ISLINGTON

Finance Department
7 Newington Barrow Way
London N7 7EP

Report of: **Corporate Director of Finance and Resources**

Meeting of	**Date**	**Agenda Item**	**Ward(s)**
Audit Committee	29th January 2015		

Delete as appropriate	~~Exempt~~	Non-exempt

Annual Treasury Management and Investment Strategy 2015-2016

1. Synopsis

1.1 This report discusses the Council's 2015-16 annual treasury management strategy and investment strategy prior to its approval by the Council at the budget and council tax setting meeting on 26th February 2015. The strategy covers

- The balance sheet and treasury position
- Prospects for interest rates
- Borrowing requirement and strategy
- Debt rescheduling
- Investment strategy and policy
- HRA Self Financing

2. Recommendations

2.1 To consider the Council's 2015-16 annual treasury management strategy and investment strategy and note the key points set out below:

- ££61.2 million is estimated to be required to be borrowed over the next 3 years

  -£47.4 million to replace existing borrowing that matures

-£13.8million of new borrowing to fund capital expenditure

- The borrowing strategy is to minimise borrowing costs, through
  - Using surplus internal cash, and
  - Borrowing at optimal times at either variable or fixed rates which can include borrowing in advance of need

- It is expected that sums for investments will be minimal. Investment activity is restricted to institutions set in paragraph 3.6.7; Appendix C gives the details

- The Council's investment priorities in order of importance are :

  -security of the invested capital
  -liquidity of the invested capital
  -an optimum yield which is commensurate with security and liquidity

- The Council's current contract with the Cooperative bank for banking services expires in 2015. Barclays PLC have been appointed following a tendering process and the arrangements will go live by spring 2015.

.

3. Background

3.1 Introduction

3.1.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) has defined treasury management as "the management of the organisations' investments and cashflow, its banking, money market and capital market transactions; the effective control of the risks associated with these activities and the pursuit of optimum performance consistent with those risks.

3.1.2 Treasury management activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). The Council adopted the Code of Practice on Treasury Management on 26th February 2002. In addition, the Department for Communities and Local Government (CLG) issued revised Guidance on Local Authority Investments in March 2010 that requires the Council to approve an investment strategy before the start of each financial year. The Council has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies procedures and practices.

3.1.3 The treasury management function is an important part of the overall financial management of the Council's affairs. Its importance has increased as a result of the freedoms provided by the Prudential Code. The Council is required to set out an Annual Treasury Strategy outlining at the least the expected treasury activity for the forthcoming three years.

3.1.4 A key requirement of this report is to explain both the risks, and the management of the risks, associated with treasury management which include:

- Liquidity Risk *(inadequate cash resources*).
- Market or Interest Rate Risk *(fluctuations in interest rate levels)*.
- Inflation Risk *(exposure to inflation)*.
- Credit and Counterparty Risk *(security of investments)*.
- Refinancing Risk *(impact of debt maturing in future years)*.
- Legal and Regulatory Risk.

3.2 **Scope**

3.2.1 The Treasury Management Strategy considers the impact of the Council's revenue budget and capital programme on its balance sheet, the prospects for interest rates, borrowing requirement and strategy, debt rescheduling, investment strategy and policy, monitoring, members training and the use of advisors**.**

Balance Sheet and Treasury Position

3.2.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). The CFR represents the level of borrowing needed for capital purposes. Revenue expenditure cannot be financed from borrowing. Net actual external borrowing should not exceed the CFR other than for short term cash flow requirements. It is permissible under the Prudential Code to borrow in advance of need, up to the level of the estimated CFR over the term of the Prudential Indicators. When this takes place the cash will form part of the invested sums until the related capital expenditure is incurred. This being the case net borrowing should not exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for the current and next two financial years other than in the short term due to cash flow requirements.

3.2.3 The CFR together with balances and reserves are the core drivers of treasury management activity. The estimates, based on the current revenue budget and capital programmes and in advance of any changes to the 2015-16 budget to be considered in February, are set out in **Table 1** below:

Table 1 – Capital Financing, Balances and Reserves Forecasts

	31/03/2015 Estimate £m	**31/03/2016 Estimate £m**	**31/03/2017 Estimate £m**	**31/03/2018 Estimate £m**
General Fund CFR	127	122	118	114
HRA CFR	442	442	442	442
Long term liabilities-PFI	163	155	145	135
Total CFR	**732**	**719**	**705**	**691**
Less: Balances and Reserves	71	51	41	41
Net Balance Sheet Position	**661**	**668**	**664**	**650**

3.2.4 The Council's level of physical debt and investments is linked to these components of the balance sheet. The Council's approach to determining its borrowing and investment strategy for the underlying Balance Sheet position will be influenced by market conditions, affordability, interest rate expectations and credit risk considerations.

3.3 Prospects for Interest Rates

3.3.1 Treasury management activities such as borrowing and investment introduce the risk of unexpected adverse movements in interest rates. The Council employs Arlingclose Ltd, treasury consultants, to advise on the treasury strategy, provide economic data and interest rate forecasts, assist in planning and reduce the impact of unforeseen adverse movements. **Appendix A** draws together a number of current forecasts for short-term and longer-term fixed interest rates. Following seven years of interest rates being at 0.5% the forecast is for official UK interest rates to rise in August 2015 and a gradual increase thereafter to give a 0.75% average rate for 2015-16. Gilts yields are expected to rise in the medium term to take the forecast average 10 year PWLB rate for 2015-16 to 3.25%. It is worth noting that for a number of the years the forecast for an upcoming rise in interest rates has not come to pass. The outlook for interest rates is monitored constantly.

3.4 Borrowing Requirement and Strategy

3.4.1 To ensure that borrowing will ultimately be financed or repaid, local authorities are required to set aside a sum from the General Fund budget each year to repay debt called the Minimum Revenue Provision (MRP).

3.4.2 Capital expenditure not financed from internal resources (i.e. capital receipts, capital grants and contributions, revenue or reserves) will produce an increase in the CFR (the underlying need to borrow) and in turn produce an increased MRP in the General Fund budget.. The Council's borrowing requirement is shown in the **Table 2** below.

Table 2 – Borrowing Requirement

	2014-15 Estimate £m	**2015-16 Estimate £m**	**2016-17-16 Estimate £m**	**2017-18 Estimate £m**
New Borrowing	6.5	4.6	4.6	4.6
Replacement borrowing	38.9	21.9	11.1	14.4
TOTAL	**45.4**	**26.5**	**15.7**	**19.0**

3.4.3 In conjunction with advice from Arlingclose, the Council will keep under review the options it has in borrowing from the Public Works Loan Board (PWLB) or its successor body, other local authorities, the market and other sources up to the available capacity within the Authorised Limit (contained within the Prudential Indicators in **Appendix B** to be adopted in the 2015-16 budget). The types of borrowing that are still appropriate for a low interest rate environment from the PWLB are:

- Variable rate borrowing.
- Medium term equal instalments of principal (EIP) or annuity loans.
- Long term maturity loans where affordable.

3.4.4 The chief objective when borrowing is to have an appropriate balance between securing low interest rates and cost certainty over the periods for which funds are required. The Council's strategy is to minimise its borrowing costs over the medium to longer term and maintain maximum control over its borrowing activities as well as flexibility on its loans' portfolio. Given the significant cuts to public expenditure and in particular local government funding, the strategy also looks to minimise the medium term cost to the budget without compromising the longer term stability of the debt portfolio. The use of internal resources in lieu of borrowing and short to medium term borrowing will continue because of the "cost of carry" (that is the differential between debt costs and investment earnings.). While variable rate loans are not currently utilised this option will be kept under regular review. Capital expenditure levels, cash flow projections, market conditions and interest rate levels will be monitored in conjunction with Arlingclose, to determine the most appropriate borrowing options.

3.4.5 As at 17th December 2014, the Council had agreed long term loans of £56.5m. All these loans are from other local authorities over periods of 18 months to 6 years at an average rate of 1.5%.

3.4.7 The Council's borrowing requirement over the next three years is estimated to be around £61.2 million. £47.4million of this borrowing will be used to replace existing PWLB debt that matures over the next three years. If market rates were to fall considerably or future rates were expected to rise, then some borrowing could be taken ahead of spend. The borrowing strategy will continue to consider opportunities to borrow not only for 2015-16, but also for the next two financial years.

3.5 Debt Rescheduling

3.5.1 The factors affecting any decision on debt rescheduling will include, the generation of cash savings and / or discounted cash flow savings in interest cost, helping to fulfil the strategy outlined in the paragraphs above; enhancing the balance of the fixed to variable rate debt in the portfolio and, amending the maturity profile. All rescheduling activity will comply with the accounting requirements of the local authority Statement Of Recommended Practice (SORP) and regulatory requirements of the Capital Finance and Accounting Regulations (SI 2007 No. 573 as amended by SI 2008/414).

3.6 Investment Strategy and Policy

3.6.1 To comply with the Government's guidance, the Council's general policy objective is to invest its surplus funds prudently.

3.6.2 The Council's investment priorities, in order of importance, are:

- security of the invested capital.
- liquidity of the invested capital.
- an optimum yield which is commensurate with security and liquidity.

3.6.3 The borrowing of monies purely to invest or on-lend and make a return is unlawful and the Council will not engage in such activity.

3.6.4 Investment instruments identified for use in the financial year are categorised under the ‘Specified’ and ‘Non-Specified’ Investments based on the CLG guidance.

Specified Investments

3.6.5 Specified investments are described in the guidance as those identified as offering high security and high liquidity, and can be relied on with minimal formalities. All must be in sterling and with a maturity of no more than one year. All such short-term investments with the UK Government, other local authorities, or Parish Councils will automatically be considered “specified”, for other deposit takers a “high” credit rating is required which the authority defines. This Council’s definition is included at the end of this report.

Non-Specified Investments

3.6.6 Non-specified investments carry a higher degree of potential risk, and the guidance requires the types of investments that can be used to be set out in the Strategy, and limits to be set on how much can be held in these investments at any time during the year. The guidance states that it is not the objective to discourage investment in any type of instrument, but to ensure that proper procedures are in place for undertaking risk assessments of investments made for longer periods or with bodies that are not highly credit rated.

3.6.7 Potential instruments for the Council’s use within its investment strategy are listed in the specified and non-specified investment schedule attached as **Appendix C**

3.6.8 The Council has reviewed the way it formulates its counterparty criteria. The lending list criteria is devised from the use of a range of rating agencies which will include Fitch, Moody’s Investor Services, Standard & Poor’s (or other rating agency where necessary) as well as other factors. The main sovereign states whose banks are to be included are Australia, Canada, Finland, France, Denmark, Germany, Netherlands, Switzerland and the US. These countries and the Banks within them have been selected after analysis and careful monitoring of:

- Credit Ratings (minimum long-term A+ minimum short term F1).
- Credit Default Swaps.
- GDP; Net Debt as a Percentage of GDP.
- Sovereign Support Mechanisms/potential support from a well-resourced parent institution.
- Share Price.

3.6.9 The Council will also take into account information on corporate developments, market sentiment towards counterparties and changes in banking regulations The Council and Arlingclose, will continue to analyse and monitor these indicators and credit developments on a regular basis and the Council will respond as necessary to ensure security of the capital sums invested.

3.6.10 The Council's internally managed investment as at 17th December 2014 totalled £81million and the forecast position for the end of March through 2015-16 will average £50million.

3.6.11 In this current environment the Council has restricted its investment activity to the following categories

- The Debt Management Agency Deposit Facility *(The rates of interest from the DMADF are below equivalent money market rates. However, the returns are an acceptable trade-off for the guarantee that the Council's capital is secure)*.
- AAA-rated Money Market Funds with a Constant Net Asset Value (CNAV).
- Deposits with other local authorities
- Business reserve accounts and term deposits. (*These have been primarily restricted to UK institutions that are rated at least A+ long term)*.

3.6.12 If the cash flow positions were to increase because of forward borrowing then investments criteria will revert to credit ratings as stated in paragraph 3.6.8.

3.6.13 A copy of the Council's current lending list and the institutions actually lent to as at December 2014 is attached as **Appendix D**.

3.6.14 Currently the Council has borrowed £74m short term (under one year) for cashflow purposes, from other Local Authorities & Public Bodies. This has proved to be a cheaper alternative to variable rate PWLB borrowing.

3.6.15 The Council will constantly reappraise its strategy as market conditions and expectations for future interest rates evolve.

3.6.16 The Corporate Director of Finance and Resources under delegated powers will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. All investments will be made in accordance with the Council's investment policies and prevailing legislation and regulations.

3.7 Housing Revenue Account Policy on Apportioning Interest

3.7.1 Local authorities are required to recharge interest expenditure and income attributable to the HRA in accordance with determinations issued by the Department for Communities and Local Government. The CIPFA Code recommends that authorities present this policy in their Treasury Management and Investment Strategy.

3.7.2 On 1st April 2012, the Council notionally split each of its existing long-term loans into General Fund and HRA pools. New long-term loans borrowed are assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g.

premiums and discounts on early redemption) are charged/ credited to the respective revenue account.

3.7.3 Internal Borrowing

Where the HRA or General Fund has surplus cash balances which allow either account to have external borrowing below the level of the Capital Financing Requirement by borrowing internally, the Corporate Director of Finance and Resources will agree an appropriate and evidenced interest rate, determined and applied at the beginning of each financial year, to reflect the assumed opportunity cost forgone.

3.8 **Monitoring**

3.8.1 The treasury position is included in the regular Executive financial monitoring reports. The Executive Member for Finance and Performance is briefed on treasury activities. At the end of the financial year, an annual treasury report on the Council's investment activity is included in the financial outturn report to the Executive. The Audit Committees annually scrutinises the Annual Treasury Strategy Statement before Council approval at its February budget and council tax setting meeting.

3.9 **Members Training**

3.9.1 CIPFA's revised Code requires the Corporate Director of Finance and Resources to ensure that all Members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities.

3.10 **Advisors**

3.10.1 Arlingclose, our appointed Treasury Advisors, undertake their role as advisors to enable the Council to make informed decisions.

3.11 **Current Account Bank**

3.11.1 The council's current account is currently held with Cooperative Bank. The contract will expire in 2015 when the Cooperative Bank ceases its commercial banking activity. A full banking service tender has been undertaken and Barclays PLC has been appointed. The target date to transfer all banking services and go live with Barclays is spring 2015.

4. Implications

4.1 **Financial Implications**

The treasury management function has resource implications on the Council's revenue budget. The paramount objective of the treasury management function is capital security and the pursuit of optimum performance must be consistent with the risk undertaken.

4.2 **Legal Implications**

Local authorities have restricted freedoms with regard to the investment of surplus funds. The rules are prescribed by statute and are laid out under section 15(1)(a) of the Local Government Act 2003.Local authorities are also required to have regard to supplementary guidance provided by the Office of the Deputy Prime Minister (ODPM; now Communities and Local Government) and by CIPFA. CIPFA's guidance is defined as a proper practice for these purposes.

4.3 **Equalities Impact Assessment**

4.3.1 The Council must, in carrying out its functions, have due regard to the need to eliminate unlawful discrimination and harassment and to promote equality of opportunity in relation to disability, race and gender and the need to take steps to take account of disabilities, even where that involves treating the disabled more favourably than others (section 49A Disability Discrimination Act 1995; section 71 Race Relations Act 1976; section 76A Sex Discrimination Act 1975**."** An equalities impact assessment has not been undertaken at this stage because this report is an update on an existing policy that is agreed at the annual council tax and budget setting.

4.4 **Environmental Implications**

None applicable to this report.

5. Conclusion and Reasons for Recommendations

5.1 This is the annual treasury and investment strategy statement report discussing the council's strategy on borrowing and investment and also reviewing current investment policy. Members are asked to consider this strategy before it is presented for approval at the council budget and council tax setting meeting on 26th February 2015.

Background Papers:

Audit Commission National Report 2009

Council Budget Report 27th February 2014

CIPFA guidance on treasury management issued in November 2009

Final Report Clearance

Signed by ………………….

……
……………………………………………………….

Director for Finance Date

Received by ……………………………………………………. ………………….

…….

Head of Democratic Services Date

Report author: Joana Marfoh (Head of Treasury and Pensions)
Tel: 020- 75272382
Fax: 020- 75272056
E-mail: joana.marfoh@islington.gov.uk

Appendix A – Economic & Interest Rate Forecast December 2014

	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Official Bank Rate													
Upside risk				0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.50**	**1.75**	**1.75**	**1.75**
Downside risk			0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00
3-month LIBID rate													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	**0.60**	**0.75**	**0.90**	**1.05**	**1.20**	**1.35**	**1.50**	**1.60**	**1.70**	**1.80**	**1.90**	**2.00**	**2.10**
Downside risk	0.15	0.20	0.30	0.40	0.55	0.65	0.75	0.85	-0.95	-0.95	-0.95	-0.95	-1.00
1-yr LIBID rate													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	**1.00**	**1.05**	**1.20**	**1.35**	**1.50**	**1.65**	**1.80**	**1.95**	**2.10**	**2.20**	**2.30**	**2.40**	**2.50**
Downside risk	-0.15	-0.20	-0.30	-0.50	-0.55	-0.60	-0.65	-0.70	-0.75	-0.80	-0.80	-0.80	-0.80
5-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	**1.45**	**1.60**	**1.75**	**1.90**	**2.00**	**2.15**	**2.25**	**2.35**	**2.45**	**2.50**	**2.55**	**2.60**	**2.60**
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.60	-0.65	-0.70	-0.70	-0.70	-0.70
10-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	**2.00**	**2.10**	**2.20**	**2.30**	**2.40**	**2.50**	**2.60**	**2.70**	**2.75**	**2.80**	**2.85**	**2.90**	**2.95**
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.55	-0.55	-0.60	-0.60	-0.60	-0.60
20-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	**2.55**	**2.65**	**2.75**	**2.85**	**2.95**	**3.00**	**3.05**	**3.10**	**3.15**	**3.20**	**3.25**	**3.30**	**3.30**
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.50	-0.55	-0.55	-0.60	-0.60	-0.60	-0.60
50-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	**2.65**	**2.70**	**2.80**	**2.90**	**3.00**	**3.05**	**3.10**	**3.15**	**3.20**	**3.25**	**3.30**	**3.55**	**3.60**
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.55	-0.55	-0.60	-0.60	-0.60	-0.60

<u>Underlying Assumptions:</u>

- The UK economic recovery has continued. Household consumption remains a significant driver, but there are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP in 2015.
- We expect consumption growth to slow, given softening housing market activity, the muted outlook for wage growth and slower employment growth. The subdued global environment suggests there is little prospect of significant contribution from external demand.
- Inflationary pressure is currently low (annual CPI is currently 1.3%) and is likely to remain so in the short-term. Despite a correction in the appreciation of sterling against the US dollar, imported inflation remains limited. We expect commodity prices will remain subdued given the weak outlook for global growth.
- The MPC's focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee.
- Nominal earnings growth remains weak and below inflation, despite large falls in unemployment, which poses a dilemma for the MPC. Our view is that spare capacity remains

extensive. The levels of part-time, self-employment and underemployment are significant and indicate capacity within the employed workforce, in addition to the still large unemployed pool. Productivity growth can therefore remain weak in the short term without creating undue inflationary pressure.

- However, we also expect employment growth to slow as economic growth decelerates. This is likely to boost productivity, which will bear down on unit labour costs and inflationary pressure.
- In addition to the lack of wage and inflationary pressures, policymakers are evidently concerned about the bleak prospects for the Eurozone. These factors will maintain the dovish stance of the MPC in the medium term.
- The continuing repair of public and private sector balance sheets leave them sensitive to higher interest rates. The MPC clearly believes the appropriate level for Bank Rate for the post-crisis UK economy is significantly lower than the previous norm. We would suggest this is between 2.5 and 3.5%.
- While the ECB is likely to introduce outright QE, fears for the Eurozone are likely to maintain a safe haven bid for UK government debt, keeping gilt yields artificially low in the short term.

  The probability of potential upside risks crystallising have waned a little over the past two months. The primary upside risk is a swifter recovery in the Eurozone.