The return from them exceeds other classes of investment but the volatility of their capital value means they are regarded as a longer term investment. At the end of October 2017 the pooled funds showed at small overall gain of £18,400. The month before that was a £39,300 capital loss which demonstrates some of the volatility in the fund values.

3.4 At the strategic level, treasury management works within the context of the Council's balance sheet and how much cash it represents. Below is the current projected analysis of the balance sheet to illustrate the trajectory of the Council's funds. It should be noted that the end of year cash balances are usually the low points in the year.

All figures at year-end £m	**Actual 16/17**	**Estimate 17/18**	**Estimate 18/19**	**Estimate 19/20**	**Estimate 20/21**
CFR	16.0	30.4	38.9	39.0	38.0
Less external borrowing	4.0	4.0	9.0	5.0	5.0
Internal borrowing	12.0	26.4	29.9	34.0	33.0
Useable reserves, receipts, contributions held	52.4	48.6	43.3	47.7	52.2
Working capital/other balance.	8.6	6.7	6.2	5.8	5.8
Estimated Investments	49.0	28.9	19.6	19.5	25.0

3.5 The projection includes capital spend approved to date and an estimate of new bids for 2018/19 and will be revised as the budget is finalised and a revised table will accompany the final Budget Report 2018/19. The use of reserves is in line with the Medium Term Financial Strategy report to the Cabinet of 23 November 2017. The same risks mentioned in that report especially around future New Homes Bonus payments apply to this projection. The projections also include a continued flow through the Council of developer contributions.

3.6 The Council can finance some of its capital programme from capital receipts and other resources but will not finance the whole programme. This gives rise to an underlying need to borrow for capital purposes which is measured by the Capital Financing Requirement (CFR). Up to this point the Council's strategy has been to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. With the large increases in the CFR in the next two years due to the estimated capital programme it is judged that it may well be necessary to supplement internal borrowing with some external borrowing and the above table assumes £5m of long term borrowing in 2018/19. This leaves the council with significant investment balances but can be seen as a reasonable balance between running down investments and borrowing.

3.7 CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. The table shows borrowing will be well under the CFR so the Council expects to comply with this recommendation during 2018/19.

4 Borrowing Strategy

4.1 The Council currently holds a £4m long-term Public Works Loan Board (PWLB) loan, as it did in the previous year, as part of its strategy for funding previous years' capital programmes. The Council's capital financing requirement (CFR, or underlying need to borrow for capital purposes) as at 31 March 2018 is expected to be £30.4m, and is forecast to rise to £38.9m by March 2019 as capital expenditure is incurred.

4.2 The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. With short-term interest rates lower than long-term borrowing rates, the Council has felt it was more cost effective in the short-term to use internal resources. Effectively the Council has borrowed from its own internal funds; sometimes termed internal borrowing.

4.3 The Council has so far only borrowed externally following its first unfinanced project of Steyning Health Centre in 2005 (refinanced in 2009). The underlying need to borrow has been increasing with the projects requiring funding. As stated above although investment balances do not entirely disappear in the projection there is £5m of external borrowing planned for the year. This planned amount will not, of course, bind the Council's actual borrowing decision which will be made by the Director of Corporate Resources during the year weighing up interest rate projections against the latest capital plans.

4.4 The alternative to long term external borrowing would be to rely on internal or short-term external borrowing. This would have the risk of incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis.

4.5 The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board 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 West Sussex County Council Pension Fund)
- Capital market bond investors
- UK Municipal Bond Agency and other special purpose companies created to enable joint local authority bond issues.

4.6 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

4.7 The Council has previously raised its long-term borrowing from the PWLB, but it will, if required, investigate other sources of finance amongst the sources listed above, that may be available at more favourable rates.

4.8 **Municipal Bonds Agency:** UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a joint and several guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

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

4.10 **Debt Rescheduling:** The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall saving or reduction in risk.

5 Investment Strategy

5.1 The Council holds significant funds, representing income received in advance of expenditure plus balances and reserves held. In the past year, the Council's total investments have ranged between £40m and £67m, and although the level of reserves is expected to reduce in the longer term, there will still be significant short to medium-term cash flow surpluses leading to larger sums being held than the core reserves of the Council would indicate. The current projections show year-end balances around £20m for the next three years.

5.2 Both the CIPFA Code and the DCLG Guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council 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.

5.3 Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to diversify into more secure and/or higher yielding asset classes during 2018/19. This is especially the case for the cash balances that are available for longer-term investment. This diversification will represent a continuation of the present strategy.

5.4 The Council may invest its surplus funds with any of the counterparty types in the table below; subject to the cash limits (per counterparty) and the time limits shown (these are unchanged from 2017/18 strategy):

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporate	Registered Providers
AAA	*£2.5m 5 years*	*£4m 20 years*	*£4m 50 years*	*£2.5m 10 years*	*£4m 20 years*
AA+	*£2.5m 5 years*	*£4m 10 years*	*£4m 25 years*	*£2.5m 7 years*	*£4m 10 years*
AA	*£2.5m 4 years*	*£4m 5 years*	*£4m 15 years*	*£2.5m 5 years*	*£4m 10 years*
AA-	*£2.5m 3 years*	*£4m 4 years*	*£4m 10 years*	*£2.5m 4 years*	*£4m 10 years*
A+	*£2.5m 2 years*	*£4m 3 years*	*£4m 5 years*	*£2.5m 3 years*	*£4m 5 years*
A	*£2.5m 13 mons*	*£4m 2 years*	*£4m 5 years*	*£2.5m 2 years*	*£4m 5 years*
A-	*£2.5m 6 mons*	*£4m 13 months*	*£4m 5 years*	*£2.5m 1 year*	*£4m 5 years*
None	*£1m 6 months*	*n/a*	*n/a*	*£50,000 5 years*	*£2m 1 year*
UK Govt	*Central government £unlimited 50 years UK Local Authority £4m 10 years*				
Pooled funds	*£5m per Fund*				

This table must be read in conjunction with the notes below.

5.5 **Credit Rating**: Investment limits are set with 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.

5.6 **Banks Unsecured**: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

5.7 **Banks Secured**: Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest 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.

5.8 **Building Societies:** Although the regulation of building societies is no longer any different to that of banks the Council takes additional comfort from building societies' business model. The Council will therefore consider investing with unrated building societies where independent credit analysis shows them to be suitably creditworthy. A minimum asset size of £250m applies and limits of £1m per Society and £8m in total apply for unrated societies.

5.9 **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 and with a UK local government body up to £4m for up to 10 years.

5.10 **Corporates**: Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made either following an external credit assessment or to a maximum of £50,000 per company as part of a diversified pool in order to spread the risk widely.

5.11 **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.

5.12 **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.

5.13 Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly. These types of funds were introduced in 2016/17 and are subject to their own specific limits which remain unchanged in the coming year.

5.14 **Operational bank accounts:** The Council may incur exposure though its current accounts 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 still subject to the risk of a bank bail-in. Balances will be kept as low as possible without affecting operations. 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 Council maintaining operational continuity. The Council currently banks with NatWest rated BBB+.

5.15 **Long Term investments**: Alongside pooled funds the Council may use long term investments when they are appropriately secure over the term of the investment. Currently the balance between security and yield is not thought to make this type of investment superior to pooled funds but there may be suitable investments so the Council sets a limit of £12m on the total long term (over a year) investments.

5.16 **Risk Assessment and Credit Ratings**: Credit ratings are monitored by the Council's treasury advisors, 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 ended 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.

5.17 Where a credit rating agency announces that a 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 no investments other than call investments 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.

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

5.19 When financial market conditions affect the creditworthiness of all organisations, as in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments. If these restrictions mean that no commercial organisations of "high credit quality" are available, then the Council will use the UK Government or other local authorities although this will cause a reduction in the level of investment income earned.

Specified and Non-specified Investments

5.20 The DCLG Guidance, that the Council have regard to under statute, uses the terms "specified" and "non-specified" investments. The guidance defines specified investments as:

- 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".

5.21 The Council defines “high credit quality” organisations and securities as those having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher. For money market funds and other pooled funds “high credit quality” is defined as those having a credit rating of A- or higher.

5.22 Any investment not meeting the definition of a specified investment is classed as “non-specified”. The Council does not intend to make any investments 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”. The limits on “non-specified” investments are:

Non-Specified Investment Limits	Cash limit
Total long-term investments	£12m
Total investments without credit ratings or rated below A- (except UK Government and local authorities)	£28m
Total investments with institutions domiciled in foreign countries rated below AA+	£10m
Total “Non-specified”	£50m

Investment limits

5.23 In order that to reduce 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 £4m. A group of banks under the same ownership funds will be treated as a single organisation for limit purposes. Limits will also be placed on pooled funds, 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. The limits are:

	Cash limit
Any single organisation, except the UK Central Government	£4m each
UK Central Government	Unlimited
Any group of organisations under the same ownership	£4m per group
Any group of pooled funds under the same management	£10m per manager
Money Market Funds	£30m in total
Pooled Bond fund with rating Minimum AA	£15m in total
Property Invested Pooled Fund	£5m in total
Other Pooled Funds incl. Equity, Unrated Bond Funds, Diversified assets funds.	£12m in total
Negotiable instruments held in a broker’s nominee account	£20m per broker
Foreign countries	£10m per country
Registered Providers	£8m in total
Unsecured investments with Building Societies	£8m in total

Cash flow management

5.24 The Council's officers maintain a detailed cash flow forecast for each coming year revising it as more information is available. This informs the short term investments such as those to cover precept payments. The forecast is compiled on a prudent basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Long term investment strategy is based on the Council's medium term financial strategy.

Non-Treasury Investments

5.25 Although not classed as treasury management activities and therefore not covered by the CIPFA Code or the DCLG Guidance, the Council may also purchase property for investment purposes and may also make loans and investments for service purposes. Such loans and investments will be subject to the Council's normal approval processes for revenue and capital expenditure and need not comply with this treasury management strategy. The prospective changes in CIPFA Codes and the DCLG Guidance imply these investments will be included in future annual investment strategies although exactly what detail is required is not certain until final versions are published. When the final versions are available a revised report including the extra detail may be required. To give some context the Council's existing non-treasury investments are mostly its commercial properties which at the last valuations totalled around £50m.

6 Treasury Management Indicators

Security benchmark: average credit rating

6.1 The Council 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. The benchmark for 2018/19 will be an average credit rating of A which is one notch up from last year.

Liquidity benchmark

6.2 The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing. The liquidity benchmark for 2018/19 is an amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing. For 2018/19 the benchmark amount available will be £3m.

Yield benchmark

6.3 The Council has adopted the voluntary yield benchmark of the 7 day London Interbank bid rate.

Interest rate exposures

6.4 This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as an amount of net principal borrowed are shown below. Fixed rate investments and borrowings are defined here as those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate. Investments count as negative borrowing.

	2018/19	2019/20	2020/21
Upper limit on fixed interest rate exposures	£15m	£15m	£15m
Upper limit on variable interest rate exposures	£0m	£0m	£0m

Maturity structure of borrowing

6.5 This indicator is set to control the Council's exposure to refinancing risk and is really most useful for councils with a portfolio of loans. The upper and lower limits on the maturity structure of fixed rate borrowing are shown below. The Council only has one such debt at present and envisages only one more in 2018/19 so will set limits to allow flexibility of term and maturity date for any new borrowing.

	Upper	Lower
Under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within five years	100%	0%
Five years and within 10 years	100%	0%
10 years and above	100%	0%

Principal sums invested for periods longer than 364 days

6.6 The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2018/19	2019/20	2020/21
Limit on investment over a year	£12m	£12m	£12m

7 **Other Treasury Management issues**

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

Policy on use of financial derivatives

7.2 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).

7.3 The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they clearly reduce the overall level of risk. 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.

7.4 Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

Treasury Management advisors

7.5 The Council's treasury management advisor is Arlingclose Limited. Arlingclose provide advice and information on the Council's investment, borrowing and capital financing activities. However, responsibility for final decision making remains with the Council and its officers. The quality of service will be monitored by the Director of Corporate Resource and officers using the services. The Director of Corporate Resources and the Head of Finance meet with a representative of the advisor at least twice a year.

Staff training

7.6 The needs of the Council's treasury management staff for training in investment management are assessed regularly as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by Arlingclose, CIPFA and other expert bodies. Staff are also encouraged to study relevant professional qualifications.

Investment of money borrowed in advance of need

7.7 The Council may, from time to time, borrow in advance of spending need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

7.8 The total borrowed will not exceed the authorised borrowing limit which is £15m. The maximum period between borrowing and expenditure is expected to be two years, although the Council does not link loans with items of expenditure.

8 Other courses of action considered but rejected

8.1 The DCLG Investment Guidance and the CIPFA Code of Practice do not prescribe any particular treasury management strategy for local authorities to adopt. Having consulted the Cabinet Member for Finance and Assets, 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 will 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 will be smaller
Borrow additional sums at long-term fixed interest rates using less internal funds	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

9 Staffing consequences

9.1 There are no staffing consequences apart from the need for appropriate training set out in paragraph 7.6.

10 Financial consequences

10 .1 The budget for investment income in 2018/19 is £0.70m (2017/18 £0.59m), based on an average investment portfolio of £24m at an interest rate of 2.9%. The budget for debt interest paid in 2018/19 is £0.19m, based on a projected average debt portfolio of £7m at an average interest rate of 2.7%.

11 Other considerations

11.1 Risks such as security of funds, liquidity, and interest rate risk are considered in the report. There are no consequences of any action proposed in respect of Crime & Disorder; Human Rights; Equality & Diversity and Sustainability.

Appendix A Economic background and interest rate forecast

Economic background

The major external influence on the Council's treasury management strategy for 2018/19 will be the UK's progress in negotiating a smooth 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 subdued throughout 2018/19.

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.

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.

Credit outlook

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.

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 ring-fence their retail banking functions into separate legal entities during 2018. It's unclear how these changes will impact upon the credit strength of the residual legal entities.

The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Council; returns from cash deposits however remain very low.

Interest rate forecast

The Council's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.50% during 2018/19, following the rise from the historic low of 0.25%. The Monetary Policy Committee re-emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

Future expectations for higher short term interest rates are subdued and on-going decisions remain data dependent and negotiations on exiting the EU cast a shadow over monetary policy decisions. The risks to Arlingclose's forecast are broadly balanced on both sides. 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.

Below is a more detailed interest rate forecast provided by Arlingclose.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.19**
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	0.50
Downside risk	0.00	0.00	0.00	0.00	0.00	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	**-0.15**
3-month LIBID rate														
Upside risk	0.10	0.10	0.10	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.22**
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	0.50
Downside risk	-0.10	-0.10	-0.15	-0.15	-0.15	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	**-0.20**
1-yr LIBID rate														
Upside risk	0.15	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	**0.27**
Arlingclose Central Case	**0.70**	**0.70**	**0.70**	**0.70**	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	**0.80**	0.77
Downside risk	-0.15	-0.20	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.15	-0.15	**-0.26**
5-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	**0.32**
Arlingclose Central Case	**0.75**	**0.75**	**0.80**	**0.80**	**0.80**	**0.85**	**0.90**	**0.90**	**0.95**	**0.95**	**1.00**	**1.05**	**1.10**	0.89
Downside risk	-0.20	-0.20	-0.25	-0.25	-0.25	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	**-0.33**
10-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	**0.32**
Arlingclose Central Case	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.30**	**1.30**	**1.35**	**1.40**	**1.45**	**1.50**	**1.55**	**1.55**	1.36
Downside risk	-0.20	-0.25	-0.25	-0.25	-0.25	-0.30	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	**-0.33**
20-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	**0.32**
Arlingclose Central Case	**1.85**	**1.85**	**1.85**	**1.85**	**1.85**	**1.90**	**1.90**	**1.95**	**1.95**	**2.00**	**2.05**	**2.05**	**2.05**	1.93
Downside risk	-0.20	-0.30	-0.25	-0.25	-0.30	-0.35	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	**-0.38**
50-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	**0.32**
Arlingclose Central Case	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**	**1.75**	**1.80**	**1.85**	**1.90**	**1.95**	**1.95**	**1.95**	**1.95**	1.82
Downside risk	-0.30	-0.30	-0.25	-0.25	-0.30	-0.35	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	**-0.39**

Appendix B Changes to codes and guidance relating to treasury management

CIPFA Codes

CIPFA is reviewing both the Prudential Indicator and Treasury Management Codes and will be issuing the new codes in late December. CIPFA has stated the time was right for a general review of the Codes and at the same time has reacted to discussions about concerns that local authorities have greatly increased investments in properties and were using increased borrowing to fund this and this should be subject to the same framework as traditional treasury management.

The consultation suggested a new ‘capital strategy’ including the capital spending plans overall approach to investment and borrowing and the government's arrangements to be approved by the full Council allowing more detailed strategy to be delegated by the Council to another committee..

Significantly the new suggested Codes bring a wider set of investments into the annual strategy including commercial property investments. It asks local authorities to make clear its process of governance and analysis of potential investments.

DCLG guidance

Department for Communities and Local Government (DCLG) issued revised guidance on local authority investments in March 2010. DCLG is now consulting on new guidance with a deadline of late December 2017 and will issue final guidance by late January 2018. The DLCG has also expressed concerns that local authorities were funding increased investments in properties with increased borrowing and have suggested changes to make this more transparent.