FAREHAM
BOROUGH COUNCIL

Report to
Audit and Governance Committee

Date: **26 November 2018**

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

Subject: **TREASURY MANAGEMENT PROGRESS REPORT**

SUMMARY

In accordance with the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code of Practice, the Council is required to maintain a Treasury Management Strategy and provide updates on the implementation of that strategy.

The Audit and Governance Committee is the responsible body to examine and assess the effectiveness of the Council's treasury management policy and strategy.

In accordance with this role, this report sets out the mid-year review of treasury management activity up to 30 September 2018 which confirms compliance with the strategy approved by Full Council on 23 February 2018.

RECOMMENDATION

It is recommended that the Audit and Governance Committee reviews and comments on the contents of the report in terms of the effectiveness of the treasury management strategy.

INTRODUCTION

1. The Council's Treasury Management Strategy for 2018/19, in appendix A, was approved by Full Council on 23 February 2018 and reported to the Audit and Governance Committee on 12 March 2018. This report provides members with a mid-year update on the implementation of this Strategy.

2. An economic commentary by the Council's Treasury Advisors, Arlingclose, can be found in Appendix B.

BORROWING ACTIVITY

3. At 30 September 2018, the Council held £42.5 million of loans, (a decrease of £9.5 million on 31 March 2018). The Council expects to borrow externally up to £8 million in 2018/19 to part fund the capital programme.

4. The Council's main objective when borrowing continues to be striking an appropriately low risk balance between securing low interest rates and achieving cost certainty over the period for which the funds are required.

5. In keeping with this objective, no new borrowing was undertaken, while all £10 million of existing short-term loans were allowed to mature without replacement.

6. With short-term interest rates remaining much lower than long-term rates, the Council considered it to be more cost effective in the near term to use internal resources rather than taking out short-term loans. This strategy enabled the Council to reduce net borrowing costs and reduce overall treasury risk.

7. Borrowing activity to 30 September 2018 was:

	Balance on 31 March 2018 £'000	**Balance on 30 Sept 2018 £'000**	**Average Rate**
Long-term borrowing	40,000	40,000	3.50%
Short-term borrowing	10,000	0	0.89%
Portchester Crematorium	2,017	2,510	0.25%
Total Borrowing	**52,017**	**42,510**	

8. The Council holds investments from Portchester Crematorium Joint Committee which is treated as a temporary loan.

INVESTMENT ACTIVITY

9. The Council holds large invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six-month period, the Council's investment balance ranged between £10 and £18 million due to timing differences between income and expenditure.

10. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

11. Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2018/19. The policy details the high quality and secure counterparty types the Council can invest with.

12. Details on investment activity to 30 September 2018 are summarised in the table below:

	Balance on 31 March 2018 £'000	Balance on 30 Sept 2018 £'000	Average Rate
Long-term investments	2,000	2,000	4.13%
Short-term investments	7,000	10,000	0.77%
Cash and cash equivalents	3,000	750	0.68%
Total Investments	**12,000**	**12,750**	

COMMERCIAL PROPERTIES

13. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return.

14. As part of the Council's on-going review of finances and new income generating opportunities, the Executive approved a Commercial Property Investment Acquisition Strategy in January 2013.

15. Since the approval of the Strategy, eight new commercial properties have been purchased. The table below shows the current asset valuation of those properties:

	Date of Purchase	Premises Type	Valuation £m
Clifton House, Segensworth	1 Aug 2013	Industrial	1,980
122-134 Seaside, Eastbourne	20 Dec 2013	Convenience Store	1,020
86-88 Mitcham Lane, Streatham	10 Mar 2014	Convenience Store	1,360
83 St Thomas St, Weymouth	29 Sept 2014	Retail	730
470 Ringwood Road, Poole	24 Nov 2014	Convenience Store	1,230
2 Armstrong Road, Oxford	20 Oct 2015	Nursery	1,980
136-138 Southampton Road, Park Gate	29 Feb 2016	Retail	7,535
Southampton Road Retail Park	16 Nov 2016	Retail	11,600
Total			**27,435**

16. The properties are expected to generate rental income of £1.9 million and an average rate of return of 6.9% during 2018/19.

BUDGETED INCOME AND OUTTURN

17. Having raised policy rates in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon. Arlingclose's central case is for the Bank Rate to rise twice in 2019.

18. The Council’s budgeted net interest received for the year is £459,900 (£417,911 was received in 2017/18).

COMPLIANCE WITH TREASURY AND PRUDENTIAL INDICATORS

19. The Council confirms compliance with its Treasury and Prudential Indicators for 2018/19, which was set on 23 February 2018 as part of the Council’s Treasury Management Strategy Statement.

20. Performance for the first half of the year is shown in Appendix C. During the financial year to date the Council has operated within the treasury limits and prudential indicators.

RISK ASSESSMENT

21. In the current economic climate, there are risks that financial institutions holding Council investments could default and be unable to fulfil their commitments to repay the sums invested with them.

22. To help mitigate this risk, the Council maintains a list of approved institutions based on a grading system operated by the Council's treasury management advisers. Maximum limits are also set for investments with individual institutions.

Appendices:

Appendix A - Treasury Management Strategy 2018/19
Annex A – Original Economic Commentary and Outlook by Arlingclose

Appendix B – Economic Commentary by Arlingclose – October 2018

Appendix C - 2018/19 Indicators - Half-Yearly Performance

Background Papers: None

Reference Papers:

23 February 2018 Council Report - Treasury Management Policy and Strategy 2018/19

The CIPFA (Chartered Institute of Public Finance and Accountancy) Prudential Code for Capital Finance in Local Authorities 2017

CIPFA Treasury Management in the Public Services Code of Practice 2017

Enquiries:

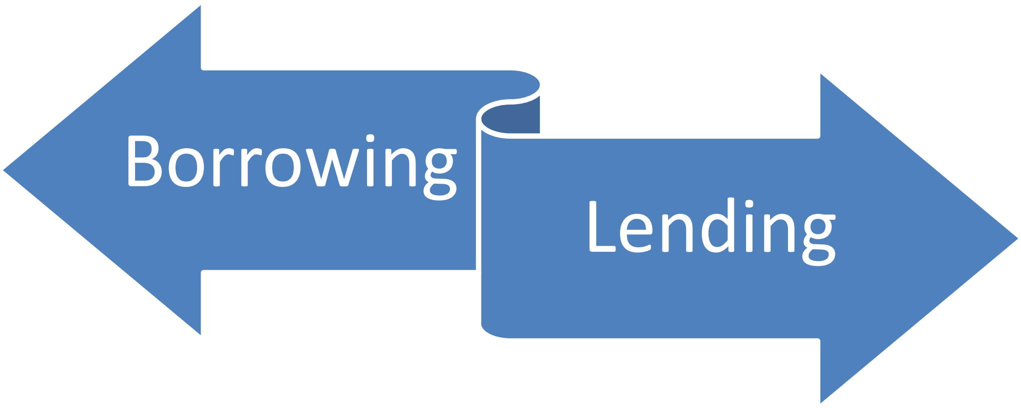
For further information on this report please contact Caroline Hancock. (Ext 4589)

APPENDIX A

FAREHAM

BOROUGH COUNCIL

TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL INDICATORS 2018/19



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. There 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 2018/19 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.

5. CIPFA published new versions of its Treasury Management Code of Practice and the Prudential Code in late December 2017. Due to the late publications, CIPFA recognises that changes may not be fully implemented until 2019/20 due to the lead -in time to produce the strategy. Because of this and because there are no changes to the format or content of the strategy, this strategy is based on the 2011 version of both Codes.

REPORTING REQUIREMENTS

6. 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:

7. 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

8. 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.

9. Treasury management officers regularly attend training courses, seminars and conferences provided by the Council’s treasury management advisers and CIPFA.

USE OF TREASURY MANAGEMENT CONSULTANTS

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

11. 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.

12. 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

13. 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

14. 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	2017/18 Revised £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000	2021/22 Estimate £'000
Public Protection	0	0	0	0	329
Streetscene	130	570	0	0	224
Leisure and Community	1,115	316	0	0	527
Housing	904	840	3,330	480	501
Planning and Development	938	30	0	0	0
Policy and Resources	19,015	10,787	8,550	3,700	490
Total General Fund	**22,102**	**12,543**	**11,880**	**4,180**	**2,071**
HRA	**2,584**	**5,498**	**4,283**	**4,334**	**3,327**
Total Expenditure	**24,686**	**18,041**	**16,163**	**8,514**	**5,398**
Capital Receipts	294	856	552	3,765	252
Capital Contributions	5,946	2,031	250	250	474
Capital Reserves	3,600	6,017	3,961	3,999	3,853
Revenue	1,205	1,326	520	500	819
Borrowing	13,641	7,811	10,880	0	0
Total Financing	**24,686**	**18,041**	**16,163**	**8,514**	**5,398**

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	2017/18 Revised £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
General Fund	37,356	44,546	54,588	53,530
HRA	50,911	50,681	50,451	50,221
Total CFR	**88,267**	**95,227**	**105,039**	**103,751**

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.

	2017/18 Revised	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
General Fund	0%	3%	6%	8%
HRA	14%	14%	14%	14%
Total	**8%**	**10%**	**11%**	**12%**

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.

	2017/18 Revised	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Council Tax Band D	-£0.41	£1.22	£1.01	-£0.16
Weekly Housing Rent Levels	-£0.09	£0.04	£0.04	£0.04

HOUSING REVENUE ACCOUNT (HRA) RATIOS

15. 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.

	2017/18 Revised	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
HRA Debt £'000	49,268	49,268	49,268	49,268
HRA Revenues £'000	11,250	11,140	10,840	11,120
Number of HRA Dwellings	2,405	2,400	2,408	2,398
Ratio of Debt to Revenues %	4.38:1	4.42:1	4.55:1	4.43:1
Debt per Dwelling £	£20,846	£20,528	£20,460	£20,545

MINIMUM REVENUE PROVISION (MRP) POLICY STATEMENT

16. 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)**.

17. 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.

18. 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.

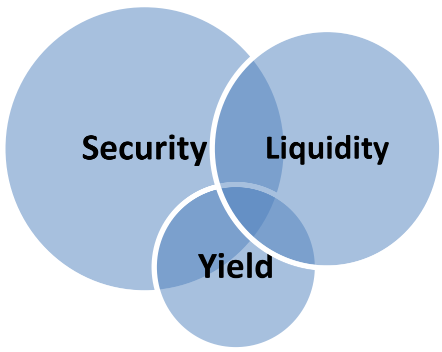
19. No MRP will be charged in respect of assets held within the HRA, in accordance with DCLG Guidance and capital expenditure incurred during 2018/19 will not be subject to a MRP charge until 2019/20.

TREASURY MANAGEMENT ISSUES

INVESTMENTS

Investment Strategy

20. 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**.



21. 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.

22. If the UK enters into a recession in 2018/19, 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.

23. Given the increasing risk and very low 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

24. 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		

25. 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 considered.

26. 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.

27. 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.

Operational Bank Accounts

28. The Council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings

no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £4m per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

Risk Assessment and Credit Ratings

29. 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.

30. 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

31. 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.

32. 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.

Specified Investments

33. 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”**.

34. 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

35. 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- (except UK Government and local authorities)	£2m
Total investments (except pooled funds) with institutions domiciled in foreign countries rated below AA+	£2m
Total non-specified investments	£10m

Investment Limits

36. The Council’s revenue reserves available to cover investment losses are forecast to be £16 million on 31st March 2018. 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

37. 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.

Non-Treasury Investments

38. Although not classed as treasury management activities and therefore not covered by the CIPFA Code or the CLG Guidance, the Council may also purchase property for investment purposes and may also make loans and investments for services purposes, for example as equity investments and loans to Council subsidiaries.

39. Such loans and investments will be subject to the Council's normal approval process for revenue and capital expenditure and need not comply with this treasury management strategy.

Investment Treasury Indicator and Limit

40. 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	2017/18 Revised	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Principal sums invested > 364 days	10	10	10	10

BORROWING

Current Portfolio Position

41. 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	**2017/18 Revised**	**2018/19 Estimate**	**2019/20 Estimate**	**2020/21 Estimate**
Debt at 1 April	41,835	51,835	59,635	70,435
Expected change in debt	10,000	7,800	10,800	0
Gross Debt at 31 March	**51,835**	**59,635**	**70,435**	**70,435**

£'000	2017/18 Revised	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Capital Financing Requirement (CFR)	**88,267**	**95,227**	**105,039**	**103,751**
Under/(Over) Borrowing	**36,432**	**35,592**	**34,604**	**33,316**
CFR for last, current and next 2 years	**311,909**	**332,649**	**336,012**	**341,860**

42. 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.

43. 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 2018/19 and the following two financial years.

44. The Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view considers current commitments, existing plans and the proposals in the budget report.

Treasury Indicators: Limits to Borrowing Activity

45. The treasury indicators include 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.

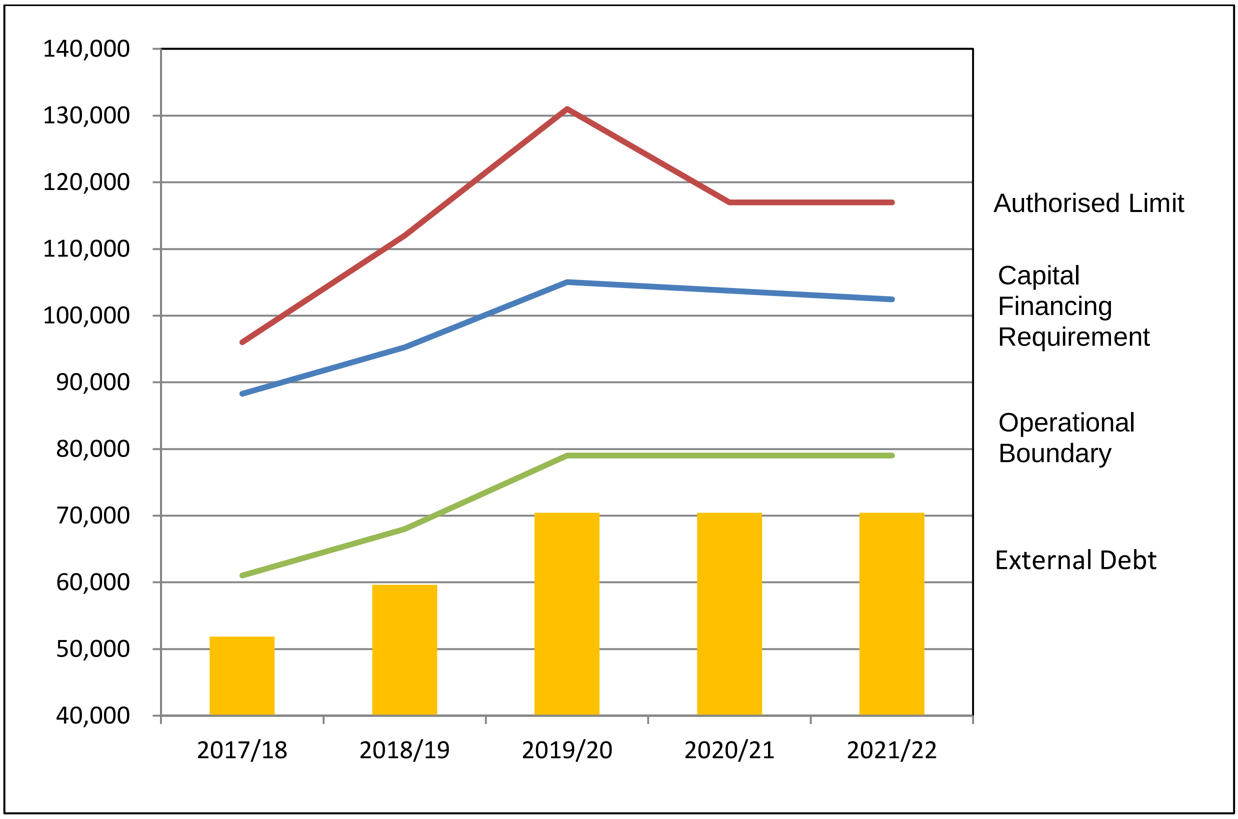
    2) The **authorised limit** is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

46. The limits are:

£'000	2017/18 Revised	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Operational Boundary				
Borrowing	56,000	63,000	74,000	74,000
Other long-term liabilities	5,000	5,000	5,000	5,000
Total	**61,000**	**68,000**	**79,000**	**79,000**
Authorised Limit				

Borrowing	89,000	105,000	124,000	110,000
Other long-term liabilities	7,000	7,000	7,000	7,000
Total	**96,000**	**112,000**	**131,000**	**117,000**

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



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

£'000	2017/18 Revised	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
HRA Debt Cap	56,851	56,851	56,851	56,851
HRA CFR	50,911	50,681	50,451	50,221
HRA Headroom	**5,940**	**6,170**	**6,400**	**6,630**

Borrowing Strategy

49. 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.

50. 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.

51. 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.

52. By doing so, the Council can 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.

53. Our treasury advisers 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 2018/19 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

54. Alternatively, the Council may arrange forward starting loans during 2018/19, 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.

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

Sources of Borrowing

56. 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.

57. 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

58. 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

59. 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.

60. The total amount borrowed will not exceed the authorised borrowing limit of £112 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

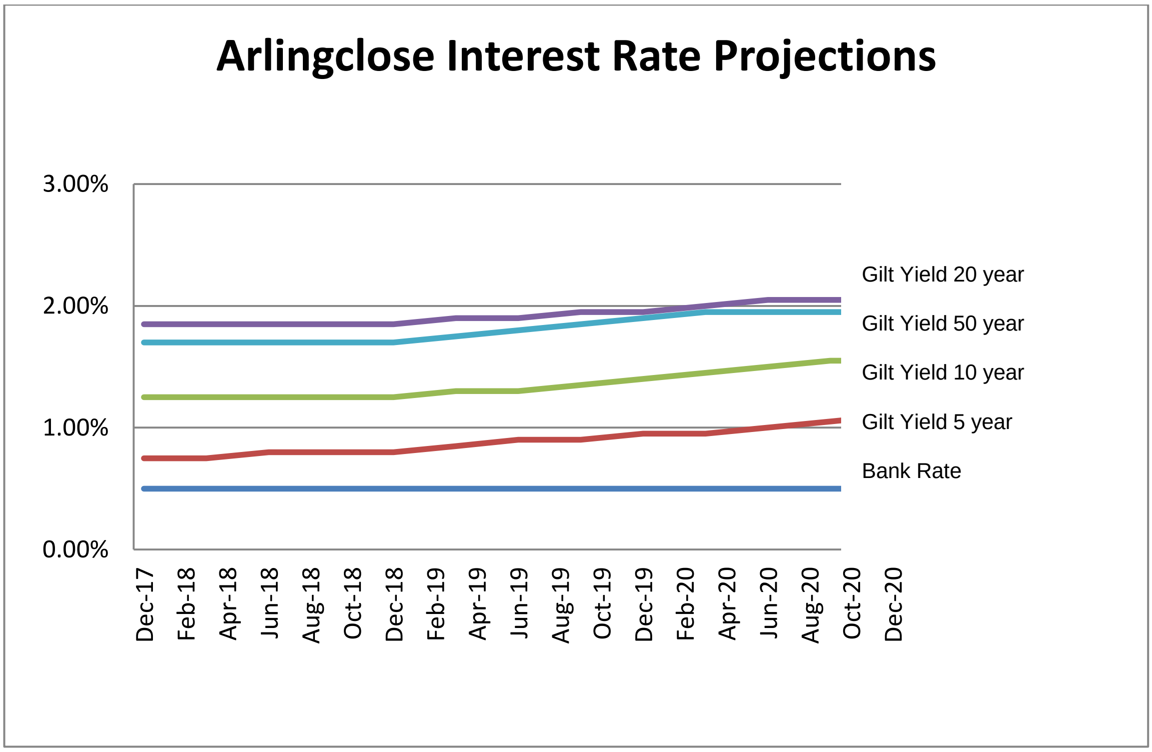
Debt Rescheduling

61. 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

62. The Council's treasury management advisers 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.

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



64. Arlingclose's central case is for UK Bank Rate to remain at 0.50% during 2018/19**,** following the rise from the historic low of 0.25%. The Monetary Policy Committee re-emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

65. Future expectations for higher short-term interest rates are subdued and on-going decisions remain data dependant and negotiations on exiting the EU cast a shadow over monetary policy decisions.

66. The risks to Arlingclose's forecast are broadly balanced on both sides. The Arlingclose central case is for gilt yields to remain broadly stable across the medium term. Upward movement will be limited, although the UK government's seemingly deteriorating fiscal stance is an upside risk.

TREASURY MANAGEMENT LIMITS ON ACTIVITY

67. 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.

68. The treasury indicators and limits are:

Upper limits on interest rate exposures	2017/18	2018/19	2019/20	2020/21
	%	**%**	**%**	**%**
- **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

69. There are many additional items that the Council is obliged by CIPFA or DCLG to include in its Treasury Management Strategy.

70. **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 considered 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.

71. 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.

72. **Policy on Apportioning Interest to the HRA:** On 28 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.

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

74. 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.

75. **Financial Implications:** The budget for investment income in 2018/19 for the General Fund is £459,900 and the HRA is £65,600 and the budget for debt interest paid in 2018/19 is £1,794,900 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

ARLINGCLOSE ECONOMIC AND INTEREST RATE FORECAST NOVEMBER 2017

Economic Background

The major external influence on the Authority's treasury management strategy for 2018/19 will be the UK's progress in negotiating its exit from the European Union and agreeing future trading arrangements. The domestic economy has remained relatively robust since the surprise outcome of the 2016 referendum, but there are indications that uncertainty over the future is now weighing on growth. Transitional arrangements may prevent a cliff-edge, but will also extend the period of uncertainty for several years. Economic growth is therefore forecast to remain sluggish throughout 2018/19.

Consumer price inflation reached 3.0% in September 2017 as the post-referendum devaluation of sterling continued to feed through to imports. Unemployment continued to fall and the Bank of England's Monetary Policy Committee judged that the extent of spare capacity in the economy seemed limited and the pace at which the economy can grow without generating inflationary pressure had fallen over recent years. With its inflation-control mandate in mind, the Bank of England's Monetary Policy Committee raised official interest rates to 0.5% in November 2017.

In contrast, the US economy is performing well and the Federal Reserve is raising interest rates in regular steps to remove some of the emergency monetary stimulus it has provided for the past decade. The European Central Bank is yet to raise rates, but has started to taper its quantitative easing programme, signalling some confidence in the Eurozone economy.

Credit Outlook

High profile bank failures in Italy and Portugal have reinforced concerns over the health of the European banking sector. Sluggish economies and fines for pre-crisis behaviour continue to weigh on bank profits, and any future economic 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. In addition, the largest UK banks will ringfence their retail banking functions into separate legal entities during 2018. There remains some uncertainty over how these changes will impact upon the credit strength of the residual legal entities.

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 remain very low.

Underlying assumptions:

- In a 7-2 vote, the MPC increased Bank Rate in line with market expectations to 0.5%. Dovish accompanying rhetoric prompted investors to lower the expected future path for interest rates. The minutes re-emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

- Further potential movement in Bank Rate is reliant on economic data and the likely outcome of the EU negotiations. Policymakers have downwardly assessed the supply capacity of the UK economy, suggesting inflationary growth is more likely. However, the MPC will be wary of raising rates much further amid low business and household confidence.

- The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. While recent economic data has improved, it has done so from a low base: UK Q3 2017 GDP growth was 0.4%, after a 0.3% expansion in Q2.

- Household consumption growth, the driver of recent UK GDP growth, has softened following a contraction in real wages, despite both saving rates and consumer credit volumes indicating that some households continue to spend in the absence of wage growth. Policymakers have expressed concern about the continued expansion of consumer credit; any action taken will further dampen household spending.

- Some data has held up better than expected, with unemployment continuing to decline and house prices remaining relatively resilient. However, both of these factors can also be seen in a negative light, displaying the structural lack of investment in the UK economy post financial crisis. Weaker long-term growth may prompt deterioration in the UK’s fiscal position.

- The depreciation in sterling may assist the economy to rebalance away from spending. Export volumes will increase, helped by a stronger Eurozone economic expansion.

- Near-term global growth prospects have continued to improve and broaden, and expectations of inflation are subdued. Central banks are moving to reduce the level of monetary stimulus.

- Geo-political risks remains elevated and helps to anchor safe-haven flows into the UK government bond (gilt) market.

APPENDIX B

ECONOMIC COMMENTARY BY TREASURY ADVISORS ARLINGCLOSE – OCTOBER 2018

Economic background: Oil prices rose by 23% over the six months to around $82/barrel. UK Consumer Price Inflation (CPI) for August rose to 2.7% year/year, above the consensus forecast and that of the Bank of England's in its August *Inflation Report*, as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4%, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9% providing some evidence that a shortage of workers is providing support to wages. However real wages (i.e. adjusted for inflation) grew only by 0.2%, a marginal increase unlikely to have had much effect on households.

The rebound in quarterly GDP growth in Q2 to 0.4% appeared to overturn the weakness in Q1 which was largely due to weather-related factors. However, the detail showed much of Q2 GDP growth was attributed to an increase in inventories. Year/year GDP growth at 1.2% also remains below trend. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.

Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in each of June and September by 0.25% to the current 2%-2.25%. Markets now expect one further rise in 2018.

The escalating trade war between the US and China as tariffs announced by the Trump administration appeared to become an entrenched dispute, damaging not just to China but also other Asian economies in the supply chain. The fallout, combined with tighter monetary policy, risks contributing to a slowdown in global economic activity and growth in 2019.

The EU Withdrawal Bill, which repeals the European Communities Act 1972 that took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament. With just six months to go when Article 50 expires on 29th March 2019, neither the Withdrawal Agreement between the UK and the EU which will be legally binding on separation issues and the financial settlement, nor its annex which will outline the shape of their future relationship, have been finalised, extending the period of economic uncertainty.

Financial markets: Gilt yields displayed marked volatility during the period, particularly following Italy's political crisis in late May when government bond yields saw sharp moves akin to those at the height of the European financial crisis with falls in yield in safe-haven UK, German and US government bonds. Over the period, despite the volatility, the bet change in gilt yields was small. The 5-year benchmark gilt only rose marginally from 1.13% to 1.16%. There was a larger increase in 10-year gilt yields from 1.37% to 1.57% and in the 20-year gilt yield from 1.74% to 1.89%. The increase in Bank Rate resulted in higher in money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.56%, 0.70% and 0.95% respectively over the period.

Credit background: Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ringfenced bank NatWest Markets plc rose relatively sharply over the period to around 96bps. The CDS for the ringfenced entity, National Westminster Bank plc, has held steady below 40bps. Although the CDS of other UK banks rose marginally over the period, they continue to remain low compared to historic averages.

The ringfencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc – is complete, the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.

There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ringfencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody's and to A- from BBB+ by both Fitch and Standard & Poor's (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody's.

Our treasury advisor Arlingclose will henceforth provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities' flexibility during bail-in. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs but not senior unsecured bonds issued by commercial banks.

APPENDIX C

2018/19 INDICATORS – HALF YEARLY PERFORMANCE

PRUDENTIAL INDICATORS

1) Level of Planned Capital Expenditure

ON TRACK

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	Revised Estimate £'000	Actual to 30 Sept £'000
Health and Public Protection	0	17
Streetscene	570	76
Leisure and Community	316	142
Housing	840	499
Planning Development	30	68
Policy and Resources	10,787	1,298
Total General Fund	**12,543**	**2,100**
HRA	**5,498**	**1,180**
Total Expenditure	**18,041**	**3,280**
Capital Receipts	856	198
Capital Grants	2,031	850
Capital Reserves	6,017	1,271
Revenue	1,326	768
Internal Borrowing	7,811	193
Total Financing	**18,041**	**3,280**

Expenditure to 30 September is within the overall original budget for the year. The budgets will be reviewed and re-phased where applicable as part of the forthcoming budget setting process to take account of carry forwards from 2017/18 and new schemes approved during the year.

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

ON TRACK

The Capital Financing Requirement (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.

ON TRACK

	Estimate £'000	Actual to 30 Sept £'000
General Fund	44,546	39,600
HRA	50,681	51,149
Total CFR	**95,227**	**90,749**

The CFR is slightly lower than projected due to lower internal borrowing for Daedalus capital expenditure.

3) Financing Costs as % of Net Revenue Stream

ON TRACK

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

	Estimate	Actual to 30 Sept
General Fund	3%	7%
HRA	14%	14%
Total	**10%**	**13%**

4) Incremental Impact of Capital Investment Decisions

ON TRACK

This is an indicator of affordability that shows the impact of capital investment 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 revenue budget requirement arising from the capital programme proposed.

	Estimate	Actual to 30 Sept
Council tax band D	£1.22	£1.23
Weekly housing rent levels	£0.04	£0.34

5) Housing Revenue Account (HRA) Ratios

ON TRACK

Due to 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.

	Estimate	End of Year Forecast
HRA debt £'000	49,268	49,268
HRA revenues £'000	11,140	12,594
Number of HRA dwellings	2,400	2,411
Ratio of debt to revenues %	4.42:1	3.91:1
Debt per dwelling £	£20,528	£20,435

TREASURY INDICATORS

6) Investments - Principal Sums Invested for Periods Longer than 364 days

ON TRACK

The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments.

£M	Estimate	Actual
Principal sums invested > 364 days	10	2

£2 million is placed with a pooled property fund which is a long term investment and the remaining investments are currently placed for less than 364 days to allow cash to be available for schemes in the capital programme that require internal borrowing.

7) Borrowing - Gross Debt and the Capital Financing Requirement

ON TRACK

In order to ensure that over the medium-term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence. The indicator shows that total debt is expected to remain below the CFR.

£'000	Estimate £'000	Actual to 30 Sept £'000
Debt at 1 April	51,835	42,510
Expected change in debt	7,800	193
Gross Debt at 31 March	**59,635**	**42,703**
Capital Financing Requirement (CFR)	95,227	90,749
Under/(Over) Borrowing	**35,592**	**48,046**
CFR for last, current and next 2 years	**332,649**	**370,611**

8) Borrowing - Limits to Borrowing Activity

ON TRACK

The actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt, below.

	Limit £'000	Actual £'000
Operational Boundary		
Borrowing	63,000	42,510
Other long-term liabilities	5,000	0
Total	**68,000**	**42,510**
Authorised Limit		
Borrowing	105,000	42,510
Other long-term liabilities	7,000	0
Total	**112,000**	**42,510**

Total debt at 30 September was £42.5 million. During the first half of 2018/19 the Authorised Limit of £112 million was not breached at any time.

9) Interest Rate Exposures

ON TRACK

This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed are, shown in the table below.

Upper limits on interest rate exposures	Limit %	Actual %
Upper limit on variable interest rate exposures	25	2
Upper limit on fixed interest rate exposures	100	100

10) Maturity Structure of Borrowing

ON TRACK

This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing are:

Maturity structure of borrowing	Upper Limit %	Actual %
Loans maturing within 1 year	25	6
Loans maturing within 1 - 2 years	25	0
Loans maturing within 2 - 5 years	25	0
Loans maturing within 5 - 10 years	50	0
Loans maturing in over 10 years	100	94

The £40m HRA loans represent 94% of loans maturing in over 10 years. The Council holds investments from Portchester Crematorium which is treated as a temporary loan. These represent 6% of loans maturing within 1 year.