Cabinet	
Meeting Date	6 February 2019
Report Title	Treasury Management Strategy 2019/20
Cabinet Member	Cllr. Duncan Dewar-Whalley, Cabinet Member for Finance & Performance
SMT Lead	Nick Vickers, Chief Financial Officer
Head of Service	Nick Vickers, Chief Financial Officer
Lead Officer	Phil Wilson, Financial Services Manager
Key Decision	Yes
Classification	Open
Recommendations	1. To approve the Treasury Strategy 2019/20 and the Prudential and Treasury Management Indicators.

1. Purpose of Report and Executive Summary

1.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public Services and the Prudential Code require the Council to approve a Treasury Strategy and Prudential Indicators before the start of each financial year.

1.2 The Chartered Institute of Public Finance and Accountancy (CIPFA) has defined Treasury Management as: "The management of the organisation'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".

1.3 This report sets out and seeks approval of the proposed Treasury Management Strategy and Prudential and Treasury Management Indicators for 2019/20.

1.4 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the DCLG Guidance. Should the assumptions upon which this report is based change significantly, then a revised Treasury Strategy will be submitted for approval.

2. Background

Interest Rate Forecast and Market Outlook

2.1 Following the Bank of England's decision to increase the 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.

2.2 The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ring-fencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ring-fenced 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 ring-fenced banks generally being better rated than their non-ring-fenced counterparts.

2.3 Following the increase in Bank Rate to 0.75% in August 2018, the Council's treasury management adviser Arlingclose is forecasting two more 0.25% increases 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 interest rates will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

Borrowing Strategy

2.4 In March 2016 Council agreed to a borrowing facility of up to £30m subject to individual business cases and in November and December Cabinet agreed a business case for borrowing up to £28m for Sittingbourne Town Centre (STC) regeneration. This facility was extended to £60m in February 2017 with any additional borrowing being subject to business cases to Cabinet.

2.5 The 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. With short-term interest rates currently lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead of borrowing at fixed rates for long periods. By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal/short-term borrowing will be monitored regularly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2019/20 with a view to keeping future interest costs low, even if this causes additional cost in the short-term. The Council may arrange forward starting loans during 2019/20, where the interest rate is fixed in advance, but the cash is received in later years.

2.6 The STC project, the Multi-Storey Car Park and the Leisure Centre improvements have all been funded from internal borrowing. The Chief Financial Officer has commissioned a specific report from Arlingclose on financing STC. This recommends short-term borrowing and deferring long-term borrowing until rent free periods for tenants are over. If longer-term interest rates have moved higher, the Council can continue to borrow short term and take opportunities for longer-term borrowing at advantageous times.

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

- Public Works Loan Board (PWLB) and any successor body;
- Any institution approved for investments;
- UK Local Authorities;
- Any other bank or building society authorised to operate in the UK;
- UK public and private sector pension funds (except the Kent Pension Fund); and,
- Capital market bond investors.

2.8 In January 2019 the Council took out two loans of £5m each, from other local authorities. One loan is for 12 months at a rate of 1.1% and the other for 18 months at a rate of 1.21%.

Investment Strategy

2.9 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has averaged £28m compared with £38m in the previous financial year.

2.10 In considering investing in assets there are two overriding principles to be applied:

- Minimising the cost to the revenue budget - given the continued reductions in local government financing there is no scope within the revenue budget to meet debt charge costs. If the Council incurs debt charge costs then, unless the investment generates sufficient income to cover these costs, the Council may have to reduce services to fund the costs. In the case of the Sittingbourne Town Centre investment, all the capital financing costs will be funded from rental income; and,
- Strategic impact - if the Council is going to invest in property it needs to support wider Council objectives around regeneration of the borough and creating new employment. This means there needs to be additionality in terms of the wider economic benefits e.g. higher business rates.

2.11 The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

2.12 Given the increasing risk and very low returns from short-term unsecured bank investments, the Council largely uses Money Market Funds for short-term investments. The only long-term investment remains the £3m in the Church, Charities and Local Authorities (CCLA) Property Fund. The Chief Financial Officer recently attended a CCLA investment seminar and believes that the Council should remain invested despite concerns over parts of the Retail sector. The CCLA fund is now valued at £1bn and around two-thirds of local authorities are invested.

2.13 The Council could make use of the following asset classes:

Government	Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.
Banks Unsecured	Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.
Banks Secured	Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the 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.
Corporates	Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made either following an external credit assessment or to a maximum of £1m per company as part of a diversified pool in order to spread the risk widely.
Non Treasury Investments	The Council is a significant owner of assets in the borough and will, where there are opportunities, invest either to generate an income stream or for a capital gain.
Registered Providers	Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing. As providers of public services, they retain the likelihood of receiving government support if needed.
Real Estate Investment Trusts (REITs)	Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with pooled property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

Pooled Funds	Shares or units 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. Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.
Operational Bank Accounts	The Council may incur operational exposures, for example through current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

2.14 The strategy for the coming year will not change significantly. The Council will retain the CCLA fund and keep the remaining monies in Money Market Funds. The Chief Financial Officer does not believe that investing in equity or bond funds is advisable at the current time given equity market valuations and the impact on bond investments of the likely rise in interest rates. This will be reviewed as market conditions develop.

2.15 Credit ratings are obtained and monitored by the 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.

2.16 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.

2.17 The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will, therefore, be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, 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.

2.18 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the 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. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

2.19 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in the Ministry of Housing, Communities and Local Government's (MHCLG's) Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return. The Council holds £3m of such longstanding investments in 13 directly owned properties. These investments are expected to generate £0.2m of investment income for the Council after taking account of direct costs, representing a rate of return of 5.7%.

3. Proposal

3.1 The Council may invest its surplus funds with any of the counterparty types in the table below, subject to the cash limits (per counterparty) and the time limits shown.

Debt Management Office (Debt Management Account Deposit Facility) and Treasury Bills	Unlimited
Major UK banks / building societies. (Barclays, HSBC, Lloyds Banking Group, RBS Group, Santander UK, Nationwide, Standard Chartered) unsecured deposits	£3m
Svenska Handelsbanken unsecured deposits	£3m
Leeds Building Society unsecured deposits	£1.5m
Close Brothers unsecured deposits	£1.5m
Money Market Funds	£3m each
Pooled Funds e.g. Property REIT's, Absolute return, Equity income	£3m each
CCLA Property Fund	£3m
Supranational Bonds	£3m in aggregate

Corporate Bond Funds and Corporate Bonds	£3m in aggregate
Non treasury investments	To be agreed on a case by case basis
Covered Bonds	£3m in aggregate with £1m limit per bank

3.2 The Council may also purchase property for investment purposes and may also make loans and investments for service purposes, for example in shared ownership housing, as loans to local businesses and landlords, or as equity investments and loans to the Council's owned companies.

3.3 The Council does not directly invest in financial derivatives although these may be present in pooled funds and will be managed in line with the overall treasury strategy.

3.4 The Council has adopted the International Financial Reporting Standard 9 (IFRS 9) with effect from 1 April 2018. A key issue is the treatment of gains and losses on the fair value of the Council's £3 million investment in the CCLA Property Fund. Previously, losses and gains were only realised when the assets were disposed of. Under IFRS 9, gains and losses will be reported every year in the accounts so that if there is a loss then it would become a 'real' cost to the Council's reserves and/ or Council Taxpayers. However, the MHCLG has introduced a 'statutory override' whereby the Council's accounts would meet IFRS 9 requirements, but any financial impact would be reversed out so it would not be a 'real' charge to the Council.

3.5 Currently the maximum duration for unsecured term deposits is 13 months. The Chief Financial Officer in consultation with the Cabinet Member for Finance and Performance may consider longer duration depending on market conditions. For bonds, the maximum duration will be five years including, where applicable, the 5-year benchmark government bond which may at the point of issue have a maturity a few months in excess of five years.

Treasury Adviser

3.6 The Council has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. Officers meet with Arlingclose on a quarterly basis, receive information daily and attend relevant training courses.

4. Alternative Options

4.1 The strategy is intended to give flexibility with regard to borrowing and investment options.

4.2 The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer, having consulted the Cabinet Member for Finance and Performance, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

5. Consultation Undertaken or Proposed

5.1 Consultation has been taken with Arlingclose.

6. Implications

Issue	Implications
Corporate Plan	Good management of the Council’s cash balances assists the overall financial position of the Council and this helps meet its objective to be a Council to be Proud of.
Financial, Resource and Property	The budget for investment income in 2019/20 is £110,000, based on an average investment portfolio of £24m at an interest rate of 0.46%.
Legal and Statutory	Ministry of Housing, Communities and Local Government and CIPFA requirements complied with.
Crime and Disorder	Not applicable
Sustainability	Not applicable
Health and Wellbeing	Not applicable

Issue	Implications
Risk Management and Health and Safety	Risk is controlled through adherence to specific guidance included in CIPFA's Treasury Management Code of Practice and Cross-Sectoral Guidance Notes. The principle of security of funds over-rides investment performance considerations.
Equality and Diversity	Not applicable
Privacy and data Protection	Not applicable

7. Appendices

7.1 The following appendices are published with this report and form part of the report.

- Appendix I Prudential and Treasury Management Indicators

8. Background Papers

None

Prudential and Treasury Management Indicators

Background

There is a requirement under the Local Government Act 2003 for local authorities to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the "CIPFA Prudential Code") when setting and reviewing their Prudential Indicators. 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 Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

1. Gross Debt and the Capital Financing Requirement (CFR)

This is a key indicator of prudence. Statutory guidance is that external debt should not exceed the capital financing requirement in the previous year plus the estimates of any increase in the CFR at the end of the current year and the next two years. The table below demonstrates that the Council is complying with this aspect of the Prudential Code.

Capital Financing Requirement	**2018/19 Revised**	**2019/20 Estimate**	**2020/21 Estimate**	**2021/22 Estimate**
	£'000	**£'000**	**£'000**	**£'000**
Gross CFR	28,853	42,475	41,395	40,314
Less: long term liabilities	(140)	0	0	0
Borrowing CFR	**28,713**	**42,475**	**41,395**	**40,314**
Gross External Debt	**10,000**	**5,000**	**0**	**0**

Prudential and Treasury Management Indicators

2. Estimates of Capital Expenditure

This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council Tax. (See Capital Programme in 2019/20 Budget Report to Cabinet 6 February 2019.)

Capital Expenditure and Financing	2018/19 Revised	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
	£'000	£'000	£'000	£'000
Total Expenditure	**20,435**	**18,652**	**2,240**	**2,470**
Revenue contributions	391	326	135	206
Capital receipts	107	350	0	0
Grants	3,798	3,763	2,105	2,264
Internally/ externally borrow	16,139	14,213	0	0
Total Financing	**20,435**	**18,652**	**2,240**	**2,470**

3. Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability, highlighting 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	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
	%	%	%	%
General Fund Total	**1.5**	**3.2**	**5.6**	**5.4**

Prudential and Treasury Management Indicators

4. Incremental Impact of Capital Investment Decision

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

Incremental Impact of Capital Investment Decisions	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
	£	**£**	**£**
Increase/(Decrease) in Band D Council Tax	**1.52**	**(3.88)**	**(0.46)**

5. Authorised Limit for External Debt

The Authorised Limit sets the maximum level of external borrowing on a gross basis (i.e., not net of investments) for the Council. It is measured on a daily basis against all external borrowing items on the Balance Sheet (i.e., long and short-term borrowing, overdrawn bank balances and long-term liabilities). This Prudential Indictor separately identifies borrowing from other long-term liabilities such as finance leases. It is consistent with the Council's existing commitments, its proposals for capital expenditure and financing, and its approved treasury management policy statement and practices.

The Authorised Limit has been set on the estimate of the most likely, prudent but not worst case scenario with sufficient headroom over and above this to allow for unusual cash movements.

The Authorised Limit is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit).

Authorised Limit for External Debt	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
	£'000	**£'000**	**£'000**	**£'000**
Borrowing	60,000	60,000	60,000	60,000
Other long-term liabilities	2,000	2,000	2,000	2,000
Total	**62,000**	**62,000**	**62,000**	**62,000**

Prudential and Treasury Management Indicators

6. Operational Boundary for External Debt

The operational boundary is based on the Council's estimate of most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the 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 and other liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary	**2018/19 Revised £'000**	**2019/20 Estimate £'000**	**2020/21 Estimate £'000**	**2021/22 Estimate £'000**
Borrowing	55,000	55,000	55,000	55,000
Other long-term liabilities	500	500	500	500
Total Operational Boundary	**55,500**	**55,500**	**55,500**	**55,500**

7. Interest Rate Risk

The Council regularly reviews its interest rate exposures with its Treasury adviser Arlingclose and this is reflected in the monitoring of the budget. It is the aim of the Council to minimise interest paid on borrowing and maximise the interest earned on investments, but in the case of investments, protection of the capital sum must take precedence over the rate of return. The Council currently has two external loans totalling £10m both of which are at fixed interest rates. As reported in the 2018/19 Half Year Treasury Report the Council had achieved a return of 0.96% on its investments and therefore an estimate of the impact of a 0.5% change in this return would be worth £139,000.

Prudential and Treasury Management Indicators

8. Maturity Structure of Borrowing

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

Maturity Structure of Borrowing	Lower Limit for 2019/20 %	Upper Limit for 2019/20 %
Under 12 months	0	100
12 months and within 24 months	0	100
24 months and within 5 years	0	100
5 years and within 10 years	0	100
10 years and above	0	100

9. Principal Sums Invested for Periods Longer than a Year

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

	2019/20 £'000	2020/21 £'000	2021/22 £'000
Limit on principal invested longer than 1 year	10,000	10,000	10,000