Report to Audit Committee

Date of meeting 4 January 2017
By the Director of Corporate Resources
DECISION REQUIRED

Not exempt

Horsham District Council

Treasury Management Strategy 2017/18

Executive Summary

This report is an annual statutory requirement setting the strategy for treasury management and specific treasury management indicators for the financial year 2017/18. The strategy is set against the context of the projected interest rates and the Council's capital spend.

The new strategy changes some of the limits for pooled funds as set out in paragraph 5.26 but otherwise continues the current strategy.

Recommendations

The Committee is recommended to recommend that the full Council:

i) approve the Treasury Management Strategy for 2017/18.

ii) approve the Treasury Management Indicators for 2017/18.

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 (CLG) 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.

Consultation: Arlingclose Limited
Wards affected: All
Contact: Julian Olszowka, Group Accountant, Technical, ext 5310

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 2017/18 that fulfils 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 expectation of the general economy. The Council receives advice on this from Arlingclose Ltd and Appendix 1 is a commentary by them on the economic background.

2.2 The forecast for the Bank Rate is that it remains at 0.25%. 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. Governments and regulators have put in place measures prompted by the crisis that restrict any government bail-out of individual financial institutions. This year's strategy continues an approach less reliant on single institutions and their credit rating and more reliant on diversification.

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 Guidance.

Relevant Government policy

2.5 The Department for Communities and Local Government (CLG) 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.

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 2016/17 was approved by the Council on 24 February 2016 having been approved by this Committee on 6th January 2016. It was modified by the Council on 9 October 2016 based on a recommendation agreed by this Committee on 13 September 2016. The modifications increased limits on long term investments and pooled funds.

3 Current and Position and Projection

3.1 The Council's treasury portfolio at 30th November 2016 was:

Type of investment or borrowing	Principal £m	Interest Rate % Average
Call accounts	0.7	0.25
Money market funds	22.4	0.64
Short-term deposits	12.9	0.63
Long-term deposits	5.8	1.57
Pooled funds	10.0	4.35*
Total Investments	**51.8**	**1.45**
Long-term PWLB loans	4.0	3.38
Total Borrowing	**4.0**	**3.38**
Net Investments	**47.8**	**1.29**

*Rates used are last full year

3.2 The current cash balances are at their highest level since the mid 2000's. For example, last year the comparative figure for total investments was £36m. The Council's reserves and other balances have been added to by large inflows of Affordable Housing payments. Although much of this cash will eventually flow out, this will take some time. In the meantime other inflows from further developments may well happen.

3.3 Members will recall that pooled funds, other than money market funds, were a new introduction for 2016/17. 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.

3.4 As at the end of November 2016, the capital loss from the new pooled funds was £293,300. However, of that £255,200 relates to a property fund. The majority of the property fund loss is the result of the bid-offer spread inherent in property investments with a small element being a devaluation following from the Brexit vote. The bid-offer spread reflects the costs incurred by the fund manager when buying and selling property, particularly stamp duty land tax at 5%. The expectation is that this loss will be made good over the longer term as valuations increase with growing rents.

3.5 Any capital loss should be seen in context of the increased yield from pooled funds. The pooled funds the Council currently hold yield about 3% more that the next highest yielding investments the Council can currently access. The extra income from current £10m limit of pooled funds would be about £300,000 per annum.

3.6 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. The projection will be revised as the budget is finalised and a revised table will accompany the final Budget Report 2017/18.

All figures at year-end £m	**Actual 15/16**	**Estimate 16/17**	**Estimate 17/18**	**Estimate 18/19**	**Estimate 19/20**
CFR	13.2	15.9	30.3	29.2	30.6
Less external borrowing	4.0	4.0	4.0	4.0	0
Internal borrowing	9.2	11.9	26.3	25.2	30.6
Useable reserves, receipts, contributions held	35.2	47.4	50.6	52.4	54.8
Working capital/other balance.	5.7	4.7	4.7	4.7	4.7
Estimated Investments	31.7	40.2	29.0	31.9	28.9

3.7 Any projection involves a number of assumptions and the projection above has the following significant assumptions:

- The capital programme within the 2017/18 budget is approved
- New Homes Bonus payments will continue although at a reduced level
- The Council will balance its revenue budget
- A prudent estimate of developer payments in the next five years
- Affordable Housing spend is within the Council's long term capital programme

3.8 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. Although there is an increasing CFR due to the capital programme it is judged this can continue due to the internal resources available.

3.9 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. The table above shows that the Council expects to comply with this recommendation during 2017/18.

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 31st March 2017 is expected to be £15.9m, and is forecast to rise to £30.3m by March 2018 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 as the number of projects requiring funding are increasing in number and size. On balance the projections suggest healthy cash balances so there is no need for long term external borrowing in the medium term.

4.4 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.

4.5 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

4.6 The Council has previously raised its long-term borrowing from the PWLB, but it will, if required, investigate other sources of finance, such as local authority loans and bank loans, that may be available at more favourable rates.

4.7 In addition to any long-term borrowing, the Council may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages.

4.8 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.

4.9 **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 although this is not expected in the medium term.

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 £32m and £58m, 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 of at least £28m for the next four years.

5.2 Both the CIPFA Code and the CLG 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.

5.3 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:

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
BBB+	£2.5m 100 days	£2.5m 6 months	£4m 2 years	£1m 6 months	£2.5m 2 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.

5.4 **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.

5.5 **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. Unsecured investment with banks rated BBB will be restricted to overnight deposits at the Council's current account bank NatWest plc which is currently rated at BBB+.

5.6 **Building Societies:** Although the regulation of building societies is no longer any different to that of banks the Council takes additional comfort from the 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 is used to avoid investment with very small societies. Limits of £1m per Society and £8m in total apply for unrated societies.

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 **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.

5.9 **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.

5.10 **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.

5.11 **Pooled Funds - Money Market Funds**: These funds are pooled investment vehicles consisting of money market deposits and similar instruments. They have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Council.

5.12 Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts, while funds whose value changes (termed variable net asset value) with market prices and/or have a notice period will be used for longer investment periods.

5.13 **Pooled Funds – other than Money Market Funds**: Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares, corporate bonds 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.

5.14 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. Capital values are "marked to market" and so are volatile although the volatility will not affect the revenue account until the investment is sold.

5.15 The wider use of pooled funds was introduced in last year's strategy and the limits were increased in the year. The limits this year are an attempt to develop the use of this type of fund, which has provided a step change in returns, while recognising the risk of the volatility of capital values. A wider discussion of pooled funds and rationale behind the new limits is discussed in Appendix 2. The new limits seek to balance capital volatility, liquidity and yield. They are set in the context of the projections in paragraph 3.6 above.

5.16 The categories for investment above have been reviewed in consultation with Arlingclose in response to the post financial crisis environment. The emphasis has shifted from unsecured bank investments to other sectors and diversified investments. Where banks are used the strategy makes a distinction between secured investments where a bank failure would be covered to a large extent.

5.17 **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 maintains its limit of £12m on the total long term (over a year) investments.

5.18 **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.

5.19 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.

5.20 **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.

5.21 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 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, then the surplus cash balances will be deposited with 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

5.22 The CLG Guidance, that the Council must follow, 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".

5.23 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.

5.24 Any investment not meeting the definition of a specified investment is classed as "non-specified". The Council does not intend to make any investments denominated in foreign currencies, nor any with low credit quality bodies, nor any that are defined as capital expenditure by legislation, such as company shares.

5.25 "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 shown below.

Non-Specified Investment Limits	Cash limit
Total long-term investments	£12m
Total investments without credit ratings or rated below A-	£30m
Total investments with institutions domiciled in foreign countries rated below AA+	£10m
Total "Non-specified"	£52m

Investment limits

5.26 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.

	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

*Modified or new limit explained in 5.13 to 5.15 above and Appendix 2

Cash flow management

5.27 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 plan.

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 2017/18 will be an average credit rating of A-.

Liquidity benchmark

6.2 The liquidity benchmark for 2017/18 is an amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing. For 2017/18 the benchmark amount available will be £3m.

Yield benchmark

6.3 The yield benchmark will remain at 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.

	2017/18	2018/19	2019/20
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. 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 may have another so will set limits to allow the flexibility to change the terms and maturity date as it sees fit.

	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:

	2017/18	2018/19	2019/20
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 and officers will meet with a representative of the advisers twice a year. The services received include:

- advice and guidance on relevant policies, strategies and reports,
- advice on investment decisions and relevant analysis,
- notification of credit ratings and changes,
- other information on credit quality,
- advice on debt management decisions,
- accounting advice,
- reports on treasury performance,
- forecasts of interest rates, and
- training courses.

Staff training

7.6 The needs of the Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by Arlingclose and 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 CLG 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 2017/18 is £0.59m, based on an average investment portfolio of £38m at an interest rate of 1.6%. This is based on the current strategy so as not to pre-empt decisions by this Committee. For illustration only assuming additional interest of 2.5% for highest volatility pooled fund and property fund and 0.5% for rated bond fund if the Council were, after due investigation, to invest to the new limits it would increase income by approximately £0.25m. The budget for debt interest paid in 2017/18 is £0.14m, based on the existing debt of £4m.

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 1 Economic background and interest rate forecast

Economic background

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

The fall and continuing weakness in sterling and the near doubling in the price of oil in 2016 have combined to drive inflation expectations higher. The Bank of England is forecasting that Consumer Price Inflation will breach its 2% target in 2017, the first time since late 2013, but the Bank is expected to look through inflation overshoots over the course of 2017 when setting interest rates so as to avoid derailing the economy.

Initial post-referendum economic data showed that the feared collapse in business and consumer confidence had not immediately led to lower GDP growth. However, the prospect of a leaving the single market has dented business confidence and resulted in a delay in new business investment and, unless counteracted by higher public spending or retail sales, will weaken economic growth in 2017/18.

Looking overseas, with the US economy and its labour market showing steady improvement, the market had priced in the Federal Reserve increasing interest rates in December 2016. The US outlook could change rapidly with the Trump presidency which promised both protectionism and fiscal stimulus. The Eurozone meanwhile has continued to struggle with very low inflation and lack of momentum in growth, and the European Central Bank has left the door open for further quantitative easing.

The impact of political risk on financial markets remains significant over the next year. Although markets seem to have more or less ridden out what appears to be a growing political anti-establishment mood as manifested by Brexit, Donald Trump and Italy's referendum on its constitution it would be premature to expect that would continue with the growing reality of Brexit, a Trump presidency and the political uncertainty of the French presidential and general elections (April – June 2017) and the German federal elections (August – October 2017).

Credit outlook:

The Markets have expressed concern over the financial viability of a number of European banks recently which the recent Italian referendum did not help. Sluggish economies and continuing fines for pre-crisis behaviour have weighed on bank profits, and any future 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. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however continue to fall.

Interest rate forecast

The Authority's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.25% during 2017/18. The Bank of England has, however, highlighted that

excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further falls in the Bank Rate look less likely. Negative Bank Rate is currently perceived by some policymakers to be counterproductive but, although a low probability, cannot be entirely ruled out in the medium term, particularly if the UK enters recession as a result of concerns over leaving the European Union.

Gilt yields have risen sharply, but remain at low levels. The Arlingclose central case is for yields to decline when the government triggers Article 50. Long-term economic fundamentals remain weak, and the quantitative easing (QE) stimulus provided by central banks globally has only delayed the fallout from the build-up of public and private sector debt. The Bank of England has defended QE as a monetary policy tool, and further QE in support of the UK economy in 2017/18 remains a distinct possibility, to keep long-term interest rates low.

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

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	**0.12**
Arlingclose Central Case	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Downside risk	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	**0.40**
5-yr gilt yield														
Upside risk	0.25	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.39**
Arlingclose Central Case	**0.50**	**0.40**	**0.35**	**0.35**	**0.35**	**0.40**	**0.40**	**0.40**	**0.45**	**0.50**	**0.55**	**0.60**	**0.65**	**0.45**
Downside risk	0.30	0.45	0.45	0.45	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	**0.47**
10-yr gilt yield														
Upside risk	0.30	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.39**
Arlingclose Central Case	**1.15**	**0.95**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.90**	**0.95**	**1.00**	**1.05**	**1.10**	**1.15**	**0.96**
Downside risk	0.30	0.45	0.45	0.45	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	**0.47**
20-yr gilt yield														
Upside risk	0.25	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.39**
Arlingclose Central Case	**1.70**	**1.50**	**1.40**	**1.40**	**1.40**	**1.40**	**1.40**	**1.45**	**1.50**	**1.55**	**1.60**	**1.65**	**1.70**	**1.75**
Downside risk	0.40	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	**0.57**
50-yr gilt yield														
Upside risk	0.25	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	**0.39**
Arlingclose Central Case	**1.60**	**1.40**	**1.30**	**1.30**	**1.30**	**1.30**	**1.30**	**1.35**	**1.40**	**1.45**	**1.50**	**1.55**	**1.60**	**1.41**
Downside risk	0.40	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	**0.57**

Appendix 2 Pooled funds – discussion of their use

Pooled funds can be said to cover a spectrum of risk from pure equity with volatile fund prices to funds which are usually termed money market funds where fund prices are stable due to the short dated nature of the underlying investments. Arlingclose don't recommend that there are limits within the pooled funds universe as it introduces unnecessary complexity in the strategy in their eyes. However, this Council has, in view of some concerns from Members, set a limit – currently £10m - to pooled funds excluding money market funds.

Short-term money market funds whose capital value is stable, so called Constant Net Asset Value, will continue to be used as instant access funds while those with Variable Net Asset Value where value changes with market prices and/or have a notice period will be used for cash required in timescale under a year. One limit for both types is thought sufficient to control risks and the proposed limit is £30m as in 2016/17.

Progressing up the risk spectrum the next category is bond funds which have ratings from recognised rating agency. These have capital values more volatile than money market funds but invest in shorter term high quality bonds. The Council has not used this categorisation before although it is useful for funds available for a year or more as they have low but not immaterial capital volatility. A rating of at least AA and a limit of £15m is proposed for this category.

Property funds were previously included with the higher volatility equity funds but it is proposed that they be a class of their own as they have a significantly different risk profile with more stable capital values than equity containing funds. As the Treasury Management Strategy should reflect the Council's risk appetite it should recognise that the Council is comfortable with property investment as it has demonstrated by its approval of direct investment in local commercial property. The investment the Treasury Management Strategy envisages for property will be through a large UK wide diversified fund which should be less volatile than a direct local property investment and more liquid. That said, a limit of £5m will be set to limit investment so as not to overbalance investments towards property.

All other pooled funds which comprise equity, high yield bonds, and derivatives as well as any of the types of instruments in lower volatility funds will be the highest risk category the Council will envisage investing in. It should be noted that all pooled fund investments will be discussed in detail with Arlingclose from a selection of funds that they have previously researched as appropriate for local government treasury purposes. The Council will not invest with a fund that Arlingclose is not comfortable with for this Council's risk profile. Council staff will talk to the fund managers together with the advisers to ensure the funds used will have a core principle of preserving capital over the medium term and are not liable to take risks the Council and its advisers are not happy with. Taking all this into account the limit proposed for this category is £12m.

Pooled fund manager limit – having discussed the limit per manager with Arlingclose the limit per manager has been raised to £10m as the £5m was deemed over-restrictive as, for instance, it would restrict investing when the Council already held a Money Market Fund with the manager. The funds would be separate entities even if they are run by the same manager and the fund limit of £5m remains.