

## **Appendix 1- Treasury Management Strategy 2017/18**

**Cabinet**

**Date:** 8<sup>th</sup> February 2017

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# **TREASURY MANAGEMENT STRATEGY 2017/18**

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## 1 Current Portfolio Position

- 1.1 The capital expenditure plans set in Annex 1 to Appendix 1 summarises the Councils current and future plans. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities.
- 1.2 The Council's actual treasury portfolio position at 31 March 2016, with forward projections are summarised below. The table shows the actual external borrowing (both relating to the general fund and the HRA), against the borrowing requirement (shown through the Capital Financing Requirement or "CFR"), highlighting any over or under borrowing. The CFR represents the amount of long term borrowing required to fund capital expenditure, but not yet taken out.

Table 1 - Portfolio position forecasts				
	16/17	17/18	18/19	19/20
	£'000's	£'000's	£'000's	£'000's
Gross Borrowing b/fwd	285,758	279,257	292,756	296,255
New Borrowing estimate	-	15,000	15,000	15,000
Maturing Debt	- 6,501	- 1,501	- 11,501	- 1,501
<b>Gross Borrowing c/fwd</b>	<b>279,257</b>	<b>292,756</b>	<b>296,255</b>	<b>309,754</b>
Net Investments c/fwd	- 72,500	- 72,500	- 72,500	- 72,500
<b>Net Borrowing c/fwd</b>	<b>206,757</b>	<b>220,256</b>	<b>223,755</b>	<b>237,254</b>
CFR	464,853	469,147	463,772	458,018
Less PFI liabilities	- 52,810	- 51,280	- 49,555	- 47,632
<b>Net Borrowing Requirement</b>	<b>412,043</b>	<b>417,867</b>	<b>414,217</b>	<b>410,386</b>
<b>(Under)/Over borrowing</b>	<b>- 205,286</b>	<b>- 197,611</b>	<b>- 190,462</b>	<b>- 173,132</b>

## 2 Prospects for Interest Rates and Economic Outlook

- 2.1 The Council has appointed Capita Asset Services (formerly Sector Group) as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives the Capita central view.

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**Table 2 – Prospects for Interest Rates**

	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	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.60%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB rate	2.70%	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%

- 2.2 The Monetary Policy Committee, (MPC), cut Bank Rate from 0.50% to 0.25% on 4th August in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016. During the two-year period 2017 – 2019, when the UK is negotiating the terms for withdrawal from the EU, it is likely that the MPC will do nothing to dampen growth prospects, (i.e. by raising Bank Rate), which will already be adversely impacted by the uncertainties of what form Brexit will eventually take. Accordingly, a first increase to 0.50% is not tentatively pencilled in, as in the table above, until quarter 2 2019, after those negotiations have been concluded, (though the period for negotiations could be extended). However, if strong domestically generated inflation, (e.g. from wage increases within the UK), were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.
- 2.3 Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts, (and MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.
- 2.4 The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. PWLB rates and gilt yields have been experiencing exceptional levels of volatility that have been highly correlated to geo-political, sovereign debt crisis and emerging market developments. It is likely that these exceptional levels of volatility could continue to occur for the foreseeable future.
- 2.5 The overall balance of risks to economic recovery in the UK is to the downside, particularly in view of the current uncertainty over the final terms of Brexit and the timetable for its implementation.
- 2.6 In summary:
- Investment returns are likely to remain low during 2017/18 and beyond;

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- Borrowing interest rates have been on a generally downward trend during most of 2016 up to mid-August; they fell sharply to historically phenomenally low levels after the referendum and then even further after the MPC meeting of 4th August when a new package of quantitative easing purchasing of gilts was announced. Gilt yields have since risen sharply due to a rise in concerns around a 'hard Brexit', the fall in the value of sterling, and an increase in inflation expectations. The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times when authorities will not be able to avoid new borrowing to finance capital expenditure and/or to refinance maturing debt;
- There will remain a cost of carry to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost – the difference between borrowing costs and investment returns

## 3 Minimum Revenue Provision Policy Statement

- 3.1 The Council is required to charge an element of the accumulated General Fund capital spend each year (measured through the CFR) to revenue (the minimum revenue provision or "MRP"), although it is also allowed to undertake additional voluntary payments if required.
- 3.2 CLG Regulations have been issued which require the full Council to approve an MRP Statement in advance of each year. A variety of options are provided to Councils, as long as there is a prudent provision. The Council is recommended to approve the following MRP Statement for 2017/18, (unchanged from that agreed in January 2017):
  - *For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP will be based on the CFR as per the regulatory method in the MRP guidance. This option provides for an approximate 4% reduction in the borrowing need (CFR) each year.*
  - *From 1 April 2008 for all unsupported borrowing the MRP will be based on the estimated life of the assets, on an annuity basis, in accordance with the regulations. Annuity method charges will be calculated using the relevant PWLB annuity rates for the estimated asset lives as at 31<sup>st</sup> March in the year of expenditure. MRP charges commence the year after the asset becomes operational.*
  - *MRP in relation to capital expenditure funded through borrowing incurred on the Wichelstowe project, will be deferred and the liability repaid through future capital receipts from the site. Should there be a shortfall between the debt and eventual receipts, the balance will incur an annual MRP charge.*
  - *This methodology will also be applied to other capital expenditure funded from borrowing where there is an intention to repay the borrowing from future receipts and where there is a strong likelihood that this will happen.*
  - *For PFI contracts MRP will be based on the estimated life of the assets, on an annuity basis, in accordance with the regulations. Annuity method charges will be*

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*calculated based on the PWLB annuity rates at 31<sup>st</sup> March in the year that the assets became operational.*

- *Where non-ring-fenced capital receipts are available, these can be applied to meet the cost of PFI liability repayment (or part thereof). Where capital receipts are applied in this manner, the MRP charge for the PFI would be reduced by an equal amount in that year.*
  - *For any future finance leases the MRP requirement would be met by a charge equal to the element of the charge applied to write down the liability.*
  - *No revenue charge is currently required for the HRA, although the existing voluntary policy is to repay £5m per annum.*

3.3 No revenue charge is currently required for the HRA, although the existing voluntary policy is to repay £5m per annum.

## 4 Borrowing Strategy

- 4.1 The Council is currently maintaining an under-borrowed position. This means that there is a shortfall between the amount of long-term loans required, and the actual level of long term loans taken out. Long term loans are required to fund capital expenditure which Cabinet has approved as “funded through borrowing”, but there is a timing difference between when the expenditure is made and when the long term loan is taken out. The timing of the taking of long term loans is part of the wider cash management strategy.
- 4.2 The difference between long term borrowing required and what has actually been taken out is known as “Internal Borrowing” and represents the temporary use of cash reserves and working capital to bridge the timing difference. As cash from reserves and working capital is currently invested at historically low rates, then the policy of delaying long-term borrowing and using existing cash balances as an interim measure is currently a cheaper option for the Council.
- 4.3 While the council will maintain an under borrowed position on the General Fund (the HRA is fully borrowed up to the CFR), future movements in interest rates will dictate the future policy and the timing of taking out long-term loans, and will be kept under careful review.
- 4.4 Against this background and the risks within the economic forecast, caution will continue to be adopted with the 2017/18 treasury operations. The Board Director Resources will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:
- if it was felt that there was a significant risk of a sharp FALL in long and short term rates (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.
  - if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast, perhaps arising from an

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increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are still lower than they will be in the next few years

## **Borrowing in Advance of Need**

- 4.5 The Council will not borrow more than or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

## **Loan Re-scheduling**

- 4.6 Opportunities from rescheduling loans to generate savings will be monitored through the year but need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).
- 4.7 The reasons for any rescheduling to take place will include:
- the generation of cash savings and / or discounted cash flow savings;
  - helping to fulfil the treasury strategy;
  - amending the balance of the portfolio (amend the maturity profile and/or the balance of volatility).
- 4.8 Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.
- 4.9 All rescheduling will be reported to the Cabinet at the earliest meeting following its action

## **5 Investment Policy, Creditworthiness Policy and Investment Strategy**

### **Investment Policy**

- 5.1 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then return.
- 5.2 In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

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- 5.3 Ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as “credit default swaps” and overlay that information on top of the credit ratings.
- 5.4 Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.
- 5.5 Investment instruments identified for use in the financial year are listed in Annex 2 under the ‘specified’ and ‘non-specified’ investments categories. Counterparty limits will be as set through the Council’s treasury management practices – schedules.

## **Creditworthiness Policy**

- 5.6 This Council applies the creditworthiness service provided by Capita Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody’s and Standard and Poor’s. The credit ratings of counterparties are supplemented with the following overlays:
- credit watches and credit outlooks from credit rating agencies;
  - CDS spreads to give early warning of likely changes in credit ratings;
  - sovereign ratings to select counterparties from only the most creditworthy countries.
- 5.7 This modelling approach combines credit ratings, credit Watches and credit Outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments.
- 5.8 The Capita Asset Services’ creditworthiness service uses a wider array of information than just primary ratings. Furthermore, by using a risk weighted scoring system, it does not give undue preponderance to just one agency’s ratings.
- 5.9 Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1 and a Long Term rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances



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consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

5.10 All credit ratings will be monitored daily. The Council is alerted to changes to ratings of all three agencies through its use of the Capita Asset Services' creditworthiness service.

- if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the Council will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a daily basis via its Passport website, provided exclusively to it by Capita Asset Services. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

5.11 Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on any external support for banks to help support its decision making process.

## **Country limits**

5.12 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch (or equivalent). This list will be amended by officers should ratings change in accordance with this policy.

## **Investment Strategy**

5.13 **In-house funds.** Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

5.14 **Investment returns expectations.** Bank Rate is forecast to stay flat at 0.25% until quarter 2 2019 and not to rise above 0.75% by quarter 1 2020. Bank Rate forecasts for financial year ends (March) are:

- 2016/17 0.25%
- 2017/18 0.25%
- 2018/19 0.25%
- 2019/20 0.50%

The estimated budgeted investment earnings rates for returns on cash investments placed for periods up to 100 days during each financial year for the next three years are as follows:

- 2017/18 0.25%
- 2018/19 0.25%

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- 2019/20 0.50%

## **Investment Periods**

5.15 Investment periods are currently restricted to no longer than 24 months. Lending to counterparties is in line with the creditworthiness policy detailed above and recommended by Capita and these are limited to a total of £20m. Any investments to banks and building societies for a period in excess of 365 days would be classed as a “non-specified investment” as detailed in Annex 2 to this strategy.

## **6 Policy on the use of external service providers**

6.1 The Council uses Capita Asset Services as its external treasury management advisors. The Council recognises that responsibility for treasury management decisions remains with the Council at all times and will ensure that undue reliance is not placed upon our external service providers. It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

## **Annexes**

- Annex 1 - Prudential Indicators.
- Annex 2 - Credit and Counterparty Risk Management, Specified and Non- Specified Investments

## **Key Decision / Decision in Forward Plan**

This is not a key decision for the Cabinet (as the approval of the full Council is required) and is included in the Cabinet Forward Plan