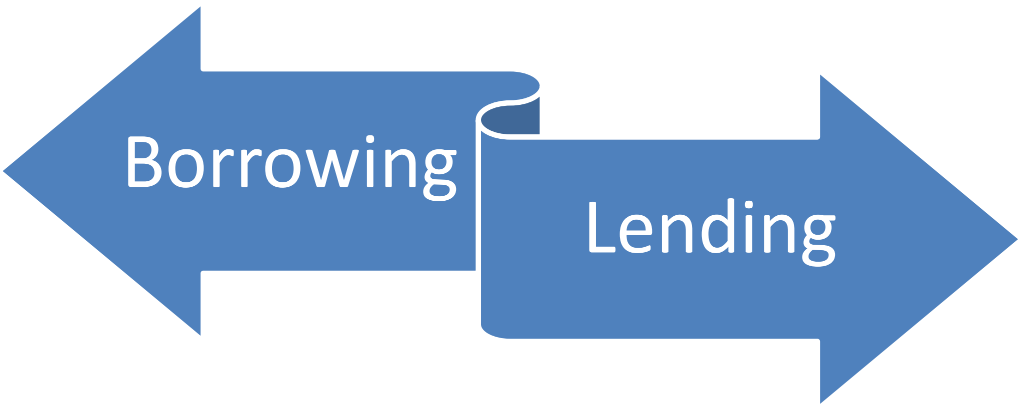
APPENDIX A

FAREHAM
BOROUGH COUNCIL

TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL INDICATORS 2017/18



INTRODUCTION

WHAT IS TREASURY MANAGEMENT?

1. Treasury Management is defined as:

> *The management of the organisation’s cash flows, its banking, money market and capital market transactions;*
>
> *the effective control of the risks associated with those activities and the pursuit of optimum performance consistent with those risks.*

2. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. The are two aspects to the treasury management service:

   a) To ensure the cash flow is adequately planned, with **cash being available when it is needed**. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council’s low risk appetite, providing adequate liquidity initially before considering investment return.

   b) To ensure the cash flow meets the Council’s **capital plans**. These capital plans provide a guide to the **borrowing need** of the Council. Essentially this is the longer term cash flow planning to ensure that the Council can meet its capital spending requirements. The management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

CONTENT OF THE ANNUAL TREASURY MANAGEMENT STRATEGY

3. This strategy sets out the expected approach to treasury management activities for 2017/18 in light of the anticipated financial climate. It covers two main areas:

Capital Issues

- Capital Expenditure and Financing
- Prudential Indicators
- Minimum Revenue Provision (MRP) policy

Treasury Management Issues

- Investment Strategy
- Borrowing Strategy
- Treasury Indicators
- Prospects for Interest Rates

4. The content of the Strategy is designed to cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the CIPFA Treasury Management Code and the DCLG Investment Guidance.

REPORTING REQUIREMENTS

5. The Council receives and approves three main reports each year in relation to Treasury Management, which incorporate a variety of polices, estimates and actuals. The three reports are:

6. The Executive Commmittee is responsible for the implementation and monitoring of these reports whilst the Audit and Governance Committee is responsible for the effective scrutiny of the treasury management strategy and policies.

TRAINING

7. The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny.

8. Treasury management officers regularly attend training courses, seminars and conferences provided by the Council's treasury management advisors and CIPFA.

USE OF TREASURY MANAGEMENT CONSULTANTS

9. The Council has appointed Arlingclose as treasury management advisers and receives specific advice on investment, debt and capital finance issues.

10. The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

11. 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.

CAPITAL ISSUES

CAPITAL EXPENDITURE AND FINANCING

12. The objectives of the CIPFA Prudential Code are to ensure that capital investment plans are **affordable**, **prudent** and **sustainable**, and that treasury decisions are taken in accordance with good professional practice.

PRUDENTIAL INDICATORS

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

1) Level of Planned Capital Expenditure

This prudential indicator is a summary of the Council's capital expenditure plans and shows how these plans are being financed by capital or revenue resources.

Capital Expenditure and Financing	2016/17 Revised £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000
Public Protection	0	0	0	0
Streetscene	543	311	0	0
Leisure and Community	5,407	797	120	0
Health and Housing	1,118	3,619	480	480
Planning and Development	478	13	13	14
Policy and Resources	21,587	20,850	1,520	770
Total General Fund	**29,133**	**25,590**	**2,133**	**1,264**
HRA	**7,472**	**4,791**	**4,556**	**3,211**
Total Expenditure	**36,605**	**30,381**	**6,689**	**4,475**
Capital Receipts	2,365	212	493	230
Capital Contributions	4,972	3,897	650	250
Capital Reserves	8,677	3,246	1,550	1,431
Revenue	2,484	3,344	3,696	2,564
Borrowing	18,107	19,682	300	0
Total Financing	**36,605**	**30,381**	**6,689**	**4,475**

2) The Council's Borrowing Need (Capital Financing Requirement)

This prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is 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 financed by borrowing will increase the CFR.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing in line with the asset's life.

The CFR projections are as follows:

£'000	2016/17 Revised £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000
General Fund	8,928	27,129	46,678	46,422
HRA	52,950	52,720	52,490	52,260
Total CFR	**61,878**	**79,849**	**99,168**	**98,682**

3) Financing Costs as % of Net Revenue Stream

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

The positive percentage for the Housing Revenue Account (HRA) reflects the net borrowing costs for the HRA settlement.

	2016/17 Revised	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
General Fund	-5%	-2%	-1%	-1%
HRA	14%	14%	14%	14%
Total	**6%**	**8%**	**8%**	**8%**

4) Incremental Impact of Capital Decisions on Council Tax and Housing Rents

This indicator shows the impact of capital decisions on council tax and housing rent levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the proposed capital programme to be approved during this budget cycle.

	2016/17 Revised	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Council Tax Band D	£2.99	£4.53	£0.22	£0.05
Weekly Housing Rent Levels	£0.06	£0.15	£0.12	£0.04

HOUSING REVENUE ACCOUNT (HRA) RATIOS

14. As a result of the HRA Reforms in 2012, the Council moved from a subsidy system to self-financing and was required to take on **£49.3 million** of debt. The table below shows additional local indicators relating to the HRA in respect of this debt.

	2016/17 Revised	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
HRA Debt £'000	49,268	49,268	49,268	49,268
HRA Revenues £'000	11,100	11,250	11,070	10,900
Number of HRA Dwellings	2,383	2,406	2,393	2,380
Ratio of Debt to Revenues %	4.43:1	4.38:1	4.45:1	4.52:1
Debt per Dwelling £	£20,675	£20,477	£20,588	£20,700

MINIMUM REVENUE PROVISION (MRP) POLICY STATEMENT

15. Where the Council finances capital expenditure by debt, it must **put aside resources to repay that debt** in later years. The amount charged to the revenue budget for the repayment of debt is known as **Minimum Revenue Provision (MRP)**.

16. The Council is required to set an annual policy on the way it calculates the prudent provision for the repayment of General Fund borrowing. The main policy adopted is that MRP will be determined by charging the expenditure over the **expected useful life** of the relevant assets on an **annuity basis** starting in the year after the asset becomes operational. This calculation will be reviewed on a case by case basis depending on the circumstances and with a view to minimising the impact on the council tax payer.

17. Where expenditure is on an asset which will be held on a short term basis (up to 5 years), no MRP will be charged. However, the capital receipt generated by the sale of the asset will be used to repay the debt instead.

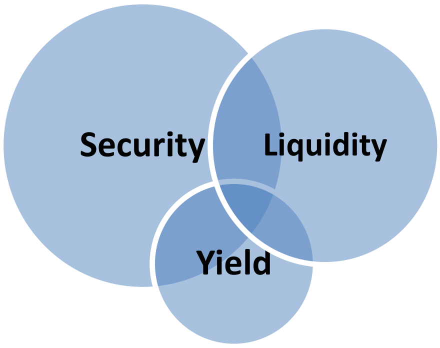
18. No MRP will be charged in respect of assets held within the HRA, in accordance with DCLG Guidance and capital expenditure incurred during 2017/18 will not be subject to a MRP charge until 2018/19.

TREASURY MANAGEMENT ISSUES

INVESTMENTS

Investment Strategy

19. Both the CIPFA Code and DCLG Guidance require the Council to invest its funds prudently, and to have regard to the **security** and **liquidity** of its investments before seeking the highest rate of return, or **yield**.



20. The Council's objective when investing money is to strike an appropriate balance between **risk and return**, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

21. If the UK enters into a recession in 2017/18, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to **negative interest rates** on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

22. Given the increasing risk and falling returns from short-term unsecured bank investments, the Council where practical and reasonable, aims to further diversify into more secure and/or higher yielding asset classes.

Approved Counterparties

23. The Council may invest its surplus funds with any of the counterparty types in the table below, subject to the cash limits (per counterparty) and the time limits shown.

Credit Rating	Banks Unsecured	Banks Secured	Government
UK Govt	n/a	n/a	£Unlimited 50 years
AAA	£2m 5 years	£4m 20 years	£4m 50 years
AA+	£2m 5 years	£4m 10 years	£4m 25 years
AA	£2m 4 years	£4m 5 years	£4m 15 years
AA-	£2m 3 years	£4m 4 years	£4m 10 years
A+	£2m 2 years	£4m 3 years	£2m 5 years
A	£2m 13 months	£4m 2 years	£2m 5 years
A-	£2m 6 months	£4m 13 months	£2m 5 years

BBB+	£1m 100 days	£2m 6 months	£1m 2 years
None	£1m 6 months	n/a	£4m 25 years
Pooled Funds	£4m per fund		

24. Investment limits are set by reference to the lowest published **long-term credit rating** from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

25. Summary of counterparty types:

    a) **Banks Unsecured:** Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.

    b) **Banks Secured:** Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

    c) **Government:** Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

    d) **Pooled Funds:** Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

26. The Council may also invest its surplus funds in corporates (loans, bonds and commercial paper issued by companies other than banks) and registered providers (loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations), subject to meeting the minimum credit rating criteria and time limits recommended by the Council's treasury advisers.

Risk Assessment and Credit Ratings

27. Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

28. Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other Information on the Security of Investments

29. The Council understands that credit ratings are good, but not perfect predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations, in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

30. The following **internal measures** are also in place:

- Investment decisions formally recorded and endorsed using a Counterparty Decision Document.
- Monthly officer reviews of the investment portfolio and quarterly reviews with the Chief Executive Officer.

31. Where cash flows determine it necessary, the **Council's bankers, NatWest**, (part of the RBS group) will be used on **an unlimited basis**. If their credit quality is reduced, the Council will continue to use their banking services but no investments will be placed with them.

Specified Investments

32. The CLG Guidance defines specified investments as those:

- denominated in pound sterling,
- **due to be repaid within 12 months** of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
  a) the UK Government,
  b) a UK local authority, parish council or community council, or
  c) a body or investment scheme of **"high credit quality"**.

33. The Council defines "high credit quality" organisations and securities as those

having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher. For money market funds and other pooled funds "high credit quality" is defined as those having a credit rating of A- or higher.

Non-specified Investments

34. Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to **long-term investments**, i.e. those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and **schemes not meeting the definition on high credit quality**. Limits (per counterparty) on non-specified investments are shown in the table below.

	Cash limit
Total long-term investments	£4m
Total investments without credit ratings or rated below A-	£2m
Total investments (except pooled funds) with institutions domiciled in foreign countries rated below AA+	£2m
Total non-specified investments	£10m

Investment Limits

35. The Council's revenue reserves available to cover investment losses are forecast to be £16 million on 31st March 2017. In order to minimise risk, in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £4 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below.

	Cash limit
Any single organisation, except the UK Central Government	£4m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£4m per group
Any group of pooled funds under the same management	£10m per manager
Negotiable instruments held in a broker's nominee account	£10m per broker
Foreign countries	£4m per country
Unsecured investments with Building Societies	£2m in total
Money Market Funds	£20m in total

Liquidity Management

36. The Council uses a purpose-built cash flow forecasting spreadsheet to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast.

Investment Treasury Indicator and Limit

37. Total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and are based on the availability of funds after each year-end.

£M	2016/17 Revised	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Principal sums invested > 364 days	17	2	2	3

BORROWING

Current Portfolio Position

38. The Council's treasury portfolio position at 31 March 2016, 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), highlighting any under or over borrowing.

£'000	2016/17 Revised	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Debt at 1 April	44,826	45,626	65,308	65,608
Expected change in debt	800	19,682	300	0
Gross Debt at 31 March	**45,626**	**65,308**	**65,608**	**65,608**
Capital Financing Requirement (CFR)	61,878	79,849	99,168	98,682
Under/(Over) Borrowing	**16,252**	**14,541**	**22,560**	**33,076**
CFR for last, current and next 2 years	**339,577**	**375,558**	**392,712**	**389,657**

39. 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.

40. 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 debt 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.

41. The Council complied with this prudential indicator 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 the budget report.

Treasury Indicators: Limits to Borrowing Activity

42. The treasury indicators includes two limits to borrowing activity:

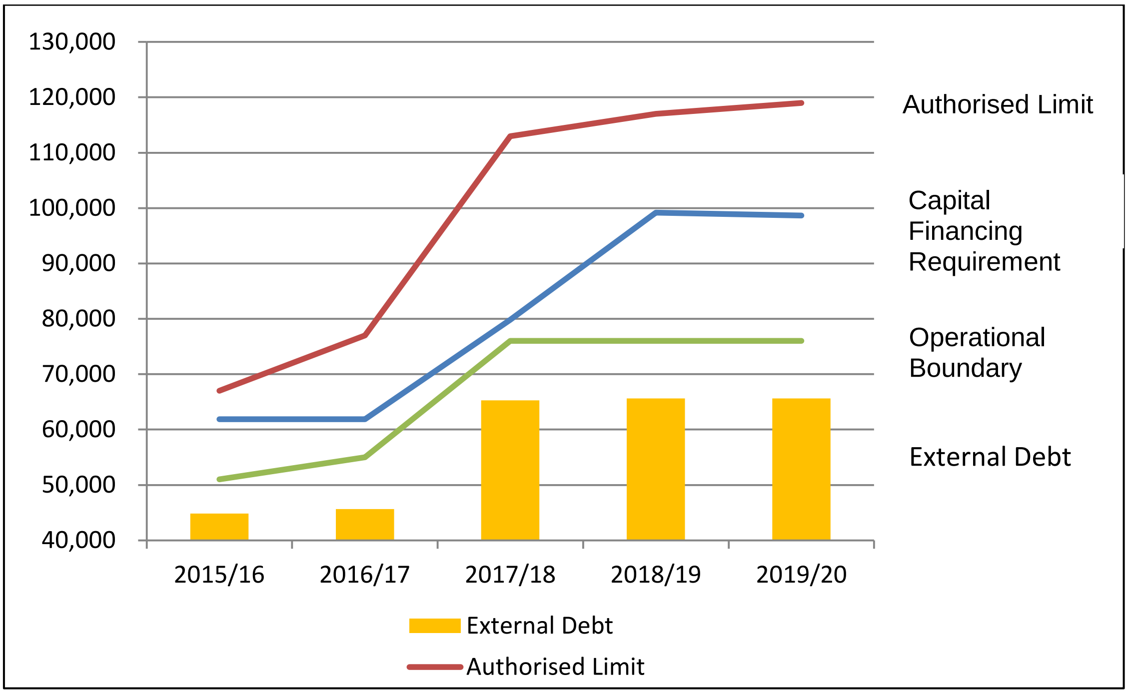
1) The **operational boundary** is based on the Council's estimate of the most likely (i.e. prudent but not worst case) scenario for external debt. This is the limit beyond which external borrowing is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual borrowing.

2) The **authorised limit** is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

43. The limits are:

£'000	**2016/17 Revised**	**2017/18 Estimate**	**2018/19 Estimate**	**2019/20 Estimate**
Operational Boundary				
Borrowing	50,000	70,000	70,000	70,000
Other long term liabilities	5,000	6,000	6,000	6,000
Total	**55,000**	**76,000**	**76,000**	**76,000**
Authorised Limit				
Borrowing	70,000	105,000	109,000	111,000
Other long term liabilities	7,000	8,000	8,000	8,000
Total	**77,000**	**113,000**	**117,000**	**119,000**

44. The graph below shows the projections for the CFR and borrowing limits:



45. Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit is currently:

£'000	2016/17 Revised	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
HRA Debt Cap	56,851	56,851	56,851	56,851
HRA CFR	52,951	52,721	52,491	52,261
HRA Headroom	**3,900**	**4,131**	**4,360**	**4,590**

Borrowing Strategy

46. The Council's main objective when borrowing money is to strike an appropriately low risk balance between **securing low interest costs** and achieving **certainty of those costs** over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

47. The Council has been in a debt free position for the General Fund for many years mainly due to having sufficient capital reserves to meet the Council's capital programme. However this position will change over the coming years as borrowing is required for large capital schemes at Daedalus and new property investment opportunities.

48. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short term to either **use internal resources**, or to **borrow short-term** loans instead.

49. By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and **reduce overall treasury risk**. The benefits of internal borrowing or short term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-

term borrowing rates are forecast to rise modestly.

50. Our treasury advisors will assist the Council with this **'cost of carry'** and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2017/18 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

51. Alternatively, the Council may arrange forward starting loans during 2017/18, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

52. In addition, the Council may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages.

Sources of Borrowing

53. The approved sources of long-term and short-term borrowing are:
    - Public Works Loan Board (PWLB) and any successor body.
    - Any institution approved for investments, including other local authorities.
    - Any other bank or building society authorised to operate in the UK.
    - UK public and private sector pension funds (expect the Hampshire County Council Pension Fund).
    - Capital market bond investors.
    - UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues.

54. In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:
    - Operating and finance leases
    - Hire purchase
    - Private Finance Initiative
    - Sale and leaseback

55. The Council has previously raised all of its long-term borrowing from the PWLB but it will investigate other sources of finance, such as local authority loans and bank loans that may be available at more favourable rates.

Borrowing in Advance of Need

56. The Council may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk

of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

57. The total amount borrowed will not exceed the authorised borrowing limit of £77 million. The maximum period between borrowing and expenditure is expected to be two years, although the Council is not required to link particular loans with particular items of expenditure

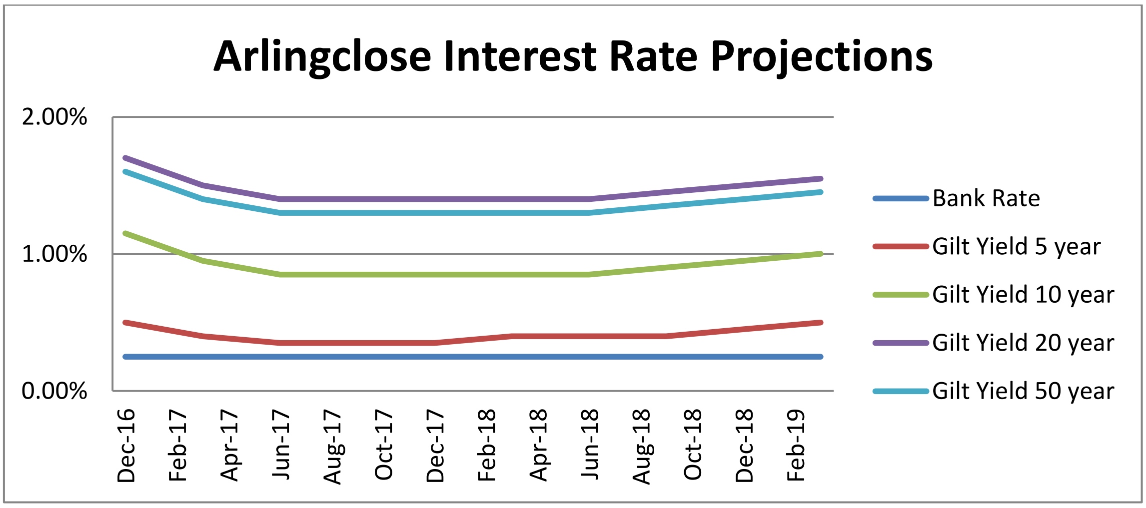
Debt Rescheduling

58. The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

PROSPECTS FOR INTEREST RATES

59. The Council's Treasury Management Consultants assist the Council to formulate a view on interest rates. The latest detailed economic and interest rate forecast provided by Arlingclose is attached at Annex A.

60. The following graph and commentary gives the Arlingclose's central view on interest rates and economic update.



61. Globally, the outlook is uncertain and risks remain weighted to the downside. The UK domestic outlook is uncertain, but likely to be weaker in the short term than previously expected.

62. 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 25% possibility of a drop to close to zero, with a very small chance of a reduction below zero.

63. Gilt yields have risen sharply, but remain at low levels. The Arlingclose central case is for yields to decline when the government triggers Article 50.

TREASURY MANAGEMENT LIMITS ON ACTIVITY

64. 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. However, if these are set to be too restrictive they will impair the opportunities to reduce costs and improve performance. The indicators are:

- Upper limits on **variable interest rate exposure**. This identifies a maximum limit for variable interest rates based upon the debt position net of investments;
- Upper limits on **fixed interest rate exposure**. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- **Maturity structure of borrowing**. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

65. The treasury indicators and limits are:

Upper limits on interest rate exposures	2016/17	2017/18	2018/19	2019/20
	%	%	%	%
- Upper limit on variable interest rate exposures	25	25	25	25
- Upper limit on fixed interest rate exposures	100	100	100	100
Maturity structure of borrowing	**Upper Limit**			
	%	%	%	%
- Loans maturing within 1 year	25	25	25	25
- Loans maturing within 1 - 2 years	25	25	25	25
- Loans maturing within 2 - 5 years	25	25	25	25
- Loans maturing within 5 - 10 years	50	50	50	50
- Loans maturing in over 10 years	100	100	100	100

Other Items

66. There are a number of additional items that the Council is obliged by CIPFA or DCLG to include in its Treasury Management Strategy.

67. **Policy on Use of Financial Derivatives:** The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks

they present will be managed in line with the overall treasury risk management strategy.

68. Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

69. **Policy on Apportioning Interest to the HRA:** On 28th March 2012, the Council borrowed £40 million from the Public Works Loan Board (PWLB) to buy itself out the of the HRA subsidy System. The monies were borrowed by the General Fund on behalf of the HRA. The interest on these loans is charged to the HRA on a half-yearly basis at the rate charged by PWLB. A further £9.268 million was lent by the General Fund to the HRA to complete the buyout. Interest on this element is charged at the average weighted rate of the PWLB loans.

70. The unfunded HRA capital financing requirement is also charged to the HRA at the average weighted rate of the PWLB loans.

71. The General Fund credits the HRA with interest earned on HRA credit balances calculated on the monthly movement in reserve balances and applied at year end. The rate used is the weighted interest rate on General Fund investments and cash balances.

72. **Financial Implications:** The budget for investment income in 2017/18 for the General Fund is £499,900 and the HRA is £118,000 and the budget for debt interest paid in 2017/18 is £1.86 million for the HRA. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

ANNEX A

EXTERNAL CONTEXT BY ARLINGCLOSE

Economic Background

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. Financial markets, wrong-footed by the referendum outcome, have since been weighed down by uncertainty over whether leaving the Union also means leaving the single market. 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 fall and continuing weakness in sterling and the near doubling in the price of oil in 2016 have combined to drive inflation expectations higher. The Bank of England is forecasting that Consumer Price Inflation will breach its 2% target in 2017, the first time since late 2013, but the Bank is expected to look through inflation overshoots over the course of 2017 when setting interest rates so as to avoid derailing the economy.

Initial post-referendum economic data showed that the feared collapse in business and consumer confidence had not immediately led to lower GDP growth. However, the prospect of a leaving the single market has dented business confidence and resulted in a delay in new business investment and, unless counteracted by higher public spending or retail sales, will weaken economic growth in 2017/18.

Looking overseas, with the US economy and its labour market showing steady improvement, the market has priced in a high probability of the Federal Reserve increasing interest rates in December 2016. The Eurozone meanwhile has continued to struggle with very low inflation and lack of momentum in growth, and the European Central Bank has left the door open for further quantitative easing.

The impact of political risk on financial markets remains significant over the next year. With challenges such as immigration, the rise of populist, anti-establishment parties and negative interest rates resulting in savers being paid nothing for their frugal efforts or even penalised for them, the outcomes of Italy's referendum on its constitution (December 2016), the French presidential and general elections (April – June 2017) and the German federal elections (August – October 2017) have the potential for upsets.

Credit Outlook

Markets have expressed concern over the financial viability of a number of European banks recently. Sluggish economies and continuing fines for pre-crisis behaviour have weighed on bank profits, and any future slowdown will exacerbate concerns in this regard.

Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the European Union, Switzerland and USA, while Australia and Canada are progressing with their own plans. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however continue to fall.

Interest Rate Forecast

The Authority's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.25% during 2017/18**.** The Bank of England has, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further falls in the Bank Rate look less likely.

Negative Bank Rate is currently perceived by some policymakers to be counterproductive but, although a low probability, cannot be entirely ruled out in the medium term, particularly if the UK enters recession as a result of concerns over leaving the European Union.

Gilt yields have risen sharply, but remain at low levels. The Arlingclose central case is for yields to decline when the government triggers Article 50. Long-term economic fundamentals remain weak, and the quantitative easing (QE) stimulus provided by central banks globally has only delayed the fallout from the build-up of public and private sector debt. The Bank of England has defended QE as a monetary policy tool, and further QE in support of the UK economy in 2017/18 remains a possibility, to keep long-term interest rates low.

Underlying assumptions:

- The medium term outlook for the UK economy is dominated by the negotiations to leave the EU. 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 global environment is also riddled with uncertainty, with repercussions for financial market volatility and long-term interest rates. Donald Trump's victory in the US general election and Brexit are symptomatic of the popular disaffection with globalisation trends. The potential rise in protectionism could dampen global growth prospects and therefore inflation. Financial market volatility will remain the norm for some time.

- However, following significant global fiscal and monetary stimulus, the short term outlook for the global economy is somewhat brighter than earlier in the year. US fiscal stimulus is also a possibility following Trump's victory.

- Recent data present a more positive picture for the post-Referendum UK economy than predicted due to continued strong household spending.

- 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.

- The currency-led rise in CPI inflation (currently 1.0% year/year) will continue, breaching the target in 2017, which will act to slow real growth in household spending due to a sharp decline in real wage growth.

- The depreciation in sterling will, however, assist the economy to rebalance away from spending. The negative contribution from net trade to GDP growth is likely to diminish, largely due to weaker domestic demand. Export volumes will increase marginally.

- Given the pressure on household spending and business investment, 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.

- Bank of England policymakers have, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further monetary loosening looks less likely.