Body:	**Cabinet**
Date:	**7 February 2018**
Subject:	**Treasury Management and Prudential Indicators 2018/19**
Report of:	**Deputy Chief Executive (Chief Finance Officer)**
Cabinet member:	Councillor Mattock, Portfolio Holder for Financial Services
Ward(s):	All
Purpose of the report:	To approve the Council's Annual Treasury Management Strategy together with the Treasury and Prudential Indicators for the next financial year.
Decision type:	Key Decision
Recommendation:	Cabinet is asked to recommend the following proposals to full Council : i) The Treasury Management Strategy and Annual Investment Strategy as set out in this report. ii) The methodology for calculating the Minimum Revenue Provision set out at paragraph 2.3. iii) The Prudential and Treasury Indicators as set out in this report. iv) The Specified and Non-specified Investment categories listed in Appendix 2. Cabinet is recommended to note the extended role of the Chief Financial Officer as set out in Appendix 4.
Reasons for recommendations:	It is a requirement of the budget setting process for the Council to review and approve the Prudential and Treasury indicators and Treasury Strategy.
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1.0 Introduction

1.1 The Prudential and Treasury Indicators and Treasury Strategy covers:

- the capital prudentail indicators;
- a Minimum Revenue Provision Policy (how residual capital expenditure is

charged to revenue over time);

- the Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

1.2 The Council adopted CIPFA's Treasury Management code of Practice on 18 May 2010. This code is supported by treasury management practices (TMPs) that set out the manner in with the council seeks to achieve the treasury management strategy and prescribes how it manages and controls those activities.

1.3 CIPFA has updated the definition of treasury management to:

"The management of the local authority's **borrowing**, 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."

2.0 THE CAPITAL PRUDENTIAL INDICATORS 2016/17 – 2020/21

2.1 In December 2017, CIPFA issued revised Prudential and Treasury Management Codes. As from 2019-20, all local authorities will be required to prepare an additional report, a Capital Strategy report, which is intended to provide the following:

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability

The aim of this report will be to ensure that all elected members on the full council fully understand the overall strategy, governance procedures and risk appetite entailed by this Strategy.

The Capital Strategy will include capital expenditure, investments and liabilities and treasury management in sufficient detail to allow all members to understand how stewardship, value for money, prudence, sustainability and affordability will be secured.

A Capital Strategy report will be prepared in 2018/19 in partnership with other services.

2.2 Capital Expenditure

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in prudential indicators, which are designed to assist Member overview and confirm capital expenditure plans.

The table below summarises the Council's capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding need (borrowing).

The capital expenditure forecasts for the Council are:

Capital Expenditure £m	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Non-HRA	21.2	71.3	46.1	31.7	10.4
HRA	5.8	8.8	4.3	4.4	4.4
Total	27.0	80.1	50.4	36.1	14.8
Financed by:					
Capital receipts	3.0	4.0	0.6	0.6	0.2
Capital grants	4.9	10.3	2.7	2.5	0.3
Capital reserves	4.9	6.6	4.4	4.4	4.4
Revenue	0.0	0.6	0.0	0.0	0.0
Net borrowing needed for the year	**14.2**	**58.6**	**42.7**	**28.6**	**9.9**

The above figures include uncommitted borrowing i.e. borrowing which has been approved but schemes have not yet been identified and will only proceed if they are financially advantageous.

2.3 The Council's Borrowing Need (the Capital Financing Requirement)

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

The CFR includes other long term liabilities (e.g. Serco, finance leases) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, these types of scheme already include a borrowing facility and the Council is not required to separately borrow for them. There are currently £0.43m of such schemes within the CFR.

The Council is asked to approve the CFR projections below:

£m	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Capital Financing Requirement					
CFR – non housing	47.2	103.7	144.9	172.4	181.2
CFR - housing	41.7	42.5	42.5	42.5	42.5
Total CFR	**88.9**	**146.2**	**187.4**	**214.9**	**223.7**
Movement in CFR	**13.8**	**57.3**	**41.2**	**27.5**	**8.8**

Movement in CFR represented by					
Net financing needed for the year (above)	14.2	58.6	42.7	28.6	9.9
Less MRP and other financing movements	(0.4)	(1.3)	(1.5)	(1.1)	(1.1)
Movement in CFR	**13.8**	**57.3**	**41.2**	**27.5**	**8.8**

Note the MRP includes Serco repayments.

2.4 MRP Policy Statement

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the minimum revenue provision - MRP), although it is also allowed to undertake additional voluntary payments if required (voluntary revenue provision - VRP). Regulations require the Council to approve an MRP Statement in advance of each financial year. A variety of options are provided to councils, so long as there is a prudent provision. It is recommended that the following methodology, as used in previous years, be continued:

- For capital expenditure incurred before 1.4.2008 MRP is provided for at 4% of the CFR.
- For capital expenditure incurred since 1.4.2008 MRP be charged using the most appropriate of the following two methods for the individual schemes as determined by the Chief Finance Officer under delegate powers
  - Asset Life method – based on the estimated life of the asset,
  - Depreciation method – based on standard depreciation accounting procedures.

No revenue charge is currently required for the HRA. However if the HRA is required to charge depreciation on its assets, this would have a revenue effect. In order to address any possible adverse impact, regulations allow the Major Repairs Allowance to be used as a proxy for depreciation.
Repayments included in annual Serco payments and any finance leases are applied as MRP.

There is no requirement to set aside a prudent provision for capital expenditure by way of loan (e.g. Eastbourne Housing Investment Co Ltd (EHIC) or investments (e.g. LAMS) which will be repaid in full at a future date.

The DCLG issued a consultation on proposed changes to their MRP guidance in November 2017. The consultation closed on 22 December but the results of the consultation are yet to be published. If changes to the guidance are published, which would require a change to this MRP policy for 2018/19, a revised policy will be presented to council for approval.

2.5 Affordability Prudential Indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. Indicators are required to be prepared on the gross capital spend and do not include any resulting income contributions expected from the implementation of the capital scheme. The Council is asked to approve the following indicators:

2.6 **Actual and estimates of the ratio of financing costs to net revenue stream.**

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

%	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Non-HRA	4.4	10.9	16.8	20.7	23.3
HRA	11.8	12.3	12.6	12.6	10.07

The estimates of financing costs exclude uncommitted borrowing.

3.0 TREASURY MANAGEMENT STRATEGY

The capital expenditure plans set out in Section 2 provide details of the service activity of the Council. 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 approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

3.1 Current Portfolio Position

The Council's treasury portfolio position at 31 March 2017, with forward projections, are summarised below. The table shows the actual external borrowing (the treasury management operations), against the capital borrowing need (the Capital Financing Requirement - CFR), highlighting any under borrowing.

£m	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
External borrowing					
Borrowing at 1 April	52.0	65.0	123.5	166.2	194.8
Expected change in borrowing	13.0	58.5	42.7	28.6	9.9
Other long-term liabilities (OLTL)	1.1	0.8	0.5	0.1	0.0
Expected change in OLTL	(0.3)	(0.3)	(0.4)	(0.1)	0.0
Actual borrowing at 31 March	**65.8**	**124.0**	**166.3**	**194.8**	**204.7**
CFR – the borrowing need	88.9	146.2	187.4	214.9	223.7
Under borrowing	23.1	22.2	21.1	20.1	19.0

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross borrowing does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

Whilst investment interest rates continue to be below that for borrowing, value for money can be best achieved by avoiding new borrowing and using internal cash balances to temporarily finance new capital expenditure or to replace maturing external debt, thus maximising short term savings. However this needs to be carefully considered to ensure borrowing is taken at advantageous rates, but not taken too long before the need to borrow to avoid the cost of carrying the debt.

3.2 Treasury Indicators: Limits to Borrowing Activity

3.2.1 **The Operational Boundary.** This is the limit beyond which external borrowing is not normally expected to exceed.

The Council is asked to approve the following operational boundary limits:

Operational boundary £m	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Borrowing	88.1	145.7	187.3	214.9	223.7
Other long term liabilities	0.8	0.5	0.1	0.0	0.0
Total	88.9	146.2	187.4	214.9	223.7

3.2.2 The Council is asked to approve the following authorised limit**:**

Authorised limit £m	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Borrowing	103.1	160.7	202.3	229.9	238.7
Other long term liabilities	0.8	0.5	0.1	0.0	0.0
Total	103.9	161.2	202.4	229.9	238.7

Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime of £42.6m, which is included in the authorised limits above.

3.2.3 The Council has complied with these prudential indicators in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

3.3 Prospects for Interest Rates

The Council has appointed Link Asset Services (previously known as Capita Asset Services) 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 their central view.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%
5yr PWLB Rate	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%
10yr PWLB View	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%
25yr PWLB View	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%

As expected, the Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November. The MPC also gave forward guidance that they expected to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%. However, Link Asset Services forecast as above includes increases in Bank Rate of 0.25% in November 2018, November 2019 and August 2020. The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently.

Investment returns are likely to remain low during 2018/19 but to be on a gently rising trend over the next few years.

Borrowing interest rates increased sharply after the result of the general election in June and then also after the September MPC meeting when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases. Since then, borrowing rates have eased back again somewhat. Apart from that, there has been little general trend in rates during the current financial year. 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 the future when the Council may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

A detailed view of the Economic forecast is set out at Appendix 1.

3.4 **Borrowing Strategy**

The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is high and will be maintained.

There is an underlying need to borrow in the future to support capital expenditure and new external borrowing will be required by the end of this year. Rates are currently being monitored and new borrowing will be taken when the rates are advantageous either as long term debt or temporary borrowing. Against the current ecenomic background and the risks within the economic forecast, caution will be adopted with the 2018/19 treasury operations. The Chief Finance Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.

The Council will maintain a balanced, affordable and sustainable maturity profile as set out below and all new borrowing will be undertaken in line with this policy.

3.5 **Treasury Management Limits on Activity**

There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates.

The Council is asked to approve the following treasury indicators and limits:

	2018/19	2019/20	2020/21
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	25%	25%	25%
Maturity Structure of fixed interest rate borrowing 2018/19			
		Lower	**Upper**
Under 12 months		0%	75%
12 months to 2 years		0%	75%
2 years to 5 years		0%	75%
5 years to 10 years		0%	100%
10 years and above		0%	100%

3.6 **Policy on Borrowing in Advance of Need**

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.

Risks associated with any borrowing in advance of activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

3.7 **Debt Rescheduling**

As short term borrowing rates are currently considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt.
Debt scheduling will only be considered under the following circumstances:

- the generation of cash savings and /or discounted cash flow to produce sufficent savings to cover the costs;
- it helps to fulfil the treasury strategy; and
- the balance of the portfolio (amend the maturity profile and/or the balance of volatility) is maintained.

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.

All rescheduling will be reported to Cabinet, at the earliest meeting following its action.

3.8 **Municipal Bond Agency**

It is possible that the Municipal Bond Agency will be offering loans to local authorities in the future. The Agency hopes that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). This Authority may make use of this new source of borrowing as and when appropriate.

4.0 ANNUAL INVESTMENT STRATEGY

4.1 **Investment Policy**

The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the CIPFA TM Code"). The Council's investment main priorities will be security first, portfolio liquidity second, then return.

After this main principle the Council will ensure:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment at appendix 2 and

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

4.2 **Creditworthiness Policy**

In order to minimise the risk to investments, the Council has clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list as set out in at Appendix 3. The aim is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk.

Credit rating information is supplied by Link, the Council's treasury consultants, on all active counterparties that comply with the criteria at Appendix 3. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing.

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AAA from Fitch, as well as UK, even if the UK rating falls below AAA.

4.3 The Chief Finance Officer will maintain a counterparty list in compliance with the criteria set out in Appendix 3 and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either Specified or Non-Specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

4.4 **The Local Authority Mortgage Scheme (LAMS)**

The Council is particpating in the cash backed mortgage scheme which requires the Council to place a matching five year deposit to the life of the indemnity. This investment is an integral part of the policy initiative and is outside the criteria above.

4.5 **Time and monetary limits applying to investments.**

The time and monetary limits for institutions on the Council's counterparty list are as follows (these will cover both Specified and Non-Specified Investments):

	Money Limit	Time Limit
Banks 1 category high quality	£5.0m	1 yr
Banks 2 category – part nationalised	£5.0m	1 yr
Limit 3 category – Council's banker (not meeting Banks 1)	£10.0m	1 day
Other institutions limit	£5.0m	1 yr
DMADF	Unlimited	6 months
Local authorities	£5.0m	2 yrs
Money market Funds	£10.0m	Liquid
Property funds	£10.0m	

4.6 The proposed criteria for Specified and Non-Specified investments are shown in Appendix 2 for approval.

Property Funds - The use of these instruments can be deemed capital expenditure, and as such will be an application (spending) of capital resources. This Authority will seek guidance on the status of any fund it may consider using. Appropriate due diligence will also be undertaken before investment of this type is undertaken.

4.7 **Non treasury management investments**

This Council invests in non treasury management (policy) investments. These do not form part of the treasury management strategy. However, Members are advised that the following non treasury investments are currently in place as at 31.12.17:

Investment	Facility	Int Rate
CloudConnX	357,000	1.5%+Base
WEL (Excl capitalised interest)	1,150,000	8%-10%
EHIC – Loan Facility	11,590,150	4.50%
EHIC - Credit Facility	250,000	2%+Base
Aspiration Homes Loan Facility	1,700,000	4.50%
Seachange (Site 6 Sov Harbour) (Excl capitalised interest)	850,000	3.00%
Seachange (Sov Harbour Innovation Mall) (Excl capitalised interest)	1,400,000	3.00%

4.8 **Investment Strategy**

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).

4.9 **Investment returns expectations.**

Bank Rate is forecast to stay flat at 0.50% until quarter 4 2018 and not to rise above 1.25% by quarter 1 2021. Bank Rate forecasts for financial year ends (March) are:

- 2017/18 0.50%
- 2018/19 0.75%
- 2019/20 1.00%
- 2020/21 1.25%

The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows:

	Now
2017/18	0.40%
2018/19	0.60%
2019/20	0.90%
2020/21	1.25%
2021/22	1.50%
2022/23	1.75%
2023/24	2.00%
Later years	2.75%

The overall balance of risks to these forecasts is currently skewed to the upside and are dependent on how strong GDP growth turns out, how quickly inflation pressures rise and how quickly the Brexit negotiations move forward positively.

4.10 **Investment treasury indicator and limit** - Total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Council is asked to approve the treasury indicator and limit:

Maximum principal sums invested > 364 days			
£m	**2018/19**	**2019/20**	**2020/21**
Principal sums invested > 364 days	£2.0m	£2.0m	£2.0m

For its cash flow generated balances, the Council will seek to utilise its current account, call accounts and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

4.11 **End of year investment report**

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

4.12 **Policy on the use of external service providers**

The Council uses Link as its external treasury management advisors.
The Council recognises that responsibility for treasury management decisions remains with the organisation at all times.

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.

5.0 Outcome expected and performance management

5.1 Loans, Investments and Prudential Indicators will be monitored regularly during 2018/19 and performance will be reported to members quarterly.

6.0 Financial appraisal

6.1 These are included in the main body of the report.

7.0 Legal implications

7.1 This report covers the requirements of the Local Government Act 2003, the CIFPA Prudential Code, the CLG MRP Guidance, the CIPFA Treasury Management Code and the CLG Investment Guidance.

8.0 Equality analysis

8.1 The equality implications of decisions relating to Treasury Management covered in this report are addressed within other relevant Council reports or as part of programmed equality analysis.

9.0 Conclusion

9.1 Capital prudential indicators have to be set to demonstrate plans for borrowing are affordable. The movement in the Capital Financing Requirement (CFR) forecasts for 2018/19, 2019/20 & 2020/21 have been set as £41.2m, £27.5m and £8.8m respectively. This borrowing has been reflected in the Capital Financing Requirement, which sets out the Council's outlining requirement for borrowing, and includes both the use of internal resources and external borrowing.

9.2 The proposed Minimum Revenue Provision Policy remains unchanged from 2017/18 and ensures that prudent provision is made for the repayment of borrowing. The Government is currently consulting on changes to the MRP policy and if there are any changes required, these will be reported to a future meeting of the Cabinet.

9.3 All Treasury indicators have been set to reflect the treasury strategy and funding requirements of the capital programme.

9.3 The Council's treasury management advisors are predicting a gradual rise in interest rates of 0.25% going forward to reach 1.25% by September 2020. Investment returns are therefore likely to remain low during 2018/19 but to be on a gently rising trend over the next few years.

9.4 The investment strategy has been set to maintain the Councils main priorities in the order of Security, Liquidity and Yield.

9.5 The proposed criteria for Specified and Non-Specified investments is shown in Appendix 2 for approval and remains unchanged from 2017/18.

9.6 CIPFA issued a revised Treasury Management Code of Practice in December 2017 which expanded the role of the Chief Finance Officer's responsibility for treasury management activities, as set out in Appendix 4. These revisions have particularly focused on non-treasury investments and introduces the requirement to produce a detailed Capital Strategy, which will be prepared in 2018/19 in partnership with other services.

Appendices

- 1 – Economic Background
- 2 – Specified and Non-Specified Investments and limits
- 3 – Creditworthiness Policy
- 4 – The Treasury Management Role of the Section 151 Officer

Background papers

The background papers used in compiling this report were as follows:

- CIPFA Treasury Management in the Public Services code of Practice (the Code)
- Cross-sectorial Guidance Notes

- CIPFA Prudential Code
- Treasury Management Strategy and Treasury Management Practices adopted by the Council on 18 May 2010.
- Council Budget 7 February 2018
- Finance Matters and Performance Monitoring Reports 2017.

To inspect or obtain copies of background papers please refer to the contact officer listed above.

APPENDIX 1 Economic Background

GLOBAL OUTLOOK. World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October, the IMF upgraded its forecast for world growth from 3.2% to 3.6% for 2017 and 3.7% for 2018.

In addition, **inflation prospects are generally muted** and it is particularly notable that **wage inflation** has been subdued despite unemployment falling to historically very low levels in the UK and US. This has led to many comments by economists that there appears to have been a fundamental shift downwards in the Phillips curve (this plots the correlation between levels of unemployment and inflation e.g. if the former is low the latter tends to be high). In turn, this raises the question of what has caused this? The likely answers probably lay in a combination of a shift towards flexible working, self-employment, falling union membership and increasing globalisation and specialisation of individual countries, which has meant that labour in one country is in competition with labour in other countries which may be offering lower wage rates, increased productivity or a combination of the two. In addition, technology is probably also exerting downward pressure on wage rates and this is likely to grow with an accelerating movement towards automation, robots and artificial intelligence, leading to many repetitive tasks being taken over by machines or computers. Indeed, this is now being labelled as being the start of the **fourth industrial revolution.**

KEY RISKS - central bank monetary policy measures
Looking back on nearly ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as Quantitative Easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the US, and more recently in the UK, on reversing those measures i.e. by raising central rates and (for the US) reducing central banks' holdings of government and other debt.

There is also a potential key question over whether economic growth has become too dependent on strong central bank stimulus and whether it will maintain its momentum against a backdrop of rising interest rates and the reversal of QE. In the UK, a key vulnerability is the **low level of productivity growth**, which may be the main driver for increases in wages; and **decreasing consumer disposable income,** which is important in the context of consumer expenditure primarily underpinning UK GDP growth.

A further question that has come to the fore is whether **an inflation target for central banks of 2%**, is now realistic given the shift down in inflation pressures from internally generated inflation, (i.e. wage inflation feeding through into the national economy), given the above mentioned shift down in the Phillips curve.

UK. After the UK surprised on the upside with strong economic growth in 2016, **growth in 2017 has been disappointingly weak**; quarter 1 came in at only +0.3% (+1.8% y/y), quarter 2 was +0.3% (+1.5% y/y) and quarter 3 was +0.4% (+1.5% y/y). The main reason for this has been the sharp increase in inflation, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 80% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the **manufacturing sector** which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year while robust world growth has also been supportive. However, this sector only accounts for around 10% of GDP so expansion in this sector will have a much more muted effect on the overall GDP growth figure for the UK economy as a whole.

One key area of risk is that consumers may have become used to cheap rates since 2008 for borrowing, especially for mortgages. It is a major concern that **some consumers may have over extended their borrowing** and have become complacent about interest rates going up after Bank Rate had been unchanged at 0.50% since March 2009 until falling further to 0.25% in August 2016. This is why forward guidance from the Bank of England continues to emphasise slow and gradual increases in Bank Rate in the coming years. However, consumer borrowing is a particularly vulnerable area in terms of the Monetary Policy Committee getting the pace and strength of Bank Rate increases right - without causing a sudden shock to consumer demand, confidence and thereby to the pace of economic growth.

Moreover, while there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two to three years will actually pan out.

EZ. Economic growth in the Eurozone (EZ), (the UK's biggest trading partner), was +0.6% in quarter 3 (2.5% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in October inflation was 1.4%. It is therefore unlikely to start on an upswing in rates until possibly 2019. It has, however, announced that it will slow down its monthly QE purchases of debt from €60bn to €30bn from January 2018 and continue to at least September 2018.

USA. Growth in the American economy has been notably erratic and volatile. Unemployment in the US has fallen to the lowest level for many years, reaching 4.1%, while wage inflation pressures, and inflationary pressures in general, have been building.

APPENDIX 2 - Specified and Non-Specified Investments and Limits

SPECIFIED INVESTMENTS: All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' quality criteria where applicable.

	*** Minimum 'High' Credit Criteria**
Debt Management Agency Deposit Facility	--
Term deposits – local authorities	--
Term deposits – banks and building societies (See appendix 5 for approved Counties)	Green - See note below
Collateralised deposit	UK sovereign rating
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating
UK Government Gilts	UK sovereign rating
Bonds issued by multilateral development banks	AAA
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government (refers solely to GEFCO – Guaranteed Export Finance Corporation)	UK sovereign rating
Sovereign bond issues (other than the UK govt)	AAA
Treasury Bills	UK sovereign rating

Term deposits with nationalised banks and banks and building societies

	Minimum Credit Criteria	**Max % of total investments**	**Max. maturity period**
UK part nationalised banks	Blue - See note below	£5.0m	1 year

Eastbourne Borough Council uses Link's credit worthiness service which overlays colour bandings to determine the maximum length of any investment. See Appendix 3 for further detail.

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

NON-SPECIFIED INVESTMENTS: These are any investments which do not meet the Specified Investment criteria. A maximum of 25% will be held in aggregate in non-specified investment.

Maturities in excess of 1 year

	Minimum Credit Criteria	**Max % of total investments**	**Max. maturity period**
Term deposits – local authorities	--	£2m with any institution	2 years
Term deposits – banks and building societies	Green	£2m with any institution	2 years
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating	£2m with any institution	2 years
Certificates of deposit issued by banks and building societies	Green	£2m with any institution	2 years
UK Government Gilts	UK sovereign rating	£2m with any institution	2 years
Bonds issued by multilateral development banks	AAA	£2m with any institution	2 years
Sovereign bond issues (other than the UK govt)	AAA	£2m with any institution	2 years
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs)			
1. Bond Funds	Long-term AA- volatility rating	£2m with any institution	2 years
2. Gilt Funds	Long-term AA- volatility rating	£2m with any institution	2 years
3. Property Funds	Long-term AA- volatility rating	£5m with any institution	

Local Authority Mortgage Scheme.

Under this scheme the Council is required to place funds of £1,000,000, with the Lender for a period of 5 years. This is classified as being a service investment, rather than a treasury management investment, and is therefore outside of the specified / non specified categories.

APPENDIX 3 – Creditworthiness Policy

This Council applies the creditworthiness service provided by Link. This service employs a sophisticated modelling approach utlilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors. 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.

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 duration for investments. The Council will therefore use counterparties within the following durational bands:

- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 3 months
- No Colour not to be used.

This methodology does not apply the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties. The Link creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

Typically the minimum credit ratings criteria the Council use will be a short term rating (Fitch or equivalents) of Short Term rating F1, Long Term rating A-, Individual of Viability ratings of C- (or BB+), and a Support rating of 3. 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 consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored weekly. The Council is alerted to changes to ratings of all three agencies through its use of the Link 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 against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

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 government support for banks and the credit ratings of that government support

Appendix 4 – The Treasury Management Role of the Section 151 Officer

The S151 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.

Role extended by the revised CIPFA Treasury Management and Prudential Codes 2017as set out below.

preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management, with a long term timeframe;

- ensuring that the capital strategy is prudent, sustainable, affordable and prudent in the long term and provides value for money;
- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authority;
- ensure that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing;
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities
- provision to members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees;
- ensuring that members are adequately informed and understand the risk exposures taken on by an authority;
- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above.