HAMPSHIRE COUNTY COUNCIL

Decision Report

Committee/Panel:	Audit Committee
Date:	21 February 2019
Title:	Treasury Management Strategy Statement 2019/20 to 2021/22
Report From:	Director of Corporate Resources – Corporate Services

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1. Recommendation

That the Audit Committee notes the following recommendations that have been made to Cabinet:

1.1. That the Treasury Management Strategy, including the Annual Investment Strategy for 2019/20 (and the remainder of 2018/19) is approved.

1.2. That authority is delegated to the Deputy Chief Executive and Director of Corporate Resources to manage the County Council's investments and borrowing according to the Treasury Management Strategy Statement as appropriate.

1.3. That a further £1m is added to the Investment Risk Reserve as protection against the irrecoverable fall in value of any investments.

2. Summary

2.1. The Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 (the CIPFA Code) requires authorities to determine the Treasury Management Strategy Statement (TMSS) 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.

3. Introduction

3.1. In 2018 the Ministry of Housing, Communities and Local Government produced new investment guidance for local authorities, including the requirement to produce an Investment Strategy. The Capital and Investment Strategy sets out the Council's broad approach to investment, including its capital programme, how this is funded, and investments held for service purposes or for commercial profit.

3.2. This treasury management strategy supports the Capital and Investment Strategy in setting out the arrangements for the management of the County Council's cash flows, borrowing and investments, and the associated risks. The County Council has borrowed and invested 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 County Council's prudent financial management.

3.3. Treasury risk management at the County Council is conducted within the framework of the CIPFA Code which requires the County Council to approve a TMSS before the start of each financial year. This report fulfils the County Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

4. External Context

4.1. The following paragraphs explain the economic and financial background against which the TMSS is being set.

Economic background

4.2. 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 County Council's TMSS for 2019/20.

4.3. UK Consumer Price Inflation for October was up 2.4% year-on-year, slightly below the consensus forecast and broadly in line with the Bank of England's (BoE) 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, this means real wages grew by 1.0%, a level still likely to have little effect on consumer spending.

4.4. The rise in quarterly GDP growth to 0.6% in Quarter 3 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 Quarter 1. At 1.5%, annual Gross Domestic Product 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.

4.5. Following the BoE's decision to increase Bank Rate to 0.75% in August 2018, 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 the Bank Rate will be required to return inflation to the 2% target. The Monetary Policy Committee (MPC) continues to reiterate that any further increases will be at a gradual pace and limited in extent.

Credit outlook

4.6. 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.

4.7. 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

4.8. 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% rises during 2019 to take official UK interest rates to 1.25%. The BoE'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 a higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

4.9. 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.

4.10. A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix 1.

5. Balance Sheet Summary and Forecast

5.1. On 30 November 2018, the County Council held £278m of borrowing and £598m of investments. This is set out in further detail at Appendix B. Forecast changes in these sums are shown in the balance sheet analysis in Table 1 below.

Table 1: Balance sheet summary and forecast

	31/03/18 Actual £m	31/03/19 Estimate £m	31/03/20 Forecast £m	31/03/21 Forecast £m	31/03/22 Forecast £m
Capital Financing Requirement	764	794	813	816	796
Less: Other long-term liabilities					
- Street Lighting PFI	(56)	(53)	(50)	(46)	(42)
- Waste Management Contract	(108)	(104)	(100)	(96)	(91)
Borrowing CFR	600	637	663	674	663
Less: External borrowing					
- Public Works Loan Board	(243)	(236)	(227)	(217)	(208)
- Market Loans (incl. LOBOs)	(41)	(41)	(41)	(41)	(41)
Internal (over) borrowing	316	360	395	416	414
Less: Reserves and balances	(646)	(629)	(612)	(619)	(623)
Less: Allowance for working capital	(184)	(184)	(184)	(184)	(184)
Resources for investment	(830)	(813)	(796)	(803)	(807)
New Borrowing or (Investments)	(514)	(453)	(401)	(387)	(393)

5.2. 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 County Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

5.3. It is forecast that the County Council will continue to take advantage of internal borrowing, which will increase, over the period forecast in Table 1, whilst paying off PWLB debt as maturities arise. Reserves and balances are due to reduce over the forecast period due to the anticipated funding of the capital programme, repayment of external debt, and use of the Grant Equalisation Reserve as part of the County Council's financial strategy. These factors result in a reducing investment balance year on year over the forecast period, as shown in Table 1.

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

6. Borrowing Strategy

6.1. The County Council currently holds £278m of loans, a decrease of £16m on the previous year, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in Table 1 shows that the County Council does not expect to need to borrow in 2019/20. The County Council may however borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £930m.

Objectives

6.2. The County 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 County Council's long-term plans change is a secondary objective.

Strategy

6.3. Given the significant cuts to public expenditure and in particular to local government funding, the County 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, if the County Council does need to borrow, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

6.4. By internally borrowing, the County Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. If borrowing is required, the benefits of internal and 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 County Council with this 'cost of carry' and breakeven analysis.

6.5. Alternatively, the County 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.

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

Sources

6.7. 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 Hampshire 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

6.8. 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

6.9. The County Council has previously raised the majority 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.

LOBOs

6.10. The County Council holds £20m of 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 County Council has the option to either accept the new rate or to repay the loan at no additional cost. All of these loans have options during 2019/20, and although the County Council understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The County Council will take the option to repay LOBO loans at no cost if it has the opportunity to do so. Total borrowing via LOBO loans will be limited to the current level of £20m.

Short-term and variable rate loans

6.11. These loans leave the Council exposed to the risk of short-term interest rate rises, which is monitored through the indicator on interest rate exposure in the treasury management indicators in section 7.

Debt rescheduling

6.12. 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 County 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.

7. Investment Strategy

7.1. The County Council holds invested funds representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the County Council's investment balance has ranged between

£550m and £665m, although lower levels are expected in the forthcoming year, as shown in Table 1.

Objectives

7.2. The CIPFA Code requires the County 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 County 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.

Negative interest rates

7.3. 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

7.4. Given the increasing risk and very low returns from short-term unsecured bank investments, the County Council aims to continue to diversify into more secure and/or higher yielding asset classes during 2019/20. This is especially the case for the estimated £410m that is available for longer-term investment. Approximately 86% of the County Council's surplus cash is invested so that it is not subject to bail-in risk, as it is invested in local authorities, registered providers, pooled property, equity and multi-asset funds, and secured bank bonds.

7.5. Of the remaining cash subject to bail-in risk, 6% is held in short-term notice accounts which are maturing before the end of the financial year, 80% is held in overnight money market funds and cash plus funds which are subject to a reduced risk of bail-in, and 14% is held in certificates of deposit which can be sold on the secondary market. This diversification is a continuation of the strategy adopted in 2015/16. Further detail is provided at Appendix B.

Investments targeting higher returns

7.6. Given the stability of the County Council's cash balances there was the opportunity during 2016/17 to increase the allocation for investments targeting higher returns, which will allow further diversification and increase the overall rate of return and the income contribution to the revenue budget. It was approved that the allocation targeting higher yields increase to £200m from £105m.

7.7. By the end of 2018/19 the County Council will have fully allocated the £200m targeted for higher yielding investments. As cash balances continue to rise, it is proposed that for 2019/20 this limit is increased to £235m.

7.8. Higher yields can be accessed through long-term cash investments (although this is currently less the case as yields have declined) and investments in other assets than cash, such as pooled property, equities and bonds. Non-cash pooled investments must be viewed as long-term investments in order that monies are not withdrawn in the event of a fall in capital values to avoid crystallising a capital loss.

7.9. When the County Council began to specifically target higher returns from a proportion of its investments, it also established an Investment Risk Reserve in order to mitigate the risk of an irrecoverable fall in the value of these investments. Given that the Council is increasing its exposure, having now reached its target, it is recommended that a further £1m is added to this reserve, to bring the total to £3m.

7.10. As shown in Appendix 2 the County Council had invested £156.8m of the £200m allocation as at 30 November 2018. In addition, the County Council has committed a further £43.2m to investments in pooled funds, which once invested will complete the allocation targeting higher yields. Without this allocation the weighted average return of the Council's cash investments would have been 1.21%; the allocation to higher yielding investments has added 0.99% (£5.9m based on the cash balance at 30 November 2018) to the average interest rate earned by the remainder of the portfolio.

7.11. Although money can usually be redeemed from the pooled funds at short notice, the County Council's intention is to hold them for at least the medium-term. Their performance and suitability in meeting the County Council's investment objectives are monitored regularly and discussed with Arlingclose.

Table 2: Pooled fund investments capital value at 30 November 2018

Pooled fund investments	Principal invested £m	Market value 30/11/18 £m	Capital yield (per annum) %
Pooled property	58.4	60.4	2.29
Pooled equity	43.4	44.8	(0.86)
Pooled multi-asset	20.0	19.5	(2.58)
Total	**121.8**	**124.6**	**0.36**

Investment limits

7.12. The maximum that will be lent to any one organisation (other than the UK Government) will be £70m. 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, and investments in pooled funds, as they would not count against a limit for any single foreign country, since the risk is diversified over many countries.

Table 3: Investment limits

	Cash limit
Any single organisation, except the UK Central Government	£70m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£70m per group
Any group of pooled funds under the same management	£70m per manager
Registered providers and registered social landlords	£70m in total
Money market funds	50% in total
Real estate investment trusts	£70m in total

Approved counterparties

7.13. The County Council may invest its surplus funds with any of the counterparty types in Table 4 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 4: Approved investment counterparties and limits

Credit Rating	Banks		Governmen t	Corporate s	Registered Providers	
	Unsecure d	Secured			Unsecure d	Secure d
UK Govt	n/a	n/a	£ Unlimited 30 years	n/a	n/a	n/a
AAA	£35m 5 years	£70m 20 years	£70m 30 years	£35m 20 years	£35m 20 years	£35m 20 years
AA+	£35m 5 years	£70m 10 years	£70m 25 years	£35m 10 years	£35m 10 years	£35m 10 years
AA	£35m 4 years	£70m 5 years	£70m 15 years	£35m 5 years	£35m 10 years	£35m 10 years
AA-	£35m 3 years	£70m 4 years	£70m 10 years	£35m 4 years	£35m 10 years	£35m 10 years
A+	£35m 2 years	£70m 3 years	£35m 5 years	£35m 3 years	£35m 5 years	£35m 5 years
A	£35m 13 months	£70m 2 years	£35m 5 years	£35m 2 years	£35m 5 years	£35m 5 years
A-	£35m 6 months	£70m 13 months	£35m 5 years	£35m 13 months	£35m 5 years	£35m 5 years
None	£35m 6 months	n/a	£70m 25 years	n/a*	£35m 5 years	£35m 25 years
Pooled funds and real estate investment trusts	£70m per fund					

*see paragraph 6.19

This table must be read in conjunction with the notes below

Credit Rating

7.14. 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

7.15. 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

7.16. 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

7.17. 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 30 years.

Corporates

7.18. 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.

7.19. The County Council will not invest in an un-rated corporation except where it owns a controlling interest in the corporation, in which case a limit of £35m will for an investment of up to 20 years will apply.

Registered Providers Secured and Unsecured

7.20. Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords. 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

7.21. Shares or units in diversified investment vehicles consisting of 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.

7.22. Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the County Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Depending on the type of pooled fund invested in, it may have to be classified as capital expenditure. 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 County Council's investment objectives will be monitored regularly.

Real estate investment trusts (REITs)

7.23. 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

7.24. The County Council may incur operational exposures, for example through current accounts, 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 low. The County Council's operational bank account is with National Westminster and aims to keep the overnight balances held in current accounts positive, and as close to £0 as possible. 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 County Council maintaining operational continuity.

Risk assessment and credit ratings

7.25. Credit ratings are obtained and monitored by the County 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.

7.26. 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

7.27. The County 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 from the County 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.

7.28. 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 County 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 County 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.

Liquidity management

7.29. The County Council has due regard for its future cash flows when determining the maximum period for which funds may prudently be committed. Historic cash flows are analysed in addition to significant future cash movements, such as payroll, grant income and council tax precept. Limits on long-term investments are set by reference to the County Council's medium term financial position (summarised in Table 1) and forecast short-term balances.

8. Treasury Management Indicators

8.1. The County Council measures and manages its exposures to treasury management risks using the following indicators.

Interest rate exposures

8.2. The following indicator shows the sensitivity of the County Council's current investments and borrowing to a change in interest rates.

Table 5: Interest rate risk indicator

	30 November 2018	Impact of +/-1% interest rate change
Sums subject to variable interest rates		
Investment	£373.1m	+/-£3.7m
Borrowing	(£20.0m)	+/-£0.2m

Maturity structure of borrowing

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

Table 6: Refinancing rate risk indicator

	Upper	Lower
Under 12 months	50%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	75%	0%
10 years and within 20 years	75%	0%
20 years and within 30 years	75%	0%
30 years and above	100%	0%

8.4. 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.

Principal sums invested for periods longer than a year

8.5. The purpose of this indicator is to control the County 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:

Table 7: Price risk indicator

	2019/20	2020/21	2021/22
Limit on principal invested beyond a year	£410m	£350m	£350m

9. Related matters

9.1. The CIPFA Code requires the County Council to include the following in its TMSS.

Financial derivatives

9.2. 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).

9.3. The County 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 County 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.

9.4. 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. The use of financial derivatives is not planned as part of the implementation of the TMSS and any changes to this would be reported to members in the first instance.

Investment Training

9.5. The needs of the County Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

9.6. Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, and other appropriate organisations.

9.7. CIPFA's Code of Practice requires that the County Council ensures that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities. All members were invited to a workshop presented by Arlingclose on 27 November 2018, which gave an update of treasury matters. A further Arlingclose workshop has been planned for November 2019.

Investment Advisers

9.8. The County Council has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled through quarterly review meetings with the Deputy Chief Executive and Director of Corporate Resources' staff and Arlingclose.

Markets in Financial Instruments Directive

9.9. The County Council has opted up to professional client status with its providers of financial services, including advisers, 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 County Council's treasury management activities, the s151 officer believes this to be the most appropriate status.

CORPORATE OR LEGAL INFORMATION:

Links to the Strategic Plan

Hampshire maintains strong and sustainable economic growth and prosperity:	No
People in Hampshire live safe, healthy and independent lives:	No
People in Hampshire enjoy a rich and diverse environment:	No
People in Hampshire enjoy being part of strong, inclusive communities:	no
OR	
This proposal does not link to the Strategic Plan but, nevertheless, requires a decision because: For the ongoing management of the County Council's investments and borrowing	

Other Significant Links

Links to previous Member decisions:	
<u>Title</u>	<u>Date</u>
Direct links to specific legislation or Government Directives	
<u>Title</u>	<u>Date</u>

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

<u>Document</u>	<u>Location</u>
None	

IMPACT ASSESSMENTS:

1. Equality Duty

1.1. The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited under the Act;
- Advance equality of opportunity between persons who share a relevant protected characteristic (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, gender and sexual orientation) and those who do not share it;

Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

1.2. **Due regard in this context involves having due regard in particular to:**

The need to remove or minimise disadvantages suffered by persons sharing a relevant characteristic connected to that characteristic;

Take steps to meet the needs of persons sharing a relevant protected characteristic different from the needs of persons who do not share it;

Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity which participation by such persons is disproportionally low.

1.3. **Equalities Impact Assessment:**

1.4. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

How does what is being proposed impact on our carbon footprint / energy consumption*?*

No specific impact.

How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

Arlingclose Economic & Interest Rate Forecast October 2018

Underlying assumptions:

- The MPC left Bank Rate unchanged at the September meeting, after voting unanimously to increase Bank Rate to 0.75% in August.

- Our projected outlook for the UK economy means we maintain the significant downside risks to our interest rate forecast. The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2% remains well below the long term average. 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 were projected to ease but have risen more recently and are forecast to remain above the Bank's 2% target through most of the forecast period. The rising price of oil and tight labour market means inflation may remain above target for longer than expected. This means that strong real income growth is unlikely in the near future.

- 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 both that: 1) ultra-low interest rates result in other economic problems, and 2) higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise and cuts are required.

- The global economy appears to be slowing, particularly the Eurozone and China, where the effects of the trade war has been keenly felt. Despite slower growth, the European Central Bank is adopting a more strident tone in conditioning markets for the end of QE, the timing of the first rate hike (2019) and their path thereafter. Meanwhile, European political issues, mostly lately with Italy, continue.

- The US economy is expanding more rapidly. The Federal Reserve has tightened monetary policy by raising interest rates to the current 2%-2.25% range; further rate hikes are likely, which will start to 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. Our central case is for Bank Rate is to rise twice in 2019. 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 interest rate projections, the strength of the US economy and the ECB's forward guidance on higher rates. However, volatility arising from both economic and political events will continue to offer borrowing opportunities.

	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
Official Bank Rate														
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	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.17
Downside risk	0.00	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.65
3-mth money market rate														
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	0.80	1.00	1.10	1.20	1.30	1.30	1.25	1.20	1.20	1.20	1.20	1.20	1.20	1.17
Downside risk	0.20	0.50	0.60	0.70	0.80	0.80	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.68
1-yr money market rate														
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	1.05	1.25	1.35	1.40	1.50	1.45	1.40	1.40	1.40	1.40	1.40	1.40	1.40	1.37
Downside risk	0.35	0.50	0.60	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.69
5-yr gilt yield														
Upside risk	0.15	0.20	0.25	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.32
Arlingclose Central Case	1.15	1.20	1.25	1.35	1.40	1.40	1.35	1.35	1.30	1.30	1.30	1.30	1.30	1.30
Downside risk	0.30	0.35	0.45	0.50	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.54
10-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.32
Arlingclose Central Case	1.60	1.65	1.65	1.70	1.75	1.75	1.75	1.70	1.70	1.70	1.70	1.70	1.70	1.70
Downside risk	0.30	0.45	0.50	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.55
20-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.32
Arlingclose Central Case	1.90	1.95	1.95	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	1.98
Downside risk	0.30	0.40	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.43
50-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.32
Arlingclose Central Case	1.80	1.85	1.85	1.90	1.90	1.90	1.90	1.90	1.90	1.90	1.90	1.90	1.90	1.88
Downside risk	0.30	0.40	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.43

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%
PWLB Local Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%

Existing Investment & Debt Portfolio Position at 30 November 2018

Investments	30/09/2018 Balance £m	Movement £m	30/11/2018 Balance £m	30/11/2018 Rate %	30/11/2018 WAM* Years
Short term Investments					
Banks and Building Societies:					
Unsecured	20.5	(3.6)	16.9	0.72	0.31
Secured	52.4	-	52.4	1.14	0.22
Money Market Funds	21.1	23.4	44.5	0.73	0.01
Cash Plus Funds	20.0	-	20.0	0.59	n/a
Local Authorities	122.0	16.5	138.5	1.34	0.47
Registered Provider	20.0	-	20.0	2.30	0.16
	256.0	36.3	292.3	1.22	0.32
Long term Investments					
Banks and Building Societies:					
Secured	78.3	-	78.3	1.06	2.40
Local Authorities	81.0	(10.0)	71.0	1.33	2.45
	159.3	(10.0)	149.3	1.20	2.42
Long term Investments – high yielding strategy					
Local Authorities					
Fixed deposits	20.0	-	20.0	3.96	15.30
Fixed bonds	10.0	-	10.0	3.78	15.11
Pooled Funds					
Pooled property**	55.0	3.4	58.4	4.19	n/a
Pooled equity**	40.0	3.4	43.4	5.80	n/a
Pooled multi-asset**	20.0	-	20.0	7.15	n/a
Registered Provider	5.0	-	5.0	3.40	0.41
	150.0	6.8	156.8	4.93	13.12
TOTAL INVESTMENTS	**565.3**	**33.1**	**598.4**	**2.20**	**1.99**

* Weighted average maturity

** The rates provided for pooled fund investments are reflective of the average of the most recent dividend return as at 30 November 2018.

Appendix 2

	£m	%
<u>**External Borrowing**</u>		
PWLB Fixed Rate	(237.2)	(4.69)
LOBO Loans	(20.0)	(4.76)
Other Market Loans	(21.0)	(4.01)
Total External Borrowing	(278.2)	(4.64)
Other Long-Term Liabilities:		
Street Lighting PFI	(107.9)	
Waste Management Contract	(56.3)	
Total Other Long-Term Liabilities	(164.2)	
Total Gross External Debt	**(442.4)**	
Investments	**598.4**	**2.20**
Net (Debt) / Investments	**156.0**	