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	24 January 2017		

Delete as appropriate	~~Exempt~~	Non-exempt

SUBJECT: Annual Treasury Management and Investment Strategy 2017-18

1. Synopsis

1.1 This report discusses the council's 2017-18 annual treasury management strategy and investment strategy.

2. Recommendations

2.1 To consider the council's 2017-18 annual treasury management strategy and investment strategy before full council's approval at its budget and council tax setting meeting on 23 February 2017. 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

2.2 To note the key points of the treasury strategy summarised below:

Summary of the key points of the treasury strategy

- £70.3 m is estimated to be required to be borrowed over the next 3 years
  - -£37.6million to replace existing borrowing that matures
  - -£32.7million 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 para 3.6.7 and 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

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). This 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 Authority to approve an investment strategy before the start of each financial year. The Council has incorporated the changes from the revised 2011 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 This Treasury Management Strategy considers the impact of the Council's revenue budget and capital programme on the balance sheet position, the prospects for interest rates, borrowing requirement and strategy, debt rescheduling, investment strategy and policy, monitoring, members training and 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 for capital purposes. Revenue expenditure cannot be financed from borrowing. Net physical 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. Where 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 2017-18 budget to be considered in February, are set out in **Table 1** below:

Table 1 – Capital Financing, Balances and Reserves Forecasts

	31/03/2017 Estimate £m	**31/03/2018 Estimate £m**	**31/03/2019 Estimate £m**	**31/03/2020 Estimate £m**
General Fund CFR	118.4	132.1	145.7	145.6
HRA CFR	442.3	442.3	442.3	442.3
Total CFR	560.7	574.4	588.0	587.9
Less Long term Liabilities- PFI	-145.3	-134.9	-125.5	-116.7
Less Balances and Reserves	-143.0	-159.5	-141.7	-102.9
Net Balance Sheet Position	**272.4**	**280.0**	**320.8**	**368.3**

3.2.4 The Council's level of physical debt and investments is linked to these components of the balance sheet. Market conditions, affordability, interest rate expectations and credit risk considerations will influence the Council's strategy in determining the borrowing and investment activity against the underlying Balance Sheet position.

3.3 **Prospects for interest rates**

3.3.1 Treasury management activities such as borrowing introduce risk to the Council via the impact of unexpected adverse movements in interest rates. The Council employs Arlingclose treasury consultants, to advise on the treasury strategy, to provide economic data and interest rate forecasts, to assist 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. The major external influence on the authority's treasury management strategy for 2017/18 will be the UK's progress in negotiating a smooth exit from the European Union. Negotiations are expected to start once the UK formally triggers exit in early 2017 and last for at least two years. Uncertainty over future economic prospects will therefore remain throughout 2017/18. The central case forecast is for UK Bank Rate to remain at 0.25% during the coming year. Gilt yields and PWLB rates are expected to trend broadly flat from current levels, albeit with short-term volatility.

3.4.1 The Council's underlying need to borrow for capital purposes is measured by reference to its Capital Financing Requirement (CFR). To ensure that this expenditure will ultimately be financed, local authorities are required to make a Minimum Revenue Provision (MRP) for debt redemption from within the revenue budget each year.

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 requirement to charge MRP in the revenue account. The Council's borrowing requirement is shown in the **Table 2** below.

	2016-17 estimate £M	2017-18 estimate £M	2018-19 estimate £M	2019-20 estimate £M
New Borrowing	0	15.0	15.4	2.3
Replacement borrowing	11.1	14.4	12.1	11.1
TOTAL	**11.1**	**29.4**	**27.5**	**13.4**

3.4.3 In conjunction with advice from our treasury advisor, Arlingclose Ltd, the Council will keep under review the options it has in borrowing from the Public Works Loan Board (PWLB), 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 201718 budget).

3.4.4 The chief objective of the council when borrowing money is achieve an appropriate risk balance between securing low interest rates and cost certainty over the periods for which funds are required. Given the significant cuts to public expenditure and in particular local government funding, the council's borrowing strategy continues to address the key issue of affordability without compromising the longer term stability of the debt portfolio. 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.

3.4.5 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. 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). Exposure to variable loans including PWLB rates will be kept under regular review, The Bank Rate is expected to remain at 0.25% during 2017-18. As at 31 December 2016, the council had agreed non PWLB long term loans of £46.5m. All these loans are from other local authorities over periods of 2 to 6 years at an average rate of 1.8%.

3.4.6 Capital expenditure levels, cash flow projections, market conditions and interest rate levels will be monitored in conjunction with our treasury advisors, Arlingclose, to determine the most appropriate option.

3.4.7 The Council's borrowing requirement over the next three years is estimated to be around £70.3million. £37.6million of this borrowing will be used to replace existing PWLB debt taken in the 1980's 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 therefore consider opportunities to borrow not only for 2017-18 but ahead 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 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 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 and market sentiment towards the counterparties. The Council and its Treasury Advisors, Arlingclose, will continue to analyse and monitor these indicators and credit developments on a regular basis and respond as necessary to ensure security of the capital sums invested.

3.6.10 The Council's internally managed investments as at 31 December 2016 totalled £110million and the forecast position for the end of March through 2017/18 will average £80million. The Council has restricted its investment activity to the following institutions while conditions in the financial sector are monitored for stability and cashflow positions are averaging around £80m:

- 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.

3.6.11 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

3.6.12 A copy of the Council's current lending list and the institutions actually lent to as at December 2016 is attached as **Appendix D** for information. In addition the Council has borrowed £45.5m at an average rate of 0.28% short term, from other Local Authorities & Public Bodies – this has proved to be a cheaper alternative to variable rate PWLB borrowing.

3.6.13 The UK bank rate had been maintained at 0.5% since March 2009 but was cut to 0.25% in August 2016 and it is anticipated to remain at low levels throughout 2017-18 with a low possibility to drop to zero Short-term money market rates are likely to remain at low levels for an extended period.

3.6.14 The economic interest rate outlook provided by the Council's treasury advisor, Arlingclose, is attached as **Appendix A**. The Council will reappraise its strategy with evolving market conditions and expectations for future interest rates.

3.6.15 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 Central Government completed its reform of the Housing Revenue Account Subsidy system at the end of 2011/12. 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 TMSS.

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 GF has surplus cash balances which allow either account to have external borrowing below its level of CFR (internal borrowing), the rate charged on this internal borrowing will be based on the 14.5 -15year PWLB fixed loan rate to reflect the assumed opportunity cost forgone.

3.8 **Monitoring**

3.8.1 Treasury management monitoring will be incorporated in the regular Executive financial monitoring reports. The Executive Member for Finance is regularly briefed on treasury activities. At the end of the financial year, an outturn report will be prepared on the Council's investment activity as part of its Annual Treasury Report. The Audit committees will scrutinise the Annual Treasury Strategy Statement before Council approval at its budget and council tax setting meeting.

3.9 **Members Training**

3.9.1 CIPFA's revised Code requires the Director of Finance 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. A training session on treasury management was provided to Members by Arlingclose in May 2016.

3.10 **Advisors**

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

4 **Implications**

4.1 **Financial Implications**

The activities of 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**."**

4.3.2 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 Implication**
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 23 February 2017

Background papers:
Audit Commission National Report 2009; Council Budget Report on 25 February 2016
CIPFA guidance on treasury management issued in November 2009

Final Report Clearance

Signed by ………………………………………………………… ………………….

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Corporate Director for Finance and Resources 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 – Arlingclose Economic & Interest Rate Forecast September 2016

Underlying assumptions:

- The economic trajectory for the UK has been immeasurably altered following the vote to leave the European Union. The long-term position of the UK economy will be largely dependent on the agreements the government is able to secure with the EU and other countries.

- The short to medium-term outlook is somewhat more downbeat due to the uncertainty generated by the result and the forthcoming negotiations (notwithstanding the Olympic and summer feel-good effects). The rapid installation of a new Prime Minister and cabinet lessened the political uncertainty, and the government/Bank of England have been proactive in tackling the economic uncertainty.

- Purchasing Managers Index data, and consumer and business confidence surveys presented a more positive picture for August following the shock-influenced data for July, in line with expectations for an initial overreaction. However, many indicators remain at lower levels than pre-Referendum.

- Over the medium term, economic and political uncertainty will likely dampen investment intentions and tighten credit availability, prompting lower activity levels and potentially a rise in unemployment. These effects will dampen economic growth through the second half of 2016 and in 2017.

- UK Consumer Price Index inflation (currently 0.6% year/year) will rise close to target over the coming year as previous rises in commodity prices and the sharp depreciation in sterling begin to drive up imported material costs for companies.

- The rise in inflation is highly unlikely to prompt monetary tightening by the Bank of England, with policymakers looking through import-led CPI spikes to the negative effects of Brexit on economic activity and, ultimately, inflation.

- There is a debatable benefit to further interest rate cuts (particularly with regard to financial stability). Negative Bank Rate is currently perceived by policymakers to be counterproductive, but there is a possibility of close-to-zero Bank Rate. QE will be used to limit the upward movement in bond yields.

- Following significant global fiscal and monetary stimulus, the short term outlook for the global economy is somewhat brighter than a few months ago. However, financial market volatility is likely at various points because the stimulus has only delayed the fallout from the build-up of public and private sector debt (particularly in developing economies, e.g. China).

Forecast:

- The likely path for Bank Rate is weighted to the downside. The Arlingclose central case is for Bank Rate to remain at 0.25%, but there is a 40% possibility of a drop to close to zero, with a small chance of a reduction below zero later in the forecast period.

- Gilt yields will be broadly flat from current levels, although there will likely be much volatility as reports of negotiations between the UK and the remaining EU affect market perceptions of both parties' economic growth potential.

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.12
Arlingclose Central Case	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Downside risk	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.40
3-month LIBID rate														
Upside risk	0.05	0.05	0.10	0.10	0.10	0.15	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.18
Arlingclose Central Case	0.25	0.25	0.25	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.29
Downside risk	0.20	0.25	0.25	0.25	0.30	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.34
1-yr LIBID rate														
Upside risk	0.10	0.10	0.15	0.15	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.23
Arlingclose Central Case	0.60	0.50	0.50	0.50	0.50	0.50	0.50	0.60	0.70	0.85	0.90	0.90	0.90	0.65
Downside risk	0.10	0.15	0.15	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.24
5-yr gilt yield														
Upside risk	0.25	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.39
Arlingclose Central Case	0.30	0.30	0.30	0.30	0.35	0.40	0.40	0.40	0.40	0.45	0.45	0.50	0.50	0.39
Downside risk	0.40	0.45	0.45	0.45	0.50	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.54
10-yr gilt yield														
Upside risk	0.30	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.39
Arlingclose Central Case	0.75	0.75	0.80	0.80	0.80	0.80	0.80	0.80	0.85	0.90	0.90	0.95	0.95	0.83
Downside risk	0.40	0.45	0.45	0.45	0.50	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.54
20-yr gilt yield														
Upside risk	0.25	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.39
Arlingclose Central Case	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.30	1.35	1.35	1.40	1.40	1.29
Downside risk	0.50	0.55	0.55	0.55	0.60	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.64
50-yr gilt yield														
Upside risk	0.25	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.39
Arlingclose Central Case	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.30	1.35	1.35	1.40	1.40	1.29
Downside risk	0.50	0.55	0.55	0.55	0.60	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.64