Division(s): N/A

AUDIT & GOVERNANCE COMMITTEE – 9 JANUARY 2019

TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2018/19

Report by the Director of Finance

Background

1. The Local Government Act 2003 and supporting regulations require the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

2. The Act requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance issued subsequent to the Act). The Annual Investment Strategy sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

3. Treasury management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

4. The proposed strategy for 2019/20 is based upon the views of the Council's Treasury Management Strategy Team (TMST)[1], informed by market forecasts provided by the Council's treasury advisor, Arlingclose Limited.

5. It is a statutory requirement for the Council to produce a balanced budget and to calculate its council tax requirement for each financial year to include the revenue costs that flow from capital financing decisions. This means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue caused by increased borrowing to finance additional capital expenditure (and any increases in running costs from new capital projects) are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

Treasury Limits for 2019/20 to 2021/22

6. It is a statutory duty, under section 3 (1) of the Local Government Act 2003, for the Council to determine and keep under review the amount it can afford to

[1]Comprising the Director of Finance, Service Manager (Pensions), Strategic Finance Manager (Treasury & Banking) and Financial Manager (Treasury Management).

borrow. This amount is termed the 'Affordable Borrowing Limit' and is equivalent to the 'Authorised Borrowing Limit' as specified in the Prudential Code.

7. The Authorised Borrowing Limit requires the Council to ensure that total capital investment remains within sustainable limits and that the impact upon future council tax levels is 'acceptable'.

8. Whilst termed an "Affordable Borrowing Limit" within the Act, the capital plans to be considered for inclusion incorporates financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.

Forecast Treasury Portfolio Position

9. The Council's treasury forecast portfolio position for the 2019/20 financial year comprises:

	Principal £m	**Average Rate %**
Opening External Debt Balance		
PWLB	293.383	4.510
LOBO	45.000	3.943
Money Market Loans	5.000	3.950
TOTAL EXTERNAL DEBT	343.383	
2019/20 Average Cash Balance		
Average In-House Cash	250.616	
Average Externally Managed	100.000	
TOTAL INVESTMENTS	350.616	

10. The average forecast cash balance for 2019/20 is comprised of the following:

	Average Balance £m
Earmarked Reserves	51.250
Capital and Developer Contributions	202.286
General Balances	22.500
Cashflow and Working Capital Adjustments	61.231
Provisions and Deferred Income	13.350
TOTAL	**350.616**

Prospects for Interest Rates

Economic Background – Provided by Arlingclose

11. The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2019/20.

12. UK Consumer Price Inflation (CPI) for October was up 2.4% year/year, slightly below the consensus forecast and broadly in line with the Bank of England's November Inflation Report. The most recent labour market data for October 2018 showed the unemployment rate edged up slightly to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pull on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level still likely to have little effect on consumer spending.

13. The rise in quarterly GDP growth to 0.6% in Q3 from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in Q1. At 1.5%, annual GDP growth continues to remain below trend. Looking ahead, the Bank of England, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

14. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy has been made since. However, the Bank expects that should the economy continue to evolve in line with its November forecast, further increases in Bank Rate will be required to return inflation to the 2% target. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.

15. While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2%-2.25% in September. Markets continued to expect one more rate rise in December, but expectations are fading that the further hikes previously expected in 2019 will materialise as concerns over trade wars drag on economic activity.

Credit outlook – Provided by Arlingclose:

16. The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ringfencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ringfenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.

17. The Bank of England released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The Bank of England did not require any bank to raise additional capital.

18. European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading here. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be very high if ever needed. The uncertainty caused by protracted negotiations between the UK and EU is weighing on the creditworthiness of both UK and European banks with substantial operations in both jurisdictions.

Interest rate forecast – Provided by Arlingclose:

19. Following the increase in Bank Rate to 0.75% in August 2018, the Authority's treasury management adviser Arlingclose is forecasting two more 0.25% hikes during 2019 to take official UK interest rates to 1.25%. The Bank of England's Monetary Policy Committee (MPC) has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

20. The UK economic environment remains relatively soft, despite seemingly strong labour market data. Arlingclose's view is that the economy still faces a challenging outlook as it exits the EU and Eurozone growth softens. While assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity (at the time of writing this commentary in late-December). As such, the risks to the interest rate forecast are considered firmly to the downside.

21. Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on Arlingclose's interest rate projections, due to the strength of the US economy and the European Central Bank's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.7% and 2.2% respectively over the interest rate forecast horizon, however volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.

Treasury Management Strategy Team's View

22. The Council's TMST, taking into account the advice from Arlingclose, market implications and the current economic outlook, have determined the rates to be included in the Strategic Measures budget for 2019/20 and over the medium term. TMST forecast a 25 bps rise in the UK Bank Rate during 2019/20 on the basis that UK inflation will continue be slightly above the Bank of England's target, a position supported by the Bank of England's November 2018 Inflation Report. The

Bank Rate forecasts set out below represent the average rate for the financial year:

- 2019/20 0.88% (increase from 0.75% to 1.00% in October 2019)
- 2020/21 1.00%
- 2021/22 1.00%
- 2022/23 1.25%

23. The TMST team has agreed that based on the current portfolio of deposits and market rates, the target in-house rate of return as set out below. These rates have been incorporated into the strategic measures budget estimates:

- 2019/20 0.98%
- 2020/21 1.00%
- 2021/22 1.00%
- 2022/23 1.25%

24. The Treasury Management Strategy Team continues to monitor the risks relating to Brexit.

Borrowing Strategy

Arlingclose's View

25. The Public Works Loan Board (PWLB) sets new borrowing rates at the gilt yield plus 1.00%. Arlingclose have forecast gilt yields as follows:

- The 50-year gilt yield - 1.950% at April 2019, rising to 2.000% by Dec 2021.
- The 20-year gilt yield - 2.100% at April 2019, rising to 2.180% by Dec 2021.
- The 10-year gilt yield - 1.650% at April 2019, rising to 1.700% by Dec 2021.
- The 5-year gilt yield - 1.250% at April 2019, rising to 1.330% by Dec 2021.

26. Arlingclose's forecasts have an upside variation range of between 25 and 40 basis points, and a downside variation range of between 55 and 75 basis points depending on the economic and political climate.

Treasury Management Strategy Team's View

27. It is expected that the Bank Rate will increase by 25 basis points to 1.00% during 2019/20 and that there will continue to be a high "cost of carry[2]" associated with the long-term borrowing compared to temporary investment returns. The TMST will continue to monitor the Council's debt portfolio and will consider debt repayment if it is in the Council's interest.

28. In April 2011, the Government replaced the 'credit approval' system for capital financing with direct provision of capital resources in the form of capital grant. This

[2] The difference between the interest payable on borrowing on debt and the interest receivable from investing surplus cash.

means that the Council only needs to borrow to finance prudential borrowing schemes. The Council's Capital Programme Financing Principles applies capital grants, developer contributions, capital receipts and revenue contributions to fund capital expenditure before using prudential borrowing. This means that the majority of the current capital programme is fully funded without the need to take up any new borrowing.

29. Financing the Council's borrowing requirement internally would reduce the cost of carry in the short term but there is a risk that the internal borrowing would need to be refinanced with external borrowing at a time when PWLB (or its successor) and market rates exceed those currently available. This could result in higher financing costs over the long term.

30. Internal borrowing is a short-term financing solution which uses temporary cash surpluses to fund the Council's capital financing requirement. The temporary cash surpluses are balances made up of creditors over debtors, earmarked reserves and capital reserves. As reserves are drawn down for their earmarked purpose internal borrowing will need to be replaced with external borrowing.

31. The Council's TMST have agreed that they should increase the option to fund new or replacement borrowing up to the value of £100m of the portfolio through internal borrowing. Internal borrowing will have the effect of reducing some of the "cost of carry" of funding. Internal borrowing will also be used to finance prudential schemes.

32. If market conditions change during the 2019/20 financial year such that the policy to borrow internally is no longer in the short term or long-term interests of the Council, the TMST will review the borrowing strategy and report any changes to Cabinet.

33. As the Accountable Body for OxLEP ltd, the Oxfordshire Local Enterprise Partnership, the Council will be required to prudentially borrow £42m on behalf of OxLEP for project funding from 2019/20 onwards. The loans will be repaid through the retained business rates of OxLEP. This represents projects to be delivered by the Council. The TMST monitor interest rates and will consider forward borrowing on behalf of OxLEP at the end of 2018/19 if it is determined to be cost-effective.

34. The Council will be able to apply for the new Local Infrastructure Rate, at a discounted interest rate of gilts + 60 basis points. The borrowing on behalf of OxLEP may be eligible as the schemes are all major infrastructure schemes.

35. The Council's chief objective when borrowing money is to strike an appropriate balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Authority's long-term plans change is a secondary objective.

36. The approved sources of long-term and short-term borrowing are:
    - Public Works Loan Board and any successor body
    - UK local authorities
    - any institution approved for investments (see below)

- any other bank or building society authorised by the Prudential Regulation Authority to operate in the UK
- UK public and private sector pension funds
- capital market bond investors
- special purpose companies created to enable joint local authority bond issues.

Borrowing for the Capital Financing Requirement

37. The Council's Capital Financing Requirement (CFR) represents the Council's underlying need to finance capital expenditure by borrowing. The CFR is the value of the Council's assets that have not been permanently financed, in other words, borrowing has been used to finance spending. When capital expenditure is financed by grants, capital receipts or direct contributions from revenue this is not included the CFR.

38. The Council is required to make an annual contribution from revenue towards the repayment of debt termed the Minimum Revenue Provision (MRP). This contribution reduces the CFR and effectively provides the resource to permanently finance the capital expenditure and reduce the Council's borrowing requirement by that amount. The Council's MRP Policy Statement sets out the methodology that the Council applies in its MRP calculation.

39. Under the Prudential Code, the Council must ensure that gross external borrowing does not, except in the short term, exceed the sum of the CFR in the previous year plus estimates of any increases to the CFR for the current and next two financial years. Where the gross debt is greater than the CFR the reasons for this should be clearly stated in the annual treasury management strategy. The Council's current position is set out below.

40. The Council's CFR is currently forecast to increase over the medium term financial plan. This is a result of the requirement to borrow on behalf of the OxLEP discussed in paragraph 33 and increased investment in the Council's Capital Programme.

41. The Council's external debt is also forecast to increase over the medium term financial plan as new external borrowing required for OxLEP projects is forecast to exceed the rate at which existing long term debt is repaid upon maturity.

Borrowing Instruments

42. The TMST's forecast for the period 2019/20 – 2022/23 for 20 and 50-year PWLB rates over the medium term are an average rate of 2.80% and 2.60% per year respectively.

43. In November 2012, the PWLB introduced the Certainty Rate which allows eligible Councils to borrow at a discounted rate of 0.20% below the advertised borrowing rate. Eligibility is established by the submission of an annual application form to the Department of Communities and Local Government. The Council has

successfully applied and qualified for the rate for the period from 1 November 2018 to 31 October 2019.

44. An annual application will be made to renew eligibility for the Certainty Rate, in order to maintain the option should it be required.

45. The Council has historically set a maximum limit of 20% of the debt portfolio to be borrowed in the form of Lender's Option Borrower's Option (LOBOs). It is recommended that this remain as the limit for 2019/20. As at 30 November 2018, LOBOs represent 13.07% of the total external debt.

46. The Council has four £5m LOBO's with call options in 2019/20, three of which have two call options in year, whilst one has a single call option in year. At each call date, the lender may choose to exercise their option to change the interest rate payable on the loan. If the lender chooses to do so, the Council will evaluate alternative financing options before deciding whether or not to exercise the borrower's option to repay the loan or to accept the new rate offered. It is likely that if the rate is changed the debt will be repaid. The TMST is also exploring early repayment of LOBO's where there is a financial benefit to do so.

Annual Investment Strategy

47. The Council complies with all relevant treasury management regulations, codes of practice and guidance. The Council's investment priorities are: -

- The security of capital and
- The liquidity of its investments

48. The Council also aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The borrowing of monies purely to invest or on-lend and make a return is unlawful and the Council will not engage in such activity.

49. The Treasury Management Code of Practice requires the Council to approve a Treasury Management Policy Statement. Good practice requires that this statement is regularly reviewed and revised as appropriate. Council approved the statement in February 2018.The statement has been reviewed and there are no revisions proposed.

Investment Instruments

50. Investment instruments identified for use in the 2019/20 financial year are set out at Appendices A and B under the 'Specified' and 'Non-Specified' Investment categories.

51. Guidance states that specified investments are those requiring "minimal procedural formalities". The placing of cash on deposit with banks and building societies 'awarded high credit ratings by a credit rating agency', the use of Money Market Funds (MMFs) and investments with the UK Government and local

authorities qualify as falling under this phrase as they form a normal part of day to day treasury management.

52. Money market funds (MMFs) will be utilised, but good treasury management practice prevails and whilst MMFs provide good diversification the council will also seek to diversify any exposure by using more than one MMF where practical. It should be noted that while exposure will be limited, the use of MMFs does give the council exposure to institutions that may not be included on the approved lending list for direct deposits. This is deemed to be an acceptable risk due to the benefits of diversification. The Treasury team use an online portal to provide details of underlying holdings in MMFs. This enables more effective and regular monitoring of full counterparty risk.

53. All specified investments will be sterling denominated, with maturities up to a maximum of 1 year, meeting the 'high' credit rating criteria where applicable.

54. Non-specified investment products are those which take on greater risk. They are subject to greater scrutiny and should therefore be subject to more rigorous justification and agreement of their use in the Annual Investment Strategy; this applies regardless of whether they are under one-year investments and have high credit ratings.

55. A maximum of 50% of the portfolio will be held in non-specified investments.

Changes to Instruments

56. There are no proposed changes to instruments for 2019/20

Credit Quality

57. The CIPFA Code of Practice on Treasury Management (2011) recommends that Councils have regard to the ratings issued by the three major credit rating agencies (Fitch, Moody's and Standard & Poor's) and to make decisions based on all ratings. Whilst the Council will have regard to the ratings provided by all three ratings agencies, the Council uses Fitch ratings as the basis by which to set its minimum credit criteria for deposits and to derive its maximum counterparty limits. Counterparty limits and maturity limits are derived from the credit rating matrix as set out in the tables at paragraphs 68 and 69 respectively.

58. The TMST may further reduce the derived limits due to the ratings provided by Moody's and Standard & Poor's or as a result of monitoring additional indicators such as Credit Default Swap rates, share prices, Ratings Watch & Outlook notices from credit rating agencies and quality Financial Media sources.

59. Notification of any rating changes (or ratings watch and outlook notifications) by all three ratings agencies are monitored daily by a member of the Treasury Management Team. Updates are also provided by the Council's Treasury Management advisors Arlingclose and reported to TMST.

60. Where a change in the Fitch credit rating places a counterparty on the approved lending list outside the credit matrix (as set out in tables at paragraphs 68 and 69), that counterparty will be immediately removed from the lending list.

61. Where a counterparty has been placed on Negative Watch or Outlook by any of three major credit rating agencies the counterparty's status on the approved lending list will be reviewed by the TMST and appropriate action taken.

62. The Authority defines "high credit quality" organisations 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 with the Fitch ratings agency.

Liquidity Management

63. The Council forecasts its cash flow to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a pessimistic 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. Limits on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast. The Council uses instant access bank deposit accounts and money market funds for balances forecast to be required at short notice to meet commitments due. The TMST will continue to monitor options available to maintain the required liquidity, and will open new accounts with approved counterparties as appropriate.

Lending Limits

64. In addition to the limits determined by the credit quality of institutions, the TMST apply further limits to mitigate risk by diversification. These include:

- Limiting the amount lent to banks in any one country (excluding the UK) to a maximum of 20% of the investment portfolio.
- Limiting the amount lent to any bank, or banks within the same group structure to 10% of the investment portfolio.

65. Where the Council has deposits on instant access, this balance may temporarily exceed the 10% bank or group limit. However, the limits as set out in paragraphs 68 and 69 will still apply.

66. Counterparty limits as set out in paragraphs 68 and 69, may be temporarily exceeded by the accrual and application of interest amounts onto accounts such as call accounts, money market funds or notice accounts. Where the application of interest causes the balance with a counterparty to exceed the agreed limits, the balance will be reduced when appropriate, dependent upon the terms and conditions of the account and cashflow forecast.

67. Any changes to the approved lending list will be reported to Cabinet as part of the Financial Monitoring and Business Strategy Delivery Report.

68. The Council also manages its credit risk by setting counterparty limits. The matrix below sets out the maximum proposed limits for 2019/20. The TMST may further restrict lending limits dependent upon prevailing market conditions. BBB+ to BBB- ratings is included for overnight balances with the Council's bank, currently Lloyds Bank Plc. This is for practical purposes should the bank be downgraded.

LENDING LIMITS - Fitch Rating	Short Term Rating	
Long Term Rating	F1+	F1
AAA	£30m	£20m
AA+	£30m	£20m
AA	£25m	£15m
AA-	£25m	£15m
A+	£20m	£15m
A	£20m	£15m
A-	£15m	£10m
BBB+, BBB, BBB- (bank with which the Council has its bank account)	£20m	£20m

69. The Council also manages its counterparty risk by setting maturity limits on deposits, restricting longer term lending to the very highest rated counterparties. The table below sets out the maximum approved limits. The TMST may further restrict lending criteria in response to changing market conditions.

MATURITY LIMITS – Fitch Rating	Short Term Rating	
Long Term Rating	F1+	F1
AAA	3 years	364 days
AA+	2 years	364 days
AA	2 years	9 months
AA-	2 years	9 months
A+	364 days	9 months
A	9 months	6 months
A-	6 months	3 months
BBB+, BBB, BBB- (bank with which the Council has its bank account)	Overnight	Overnight

Other institutions included on the councils lending list

70. In addition to highly credit rated banks and building societies the authority may also place deposits with AAA rated Money Market funds, Collective Investment Schemes and local authorities.

Structured Products

71. As at 30 November 2018, the Council had no structured products within its investment portfolio. Structured products involve varying degrees of additional risk over fixed rate deposits, with the potential for higher returns. It is recommended that the authority maintain the option to use structured products up to a maximum of 10% of the investment portfolio. The Council will continue to monitor structured products and consider restructuring opportunities as appropriate.

Revolving Credit Facility

72. The Council has a £10m revolving credit facility (RCF) investment with Network Homes, whereby Network Homes as the ability to draw down an amount, up to the value of £10m in any 6 month period from the RCF. The investment was arranged with the advice of Arlingclose in July 2017 and continues to be utilised in full. The investment returns 3 month LIBOR + 1.50% and has a final maturity in July 2020.

External Funds

73. The Council uses external fund managers and pooled funds to diversify the investment portfolio through the use of different investment instruments, investment in different markets, and exposure to a range of counterparties. It is expected that these funds should outperform the Council's in-house investment performance over a rolling three-year period. The Council will have no more than 50% of the total portfolio invested with external fund managers and pooled funds (excluding MMFs). This allows the Council to achieve diversification while limiting the exposure to funds with a variable net asset value. And, in order to ensure appropriate diversification within externally managed and pooled funds these should be diversified between a minimum of two asset classes.

74. As at 30 November 2018, the Council had £58m invested in external funds (excluding MMFs), representing 13% of the Council's total investment portfolio.

75. In December 2018 the TMST agreed to increase the exposure to external funds (excluding MMFs) to £100m from £58m, representing an increase of 10% to 23% of the Council's total investment portfolio. It was agreed to move away from lower yielding short dated funds and to invest in longer dated strategic funds with the aim of a more balanced portfolio with a higher return. There will be an equal allocation to 4 asset classes (Bond Funds, Equity, Property & Multi Asset) to limit overall portfolio volatility. All of the funds are income producing funds, as opposed to accumulating value funds. These funds have a variable net asset value which means that the value of the funds can decrease as well as increase depending on the performance of the instruments in the fund.

76. The external funds have a higher targeted income return than in house deposits of 3.75% which has been incorporated into the medium term financial plan.

77. The Council’s holding in the Columbia Threadneedle Strategic Bond Fund was transferred from an accumulating fund to an income producing fund. The switch has realised a one-off gain of £2.9m which will be taken to the General Fund in 2018/19.

78. The performance of the pooled funds is monitored by the TMST throughout the year against the funds’ benchmarks and the in-house investment returns. The TMST will keep the external fund investments under review and consider alternative instruments and fund structures, to manage overall portfolio risk. It is recommended that authority to withdraw, or advance additional funds to/from external fund managers, continue to be delegated to the TMST.

Investment Approach

79. The weighted average maturity (WAM) of in-house deposits as at 30 November 2018 was 209 days. This was made up of £89.5m of instant access balances with a maturity of 1 day, and £295.5m of deposits with a WAM of 272 days.

80. With the increased investment in longer dated external funds, the TMST will aim to maintain the balance between medium-term deposits with local authorities and short-term secured and unsecured deposits with high credit quality financial institutions. Money Market Funds will continue to be utilised for instant access cash. This approach will maintain a degree of certainty about the investment returns for a proportion of the portfolio, while also enabling the Treasury Management team to respond to any increases in interest rates in the short-term.

81. The Council maintain the option to invest directly in UK Government Gilts, T-bills, Certificates of Deposits and other Sovereign Bonds, use of such instruments remains dependent upon custody arrangements. If availability of acceptable credit worthy institutions is reduced, the Council may use the Debt Management Office Deposit Facility and will continue to prioritise security and liquidity of assets over investment returns.

82. It is proposed that any further changes required to the Annual Treasury Management Strategy & Annual Investment Strategy, continue to be delegated to the Chief Finance Officer in consultation with the Leader of the Council and Cabinet Member for Finance.

Treasury Management Prudential Indicators

Gross and Net Debt

83. This indicator is intended to identify where an authority may be borrowing in advance of need.

Upper Limit of net debt:	2018/19	2019/20	2020/21	2021/22
Net Debt / Gross Debt	70%	70%	70%	70%

Upper and lower limits to maturity structure of fixed rate borrowing

84. This indicator highlights the existence of any large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates and is designed to protect against excessive exposures to interest rate changes in any one period, in particular in the course of the next ten years.

85. It is calculated as the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate. The maturity of borrowing is determined by reference to the earliest date on which the lender can require payment.

86. LOBOs are classified as maturing on the next call date, this being the earliest date that the lender can require repayment.

Maturity structure of fixed rate borrowing during 2018/19	Lower Limit %	Upper Limit %
Under 12 months	0	20
12 months and within 24 months	0	25
24 months and within 5 years	0	35
5 years and within 10 years	5	40
10 years and above	50	95

Upper limits on fixed and variable rate interest exposures

87. These indicators allow the Authority to manage the extent to which it is exposed to changes in interest rates.

Fixed interest rate exposure

88. Limits in the table below have been set to reflect the current low interest rate environment. The limits set out offer the Council protection in an uncertain interest rate environment by allowing the majority of the debt portfolio to be held at fixed interest rates, thus not subjecting the Council to rising debt interest.

Upper limit for fixed interest rate exposure	2018/19	2019/20	2020/21	2021/22
Net principal re fixed rate borrowing / investments	£350m	£350m	£350m	£350m

89. 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.

Variable interest rate exposure

90. The upper limit for variable rate exposure has been set to ensure that the Authority is not exposed to interest rate rises which could adversely impact on the revenue budget. As with the fixed rate exposure limits, the variable rate exposure limits set offer the council protection in an uncertain interest rate environment. This is

achieved by ensuring variable rate debt is lower than variable rate investments, which would result in a net benefit if interest rates were to increase.

91. Interest rate exposure limits will be amended in future years to reflect any changes to the forecast trajectory of interest rates.

Upper limit for variable rate exposure	**2018/19**	**2019/20**	**2020/21**	**2021/22**
Net principal re variable rate borrowing / investments	£0	£0	£0	£0

Upper limit to total of principal sums invested longer than 364 days

92. The purpose of this limit is to contain exposure to the risk of loss that may arise as a result of the Authority having to seek early repayment of the sums invested.

93. It is proposed to maintain the upper limit of £150m in 2018/19. This limit had previously been set to reduce to £120m in 2020/21 however maintaining the £150m is to reflect higher forecast cash balance than previously forecast.

	2018/19 £m	**2019/20 £m**	**2020/21 £m**	**2021/22 £m**
Upper limit on principal sums invested longer than 364 days	150	150	150	150

94. Prudential Indicators are reported to and monitored by the TMST on a regular basis and will be reported to the Audit & Governance Committee and Cabinet in the Treasury Management Outturn Report 2018/19 and the Treasury Management Mid-Term Review 2019/20, which will be considered in July and November 2018 respectively.

Policy on Use of Financial Derivatives

95. 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). The CIPFA Code (2011) requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

96. The 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 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 will not

be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

97. 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.

98. It is the view of the TMST that the use of standalone financial derivatives will not be required for Treasury Management purposes during 2019/20. The Council will only use derivatives after seeking expertise, a legal opinion and ensuring officers have the appropriate training for their use.

Performance Monitoring

99. The Council will monitor its Treasury Management performance against other authorities through its membership of the CIPFA Treasury Management benchmarking club.

100. Arlingclose benchmark the performance of their clients against each other on a quarterly basis, looking at a variety of indicators including investment risk and returns.

101. The Council will benchmark its internal return against the 3 month London Interbank Bid Rate (LIBID) - the rate at which banks are willing to borrow from other banks.

102. Latest performance figures will be reported to the Audit & Governance Committee and Cabinet in the Treasury Management Outturn Report 2018/19, and the Treasury Management Mid-Term Review 2019/20, which will be considered in July and November 2019 respectively.

Investment Training

103. All members of the Treasury Management Strategy Team are members of CIPFA or other professional accounting body. In addition, key Treasury Management officers receive in-house and externally provided training as deemed appropriate and training needs are regularly reviewed, including as part of the staff appraisal process.

104. The Council has opted up to ‘professional client’ categorisation with under the second Markets in Financial Instruments Directive (MiFID II). In order to achieve this, evidence was required that the person(s) authorised to make investment decisions on behalf of the authority have at least one year’s relevant professional experience and the expertise and knowledge to make investment decisions and understand the risks involved. Members of the TMST currently meet these criteria and training needs will be regularly monitored and reviewed to ensure continued compliance.

Treasury Management Advisors

Arlingclose continue to provide the Council’s Treasury Management Advisory Service, following the award of a three-year contract via a competitive procurement process.

Appendix A

Specified Investments

Investment Instrument	Minimum Credit Criteria	Use
Debt Management Agency Deposit Facility	N/A	In-house and Fund Managers
Term Deposits – UK Government	N/A	In-house
Term Deposits – other Local Authorities	N/A	In-house
Term Deposits – Banks and Building Societies	Short-term F1, Long-term BBB+, Minimum Sovereign Rating AA+	In-house and Fund Managers
Certificates of Deposit issued by Banks and Building Societies	A1 or P1	In-house on a buy and hold basis and Fund Managers
Money Market Funds	AAA	In-house and Fund Managers
Other Money Market Funds and Collective Investment Schemes[3]	Minimum equivalent credit rating of A+. These funds do not have short-term or support ratings.	In-house and Fund Managers
UK Government Gilts	N/A	In-house on a buy and hold basis and Fund Managers
Treasury Bills	N/A	In-house and Fund Managers
Reverse Repurchase Agreements - maturity under 1 year from arrangement and counterparty is of high credit quality (not collateral)	Long Term Counterparty Rating A-	In-house and Fund Managers
Covered Bonds – maturity under 1 year from arrangement	Minimum issue rating of A-	In-house and Fund Managers

[3] I.e., credit rated funds which meet the definition of a collective investment scheme as defined in SI 2004 No 534 and SI 2007 No 573.

Appendix B

Non-Specified Investments

Investment Instrument	Minimum Credit Criteria	Use	Max % of total Investments	Max Maturity Period
Term Deposits – other Local Authorities (maturities in excess of 1 year)	N/A	In-house	50%	3 years
Term Deposits – Banks and Building Societies (maturities in excess of 1 year)	Short-term F1+, Long-term AA-	In-house and Fund Managers	50% in-house; 100% External Funds	3 years
Structured Products (e.g. Callable deposits, range accruals, snowballs, escalators etc.)	Short-term F1+, Long-term AA-	In-house and Fund Managers	50% in-house; 100% External Funds	3 years
UK Government Gilts with maturities in excess of 1 year	N/A	In-house and Fund Managers	50% in-house; 100% External Funds	5 years in-house, 10 years fund managers
Bonds issued by Multilateral Development Banks	AAA	In-house and Fund Managers	50% in-house; 100% External Fund	25 years
Bonds issued by a financial institution which is guaranteed by the UK Government	AA	In-house and Fund Managers	50% in-house; 100% External Fund	5 years in-house

Investment Instrument	Minimum Credit Criteria	Use	Max % of total Investments	Max Maturity Period
Collective Investment Schemes[4] but which are not credit rated	N/A	In-house and Fund Managers	50% In-house; 100% External Funds	Pooled Funds do not have a defined maturity date
Sovereign Bond Issues	AAA	In-house on a buy and hold basis. Fund Managers	50% in-house; 100% External Funds	5 year in-house, 30 years fund managers
Reverse Repurchase Agreements - maturity in excess of 1 year, or/and counterparty not of high credit quality.	Minimum long term rating of A-	In-house and Fund Managers	50% in-house; 100% External Funds	3 years
Covered Bonds	AAA	In-house and Fund Managers	50% in-house; 100% External Funds	20 years
Registered Providers	As agreed by TMST in consultation with the Leader and the Cabinet Member for Finance	In-house	50% In-house	5 years

The maximum limits for in-house investments apply at the time of arrangement.

[4] Pooled funds which meet the definition of a collective investment scheme as defined in SI 2004 No 534 and SI 2007 No 573.