

HAMPSHIRE COUNTY COUNCIL**Decision Report**

Decision Maker:	Audit Committee
Date:	2 February 2017
Title:	Treasury Management Strategy and Investment Strategy 2017/18 to 2019/20
Reference:	7969
Report From:	Director of Corporate Resources – Corporate Services

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1. Summary

- 1.1. The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public Services (the CIPFA Code) and the Prudential Code require authorities to determine the Treasury Management Strategy Statement (TMSS) and Prudential Indicators on an annual basis. The TMSS also includes the Annual Investment Strategy that is a requirement of the Department for Communities and Local Government's (DCLG) Investment Guidance.
- 1.2. As per the requirements of the Prudential Code, Hampshire County Council adopted the CIPFA Treasury Management Code at its meeting in February 2012. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the DCLG Guidance.
- 1.3. The County Council has potentially large exposures to financial risks through its investment and borrowing activity, including the loss of invested funds and the effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

2. Introduction

- 2.1. In February 2012 the County 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 County Council to approve a treasury management strategy before the start of each financial year.

- 2.2. In addition, the DCLG issued revised Guidance on Local Authority Investments in March 2010 that requires the County Council to approve an investment strategy before the start of each financial year.
- 2.3. This report fulfils the County Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the DCLG Guidance.
- 2.4. The County Council has borrowed and invested 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 County Council's treasury management strategy.

3. External Context

- 3.1. The following paragraphs explain the economic and financial background against which the Treasury Management Strategy is being set.

Economic background

- 3.2. The major external influence on the County Council'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.
- 3.3. 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.
- 3.4. 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 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.

Credit outlook

- 3.5. 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 County Council; returns from cash deposits however continue to fall.

Interest rate forecast

- 3.6. The County Council'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. A 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.
- 3.7. A more detailed economic and interest rate forecast provided by Arlingclose is attached at Annex A.

4. Balance Sheet Summary and Forecast

- 4.1. On 30th November 2016, the County Council held £336m of borrowing and £517m of investments. This is set out in further detail at Annex B. Forecast changes in these sums are shown in the balance sheet analysis in Table 1 below.

Table 1: Balance Sheet Summary and Forecast

	31/03/16 Actual £m	31/03/17 Estimate £m	31/03/18 Forecast £m	31/03/19 Forecast £m	31/03/20 Forecast £m
Capital Financing Requirement	757	763	788	795	788
Less: Other long-term liabilities					
- Street Lighting PFI	(115)	(112)	(109)	(105)	(101)
- Waste Management Contract	(63)	(59)	(56)	(53)	(50)
Borrowing CFR	578	592	623	637	637
Less: External borrowing					
- Public Works Loan Board	(270)	(257)	(243)	(236)	(227)
- Market Loans (incl. LOBOs)	(73)	(73)	(73)	(73)	(73)
Internal (over) borrowing	235	262	307	328	337
Less: Reserves and balances	(497)	(442)	(427)	(350)	(358)
Less: Allowance for working capital	(193)	(190)	(190)	(190)	(190)
Resources for investment	(690)	(632)	(617)	(540)	(548)
New Borrowing or (Investments)	(455)	(370)	(310)	(212)	(211)

- 4.2. 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 County Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

- 4.3. It is forecast that the County Council will take advantage of internal borrowing over the period forecast in Table 1, whilst paying off PWLB debt as maturities arise. Reserves and balances are due to reduce over the forecast period due to the anticipated funding of the capital programme and use of the Grant Equalisation Reserve as part of the County Council's financial strategy. These factors result in a reducing investment balance year on year over the forecast period, as shown in Table 1.
- 4.4. CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the County Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the County Council expects to comply with this recommendation during 2017/18.

5. Borrowing Strategy

- 5.1. The County Council currently holds £336 million of loans, a decrease of £14 million on the previous year, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in Table 1 shows that the County Council does not expect to need to borrow in 2017/18. The County Council may however borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £750 million.

Objectives

- 5.2. The County Council'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 County Council's long-term plans change is a secondary objective.

Strategy

- 5.3. Given the significant cuts to public expenditure and in particular to local government funding, the County Council'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, if the County Council does need to borrow, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.
- 5.4. By internally borrowing, the County Council would be able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. If borrowing is required, the benefits of 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 County Council with this 'cost of carry' and breakeven analysis.

- 5.5. In addition, the County Council may borrow short-term loans (normally for up to one month) to cover unplanned cash flow shortages.

Sources

- 5.6. The approved sources of long-term and short-term borrowing are:
- Public Works Loan Board (PWLB) and any successor body
 - UK local authorities
 - 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 Hampshire Pension Fund)
 - capital market bond investors
 - UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues
- 5.7. 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
- 5.8. The County Council has previously raised the majority of its long-term borrowing from the PWLB but it continues to investigate other sources of finance, such as local authority loans and bank loans, which may be available at more favourable rates.

LOBOs

- 5.9. The County Council holds £60m of LOBO (Lender's Option Borrower's Option) loans (down from £73m due to the conversion of Barclays LOBO loans to fixed rate loans in June 2016) where the lender has the option to propose an increase in the interest rate at set dates, following which the County Council has the option to either accept the new rate or to repay the loan at no additional cost. In the current low interest rate environment the County Council understands that lenders are unlikely to exercise their options, but there remains an element of refinancing risk. The County Council will take the option to repay LOBO loans at no cost if it has the opportunity to do so.

Short-term and Variable Rate loans

- 5.10. These loans leave the County 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 at section 7 of this strategy.

Debt Rescheduling

- 5.11. 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 County 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 cost saving or a reduction in risk.

6. Investment Strategy

- 6.1. The County Council holds invested funds representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the County Council's investment balance has ranged between £490 and £645 million, and slightly lower levels are expected in the forthcoming year, as shown in Table 1.

Objectives

- 6.2. Both the CIPFA Code and the DCLG Guidance require the County 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 County 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.

Negative Interest Rates

- 6.3. If the UK enters into a recession in 2017/18, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Strategy

- 6.4. Given the increasing risk and falling returns from short-term unsecured bank investments, the County Council aims to further diversify into more secure and/or higher yielding asset classes during 2017/18. This is especially the case for the estimated £375m that is available for longer-term investment. Approximately 90% (increased from 70% last year) of the County Council's surplus cash is invested so that it is not subject to bail-in risk, as it is invested in local authorities, supranational banks, corporate bonds, pooled property and equity funds, and secured bank bonds. Whilst the remaining cash subject to bail-in risk, 55% is held in short-term notice accounts which produce a significant return commensurate with the bail-in risk, 24% is held in overnight money market funds which are subject to a reduced risk of bail-in, 20% is held in certificates of deposit which can be sold on the secondary market, and the remaining 1% of cash subject to

bail-in risk is held in overnight bank call accounts for liquidity purposes. Further detail is provided at Annex B. This diversification will represent a continuation of the new strategy adopted in 2015/16.

Investments Targeting Higher Returns

- 6.5. Given the stability of the County Council's cash balances there was the opportunity during 2016/17 to increase the allocation for investments targeting higher returns, which will allow further diversification, increase the overall rate of return and the income contributed to the revenue budget. It was approved that the allocation targeting higher yields increase to £200m from £105m. This amount represented half of the County Council's forecast minimum cash balance and is therefore an amount that can be managed appropriately as a long-term investment.
- 6.6. Higher yields can be accessed through long-term cash investments (although this is currently less the case as yields have declined) and investments in other assets than cash, such as pooled property, equities and bonds. Non-cash pooled investments must be viewed as long-term investments in order that monies are not withdrawn in the event of a fall in capital values to avoid crystallising a capital loss.
- 6.7. As shown in Annex B the County Council has invested £90m of the £200m allocation. In addition, the County Council has committed a further £30m to investments in pooled funds. The County Council is continuing to work with its advisors, Arlingclose, to identify additional opportunities for this allocation. Without this allocation the weighted average return of the Council's cash investments would have been 1.04%; the allocation to higher yielding investments has added 0.46% (£2.4m based on the cash balance at 30 November 2016) to the average interest rate earned by the remainder of the portfolio.
- 6.8. The 2015/16 Investment Strategy recommended that the returns from a pooled property fund be used to contribute £0.5m each year to a reserve in the County Council's accounts as protection against the irrecoverable fall in value of any investments. It is now recommended that £0.5m is added to this reserve in line with this strategy to further protect the County Council's funds. This is prudent given the additional risk that is being taken in targeting investments with higher returns and will bring the total amount in the reserve to £1.5m.

Investment Limits

- 6.9. Given the impact of the Bank Reform Act, Bank Recovery and Resolution Directive, and the recast Deposit Guarantee Schemes Directive, which have increased the credit risk that unsecured bank investments could be 'bailed-in', the following investment limits are proposed to mitigate the risk whilst allowing sufficient flexibility to manage the County Council's investment balances.

Table 2: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£70m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£70m per group
Any group of pooled funds under the same management	£70m per manager
Registered Providers	£70m in total
Money Market Funds	50% in total

Approved Counterparties

- 6.10. The County Council 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

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates	Registered Providers Unsecured	Registered Providers Secured
UK Govt	n/a	n/a	£ Unlimited 30 years	n/a	n/a	n/a
AAA	£35m 5 years	£70m 20 years	£70m 30 years	£35m 20 years	£35m 20 years	£35m 20 years
AA+	£35m 5 years	£70m 10 years	£70m 25 years	£35m 10 years	£35m 10 years	£35m 10 years
AA	£35m 4 years	£70m 5 years	£70m 15 years	£35m 5 years	£35m 10 years	£35m 10 years
AA-	£35m 3 years	£70m 4 years	£70m 10 years	£35m 4 years	£35m 10 years	£35m 10 years
A+	£35m 2 years	£70m 3 years	£35m 5 years	£35m 3 years	£35m 5 years	£35m 5 years
A	£35m 13 months	£70m 2 years	£35m 5 years	£35m 2 years	£35m 5 years	£35m 5 years
A-	£35m 6 months	£70m 13 months	£35m 5 years	£35m 13 months	£35m 5 years	£35m 5 years
BBB+	£20m 100 days	£35m 6 months	£20m 2 years	£20m 6 months	£20m 2 years	£35m 2 years
None	£35m 6 months	n/a	£35m 25 years	n/a	£35m 5 years	£35m 25 years
Pooled funds	£70m per fund					

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

Credit Rating

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

Banks Unsecured

- 6.13. 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.

Banks Secured

- 6.14. 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.

Government

- 6.15. 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 30 years.

Corporates

- 6.16. 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.

Registered Providers Secured and Unsecured

- 6.17. 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.

Pooled Funds

- 6.18. Shares in diversified investment vehicles consisting of 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.

- 6.19. Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the County Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Depending on the type of pooled fund invested in, it may have to be classified as capital expenditure. 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 County Council's investment objectives will be monitored regularly. Much of the allocation for investments targeting higher returns will be invested in pooled funds.

Risk Assessment and Credit Ratings

- 6.20. Credit ratings are obtained and monitored by the County Council'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.
- 6.21. 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.

Other Information on the Security of Investments

- 6.22. The County 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, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.
- 6.23. Based on the available information and the advice of the County Council's advisers, Arlingclose, the Director of Corporate Resources may reduce the

investment limits shown in Tables 2 & 3, and suspend investing with certain counterparties as necessary.

- 6.24. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the County Council'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.

Specified Investments

- 6.25. The CLG Guidance defines specified investments as those:

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

- 6.26. The County 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.

Non-specified Investments

- 6.27. Any investment not meeting the definition of a specified investment is classed as non-specified. The County Council does not intend to make any investments denominated in foreign currencies. 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), pooled funds that the County Council intends to hold as long-term investments (for more than one year) and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in Table 4 below.

Table 4: Non-Specified Investment Limits

	Cash limit
Total long-term investments	£375m
Total investments without credit ratings or rated below A- (excluding investments with other local authorities)	£200m
Total non-Sterling investments	£0m
Total investments in foreign countries rated below AA+	£0m
Total non-specified investments	£375m*

* Total non-specified investments is a limit in its own right, and is not meant to equal the aggregate of the limits for total long-term investments, and total investments without credit ratings or rated below A-.

- 6.28. Although the total long-term investments limit is greater than the expected investment balance at 31 March 2018, as shown in Table 1, this limit has been set to allow for current long-term investments to mature, as well as to allow flexibility if capital expenditure is experienced to be slower than forecast.

Liquidity Management

- 6.29. The County Council has due regard for its future cash flows when determining the maximum period for which funds may prudently be committed. Historic cash flows are analysed in addition to significant future cash movements, such as payroll, grant income and council tax precept. Limits on long-term investments are set by reference to the County Council's medium term financial position (summarised in Table 1) and forecast short-term balances.

7. Treasury Management Indicators

- 7.1. The County Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

- 7.2. This indicator is set to control the County Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of principal borrowed or invested will be:

Table 5: Interest Rate Exposures

	2017/18	2018/19	2019/20
Upper limit on fixed interest rate investment exposure	£375m	£300m	£300m
Upper limit on variable interest rate investment exposure	£700m	£700m	£700m
Upper limit on fixed interest rate borrowing exposure	£960m	£970m	£960m
Upper limit on variable interest rate borrowing exposure	£960m	£970m	£960m

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

Maturity Structure of Borrowing

- 7.4. This indicator is set to control the County Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 6: Maturity Structure of Borrowing

	Upper	Lower
Under 12 months	50%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	75%	0%
10 years and within 20 years	75%	0%
20 years and within 30 years	75%	0%
30 years and above	100%	0%

Principal Sums Invested for Periods Longer than 364 days

- 7.5. The purpose of this indicator is to control the County Council'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:

Table 7: Principal Sums Invested for Periods Longer than 364 days

	2017/18	2018/19	2019/20
Limit on principal invested beyond year end	£375m	£300m	£300m

8. Other Items

- 8.1. There are a number of additional items that the County Council is obliged by CIPFA or DCLG to include in its Treasury Management Strategy.

Policy on Use of Financial Derivatives

- 8.2. 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).
- 8.3. The County Council 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 County Council 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.
- 8.4. 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. The use of financial derivatives is not planned as part of the implementation of the Treasury Management Strategy and any changes to this would be reported to members in the first instance.

Investment Training

- 8.5. The needs of the County 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.
- 8.6. Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, and other appropriate organisations.
- 8.7. CIPFA's Code of Practice requires that the County Council ensures that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities. All members were invited to a workshop presented by Arlingclose on 29 November 2016, which gave an update of treasury matters. A further Arlingclose workshop has been planned for 29 November 2017.

Investment Advisers

- 8.8. The County Council has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled through quarterly review meetings with the Director of Corporate Resources, her staff and Arlingclose.

Investment of Money Borrowed in Advance of Need

- 8.9. The County Council may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the County 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 County Council's overall management of its treasury risks. The total amount borrowed will not exceed the authorised borrowing limit of £750 million.

9. Recommendations

- 9.1. It is recommended that the Audit Committee note the following recommendations that are being made to Cabinet:
- 9.2. Treasury Management Strategy and Annual Investment Strategy for 2017/18 (and the remainder of 2016/17) including:
- Prudential Indicators for 2017/18, 2018/19 and 2019/20 – Annex C
 - Minimum Revenue Provision (MRP) Statement – Annex D
 - That authority is delegated to the Director of Corporate Resources to manage the Council's investments according to the risk assessment process in the Investment Strategy as appropriate to most effectively manage the Council's investments.
- 9.3. The addition of a further £0.5m to the Investment Risk Reserve created in the County Council's accounts in the Treasury Management Strategy 2015/16 as protection against the irrecoverable fall in value of any investments.

CORPORATE OR LEGAL INFORMATION:**Links to the Corporate Strategy**

This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because the management of the County Council's cash balance needs to be decided.

Other Significant Links

Links to previous Member decisions:		
<u>Title</u>	<u>Reference</u>	<u>Date</u>
Direct links to specific legislation or Government Directives		
<u>Title</u>	<u>Date</u>	

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

DocumentLocation

None

IMPACT ASSESSMENTS:

1. Equality Duty

1.1. The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited under the Act;
- Advance equality of opportunity between persons who share a relevant protected characteristic (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, gender and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

Due regard in this context involves having due regard in particular to:

- a) The need to remove or minimise disadvantages suffered by persons sharing a relevant characteristic connected to that characteristic;
- b) Take steps to meet the needs of persons sharing a relevant protected characteristic different from the needs of persons who do not share it;
- c) Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity which participation by such persons is disproportionately low.

1.2. Equalities Impact Assessment:

1.3. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- a) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

Arlingclose Economic & Interest Rate Forecast November 2016

Underlying assumptions:

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

Forecast:

- Globally, the outlook is uncertain and risks remain weighted to the downside. The UK domestic outlook is uncertain, but likely to be weaker in the short term than previously expected.
- The likely path for Bank Rate is weighted to the downside. The Arlingclose central case is for Bank Rate to remain at 0.25%, but there is a 25%

possibility of a drop to close to zero, with a very small chance of a reduction below zero.

- 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.

	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	Ave
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
3-month LIBID rate														
Upside risk	0.05	0.05	0.10	0.10	0.10	0.15	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.18
Arlingclose Central Case	0.25	0.25	0.25	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.29
Downside risk	0.20	0.25	0.25	0.25	0.30	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.34
1-yr LIBID rate														
Upside risk	0.10	0.10	0.15	0.15	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.23
Arlingclose Central Case	0.60	0.50	0.50	0.50	0.50	0.50	0.50	0.60	0.70	0.85	0.90	0.90	0.90	0.65
Downside risk	0.10	0.15	0.15	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.24
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

Existing Investment & Debt Portfolio Position at 30 November 2016

Investments Duration to maturity	Overnight	<1 year	>1 year	Total	Average rate/yield	Average life
	£m	£m	£m	£m	%	(years)
<i>Subject to bail-in risk</i>						
Bank call accounts	1	0	0	1	0.20	0.00
Bank notice accounts	0	28	0	28	0.78	0.18
Certificates of deposit ¹	0	10	0	10	0.33	0.25
Money market funds ²	12	0	0	12	0.32	0.00
	13	38	0	51	0.57	0.15
<i>Exempt from bail-in risk</i>						
Covered floating rate notes	0	63	50	113	0.68	1.19
Covered fixed bonds	0	0	15	15	1.30	1.36
Supranational bonds	0	9	0	9	0.60	0.02
Government bonds	0	27	0	27	0.68	0.03
Corporate floating rate notes	0	10	0	10	0.67	0.19
Corporate fixed bonds	0	1	0	1	0.37	0.52
Local authorities	0	83	118	201	1.40	1.24
	0	193	183	376	1.09	1.08
<i>Targeting higher yields</i>						
Government fixed bonds	0	0	10	10	3.78	17.11
Local authorities	0	0	20	20	3.96	17.30
Pooled property funds ³	0	0	35	35	4.56	n/a
Pooled equity funds ⁴	0	0	20	20	2.19	n/a
Registered provider	0	0	5	5	3.40	2.41
	0	0	90	90	3.75	15.12
Total	13	231	273	517	1.50	2.04

¹ Certificates of deposit are financial instruments that have the ability of being sold on the secondary market.

² Money market funds have a reduced risk of bail-in due to the portfolio of investments each fund is invested in.

³ The average rate/yield provided for the pooled property funds is the average income return per annum.

⁴ The County Council invested in the pooled equity funds part-way through the year, therefore the average rate/yield is the income return for the investment period, annualised.

	£m	%
External Borrowing:		
PWLB Fixed Rate	(263)	(4.83)
Other Loans	(73)	(4.45)
Total External Borrowing	(336)	(4.75)
Other Long-Term Liabilities:		
Street Lighting PFI	(114)	
Waste Management Contract	(60)	
Total Other Long-Term Liabilities	(174)	
Total Gross External Debt	(510)	
Investments	517	1.50
Net (Debt) / Investments	7	

Prudential Indicators 2017/18

The Local Government Act 2003 requires the County Council to have regard to the Chartered Institute of Public Finance and Accountancy's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the County Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Estimates of Capital Expenditure

The County Council's planned capital expenditure and financing may be summarised as follows. Further detail is provided in the capital programme.

Capital Expenditure and Financing	2016/17 Revised £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m
Total Expenditure	209	283	228	158
Capital receipts	8	8	6	4
Grants and other income	102	209	187	164
Revenue contributions	69	18	33	(21)
Contributions from/to reserves	10	9	2	0
Total Financing	189	244	228	147
Prudential borrowing	25	49	34	20
less repayments from capital receipts etc	(5)	(10)	(12)	(9)
Total Funding	20	39	22	11
Total Financing and Funding	209	283	228	158

Estimates of Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the County Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31/03/17 Revised £m	31/03/18 Estimate £m	31/03/19 Estimate £m	31/03/20 Estimate £m
General Fund	763	788	795	788
Total CFR	763	788	795	788

The CFR is forecast to rise by £32m over the next two years as capital expenditure financed by debt is outweighs resources put aside for debt repayment.

Gross Debt and the Capital Financing Requirement

In order to ensure that over the medium term debt will only be for a capital purpose, the County Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	31/03/17 Revised £m	31/03/18 Estimate £m	31/03/19 Estimate £m	31/03/20 Estimate £m
Borrowing	330	316	309	300
PFI liabilities	172	166	159	152
Total Debt	502	482	468	452

Total debt is expected to remain below the CFR during the forecast period.

Operational Boundary for External Debt

The operational boundary is based on the County Council's estimate of most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the County Council's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the County Council's debt.

Operational Boundary	2016/17 Revised £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m
Borrowing	660	690	700	700
Other long-term liabilities	180	170	160	160
Total Debt	840	860	860	860

Authorised Limit for External Debt

The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the County Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	2016/17 Revised £m	2017/18 Limit £m	2018/19 Limit £m	2019/20 Limit £m
Borrowing	720	750	770	770
Other long-term liabilities	220	210	200	190
Total Debt	940	960	970	960

Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2016/17 Revised %	2017/18 Estimate %	2018/19 Estimate %	2019/20 Estimate %
General Fund	4.22	3.99	4.01	4.03

Incremental Impact of Capital Investment Decisions

This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme proposed.

Incremental Impact of Capital Investment Decisions	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
	£	£	£
General Fund - increase in annual band D Council Tax	1.86	8.63	4.05

Adoption of the CIPFA Treasury Management Code

The County Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* in February 2012.

Annual Minimum Revenue Provision Statement 2017/18

Where the County Council finances capital expenditure by debt, it must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The Local Government Act 2003 requires the County Council to have regard to the Department for Communities and Local Government's *Guidance on Minimum Revenue Provision* (the DCLG Guidance) most recently issued in 2012.

The broad aim of the DCLG Guidance is to ensure that debt is repaid over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

The CLG Guidance requires the County Council to approve an Annual MRP Statement each year, and whilst it provides a range of options for the calculation of MRP the guidance also notes that other options are permissible provided that they are fully consistent with the statutory duty to make prudent revenue provision.

MRP in 2017/18

Prior to 2015/16 the County Council calculated MRP for supported borrowing on a 4% reducing balance basis. It was agreed by Cabinet in December 2015 that the calculation of MRP from 2015/16 onwards would change to a 50 year straight line basis. To be more prudent the 50 years has been started from 2008 and the actual calculation is 1/43's. Had the County Council been applying the new policy of a 50 year straight line calculation starting in 2008 it would have made £67m less in MRP payments by 31 March 2016.

Starting in 2016/17 the County Council will pause in making MRP payments on supported borrowing until it has realigned the total amount of MRP payments with the new policy, which will be during 2021/22. This policy continues the County Council's prudent approach of repaying expenditure financed by borrowing sooner, on a straight line basis.

The County Council will continue to apply the Asset Life or Depreciation Method (which are Options 3 and 4 from the range provided by the DCLG) in respect of unsupported capital expenditure funded from borrowing. Where the borrowing is in effect a bridging loan from a guaranteed future income source, such as Section106 Developers Contributions, MRP will not be applied.

MRP in respect of leases and Private Finance Initiative schemes brought on Balance Sheet under the International Financial Reporting Standards (IFRS) based Accounting Code of Practice will match the annual principal repayment for the associated deferred liability.

Capital expenditure incurred during 2017/18 will not be subject to a MRP charge until 2018/19.