

## Cherwell District Council

### Treasury Management Strategy Statement 2019/20

#### 1 Introduction

- 1.1 Treasury management is the management of the council's cash flows, borrowing and investments, and the associated risks. The council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the council's prudent financial management.
- 1.2 Treasury risk management at the council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires the council to approve a treasury management strategy before the start of each financial year. This report fulfils the council's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.
- 1.3 Investments held for service purposes or for commercial profit are considered in a different report, the Investment Strategy.

#### 2 External Context (provided by Arlingclose - December 2018)

##### Economic background

- 2.1 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 Council's treasury management strategy for 2019/20.
- 2.2 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.
- 2.3 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.
- 2.4 Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have 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.
- 2.5 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

- 2.6 The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ring-fencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ring-fenced 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 ring-fenced banks generally being better rated than their non-ring-fenced counterparts.
- 2.7 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.
- 2.8 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.

### Interest rate forecast

- 2.9 Following the increase in Bank Rate to 0.75% in August 2018, 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.
- 2.10 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 (*at the time of writing this commentary in mid-December*). As such, the risks to the interest rate forecast are considered firmly to the downside.
- 2.11 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.
- 2.12 The economic and interest rate forecast provided by Arlingclose is attached at Appendix A.

For the purpose of setting the budget, it has been assumed that investments will be made at an average rate of 1.03%, and that loans will be borrowed at an average rate of 1.78%.

### 3 Local Context

- 3.1 On 31<sup>st</sup> December 2018, the council held £89.5m of borrowing and £15.7m of investments. This is set out in further detail below:

	<b>31.12.18 Actual Portfolio £m</b>	<b>31.12.18 Average Rate %</b>
<b>External borrowing:</b>		
Public Works Loan Board	41.0	2.05%
Local authorities	48.5	1.02%
<b>Total gross external debt</b>	<b>89.5</b>	<b>1.49%</b>
<b>Treasury investments:</b>		
Banks & building societies (unsecured)	2.0	0.65%
UK Government	7.6	0.50%
Money Market Funds	6.1	0.72%
<b>Total treasury investments</b>	<b>15.7</b>	<b>0.61%</b>
<b>Net debt</b>	<b>73.8</b>	<b>1.68%</b>

Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance sheet summary and forecast

	<b>31.3.18 Actual £m</b>	<b>31.3.19 Estimate £m</b>	<b>31.3.20 Forecast £m</b>	<b>31.3.21 Forecast £m</b>	<b>31.3.22 Forecast £m</b>
General Fund CFR	137.5	176.8	223.6	246.4	243.2
Less: External borrowing **	(111.5)	(96.0)	(68.0)	(41.0)	(41.0)
<b>Internal/(over) borrowing</b>	<b>26.0</b>	<b>80.8</b>	<b>155.6</b>	<b>205.4</b>	<b>202.2</b>
Less: Usable reserves	(17.1)	(17.1)	(17.1)	(17.1)	(17.1)
Less: Working capital	(28.0)	(28.0)	(28.0)	(28.0)	(28.0)
<b>Investments/(New borrowing required)</b>	<b>19.1</b>	<b>(35.7)</b>	<b>(110.5)</b>	<b>(160.3)</b>	<b>(157.1)</b>

\*\* shows only loans to which the council is currently committed

- 3.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.
- 3.3 The council has an increasing CFR due to the capital programme, but minimal investments and will therefore be required to borrow up to a total of £201m over the forecast period.

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the council expects to comply with this recommendation during 2019/20.

#### **4 Borrowing Strategy**

- 4.1 The council currently (31/12/2018) holds £89.5 million of loans, a decrease of £22 million on the previous year end, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 1 shows that the council expects to borrow up to a total of £178

million in 2019/20. The council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £225 million.

### **Objectives**

- 4.2 The council's chief 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.

### **Strategy**

- 4.3 Given the significant cuts to public expenditure and in particular to local government funding, the council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. 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.
- 4.4 By doing so, the council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal / 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. Arlingclose 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 2019/20 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.
- 4.5 Alternatively, the council may arrange forward starting loans during 2019/20, 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.

In addition, the council may borrow further short-term loans to cover unplanned cash flow shortages.

### **Sources of borrowing**

- 4.6 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 (see below)
  - 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 (except Oxfordshire 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

### **Other sources of debt finance**

- 4.7 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

- 4.8 The council has previously raised around 40% of its long-term borrowing from the PWLB but it continues to investigate other sources of finance, such as local authority loans and bank loans, which may be available at more favourable rates.

### **Municipal Bonds Agency**

- 4.9 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.

### **LOBOs**

- 4.10 The council does not hold any LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the council has the option to either accept the new rate or to repay the loan at no additional cost.

### **Short-term and variable rate loans**

- 4.11 These loans leave the council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below.

### **Debt rescheduling**

- 4.12 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. Other lenders may also be prepared to negotiate premature redemption terms. 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.

## **5 Investment Strategy**

- 5.1 The council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months (January - December 2018), the council's investment balance has ranged between £5 million and £70 million. Levels in the forthcoming year are expected to be general lower, ranging from £10m and £25m, but may vary for short periods to due to cashflow needs and borrowing opportunities.

### **Objectives**

- 5.2 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. 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.

### Negative interest rates

- 5.3 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.

### Strategy

- 5.4 Given the increasing risk and low returns from short-term unsecured bank investments, the council would aspire to diversify into more secure and/or higher yielding asset classes. However, given the low level of funds available for longer-term investment and the high liquidity requirements, the council's surplus cash is likely to remain invested in short-term bank deposits and call accounts, money market funds, and deposits with the UK Government and other local authorities.

### Business models

- 5.5 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

- 5.6 The council may invest its surplus funds with any of the counterparty types in table 3 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 3: Approved investment counterparties and limits

Credit rating	Banks unsecured	Banks secured	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£3m 5 years	£3m 20 years	£5m 50 years	£3m 20 years	£3m 20 years
AA+	£3m 5 years	£3m 10 years	£5m 25 years	£3m 10 years	£3m 10 years
AA	£3 m 4 years	£3m 5 years	£5m 15 years	£3m 5 years	£3m 10 years
AA-	£3m 3 years	£3m 4 years	£5m 10 years	£3m 4 years	£3m 10 years
A+	£3m 2 years	£3m 3 years	£5m 5 years	£3m 3 years	£3m 5 years
A	£3m 13 months	£3m 2 years	£5m 5 years	£3m 2 years	£3m 5 years
A-	£3m 6 months	£3m 13 months	£5m 5 years	£3m 13 months	£3m 5 years
None	None	None	£5m 2 years	None	None
<b>Pooled funds and real estate investment trusts</b>		£5m per fund or trust			

*This table must be read in conjunction with the notes below*

**Credit rating**

- 5.7 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 taken into account.

**Banks unsecured**

- 5.8 Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. 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. See below for arrangements relating to operational bank accounts.

**Banks secured**

- 5.9 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. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

**Government**

- 5.10 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.

**Corporates**

- 5.11 Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made following an external credit assessment.

**Registered providers**

- 5.12 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. These bodies are tightly regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

**Pooled funds**

- 5.13 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.
- 5.14 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.

#### **Real estate investment trusts**

- 5.15 Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

#### **Operational bank accounts**

- 5.16 The council may incur operational exposures, for example through 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 £50,000 per bank wherever possible e.g. except for overnight balances where funds are received during the day and it is too late to transfer to another counterparty. 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**

- 5.17 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.
- 5.18 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**

- 5.19 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, reports in the quality financial press and analysis and advice from the council's 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 criteria. In addition to Arlingclose ratings and advice, the council maintains an internal counterparty 'Watch List' based on intelligence from a variety of other sources available to officers.
- 5.20 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial



market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

### Investment limits

- 5.21 In order that the council's revenue reserves available to cover investment losses are not put at 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 £5 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.

Table 4: Investment limits

	<b>Cash limit</b>
Any single organisation, except the UK Central Government	£5m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£5m per group
Any group of pooled funds under the same management	£5m per manager
Negotiable instruments held in a broker's nominee account	£3m per broker
Foreign countries	£5m per country
Registered providers and registered social landlords	£10m in total
Unsecured investments with building societies	£10m in total
Loans to unrated corporates	£5m in total
Money market funds	£15m in total
Real estate investment trusts	£5m in total

### Liquidity management

- 5.22 The council uses in-house cash flow forecasting software 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.

## 6 Treasury Management Indicators

- 6.1 The council measures and manages its exposures to treasury management risks using the following indicators.

### Interest rate exposures

- 6.2 This indicator is set to control the council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	Limit
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£160,000
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£160,000

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

### Maturity structure of borrowing

- 6.3 This 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:

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	80%	10%
12 months and within 24 months	80%	0%
24 months and within 5 years	80%	0%
5 years and within 10 years	80%	0%
10 years and above	80%	0%

- 6.4 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. The upper and lower limits as shown above provide the scope to accommodate new loan(s) in the most appropriate maturity band at the time of borrowing

### Principal sums invested for periods longer than a year

- 6.5 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 period end will be:

Price risk indicator	2019/20	2020/21	2021/22
Limit on principal invested beyond year end	£10m	£5m	£5m

## 7 Related Matters

The CIPFA Code requires the council to include the following in its treasury management strategy.

### Financial Derivatives

- 7.1 Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).
- 7.2 The council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be

subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

- 7.3 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.

### **Markets in Financial Instruments Directive (MiFID II)**

- 7.4 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 council's treasury management activities, the Executive Director of Finance and Governance believes this to be the most appropriate status.

## **8 Financial Implications**

- 8.1 The budget for investment income in 2019/20 is £0.15 million, based on an average investment portfolio of £15 million at an average interest rate of 1.03%.

The budget for debt interest paid in 2019/20 is £2.764 million, based on an average debt portfolio of £155 million at an average interest rate of 1.78%.

If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different.

## **9 Other Options Considered**

- 9.1 The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Executive Director of Finance and Governance, having consulted the Lead Member for Financial Management & Governance, 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.

<b>Alternative</b>	<b>Impact on income and expenditure</b>	<b>Impact on risk management</b>
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 long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset 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

**Appendix A – Arlingclose Economic & Interest Rate Forecast - December 2018****Underlying assumptions:**

- Our central interest rate forecasts are predicated on there being a transitional 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 transitional 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.

Appendix 6

	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Average
<b>Official Bank Rate</b>														
Upside risk	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.17
Arlingclose Central Case	0.75	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.13
Downside risk	0.00	-0.50	-0.75	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-0.85
<b>3-mth money market rate</b>														
Upside risk	0.10	0.10	0.10	0.10	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.17
Arlingclose Central Case	0.90	0.95	1.10	1.30	1.40	1.40	1.40	1.35	1.35	1.35	1.35	1.35	1.35	1.27
Downside risk	-0.20	-0.45	-0.60	-0.80	-0.90	-0.90	-0.90	-0.85	-0.85	-0.85	-0.85	-0.85	-0.85	-0.76
<b>1-yr money market rate</b>														
Upside risk	0.20	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.33
Arlingclose Central Case	1.15	1.25	1.35	1.50	1.70	1.60	1.50	1.40	1.35	1.35	1.35	1.35	1.35	1.40
Downside risk	-0.35	-0.50	-0.60	-0.80	-0.90	-0.90	-0.90	-0.85	-0.85	-0.85	-0.85	-0.85	-0.85	-0.77
<b>5-yr gilt yield</b>														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.37
Arlingclose Central Case	1.15	1.25	1.35	1.50	1.50	1.40	1.35	1.35	1.30	1.30	1.30	1.30	1.30	1.33
Downside risk	-0.50	-0.60	-0.65	-0.80	-0.80	-0.70	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.66
<b>10-yr gilt yield</b>														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.37
Arlingclose Central Case	1.50	1.65	1.70	1.80	1.80	1.75	1.75	1.70	1.70	1.70	1.70	1.70	1.70	1.70
Downside risk	-0.55	-0.70	-0.70	-0.80	-0.80	-0.75	-0.75	-0.70	-0.70	-0.70	-0.70	-0.70	-0.70	-0.71
<b>20-yr gilt yield</b>														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.37
Arlingclose Central Case	2.00	2.10	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.18
Downside risk	-0.60	-0.70	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.73
<b>50-yr gilt yield</b>														
Upside risk	0.25	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.37
Arlingclose Central Case	1.90	1.95	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	1.99
Downside risk	-0.60	-0.70	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.73

**PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%**

**PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%**

# Cherwell District Council

## Investment Strategy 2019/20

### 1 Introduction

1.1 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).

1.2 This investment strategy is a new report 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.

### 2 Treasury Management Investments

2.1 The council typically receives its income in cash (e.g. from taxes and grants) before it pays for its expenditure in cash (e.g. through payroll and invoices). It also holds reserves for future expenditure and collects local taxes on behalf of other local authorities and central government. These activities, plus the timing of borrowing decisions, lead to a cash surplus which is invested in accordance with guidance from the Chartered Institute of Public Finance and Accountancy. The balance of treasury management investments is expected to be an average of £15m during the 2019/20 financial year.

#### Contribution

2.2 The contribution that these investments make to the objectives of the council is to support effective treasury management activities.

#### Further details

2.3 Full details of the council's policies and its plan for 2019/20 for treasury management investments are covered in a separate document, the treasury management strategy.

### 3 Service Investments: Loans

#### Contribution

3.1 The council lends money to its subsidiaries, local parishes, the local Business Improvement District, and local charities to support local public services and stimulate local economic growth. The main loans issued are to the council's subsidiaries – Graven Hill Village Holding Company Ltd and Crown House Banbury Ltd. Graven Hill is an ambitious self-build housing development providing significant housing in Bicester. Crown House is redeveloping a derelict building in the centre of Banbury which will provide significant rental opportunities in the town centre while removing an eye-sore.

#### Security

3.2 The main risk when making service loans is that the borrower will be unable to repay the principal lent and/or the interest due. In order to limit this risk, and ensure that total exposure to service loans remains proportionate to the size of the council, upper limits on the outstanding loans to each category of borrower have been set as follows:

Table 1: Loans for service purposes in £ millions

Category of borrower	31.3.2018 actual			2019/20
	Balance	Loss allowance	Net figure in accounts	Approved Limit
Subsidiaries	37.827	0	37.827	51.0
Local Council	0.725	0	0.725	1.0
Local charities	0.05	0	0.05	0.2
Local Business	0.02	0	0.02	1.5
Parishes	0.111	0	0.111	1.0
<b>TOTAL</b>	<b>38.733</b>	<b>0</b>	<b>38.733</b>	<b>54.7</b>

3.3 Accounting standards require the council to set aside loss allowance for loans, reflecting the likelihood of non-payment. The figures for loans in the council's statement of accounts from 2018/19 onwards will be shown net of this loss allowance. However, the council makes every reasonable effort to collect the full sum lent and has appropriate credit control arrangements in place to recover overdue repayments.

#### Risk assessment

3.4 The council assesses the risk of loss before entering into and whilst holding service loans by approaching each loan request individually. The bulk of the council's loans are to its subsidiaries. When the council considers whether or not to create or acquire a subsidiary a full business case is prepared which sets out the optimal financing of the company. This will include an assessment of the market in which it will be competing, the nature and level of competition, how that market may evolve over time, exit strategy and any ongoing investment requirements. External advisors are used where appropriate to complement officer expertise and second opinions from alternate advisors is sought in order to monitor and maintain the quality of advice provided by external advisors.

3.5 Other service loans are evaluated against a set of criteria designed to demonstrate:

- Evidence of project objectives and needs analysis is provided
- The loan must have a demonstrable community impact
- The loan would provide up to 50% of the whole project cost
- Such a loan can only be applied for by constituted voluntary organisations with their own bank account; Town or Parish councils; charitable organisations
- The loan cannot be applied retrospectively
- The applicant has provided evidence of its financial stability and of its ability to manage the proposed scheme
- The applicant has demonstrated that the proposed scheme has been developed following good practice in terms of planning, procurement and financial appraisal
- The applicant has provided evidence the affordability of their proposed scheme and the loan repayments
- That the project furthers the council's priorities as reflected in its Business Plan

## 4 Service Investments: Shares

### Contribution

- 4.1 The council invests in the shares of its subsidiaries to support local public services and stimulate local economic and housing growth. The council currently holds shares in Graven Hill Holding Company Ltd and Crown House Banbury Ltd. .

### Security

- 4.2 One of the risks of investing in shares is that they fall in value meaning that the initial outlay may not be recovered. In order to limit this risk, upper limits on the sum invested in each category of shares have been set as follows:

*Table 2: Shares held for service purposes in £ millions*

Category of company	31.3.2018 actual			2019/20
	Amounts invested	Gains or losses	Value in accounts	Approved Limit
Subsidiaries	22.538	0	22.538	35.0
<b>TOTAL</b>	<b>22.538</b>	<b>0</b>	<b>22.538</b>	<b>35.0</b>

### Risk assessment

- 4.3 The council assesses the risk of loss before entering into and whilst holding shares by maintaining close links with the boards of directors of the companies through an established Shareholder Committee. Risk is assessed as above in Service Loans.

### Liquidity

- 4.4 The maximum periods for which funds may prudently be committed are assessed on a project by project basis. The decision will balance both the long term viability of the subsidiary and the revenue and capital requirements of the council.

### Non-specified Investments

- 4.5 Shares are the only investment type that the council has identified that meets the definition of a non-specified investment in the government guidance. The limits above on share investments are therefore also the council's upper limits on non-specified investments. The council has not adopted any procedures for determining further categories of non-specified investment since none are likely to meet the definition.

## 5 Commercial Investments: Property

### Contribution

- 5.1 The council invests in local commercial and residential property with the intention of making a profit that will be spent on local public services. The portfolio comprises a cross section of retail, office and industrial assets together with a health centre. The four largest investments are as follows:

- Castle Quay, Banbury; a covered shopping centre and development site
- Pioneer Square, Bicester; a modern retail parade of shops
- Franklins House, Bicester; a mixed use complex comprising offices, hotel, business centre and public library



- Tramway Industrial Estate

5.2 These assets contribute an aggregate £6m gross income to the council's revenue budget. They are all town centre properties and afford the council an opportunity to influence the amenity and environment of its two principal strategic centres. Castle Quay will, in particular, allow the development of a new leisure orientated focal point to help revitalise Banbury town centre.

The component parts of the entire investment portfolio are described below:

Table 3: Property held for investment purposes in £ millions0

Property	Actual	Actual	31.3.2018 actual		31.3.2019 expected	
	Closing Balance 2016/17	Purchase / Build Costs 2017/18	Gains or (losses)	Value at 31.3.18	Gains or (losses)	Value in accounts
Castle Quay		60.364	0.756	61.120	0	61.120
Pioneer Square	9.238		-1.212	8.026	0	8.026
Tramway Industrial Estate					0	9.500
Other properties valued under £5m	9.255	2.793	-0.324	11.725	0	11.725
<b>TOTAL</b>	<b>18.493</b>	<b>63.157</b>	<b>-0.779</b>	<b>80.871</b>	<b>0</b>	<b>90.371</b>

### Security

- 5.3 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.
- 5.4 A fair value assessment of the council's investment property portfolio 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.

### Risk assessment

- 5.5 The council assesses the risk of loss before entering into and whilst holding property investments by cash flow modelling the income and expenditure profile of each investment and interrogating that model across a range of scenarios to test the robustness of the investment. The modelling exercise is informed by the likelihood of tenant default and the chances that individual units will become empty during the hold period.
- 5.6 The property investment market is dynamic and we are kept abreast of developments by frequent communication and established relationships with local and national agents, supplemented by in-house investigations and reading of published research. The market is at present competitive in most asset sectors and our focus is on assets that are local, strategic and meet our investment return criteria. We are mindful of the council's need for a reliable future income streams and occupational demand is fundamental to our appraisals as longer let assets tend not to generate sufficiently attractive returns.
- 5.7 In all acquisitions we take external advice from acknowledged experts in the field and sense-check their input against our in-house knowledge, experience and expertise. The advice sourced covers

market value but also, given the purpose of the investment, letting risk, marketability and occupational demand, and likely expenditure over the hold period.

5.8 The council uses a number of local and national advisors and cross reference their views periodically. There is no single party who expects to be instructed by the council without competition.

5.9 Credit ratings are used on acquisitions, new lettings and when tenants request consent to assign their leases. The council uses D&B ratings and also study published accounts.

Credit ratings have not historically been used to monitor existing tenants but this will be introduced for our largest tenants this year.

5.10 A number of other strategies are used to mitigate risk:

- Tenant rent payment histories are analysed on any acquisition.
- Tenant rent payment patterns and arrears are examined in the existing portfolio.
- Introducing agents advise the council throughout the acquisition process and their advice includes market commentary at a national and a local level and commentary on perceived risks to the investment.
- In tandem with the above every acquisition is subject to a third party valuation by national surveyors who are independent i.e. not acting for the council or the vendor on the acquisition.

### **Liquidity**

5.11 Compared with other investment types, property is relatively difficult to sell and convert to cash at short notice, and can take a considerable period to sell in certain market conditions. To ensure that the invested funds can be accessed when they are needed, for example to repay capital borrowed. The council acknowledges illiquidity as a risk in property and whilst it cannot be avoided the risk is mitigated by the following strategies:

- The council invests across a range of sectors. Illiquidity is to an extent fluid and at any given time varies across sectors. This allows the council the opportunity to affect sales, if required, in the more liquid sectors.
- The council's assets are likewise diversified in terms of lot size. This affords the council the ability to access a range of purchaser types e.g. small local investors, listed property companies or institutions.
- The council does not invest in high risk assets which can be the most illiquid of all.
- The council's investments are not what is termed 'Investment Grade', but they are fundable – i.e. if sold they could be suitable for debt backed investors.
- The council does not invest in specialist properties, where the market tends to be most illiquid.
- The council's assets are uncharged. It is often lenders who require assets to be sold and whilst gearing does not increase illiquidity per se, it can expose an owner to greater risk of selling an illiquid asset at an inopportune time.

## **6 Loan Commitments and Financial Guarantees**

6.1 Although not strictly counted as investments, since no money has exchanged hands yet, loan commitments and financial guarantees carry similar risks to the council and are included here for completeness.

The council has contractually committed to the following loan amounts which have yet to be drawn upon:

Table 4: Loan Commitments and Guarantees

<b>Borrower</b>	<b>Purpose</b>	<b>£m Contractually Available</b>
Silverstone Heritage Ltd	Development of tourist attraction at Silverstone race track	1.0
Crown House Banbury Ltd	Redevelopment of town centre building into housing	1.8
Graven Hill Village Development Company Ltd	Revolving Credit Facility available to the council's subsidiary until 2026	17.0
Graven Hill Holding Company Ltd	Facility Agreement that has been in place since 2014 to deliver the project.	6.6
Graven Hill Development Company Ltd	Loan Note instrument to enable the company to deliver its objectives	10.0
<b>TOTAL</b>		<b>36.4</b>

## 7 Capacity, Skills and Culture

### Elected members and statutory officers

- 7.1 The majority of senior statutory officers are qualified to degree level and have appropriate professional qualifications. Their shared business experience encompasses both the public and private sectors and the three most senior Property & Investment team members have on average 20+ years commercial experience.

Training and guidance are provided to support members in delivering their roles and support effective decision making.

### Commercial Investments

- 7.2 Negotiations are either undertaken directly by Assistant Directors or at a senior level with Assistant Director direct involvement and oversight, alongside input from Directors and Lead Members where required. Assistant Directors are aware of the regulatory regime and convey that to all junior staff.

### Corporate governance

- 7.3 There are appropriate corporate governance measures in place which comprise end to end decision making procedures. These include risk assessments within the organisation; presentation to relevant committees including Members, statutory officers approvals and relevant project boards. The annual Corporate Investment Strategy provides the reference point against which investment decisions are undertaken.

## 8 Investment Indicators

- 8.1 The council has set the following quantitative indicators to allow elected members and the public to assess the council's total risk exposure as a result of its investment decisions.

### Total risk exposure

- 8.2 The first indicator shows the council's total exposure to potential investment losses. This includes amounts the council is contractually committed to lend but have yet to be drawn down and guarantees the council has issued over third party loans.

Table 5: Total investment exposure in £millions

Total investment exposure	31.03.2018 Actual	31.03.2019 Forecast	31.03.2020 Forecast
Treasury management investments	19.1	15.0	15.0
Service investments: Loans	38.7	50.0	55.0
Service investments: Shares	22.5	23.0	33.0
Commercial investments: Property	80.9	91.0	100.0
<b>TOTAL INVESTMENTS</b>	<b>161.2</b>	<b>179.0</b>	<b>203.0</b>
Commitments to lend	1.8	36.4	34.0
<b>TOTAL EXPOSURE</b>	<b>163.0</b>	<b>215.4</b>	<b>237.0</b>

### How investments are funded

- 8.3 Government guidance is that these indicators should include how investments are funded. The council's investments are funded by usable reserves, income received in advance of expenditure and borrowing.

### Rate of return received

- 8.4 This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested. Note that due to the complex local government accounting framework, not all recorded gains and losses affect the revenue account in the year they are incurred.

Table 6: Investment rate of return (net of all costs)

Investments net rate of return	2017/18 Actual	2018/19 Forecast	2019/20 Forecast
Treasury management investments	0.31%	0.58%	1.03%
Service investments: Loans	1% - 12%	1% - 12%	1% - 12%
Commercial investments: Property	Variable	Variable	Variable