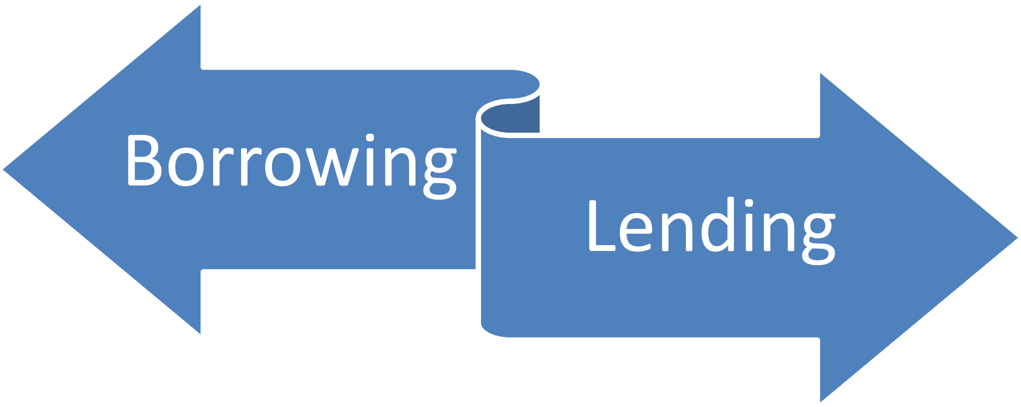
APPENDIX A

FAREHAM
BOROUGH COUNCIL

TREASURY MANAGEMENT STRATEGY AND INVESTMENT STRATEGY 2019/20



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 TREASURY MANAGEMENT AND INVESTMENT STRATEGIES

3. These strategies set out the expected approach to capital, treasury management and investment activities for 2019/20. It covers three main areas:

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

Treasury Management
- Treasury Investment Strategy
- Borrowing Strategy
- Treasury Indicators
- Interest Rate Forecast

Investment Strategy
- Service Investments
- Commercial Investments
- Investment Indicators
- Capacity and Skills

4. The content of the Strategy

5. is designed to cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the CIPFA Treasury Management Code and the MHCLG Investment Guidance.

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.

CAPITAL

CAPITAL EXPENDITURE AND FINANCING

8. 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.

9. 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 **three 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	2018/19 Revised £'000	2019/20 Estimate £'000	2020/21 Estimate £'000	2021/22 Estimate £'000	2022/23 Estimate £'000	Total £'000
Public Protection	100	0	0	0	0	100
Streetscene	107	574	0	0	158	839
Leisure and Community	348	378	100	100	600	1,526
Housing	1,098	500	500	500	529	3,127
Planning and Development	63	0	0	0	0	63
Policy and Resources	8,370	18,726	5,899	0	1,323	34,318
Total General Fund	**10,086**	**20,178**	**6,499**	**600**	**2,610**	**39,973**
HRA	**4,441**	**8,575**	**5,552**	**4,079**	**3,429**	**26,076**
Total Expenditure	**14,527**	**28,753**	**12,051**	**4,679**	**6,039**	**66,049**
Capital Receipts	1,294	322	3,106	232	29	4,983
Capital Contributions	1,771	3,823	600	600	758	7,552
Capital Reserves	3,134	6,356	5,556	2,644	3,243	20,933
Revenue	2,626	2,047	2,789	1,203	2,009	10,674
Borrowing	5,702	16,205	0	0	0	21,907
Total Financing	**14,527**	**28,753**	**12,051**	**4,679**	**6,039**	**66,049**

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	2018/19 Revised £'000	2019/20 Estimate £'000	2020/21 Estimate £'000	2021/22 Estimate £'000
General Fund	44,487	59,846	58,610	57,336
HRA	51,141	51,141	51,141	51,141
Total CFR	**95,628**	**110,987**	**109,751**	**108,477**

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.

	2018/19 Revised	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
General Fund	3%	6%	10%	10%
HRA	15%	14%	14%	13%
Total	**10%**	**11%**	**12%**	**12%**

HOUSING REVENUE ACCOUNT (HRA) RATIOS

10. 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.

	2018/19 Revised	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
HRA Debt £'000	49,268	49,268	49,268	49,268
HRA Revenues £'000	12,238	12,321	12,760	13,079
Number of HRA Dwellings	2,401	2,417	2,407	2,397
Ratio of Debt to Revenues %	4.03:1	4.00:1	3.86:1	3.77:1
Debt per Dwelling £	£20,518	£20,382	£20,467	£20,552

MINIMUM REVENUE PROVISION (MRP) POLICY STATEMENT

11. 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)**.

12. 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.

13. 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.

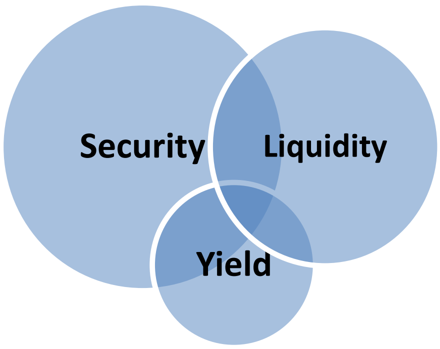
14. No MRP will be charged in respect of assets held within the HRA, in accordance with MHCLG Guidance and capital expenditure incurred during 2019/20 will not be subject to a MRP charge until 2020/21.

TREASURY MANAGEMENT

INVESTMENTS

Treasury Investment Strategy

15. The CIPFA Code requires 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**.



16. 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.

17. If the UK enters into a recession in 2019/20, 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.

18. 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**. This is especially the case for the estimated £10m that is available for longer-term investment. The majority of the Council's surplus cash is currently invested in short-term unsecured bank deposits and money market funds. This diversification will represent a continuation of the strategy adopted in 2017/18.

19. Under the new IFRS 9 standard, the accounting for certain investments depends on the Council's **business model** for managing them. The Council aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Approved Counterparties

20. 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		

21. Investment limits are set by reference to the lowest published **long-term credit rating** from a selection of external rating agencies. 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.

22. 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 and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

d) **Pooled Funds:** Shares or units 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.

   Bond, equity and property funds offer enhanced returns over the longer term but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.

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

Operational Bank Accounts

24. 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

25. 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.

26. 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

27. 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 and analysis and advice from the Council treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above credit rating criteria.

28. 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.

Investment Limits

29. The Council's revenue reserves available to cover investment losses are forecast to be £13 million on 31st March 2019. 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. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

	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

30. 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 Management Indicator

31. **Principal sums invested for longer than a year.** 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. The limits on the long-term principal sum invested to final maturities beyond the year end will be:

£M	2018/19 Revised	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Limit on principal invested beyond year end	10	10	10	10

BORROWING

Current Portfolio Position

32. 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	2018/19 Revised	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Debt at 1 April	52,017	58,017	74,017	74,017

£'000	2018/19 Revised	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Expected change in debt	6,000	16,000	0	0
Gross Debt at 31 March	**58,017**	**74,017**	**74,017**	**74,017**
Capital Financing Requirement (CFR)	**95,628**	**110,987**	**109,751**	**108,477**
Under/(Over) Borrowing	**37,611**	**36,970**	**35,734**	**34,460**
CFR for last, current and next 2 years	**406,922**	**424,843**	**436,380**	**431,206**

33. 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.

34. 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 2019/20 and the following two financial years.

35. 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

36. 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.

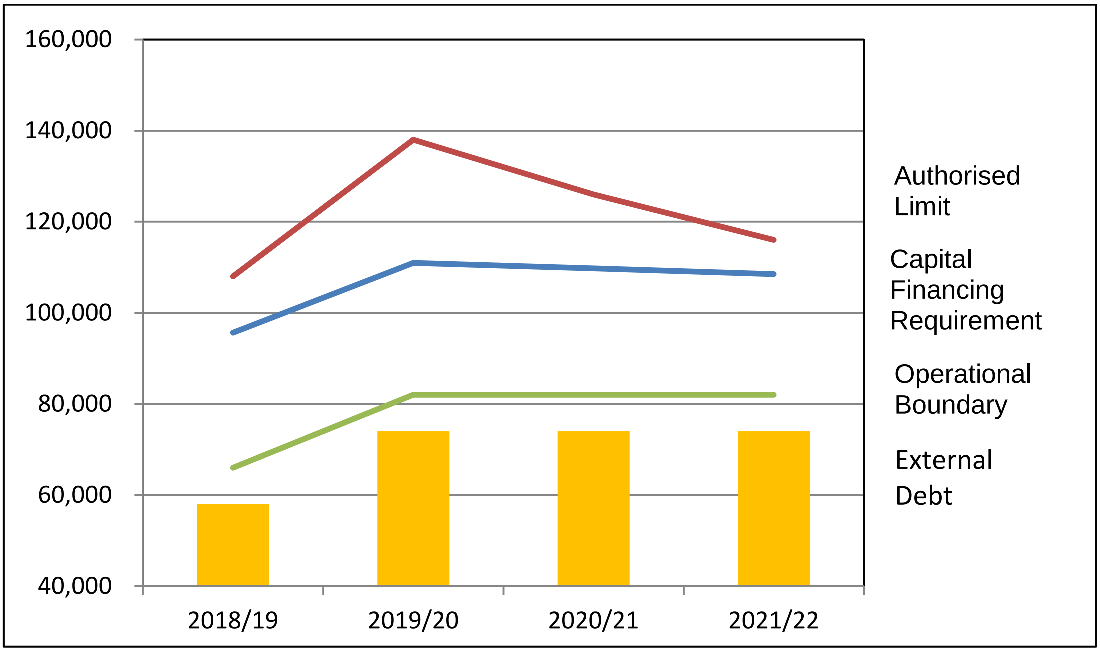
    2) The **authorised limit** is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

37. The limits are:

£'000	2018/19 Revised	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Operational Boundary				
Borrowing	62,000	78,000	78,000	78,000
Other long-term liabilities	4,000	4,000	4,000	4,000
Total	**66,000**	**82,000**	**82,000**	**82,000**
Authorised Limit				
Borrowing	102,000	132,000	120,000	110,000

Other long-term liabilities	6,000	6,000	6,000	6,000
Total	**108,000**	**138,000**	**126,000**	**116,000**

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



Treasury Indicator: Maturity Structure of Borrowing

39. This treasury indicator is set to control the Council’s exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Maturity structure of borrowing	Upper Limit	Lower Limit
	%	%
- Loans maturing within 1 year	25	0
- 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	100

40. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Borrowing Strategy

41. 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.

42. 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.

43. 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.

44. 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.

45. 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.

46. 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.

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

Sources of Borrowing

48. 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.
    - Any other bank or building society authorised to operate in the UK.
    - Any other UK public sector body.
    - UK public and private sector pension funds (expect the Hampshire County Council Pension Fund).
    - Capital market bond investors.
    - UK Municipal Bonds Agency plc (see below) and other special purpose companies created to enable local authority bond issues.

49. In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

    - Leasing
    - Hire purchase
    - Private Finance Initiative
    - Sale and leaseback

50. 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.

51. **Municipal Bonds Agency:** UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a joint and several guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

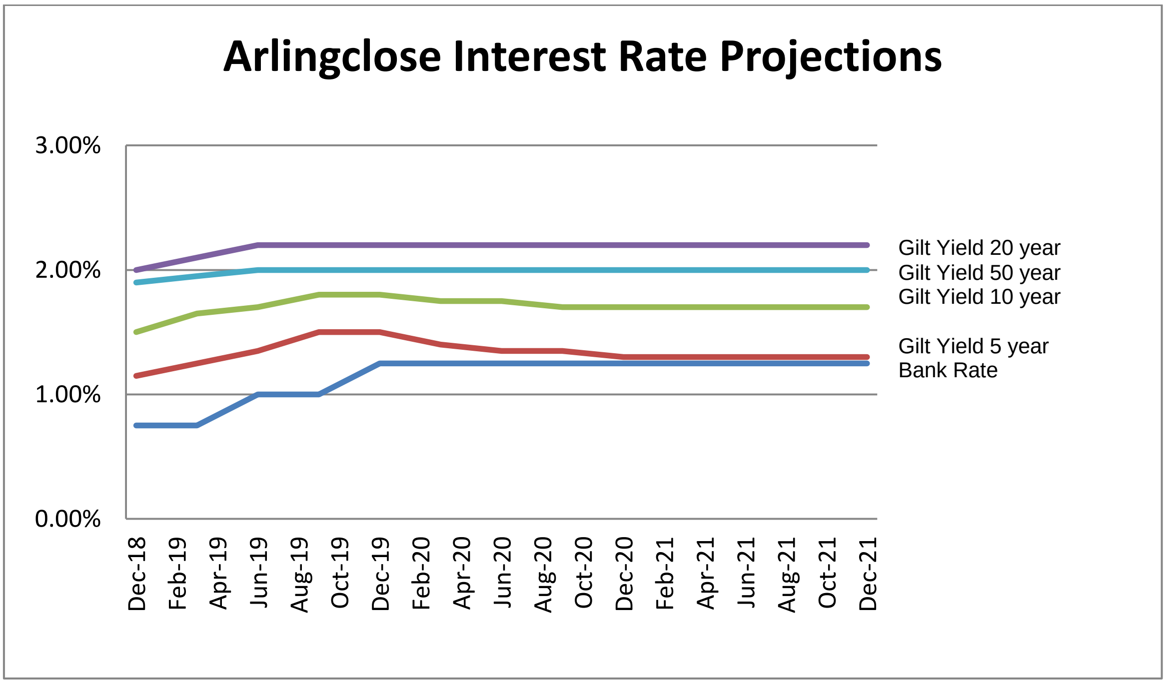
Debt Rescheduling

52. 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

53. 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.

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



55. Following the increase in Bank Rate to 0.75% in August 2018, the Council's treasury management adviser Arlingclose is forecasting two more 0.25% hikes during 2019 to take official UK interest rates to 1.25%. The Bank of England's MPC has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

56. The UK economic environment remains relatively soft, despite seemingly strong labour market data. Arlingclose's view is that the economy still faces a challenging outlook as it exits the European Union and Eurozone growth softens. While assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity. As such, the risks to the interest rate forecast are considered firmly to the downside.

57. Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on Arlingclose's interest rate projections, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.7% and 2.2% respectively over the interest rate forecast horizon, however volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.

Other Items

58. The CIPFA Code requires the Council to include the following in its Treasury Management Strategy.

59. **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.

60. 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.

61. **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.

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

63. 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.

64. **Markets in Financial Instruments Directive**: The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Authority's treasury management activities, the Chief Financial Officer believes this to be the most appropriate status.

Financial Implications

65. The budget for interest received in 2019/20 for the General Fund is £500,600 and the HRA is £126,300 and the budget for debt interest paid in 2019/20 is £35,000 for the General Fund and £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.

Other Options Considered

66. The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset

long-term fixed rates		by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater

INVESTMENT STRATEGY

67. The Council invests its money for three broad purposes:
    - because it has surplus cash as a result of its day-to-day activities, for example when income is received in advance of expenditure (known as **treasury management investments**),
    - to support local public services by lending to or buying shares in other organisations (**service investments**), and
    - to earn investment income (known as **commercial investments** where this is the main purpose).

68. This investment strategy is a **new part of this document for 2019/20**, meeting the requirements of statutory guidance issued by the Government in January 2018, and focuses on the second and third of these categories.

Service Investments

69. The Council does not currently lend to or buy shares in other organisations.

Commercial Investments

70. The Council invests in local and some regional UK commercial property with the intention of making a profit that will be spent on local public services.

71. Since the Executive approval of a Commercial Property Investment Acquisition Strategy in January 2013, the Council has purchased 8 commercial investment properties, as summarised below, averaging a return of 6.98%.

Property Type	Purchase Cost £'000	Value at 31 March 2018 £'000
Retail	23,705	23,475
Commercial	1,721	1,980
Other	1,890	1,980
Total	**27,316**	**27,435**

72. The Council's total investment property portfolio is shown below and includes Fareham Shopping Centre, Faretec and industrial estates at Palmerston Business Park and Newgate Lane.

Property Type	Value at 31 March 2018 £'000
Retail	39,741
Commercial	9,775
Other	3,666
Office	4,652
Leisure	1,138
Total	**58,972**

73. In accordance with government guidance, the Council considers a property investment to be secure if its accounting valuation is at or higher than its purchase cost including taxes and transaction costs.

74. A fair value assessment of the Council's more recent commercial property purchases has been made within the past twelve months, and the underlying assets provide security for capital investment. Should the 2018/19 year-end accounts preparation and audit process value these properties below their purchase cost, then an updated investment strategy will be presented to full Council detailing the impact of the loss on the security of investments and any revenue consequences arising therefrom.

75. The Council assesses the risk of loss before entering into and whilst holding property investments. These risks are managed by ensuring:
    - funds available for new purchases are disaggregated to limit the overall impact that any single investment would have on the Council's finances;
    - new purchases are only considered with existing tenants of "high quality" and sufficiently long tenancy term;
    - appropriate checks are carried out to ascertain the tenant's reliability;
    - other "due diligence" is undertaken to protect the Councils investment as far as possible such as checks on planning conditions, land contamination issues and planning policy issues.

Proportionality

76. The Council is dependent on profit generating investment activity to achieve a balanced revenue budget. The table below shows the extent to which the expenditure planned to meet the service delivery objectives is dependent on achieving the expected net profit from investments over the lifecycle of the Medium Term Financial Strategy.

£'000	2017/18 Actual	2018/19 Forecast	2019/20 Budget	2020/21 Budget	2021/22 Budget
Gross service expenditure	46,124	46,131	46,627	46,696	46,986
Investment income	3,807	4,246	4,555	4,555	4,555
Proportion	**8.3%**	**9.2%**	**9.8%**	**9.8%**	**9.7%**

Investment Indicators

77. The Council has set the following quantitative indicators to assess the Council's total risk exposure as a result of its investment decisions.

78. **Total risk exposure:** The first indicator shows the Council's total exposure to potential investment losses.

Total Investment Exposure	2017/18 Actual £'000	2018/19 Forecast £'000	2019/20 Forecast £'000
Treasury Management Investments	12,000	14,000	12,000
Commercial Investments	58,972	64,082	64,082
Total	**70,972**	**78,082**	**76,082**

79. **How investments are funded:** Government guidance is that these indicators should include how investments are funded. Since the Council does not normally associate particular assets with particular liabilities, this guidance is difficult to comply with. However, the following investments could be described as being funded by borrowing. The remainder of the Council's investments are funded by usable reserves and income received in advance of expenditure.

Investments funded by borrowing	**2017/18 Actual £'000**	**2018/19 Forecast £'000**	**2019/20 Forecast £'000**
Treasury Management Investments	0	0	0
Commercial Investments	18,840	18,412	17,972
Total	**18,840**	**18,412**	**17,972**

Capacity and Skills

TRAINING

80. 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.

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

82. Property services officers also regularly attend training courses, seminars and conferences provided RICS (Royal Institution of Chartered Surveyors) accredited/approved providers.

USE OF TREASURY MANAGEMENT CONSULTANTS

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

84. 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.

85. 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.

ANNEX A

ARLINGCLOSE ECONOMIC AND INTEREST RATE FORECAST DECEMBER 2018

Economic Background

The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2019/20.

UK Consumer Price Inflation (CPI) for October was up 2.4% year/year, slightly below the consensus forecast and broadly in line with the Bank of England's November Inflation Report. The most recent labour market data for October 2018 showed the unemployment rate edged up slightly to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pull on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level still likely to have little effect on consumer spending.

The rise in quarterly GDP growth to 0.6% in Q3 from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in Q1. At 1.5%, annual GDP growth continues to remain below trend. Looking ahead, the BoE, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy has been made since. However, the Bank expects that should the economy continue to evolve in line with its November forecast, further increases in Bank Rate will be required to return inflation to the 2% target. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.

While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2%-2.25% in September. Markets continue to expect one more rate rise in December, but expectations are fading that the further hikes previously expected in 2019 will materialise as concerns over trade wars drag on economic activity.

Credit Outlook

The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ringfencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ringfenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.

The Bank of England released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading here. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be very high if ever needed. The uncertainty caused by protracted negotiations between the UK and EU is weighing on the creditworthiness of both UK and European banks with substantial operations in both jurisdictions.

Underlying assumptions:

- Our central interest rate forecasts are predicated on there being a transitionary period following the UK's official exit from the EU.

- The MPC has a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. We believe that MPC members consider that: 1) tight labour markets will prompt inflationary pressure in the future, 2) ultra-low interest rates result in other economic problems, and 3) higher Bank Rate will be a more effective policy weapon if downside risks to growth crystallise.

- Both our projected outlook and the increase in the magnitude of political and economic risks facing the UK economy means we maintain the significant downside risks to our forecasts, despite the potential for slightly stronger growth next year as business investment rebounds should the EU Withdrawal Agreement be approved. The potential for severe economic outcomes has increased following the poor reception of the Withdrawal Agreement by MPs. We expect the Bank of England to hold at or reduce interest rates from current levels if Brexit risks materialise.

- The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in the middle quarters of 2018, but more recent data suggests the economy slowed markedly in Q4. Our view is that the UK economy still faces a challenging outlook as the country exits the European Union and Eurozone economic growth softens.

- Cost pressures are easing but inflation is forecast to remain above the Bank's 2% target through most of the forecast period. Lower oil prices have reduced inflationary pressure, but the tight labour market and decline in the value of sterling means inflation may remain above target for longer than expected.

- Global economic growth is slowing. Despite slower growth, the European Central Bank is conditioning markets for the end of QE, the timing of the first rate hike (2019) and their path thereafter. More recent US data has placed pressure on the Federal Reserve to reduce the pace of monetary tightening –

previous hikes and heightened expectations will, however, slow economic growth.

- Central bank actions and geopolitical risks have and will continue to produce significant volatility in financial markets, including bond markets.

Forecast:

- The MPC has maintained expectations of a slow rise in interest rates over the forecast horizon, but recent events around Brexit have dampened interest rate expectations. Our central case is for Bank Rate to rise twice in 2019, after the UK exits the EU. The risks are weighted to the downside.

- Gilt yields have remained at low levels. We expect some upward movement from current levels based on our central case that the UK will enter a transitionary period following its EU exit in March 2019. However, our projected weak economic outlook and volatility arising from both economic and political events will continue to offer borrowing opportunities.