WOKINGHAM BOROUGH COUNCIL

Treasury Management

Treasury Management Strategy Report 2017-18

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1. Introduction

This report presents the Council treasury strategy for 2017-18 in accordance with the Council's treasury management practices.

The Council is required to receive and approve three main reports each year, which incorporate a variety of policies, estimates and actuals. These are the Treasury Management Strategy (this report), the Treasury Management mid-year report and finally the Annual outturn Treasury report:

Treasury management strategy:

The first and most important report covers:

- The Treasury management strategy ***-How the investments and borrowings are to be organised*** including Treasury indicators
- An investment strategy -***The criteria on how investments are to be managed and the limitations***
- The capital plans (including Prudential Indicators)
- A minimum revenue provision (MRP) policy ***-How outstanding borrowing in respect of capital expenditure is repaid by charges to revenue over time***

Treasury management mid-year report

This Report updates members with the progress of the capital position, amending prudential indicators as necessary, and confirming whether the Treasury strategy is being complied with or whether any policies require revision.

Annual Treasury report

This report, which is produced following the year-end provides details of a selection of actual Prudential and Treasury indicators and actual Treasury operations compared with the estimates within the strategy.

2. The Economy and Interest Rates forecast

The Monetary Policy Committee, (MPC), cut Bank Rate from 0.50% to 0.25% on 4th August in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016. It also gave a strong steer that it was likely to cut Bank Rate again by the end of the year. However, economic data since August has indicated much stronger growth in the second half 2016 than that forecast; also, inflation forecasts have risen substantially as a result of a continuation of the sharp fall in the value of sterling since early August. Consequently, Bank Rate was not cut again in November or December and, on current trends, it now appears unlikely that there will be another cut in the near future, although that cannot be completely ruled out if there was a significant dip downwards in economic growth. During the two-year period 2017 – 2019, when the UK is negotiating the terms for withdrawal from the EU, it is likely that the MPC will do nothing to dampen growth prospects, (i.e. by raising Bank Rate), which will already be adversely impacted by the uncertainties of what form Brexit will eventually take. Accordingly, a first increase to 0.50% is not tentatively pencilled in, until quarter 2 2019, after those negotiations have been concluded, (though the period for negotiations could be extended). However, if strong domestically generated inflation, (e.g. from wage increases within the UK), were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.

Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The forecasts, (and MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

PWLB rates and gilt yields have been experiencing exceptional levels of volatility that have been highly correlated to geo-political, sovereign debt crisis and emerging market developments. It is likely that these exceptional levels of volatility could continue to occur for the foreseeable future.

The overall balance of risks to economic recovery in the UK is to the downside, particularly in view of the current uncertainty over the final terms of Brexit and the timetable for its implementation.

Apart from the above uncertainties, **downside risks to current forecasts** for UK gilt yields and PWLB rates currently include:

- Monetary policy action by the central banks of major economies reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some countries, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
- Major national polls:
  - Italian constitutional referendum 4.12.16 resulted in a ‘No’ vote which led to the resignation of Prime Minister Renzi. This means that Italy needs to appoint a new government.
  - Spain has a minority government with only 137 seats out of 350 after already having had two inconclusive general elections in 2015 and 2016. This is potentially highly unstable.
  - Dutch general election 15.3.17;
  - French presidential election April/May 2017;
  - French National Assembly election June 2017;
  - German Federal election August – October 2017.

- A resurgence of the Eurozone sovereign debt crisis, with Greece being a particular problem, and stress arising from disagreement between EU countries on free movement of people and how to handle a huge influx of immigrants and terrorist threats

- Weak capitalisation of some European banks, especially Italian.
- Geopolitical risks in Europe, the Middle East and Asia, causing a significant increase in safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.

The potential for **upside risks to current forecasts** for UK gilt yields and PWLB rates, especially for longer term PWLB rates, include: -

- UK inflation rising to significantly higher levels than in the wider EU and in the US, causing an increase in the inflation premium in gilt yields.
- A rise in US Treasury yields as a result of Fed. funds rate increases and rising inflation expectations in the USA, dragging UK gilt yields upwards.
- The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- A downward revision to the UK's sovereign credit rating undermining investor confidence in holding sovereign debt (gilts).

3. The Council's Capital Expenditure and Financing 2017/18

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- financed in year, immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need or;
- funded by borrowing (internal or external).

Capital Expenditure and funding

Table 1: Capital financing requirement: General Fund	2016/17 Estimated Outturn £'000	2017/18 Budget £'000	2018/19 Budget £'000	2019/20 Budget £'000
Opening balance (estimated)	118,580	119,013	197,975	235,021
Capital expenditure funded by Borrowing	3,672	82,527	40,611	67,648
Sub Total	122,252	201,540	238,586	302,669
Less Minimum Revenue Provision				
MRP Charge	(3,024)	(3,350)	(3,350)	(3,350)
PFI Principal Charge	(215)	(215)	(215)	(215)
Sub Total	(3,239)	(3,565)	(3,565)	(3,565)
Closing Balance	119,013	197,975	235,021	299,104
Movement	433	78,962	37,046	64,083

Table 2: Capital financing requirement: HRA	2016/17 Estimated Outturn £'000	2017/18 Budget £'000	2018/19 Budget £'000	2019/20 Budget £'000
Opening balance (estimated)	93,876	90,400	88,650	85,552
Capital expenditure funded by Borrowing	0	0	0	0
Sub Total	93,876	90,400	88,650	85,552
Less Minimum Revenue Provision				
MRP Charge/ Principle repayment	(3,476)	(1,750)	(3,098)	(1,988)
PFI Principal Charge	-	-	-	-
Sub Total	(3,476)	(1,750)	(3,098)	(1,988)
Closing Balance	90,400	88,650	85,552	83,564
Movement	(3,476)	(1,750)	(3,098)	(1,988)

The table above shows the Housing Revenue account (HRA) with no capital expenditure funded by borrowing. The capital expenditure of £9,074k is funded by the major repairs reserve and HRA revenue contribution.

Table 3: Capital financing requirement: General fund & HRA	2016/17 Estimated Outturn	2017/18 Budget £'000	2018/19 Budget £'000	2019/20 Budget £'000

£'000

Opening balance (estimated)	212,456	209,413	286,625	320,573
Capital expenditure funded by Borrowing	3,672	82,527	40,611	67,648
Sub Total	216,128	291,940	327,236	388,221
Less Minimum Revenue Provision				
MRP Charge/ Principle repayment	(6,500)	(5,100)	(6,448)	(5,338)
PFI Principal Charge	(215)	(215)	(215)	(215)
Sub Total	(6,715)	(5,315)	(6,663)	(5,553)
Closing Balance	209,413	286,625	320,573	382,668
Movement	(3,043)	77,212	33,948	62,095

The in-year increase in the borrowing requirement is due to a large increase in the capital programme for schemes such as the town centre regeneration and loans to group companies and will reduce again when capital receipts are recovered or loans repaid. It has also increased as a result of the forward funded schemes. These will decrease again as developer contributions are received.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. The Council does not borrow all of this money externally but uses some of its internal cash reserves to fund this expenditure. This is referred to as "internal borrowing". This means that the Council's capital financing requirement is higher than its external borrowing figures. External borrowing may be sourced from bodies such as the Public Works Loan Board [PWLB] or the money markets.

4. Minimum revenue provision (MRP) policy statement

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the Capital Financing Requirement (CFR) through a revenue charge (the minimum revenue provision - MRP), and it is also allowed to undertake additional voluntary payments (voluntary revenue provision - VRP). Department for Communities and Local Government (DCLG) regulations have been issued which require the full Council to approve a MRP Statement in advance of each financial year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement:

For capital expenditure incurred before 1 April 2008, the MRP policy will be:

- MRP will be based on the CFR (option 2);

These options provide for an approximate 4% reduction in the borrowing need (CFR) each year.

From 1 April 2008 for all borrowing (including PFI and finance leases) the MRP policy will be based on the estimated life of the assets, in accordance with the regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction).

This option provides for a reduction in the borrowing need over approximately the asset's life. There is no requirement on the HRA to make a minimum revenue provision but there is a requirement for a charge for depreciation to be made (although there are transitional arrangements in place).
Repayments included in annual PFI or finance leases are applied as MRP

5. External borrowing and compliance with treasury limits and Prudential Indicators for debt

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators found in table 4. Further detail on each of these indicators is included in Appendix B.

Table 4: Prudential Indicator – Debt	2016/17 Estimated Outturn	2017/18 Budget	2018/19 Budget	2019/20 Budget
Authorised limit £,000	243,238	358,400	400,800	478,400
Gross external borrowing £,000	158,712	211,800	234,800	279,800
HRA debt limit £,000	90,400	102,000	102,000	102,000
HRA debt per dwelling £	35	35	34	33
Incremental impact of capital investment decisions on council tax £*	39.80	(3.44)	(3.95)	(4.80)
% of internal borrowing to CFR	24.21%	26.11%	26.76%	26.88%
Maturity structure of borrowing	See Appendix B			
Operational boundary for external debt £'000	205,200	301,000	336,700	401,900
Ratio of financing costs to net revenue stream*	2.90%	3.38%	3.43%	3.53%
Upper limits on interest rate exposure£,000	100	172	214	294

' *Note: The large decrease from 16/17 to 17/18 is due to investments and savings created from the capital programme which are now being achieved in these years.
**Note: The increase from 2.9% in 2016/17 to 3.38% in 2017/18 is a full year effect of an £18,000k loan estimated to be taken out in March 2017.

6. External borrowing and compliance with treasury limits

Table 5, below, demonstrates the current and forecast for 2017/18 external borrowing.

Table 5: External Borrowing	2016/17 Estimated Outturn £'000	2017/18 Budget £'000	2018/19 Budget £'000	2019/20 Budget £'000
Market	24,000	24,000	24,000	24,000
PWLB	125,482	178,570	202,200	247,200
Local Enterprise Partnership	630	630	0	0
Total borrowing	150,112	203,200	226,200	271,200

Included in the total borrowing is an estimated £18m loan to be taken out prior to 31 March 2018. This will be at a special rate of 40 bases points lower than the PWLB rate. (Local Enterprise Partnership Agreement).

In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the 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 essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs.

7. Compliance with treasury limits and prudential indicators for investments

The treasury management team ensure the cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return. The return on investments contributes to the Council's budget for both the general fund and housing revenue account.

Table 6, below, shows the counterparties where estimated cash deposits are for 2017/18 to 2019/20.

Table 6: Investment Type	2016/17 Estimated Outturn £'000	2017/18 Estimated Outturn £'000	2018/19 Estimated Outturn £'000	2019/20 Estimated Outturn £'000
Local Authorities	37,000	22,341	31,192	18,796
Fund Mangers	18,000	10,880	15,200	9,160
Internal Companies investments	15,150	13,150	14,300	16,550
Total	70,150	46,371	60,692	44,506

8.1 Investment policy

The Council's investment policy has regard to the DCLG's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, and then return.

In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk.

Continuing regulatory changes in the banking sector are designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key ratings used to monitor counterparties being the Short Term and Long Term ratings only.

As with previous practice, ratings will not be the sole determinant of the quality of an institution and it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.

Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentrated risk.

The intention of the strategy is to provide security of investment and minimisation of risk.

Investment instruments identified for use in the financial year are listed in appendix D under the 'specified' and 'non-specified' investments categories. Counterparty limits will be as set through the Council's treasury management practices.

8.2 Creditworthiness policy

The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle, the Council will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections ; and

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

The Director of Finance and Resources will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to those which determine which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.
The minimum rating criteria uses the lowest common denominator method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council's criteria, the other does not, and then the institution will fall outside the lending criteria. Credit rating information is supplied by Capita Asset Services, our treasury advisors, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance, a negative rating watch applying to a counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions. The criteria for providing a pool of high quality investment counterparties (both specified and non-specified investments) is:

- Banks 1 - good credit quality – the Council will only use banks which:
  i. are UK banks; and/or
  ii. are non-UK and domiciled in a country which has a minimum sovereign long term rating of AAA (in house team only)
  iii and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):

    I. Short term – F1+ (Fitch), P-1 (Moody's), A-1+ (Standard and Poor's)

    ii.Long term – AA (Fitch), Aa2 (Moody's) , AA (Standard and Poor's)

• Banks 2 – Part nationalised UK banks – . This bank can be included if it continues to be part nationalised or they meet the ratings in Banks 1 above.

• Banks 3 – The Council's own banker (Nat West) for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

• Building societies. Subject to a minimum asset size of £5bn and meeting a minimum credit rating of A-.

• UK Government: including Money market funds – the Council and its Fund Managers will use AAA rated funds. The Director of Finance and Resources will keep under review the Money Market Funds used and will amend as necessary.

• Gilts and the Debt Management Account Deposit Facility (DMADF)

• Local authorities, parish councils etc.

• Supranational institutions – multilateral investment organisations such as the World Bank or European Investment Bank (sometimes used by the Fund Managers)

• In the event of an emergency, to allow an unlimited amount to be invested in the RBS Money Market Fund. This would be done in the event of an extreme IT failure of the Council's computer systems. This fund is an AAA rated investment and would be a less risky option than leaving the funds in the NatWest accounts.

• Group Limits – For each banking group the following limits will apply, dependent on the rating of the Parent Bank

i. AAA : £7m with a maximum average duration of 1 year
ii. AA- :£5m with a maximum average duration of 6 months

Use of additional information other than credit ratings. Additional requirements under the Code require the Council to supplement credit rating information. Whilst above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

8.3 Time and monetary limits applying to investments

The time and monetary limits for institutions on the Council's counterparty list are as follows (these will cover both specified and non-specified investments):

	Fitch Long term Rating	Moody's	Standard & Poors	Money Limit	Time Limit
Banks 1 higher quality	***F1+/AAA***	***P-1Aaa***	***A-1+/AA-***	**£5m**	**364 days**
Banks 1 medium quality	***F1+/AA-***	***P-1Aa3***	***A-1+/AA-***	**£3m**	**364 days**
Building Societies				**£2m**	**6 Months**
Debt Management Office Account (DMADF)	**-**	**-**	**-**	**£20m**	**3 Months**
Guaranteed Organisations	**-**	**-**	**-**	**£2m**	**3 Months**
Other Institution Limits (other local authorities, Money Market Funds, Gilts and Supranational investments)	**-**	**-**	**-**	**£5m**	**364 days**

8.4 Country limits

The Council has determined that it will only use approve counterparties from countries with a minimum sovereign credit rating of AAA. The exception will be the UK, which currently has an AA+ sovereign rating.

A Non UK counterparty will need to meet all above mentioned criteria in 4.2 & 4.3 and have a sovereign rating AAA as a minimum. Countries with a sovereign rating of AAA (based on lowest available rating @ Jan 2017) are shown in the table below:

	S&P	Moody's	Fitch
Australia	AAA	Aaa	AAA
Canada	AAA	Aaa	AAA
Denmark	AAA	Aaa	AAA
Germany	AAA	Aaa	AAA
Luxembourg	AAA	Aaa	AAA
Netherlands	AAA	Aaa	AAA
Norway	AAA	Aaa	AAA
Singapore	AAA	Aaa	AAA
Sweden	AAA	Aaa	AAA
Switzerland	AAA	Aaa	AAA

8.5 Investment strategy

Investment returns expectations. The Bank Rate is forecast to remain unchanged at 0.25% before starting to rise from quarter 4 of 2019/20. Bank Rate forecasts for financial year ends (March) are:

- 2016/17 0.25%
- 2017/18 0.25%
- 2018/19 0.25%
- 2019/20 0.50% (forecast rise from Q)

There are downside risks to these forecasts (i.e. start of increases in Bank Rate occurs later) if economic growth weakens. However, should the pace of growth quicken, there could be an upside risk.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next eight years are as follows:

- 2016/17 0.25%
- 2017/18 0.25%
- 2018/19 0.25%
- 2019/20 0.50%
- 2020/21 0.75%
- 2021/22 1.00%
- 2022/23 1.50%
- 2023/24 1.75%
- Later years 2.75%

Investment treasury indicator and limit

This is the amount invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.
The Council is asked to approve the treasury indicator and limit: -

Principal sums invested > 364 Days	2016/17 Estimated £'000	2017/18 Budget £'000	2018/19 Budget £'000	2019/20 Budget £'000
In house	0	0	0	0
Fund managers	10,000	10,000	10,000	10,000

Review of investment strategy

As part of continued improvement the treasury function will review the latest information and tools that are available to ensure the strength of the council's investment strategy. The council has adapted a risk adverse approach to investment following the collapse of Icelandic banks. This has resulted in a low level of investment returns. In general the safer the investment the lower the interest rate paid.
A review of the economic situation and the council approach to risk and returns is being undertaken to enable executive to consider it counterparty parameters.

8.6 Investment risk benchmarking

These benchmarks are simple guides to maximum risk, so they may be breached on occasion, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or Annual Report.

Security - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:

- 0.01% historic risk of default when compared to the whole portfolio.

Liquidity – in respect of this area the Council seeks to maintain:

- Bank overdraft - £0.5m
- Liquid short term deposits of at least £5m available with a week's notice.
- Weighted average life benchmark is expected to be 0.25 years, with a maximum of 0.5 years.

Yield - local measures of yield benchmarks is:

- Investments – internal returns above the 7 day LIBID rate

8.7 External fund managers

It is the Council's policy to use external fund managers for part of its investment portfolio. The fund managers will use both specified and non-specified investment categories and are contractually committed to keep to the Council's investment strategy. The performance of each manager is reviewed at least quarterly by the Director of Finance and Resources.

9. Flexible use of Capital Receipts

Since December 2015, the Government has provided local authorities with the flexibility of utilising Capital Receipts for qualifying expenditure. This is to enable authorities to fund transformation and cost reduction programmes from capital receipts rather than revenue expenditure.

The guidance recommends that a strategy should be prepared that includes separate disclosure of the individual projects that will be funded or part funded through capital receipts flexibility and that the strategy is approved by full council.

10. Conclusion

The Director of Finance and Resources confirms that the treasury team will abide by the strategy set out within this document and will report to the Audit Committee December 2017 as part of the mid-year report, any breaches to limits and prudential indicators.