TREASURY MANAGEMENT STRATEGY 2016/17

Introduction

1. Treasury Management is defined by the Chartered Institute of Public Finance and Accountancy (CIPFA) 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".

2. The Local Government Act 2003 (the Act) requires local authorities "to have regard –
   (a) to such guidance as the Secretary of State may issue, and
   (b) to such other guidance as the Secretary of State may by regulations specify for the purposes of this provision."

3. The Local Authorities (Capital Finance and Accounting)(England) Regulations 2003 state that:
   "In carrying out its capital finance functions, a local authority must have regard to the code of practice in 'Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes' (regulation 24)."

4. The 2003 regulations further require local authorities to have regard to the code of practice entitled the 'Prudential Code for Capital Finance in Local Authorities' (published by CIPFA), when considering how much they can afford to borrow. Both the Treasury Management Code (the Code) and the Prudential Code were updated in November 2011.

5. With regard to investment of funds, the Secretary of State issued revised guidance in 2010 that requires local authorities to prepare an annual investment strategy which has the key objectives of security and liquidity of funds.

6. The Code has 3 key principles which are:

   i) the establishment of 'comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of their treasury activities'.
   ii) the effective management and control of risk are prime objectives and that responsibility for these lies clearly within the organisation.
   iii) the pursuit of value for money and the use of suitable performance measures are valid and important tools.

7. In accordance with the CIPFA Code, the Council adopts the following:
   (a) The Council will create, and maintain, as the cornerstones for effective treasury management:

   - a Treasury Management Policy Statement, stating the policies, objectives and approach to risk management of its treasury management activities
   - suitable Treasury Management Practices (TMPs), setting out the manner in which the Council will seek to achieve those policies and objectives, and prescribing how it will manage and control th activities.

   The content of the policy statement and TMPs will follow the recommendations contained in Sections 6 and 7 of the Code, subject to amendment only where necessary to reflect the particular circumstances of the Council. Such amendments will not result in the Council materially deviating from the Code's key principles.

   (b) The Council will receive reports on its treasury management policies, practices and activities, including an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMPs.

   (c) The Council delegates responsibility for the implementation, scrutiny and monitoring of its treasury management policies and practices to the Treasury Management Group, comprising:
   - Service Director (Finance, Procurement & Improvement)
   - Group Manager (Financial Strategy & Compliance)
   - Group Manager (Financial Management)
   - Senior Accountant (Financial Strategy & Accounting)
   - Senior Accountant (Pensions & Treasury Management)

   The responsible officer for the execution and administration of treasury management decisions is the Senior Accountant (Pensions & Treasury Management), who will act in accordance with the policy statement and TMPs.

8. This Treasury Management Strategy has been prepared in accordance with regulations, guidance and codes of practice to support the Council's Medium Term Financial Strategy and in particular the financing of the capital programme and the management of cash balances. In addition to this strategy there is a Treasury Management Policy Statement in Appendix H that underpins the strategy, together with the TMPs that govern treasury management operations.

9. The strategy covers:
   - Current treasury position
   - Borrowing requirement
   - Treasury Indicators
   - Interest rate forecasts
   - Borrowing strategy
   - Investment strategy

Current Treasury Position

10. The table below shows the Council's forecast treasury position as at 31 March 2016:

Table 1		Total £m	Average Interest Rate
EXTERNAL BORROWING			
Fixed Rate	PWLB	317.5	5.00%
	Market Loan	101.3	3.85%
	Other	5.1	2.08%
Total External Borrowing		**423.9**	**4.93%**
Other Long Term Liabilities		125.7	
Total Gross Debt		**549.6**	
Less: Investments		(33.1)	
Total Net Debt		**516.5**	

Note 1: PWLB = Public Works Loans Board
Note 2: Market Loans = Lenders' Option Borrowers' Option (LOBO)
Note 3: External debt figures include accrued interest

Borrowing Requirement

11. Under the Prudential Code, the Council is required to calculate the 'Capital Financing Requirement' (CFR). This represents the Council's underlying need to borrow for the approved capital programme. New capital expenditure, financed by borrowing or by credit arrangements such as finance leases and private finance initiative schemes, increases the CFR.

12. The Council also sets aside an amount each year as a provision for the repayment of debt. This is known as the Minimum Revenue Provision (MRP) and is, in effect, the principal repayment for the borrowing expected to be undertaken by the Council to finance its capital programme. MRP set aside reduces the CFR. The Council's MRP policy from 2016/17 onwards is changing (see appendix E), but the principles behind it will not change.

13. The difference between the CFR and the total of long-term liabilities and existing and new borrowing indicates that the Council has made temporary use of internal cash balances (from its own earmarked reserves and working capital) to finance the capital programme. This is known as "internal borrowing". Internal borrowing is a way of making short-term savings and avoiding the risks associated with holding large cash balances and is explained further in the "Borrowing Strategy" section below.

14. The Local Government Act 2003 and supporting regulations requires the Council to determine and keep under review how much it is prepared to borrow, termed the “Authorised Limit”. This limit is determined for external borrowing (including both long-term and temporary borrowing and other forms of long-term liability, such as credit arrangements). This limit reflects the need to borrow for capital purposes. The Authorised Limit is set for at least the forthcoming financial year and two successive financial years. The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that its total capital investment is ‘affordable, prudent and sustainable’.

15. In practice during the year the level of borrowing will be monitored against the “Operational Boundary”. This represents the planned level of borrowing for capital purposes and, as shown in Appendix F, is made up as follows:
    - Existing borrowing and other long-term liabilities
    - Increased by:
        - planned new borrowing
        - net change in long-term liabilities
    - Reduced by amounts set aside for repayment of debt (referred to as Minimum Revenue Provision or MRP).
    - Contingency for changes to reserves forecast

16. The Operational Boundary is set for the forthcoming financial year and next two financial years. Any breach of this indicator would provide an early warning of a potential breach of the Authorised Limit and allow time for the Council to take appropriate action.

17. There are two main reasons why planned actual borrowing may be lower than that shown as being required to finance the capital programme. These are slippage in capital schemes and the Council temporarily making use of its cash reserves to delay external borrowing (the internal borrowing referred to above). The main components involved in calculating planned actual borrowing over the next three years are shown in the table below.

Table 2	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
	£m	£m	£m	£m	£m
Closing Capital Financing Requirement	717.3	738.1	777.4	790.0	799.8
Less:					
- Long-term liabilities	-126.9	-125.7	-125.4	-128.0	-124.2
- Existing borrowing	-408.1	-417.1	-406.2	-396.1	-381.8
- Cap Ex to be financed by borrowing			-54.7	-23.8	-24.4
- Replenishment/Replacement borrowing			2.3	-61.6	-99.8
Internal borrowing (A)	**182.3**	**195.3**	**193.4**	**180.5**	**169.7**
Cash and cash equivalents	45.7	18.6	5.0	5.0	5.0
Fixed investments	24.5	14.5	4.5	2.5	0
Y/E investment balances (B)	**70.2**	**33.1**	**9.5**	**7.5**	**5.0**
Cash deployed (A+B)	**252.5**	**228.4**	**202.9**	**188.0**	**174.7**
comprising:					
- Usable reserves	198.2	174.1	148.6	133.7	120.4
- Provisions / Working capital	54.3	54.3	54.3	54.3	54.3
Cumulative minimum borrowing requirement	**0.0**	**0.0**	**52.4**	**85.4**	**124.2**
Annual borrowing requirement			52.4	33.0	38.8

18. The table above shows that, after factoring in internal borrowing, the Council is expecting to borrow around £124m from the financial markets over the next 3 years. This is a minimum and should not result in any surplus cash that could be held as long-term investments by the Council. Therefore, if reserve balances are used quicker than forecast, or if working capital is reduced, additional borrowing – up to the Capital Financing Requirement - will be necessary.

19. Under the capital finance regulations, local authorities are permitted to *fully borrow* up to three years in advance of need as determined by the Capital Financing Requirement. This will only be done if cash flow dictates or if market conditions indicate that it is the best course of action. One of the reasons for borrowing more than the minimal amount is to take advantage of, and lock in, low long-term interest rates, make long-term savings and also reduce the Council's exposure to variable interest rate risk. However, there will almost certainly be a short term 'carry cost' to borrowing in advance of need when current investment rates are lower than long-term borrowing rates. This would be fully evaluated before any decision is taken.

20. Borrowing in advance of need also increases the level of temporary investments and makes the security of those funds even more important. However, the Council's treasury management practices ensure that the risks of investing funds are minimised.

21. A summary of the proposed Treasury Management Indicators for 2016-19 are set out below. The 'Authorised Limit and 'Operational Boundary' are detailed in Appendix F but are shown in the table below for completeness.

Table 3 TREASURY INDICATORS	Proposed 2016/17 £m	Proposed 2017/18 £m	Proposed 2018/19 £m
Operational Boundary			
Borrowing	502	549	599
Other long term liabilities	125	128	124
TOTAL	**627**	**677**	**723**
Authorised Limit			
Borrowing	527	574	624
Other long term liabilities	125	128	124
TOTAL	**652**	**702**	**748**
Upper limit for Rate Exposure			
Fixed Rate	100%	100%	100%
Variable Rate	75%	75%	75%
Upper limit for principal sums invested for over 364 days	Higher of £20m and 15%	Higher of £20m and 15%	Higher of £20m and 15%

Table 4. Maturity structure of fixed rate borrowing	Lower limit	Upper limit
under 12 months	0%	25%
12 months and within 24 months	0%	25%
24 months and within 5 years	0%	75%
5 years and within 10 years	0%	100%
10 years and above	0%	100%
Adoption of CIPFA's Treasury Management in the Public Services Code of Practice and Cross Sectoral Guidance Notes	Adopted	

Review of 2015 and forecasts for 2016

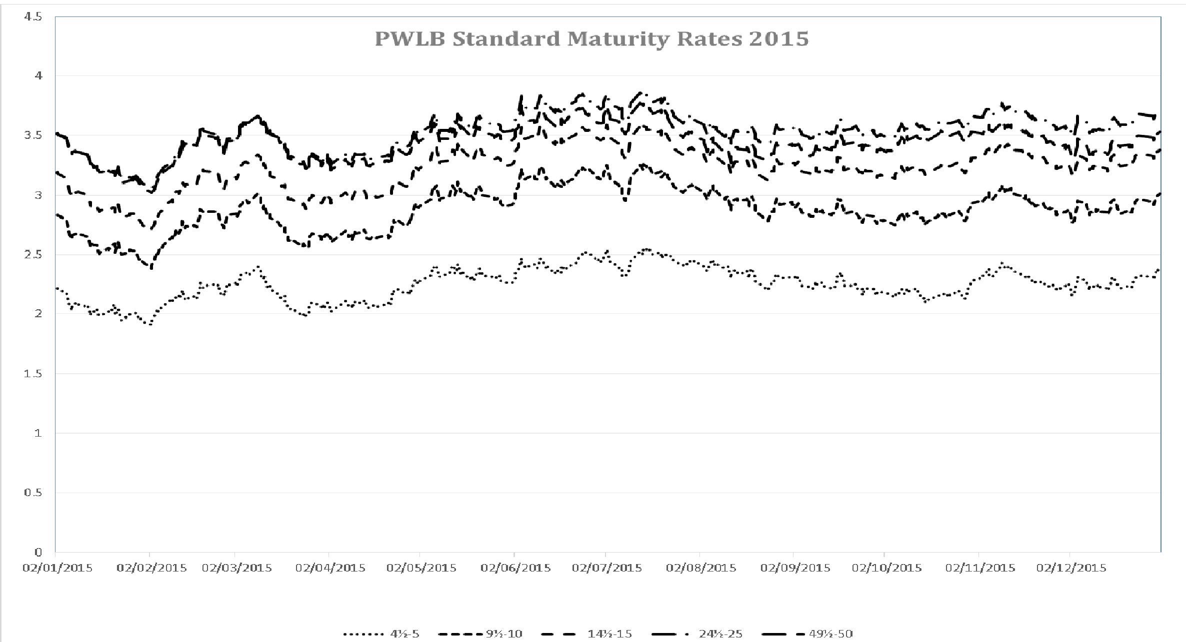
22. Domestic demand has grown robustly over 2015, supported by sustained real income growth and a gradual decline in private sector savings. Low oil and commodity prices were a notable feature of 2015, and contributed to annual CPI inflation falling to 0.1% in October. Wages are growing at 3% a year, and the unemployment rate has dropped to 5.4%. Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 3.5%.

23. These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was 2.3% a year in the third quarter of 2015. Although speeches by the Bank of England's Monetary Policy Committee (MPC) members indicated that some were willing to countenance higher interest rates, the MPC, at its meeting in November 2015, held policy rates at 0.5% for the 81st consecutive month. Quantitative easing (QE) has been maintained at £375bn since July 2012.

24. The outcome of the UK general election saw some big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

25. China's growth has slowed and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. US domestic growth has accelerated but the globally sensitive sectors of the US economy have slowed. Strong US labour market data and other economic indicators however suggest recent global turbulence has not knocked the American recovery off course. The Federal Reserve finally raised policy rates by a quarter percentage point in December 2015. In contrast, the European Central Bank embarked on QE in 2015 to counter the risk of deflation.

26. Over the course of 2015 PWLB rates generally reflected the UK's slowly growing economic strength, but these were not without their fluctuations, as investors responded to news of the changing investment environment. The rates are shown in the chart below:



27. The varying fortunes of different parts of the global economy are reflected in market indicators of credit risk. UK Banks operating in the Far East and parts of mainland Europe have seen their perceived risk increase, while those with a more domestic focus continue to show improvement. The sale of most of

the government's stake in Lloyds and the first sale of its shares in RBS have generally been seen as credit positive.

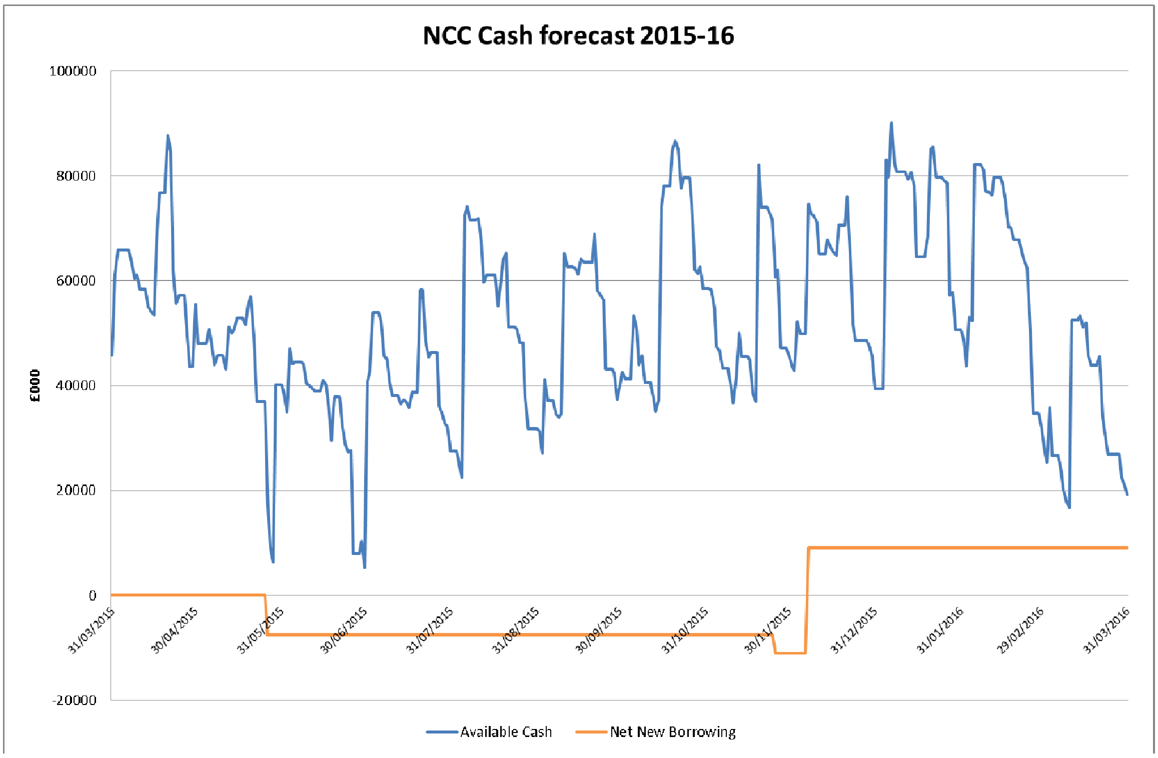
28. Bail-in legislation, which aims to ensure that large investors (including local authorities) will rescue failing banks instead of taxpayers, has now been fully implemented in the UK, USA and Germany. The rest of the European Union will follow suit in January 2016, while Australia, Canada and Switzerland are well advanced with their own plans. Meanwhile, changes to the UK Financial Services Compensation Scheme and similar European schemes in July 2015 mean that most private sector investors are now partially or fully exempt from contributing to a bail-in. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however remain stubbornly low.

29. Forecasters project the first quarter percentage point increase in the UK Bank Rate in the third quarter of 2016, rising by 0.5% a year thereafter, finally settling between 2% and 3% in several years' time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted to the downside.

30. A shallow upward path for medium term gilt yields is also forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Forecasters project the 10 year gilt yield to rise from its current 2.0% level by around 0.3% a year. The uncertainties surrounding the timing of UK and US interest rate rises are likely to prompt short-term volatility in yields.

Borrowing Strategy

31. The chart below shows how the Council's cash position has progressed over the financial year 2015/16. The cash position has been fairly stable over the year between £20m and £80m (with the occasional peak as grant money is received, and occasional trough when large payments are made). This has partly been achieved through the Council's borrowing strategy. Net new borrowing has increased by £9m over the course of the year. The forecast for the year, as reported in the 2015/16 Strategy Report, was £78m; the difference of £69m is due to slippage in the capital programme and the use of reserves being lower than forecast.



32. Generally the activity of investing surplus cash comes to the fore in the first few months of the financial year, when grant income and precept income tends to exceed outgoing payments. Towards the end of the year the cash flow tends to reverse, and the focus shifts towards the borrowing strategy. Decisions then have to be taken about the mix of short- and long-term borrowing and the extent to which use can be made of internal borrowing.

33. Over the past several years the Council has financed the capital programme (on a temporary basis) by using its cash balances. These are essentially earmarked reserves, general fund reserves and net movement on current assets. As the cash in these reserves is not required in the short term for the reserves' specific purposes, it has been utilised to reduce external borrowing.

34. The advantage to the Council of internal borrowing is that it costs less than external borrowing, the cost being the opportunity cost of interest foregone by not investing the cash (investment rates are typically around 0.5% for short-term deposits). It therefore generates short-term savings for the Council. Another advantage is that counterparty risk is reduced by having less cash to invest.

35. On the other hand, by postponing its long-term borrowing the Council is in effect increasing its exposure to interest rate risk, as rates will fluctuate in the intervening period until long-term fixed rate borrowing is taken. Treasury management staff monitor this risk, and regularly review interest rates.

36. As a result of all this, the borrowing strategy needs to provide funds not only to finance the capital programme but also to replenish reserves as and when these are required and cover principal repayments on any maturing debt. If long-term borrowing is not taken to cover these outflows of cash then the Council would consider other sources of finance (such as any bank overdraft facility or market loans).

37. These strategic factors drive the Council's objective need to secure long-term debt finance, but there are a number of day-to-day factors – relating to market conditions and the Council's own revenue budget - that must be taken into account when deciding precisely when to borrow.

38. Despite recent fluctuations in the gilt market it is still the case that short-term debt is considerably cheaper than long-term: 1 year loans are approximately 1.1% (taking account of the 'certainty' rate offered by PWLB), whereas 40 year loans (reflecting the asset life of the assets within the capital programme) are approximately 3.1%. In cash terms taking the very short-dated debt would equate to a saving of £20,000 per annum for every £1m of Council borrowing.

39. However, there would be a significant risk in pursuing such a short-term approach, since short-term loans need regular refinancing and at these points the Council would find itself exposed to interest rate risk, i.e. it would be forced to accept whatever the prevailing interest rates were at the time. If this happened the Council could find itself facing considerably higher interest rates, which would quickly undermine any saving made by taking short-dated debt.

40. Given that the Council's current portfolio of PWLB loans average 5.00% the long-term rates being offered by PWLB look relatively attractive. Occasionally, however, long-term loans offered by the market or by other local authorities can be a competitive alternative to PWLB loans, and these may also be worth considering.

41. In practice, a balanced portfolio will include a mix of:
    - Temporary use of the Council's cash reserves
    - Short-term debt provided by the market/other local authorities
    - Short-term or variable rate debt provided by PWLB
    - Long-term debt provided by PWLB
    - Long-term debt provided by the market or other local authorities

42. Given these contingencies the amount, type, period, rate and timing of new borrowing will be an operational matter falling under the responsibility of the Service Director (Finance, Procurement and Improvement) exercised by the Senior Accountant (Pensions & Treasury Management) within the approved borrowing strategy, taking into account the following factors:
    - expected movements in interest rates as outlined above
    - current debt maturity profile
    - the impact on the medium term financial strategy
    - the capital financing requirement
    - the operational boundary
    - the authorised limit.

43. Opportunities to reschedule debt will be reviewed periodically throughout 2016/17 but the current structure of repayment rates from the PWLB indicate significant premiums to be paid on the premature repayment of existing loans which would not be compensated by lower rates available for new loans.

Investment Strategy

44. During 2016/17 cash balances are expected to be kept at a low level with the aim of maintaining a working balance of around £20m, and a minimal level of around £5m by year end. This will provide a level of liquidity without recourse to temporary borrowing, and will minimise the risk of having to seek funds when availability may be restricted or expensive.

45. As the 2015/16 cash flow chart above suggests, the most suitable strategy will be for the Council to consider making use of fixed-term investments in the early part of the financial year, and use call accounts or money market funds for a substantial part of its portfolio in order to manage any liquidity risk.

46. The Council actively manages counterparty risk by monitoring the ratings of the institutions in which it could invest. Members will note that exposure to the Eurozone is limited by investing in UK banks and high credit quality overseas banks. The criteria for selecting counterparties are detailed in TMP 1 in Appendix H.

47. A further measure to ensure security of the Council's investments is to maintain the Council's exposure to the UK local authority sector and UK government securities. When lending to local authorities fixed term deposits would be used but these are subject to demand and cannot be relied upon in the same way as bank lending. The use of treasury bills and UK government gilts may be considered and would ensure priority is given to security and liquidity of funds.

NIGEL STEVENSON

SERVICE DIRECTOR – FINANCE, PROCUREMENT AND IMPROVEMENT