

## **Report of the Service Director – Finance, Procurement and Improvement**

### **Treasury Management Strategy 2017/18**

#### **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 those 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 and Improvement)
  - Group Manager (Financial Strategy and Compliance)
  - Group Manager (Financial Management)
  - Senior Accountant (Financial Strategy and Accounting)
  - Senior Accountant (Pensions and Treasury Management)

The responsible officer for the execution and administration of treasury management decisions is the Senior Accountant (Pensions and 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 F 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 2017:

<b>Table 1</b>		<b>Total £m</b>	<b>Average Interest Rate</b>
<b>EXTERNAL BORROWING</b>			
Fixed Rate	PWLB	331.2	4.79%
	Market loans	100.0	3.85%
	Loans from other LAs	5.0	2.08%
<b>Total External Borrowing</b>		<b>436.2</b>	<b>4.54%</b>
Other Long Term Liabilities		127.2	
<b>Total Gross Debt</b>		<b>563.4</b>	
Less: Investments		(53.4)	
<b>Total Net Debt</b>		<b>510.0</b>	

Note 1: PWLB = Public Works Loans Board

Note 2: Figures exclude 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.
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 D, 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.

	2015/16 Actual	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
	£m	£m	£m	£m	£m
Closing Capital Financing Requirement	715.5	742.0	793.0	810.0	813.0
Less:					
- Long-term liabilities	-125.7	-127.2	-129.8	-126.0	-122.0
- Existing borrowing	-437.1	-436.2	-426.1	-411.8	-397.8
- Cap Ex to be financed by borrowing			-56.9	-34.0	-20.1
- Replenishment/Replacement borrowing			26.5	-26.0	-54.8
<b>Internal borrowing (A)</b>	<b>152.7</b>	<b>178.6</b>	<b>206.8</b>	<b>212.3</b>	<b>218.3</b>
Cash and cash equivalents	67.7	40.4	5.0	5.0	5.0
Fixed investments	34.5	14.5	2.5	0	0
<b>Y/E investment balances (B)</b>	<b>102.2</b>	<b>54.9</b>	<b>7.5</b>	<b>5.0</b>	<b>5.0</b>
<b>Cash deployed (A+B)</b>	<b>254.9</b>	<b>233.5</b>	<b>214.3</b>	<b>217.3</b>	<b>223.3</b>
comprising:					
- Usable reserves	195.0	173.6	154.4	157.4	163.4
- Provisions / Working capital	59.9	59.9	59.9	59.9	59.9
<b>Cumulative minimum borrowing requirement</b>	<b>0.0</b>	<b>0.0</b>	<b>30.4</b>	<b>60.0</b>	<b>74.9</b>
Annual borrowing requirement	0.0	0.0	30.4	29.6	14.9

18. The table above shows that, after factoring in internal borrowing, the Council is expecting to borrow around £75m 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. The forecast borrowing for 2016/17, as reported in the 2016/17 Strategy Report, was £52m. Actual borrowing is forecast to be £10m, the difference of £42m being due to slippage in the capital programme and the actual use of reserves being lower than forecast.

20. 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 cashflow 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.

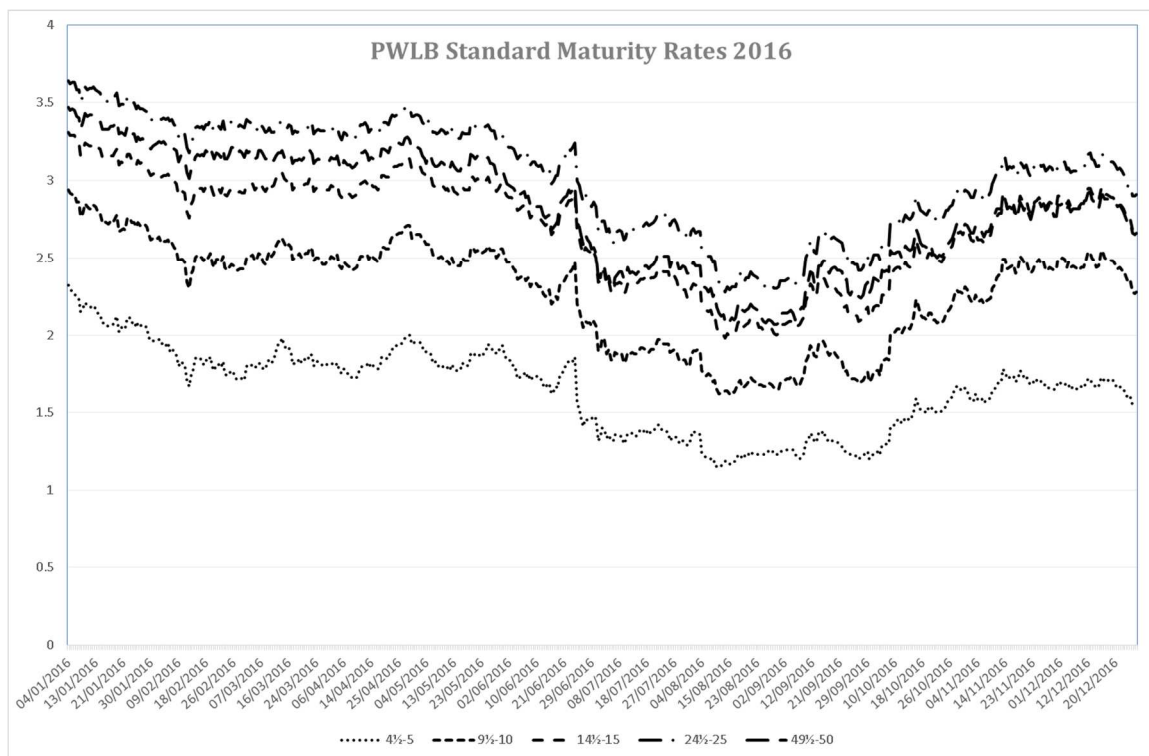
21. Borrowing in advance of need also increases the level of temporary investments and makes the security of those funds even more important. However, the Council's treasury management practices ensure that the risks of investing funds are minimised.
22. A summary of the proposed Treasury Management Indicators for 2017-20 are set out in the tables below. Please note that the 'Authorised Limit and 'Operational Boundary' are detailed in Appendix D.

<b>Table 3 TREASURY INDICATORS</b>	<b>Proposed 2017/18 £m</b>	<b>Proposed 2018/19 £m</b>	<b>Proposed 2019/20 £m</b>
<b>Upper limit for Rate Exposure</b> Fixed Rate Variable Rate	100% 75%	100% 75%	100% 75%
<b>Upper limit for principal sums invested for over 364 days</b>	Higher of £20m and 15%	Higher of £20m and 15%	Higher of £20m and 15%

<b>Table 4. Maturity structure of fixed rate borrowing</b>	<b>Lower limit</b>	<b>Upper limit</b>
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%
<b>Adoption of CIPFA's Treasury Management in the Public Services Code of Practice and Cross Sectoral Guidance Notes</b>	Adopted	

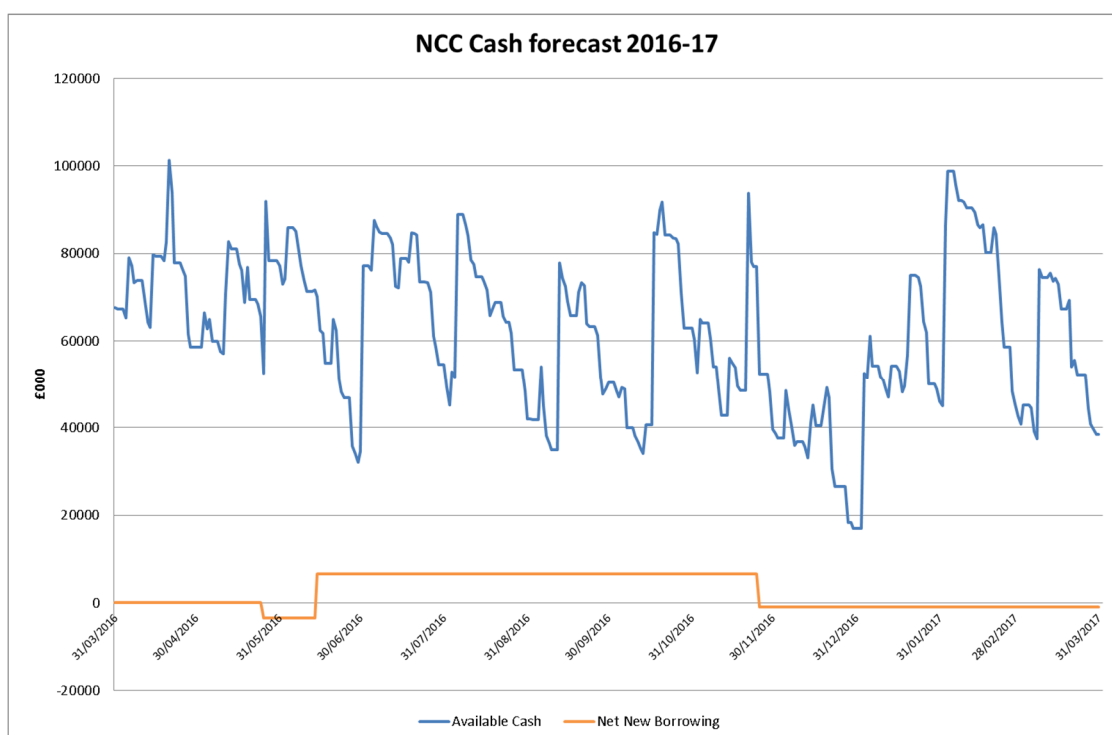
### **Borrowing Strategy**

23. Over the course of 2016 PWLB rates generally reflected the UK's decline in economic strength following the EU referendum, but the rates were not without their fluctuations, as investors recovered from the initial shock and tentatively began to move out of government gilts and once more into equities. The rates are shown in the chart below:



24. The chart below shows how the Council's instant-access cash position has progressed over the financial year to January 2017 and how it is forecast to progress until the year-end. This position has varied over the year between £20m and £100m, reflecting the cumulative profile of the Council's revenue and capital expenditure, grant and precept income, together with any borrowing or term-lending decisions made by the Council's treasury management team.

25. The lower line shows the Council's net new borrowing over the course of the year. It can be seen that for 2016/17 this was approximately zero (that is, new borrowing was approximately equal to loan repayments), since the Council's cash position and the relative cost of borrowing served to discourage more borrowing than a minimal amount. Indeed, the new borrowing was taken only because of the dramatic fall in interest rates following the EU referendum in June 2016.



26. 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 cashflow 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.
27. 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.
28. 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.
29. 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.
30. 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).

31. 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.
32. Despite recent fluctuations in the gilt market it is still the case that short-term debt is considerably cheaper than long-term: as of mid-January 2017 1 year loans are approximately 0.9% (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 2.6%. 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.
33. 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.
34. Given that the Council's current portfolio of PWLB loans average 4.79% 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.
35. 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
36. 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 and 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.
37. Opportunities to reschedule debt will be reviewed periodically throughout 2017/18 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**

38. During 2017/18 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, i.e. having to seek funds when availability may be restricted and therefore expensive.
39. As the 2016/17 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.
40. The Council actively manages counterparty risk by monitoring the ratings of the institutions in which it could invest. 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 F.
41. 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.