**Newry, Mourne and Down District Council**

**Treasury Management Strategy Statement 2016/17**

**Introduction**

At the Council meeting held on Wednesday 10th February the Authority adopted the Chartered Institute of Public Finance and Accountancy’s Treasury Management in the Public Services: Code of Practice 2011 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year.

In addition, the Department of the Environment (DOE) issued revised Guidance on Local Authority Investments in October 2011 that requires the Authority to approve an investment strategy before the start of each financial year.

This report fulfils the Authority’s legal obligation under the Local Government Act (Northern Ireland) 2011 to have regard to both the CIPFA Code and the DOE Guidance.

The Authority has and will be borrowing and investing 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 risk are therefore central to the Authority’s treasury management strategy.

**External Context**

**Economic background:**

Domestic demand has grown robustly, supported by sustained real income growth and a gradual decline in private sector savings.  Low oil and commodity prices were a notable feature of 2015, and contributed to annual CPI inflation falling to 0.1% in October.  Wages are growing at 3% a year, and the unemployment rate has dropped to 5.4%.  Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 3.5%.  These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was an encouraging 2.3% a year in the third quarter of 2015. Although speeches by the Bank of England’s Monetary Policy Committee (MPC) members sent signals that some were willing to countenance higher interest rates, the MPC held policy rates at 0.5% for the 81st consecutive month at its meeting in November 2015. Quantitative easing (QE) has been maintained at £375bn since July 2012.

The outcome of the UK general election, which was largely fought over the parties’ approach to dealing with the deficit in the public finances, saw some big shifts in the political landscape and put the key issue of the UK’s relationship with the EU at the heart of future politics. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

China's growth has slowed and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. US domestic growth has accelerated but the globally sensitive sectors of the US economy have slowed. Strong US labour market data and other economic indicators however suggest recent global turbulence has not knocked the American recovery off course. The Federal Reserve did not raise policy rates at its meetings in October and November, but in December 2015 raised the interest rate by **¼%**. In contrast, the European Central Bank finally embarked on QE in 2015 to counter the perils of deflation.

**Credit outlook:**

The varying fortunes of different parts of the global economy are reflected in market indicators of credit risk. UK Banks operating in the Far East and parts of mainland Europe have seen their perceived risk increase, while those with a more domestic focus continue to show improvement. The sale of most of the government’s stake in Lloyds and the proposed first sale of its shares in RBS have generally been seen as credit positive.

Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the UK, USA and Germany. The rest of the European Union followed in January 2016, while Australia, Canada and Switzerland are well advanced with their own plans. Meanwhile, changes to the UK Financial Services Compensation Scheme and similar European schemes in July 2015 mean that most private sector investors are now partially or fully exempt from contributing to a bail-in. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however remain stubbornly low.

**Interest rate forecast:**

The Authority’s treasury advisor Arlingclose projects the first 0.25% increase in UK Bank Rate in the third quarter of 2016, rising by 0.5% a year thereafter, finally settling between 2% and 3% in several years’ time. Persistently low inflation, subdued global growth and potential concerns over the UK’s position in Europe mean that the risks to this forecast are weighted towards the downside.

A shallow upward path for medium term gilt yields is forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Arlingclose projects the 10 year gilt yield to rise from its current 2.0% level by around 0.3% a year. The uncertainties surrounding the timing of UK and US interest rate rises are likely to prompt short-term volatility in gilt yields.

A more detailed 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 new investments will be made at an average rate of 0.2%, and that new long-term loans will be borrowed at an average rate of 2.7%.

**Local Context**

The Authority currently has £51.9m of borrowing (excluding borrowing for severance costs) and £4.5m of investments as at 31st January 2016. 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

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **31.3.15****Actual****£m** | **31.3.16****Estimate****£m** | **31.3.17****Forecast****£m** | **31.3.18****Forecast****£m** | **31.3.19****Forecast****£m** |
| **Capital Financing Requirement** | **61.9** | **62.4** | **84.3** | **98.5** | **97.4** |
| Less: Other debt liabilities \*  | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Borrowing CFR**  | **61.9** | **62.4** | **84.3** | **98.5** | **97.4** |
| Less: External borrowing \*\* | 56.7 | 57.3 | 79.2 | 93.4 | 92.3 |
| **Internal borrowing** | **5.2** | **5.1** | **5.1** | **5.1** | **5.1** |
| Less: Usable reserves | 8.2 | 8.2 | 8.2 | 8.2 | 8.2 |
| Less: Working capital | 0.9 | 1.0 | 1.0 | 1.0 | 1.0 |
| **New gross borrowing** | **8.5** | **5.4** | **27.6** | **20.8** | **5.8** |

\* finance leases form part of the Authority’s total debt

\*\* shows only loans to which the Authority is committed and excludes optional refinancing

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 Authority’s current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

The Authority has an increasing C.F.R. due to the capital programme but minimal investments and will therefore be required to borrow up to £94 million over the forecast period.

CIPFA’s *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority’s total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Authority expects to comply with this recommendation during 2016/17.

**Borrowing Strategy**

The Authority currently holds (February 2016) £52 million of loans, a decrease of £4.7 million on the figure as at 31st March 2015, as part of its strategy for funding previous years’ capital programmes. The balance sheet forecast in table 1 shows that the Authority expects to borrow up to £5.4 million gross in 2015/2016 and £27.6 million gross in 2016/17. The Authority may also borrow additional sums to pre-fund future years’ requirements, providing this does not exceed the authorised limit for borrowing of £81.2 million in 2016/2017.

**Objectives:** The Authority’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 Authority’s long-term plans change is a secondary objective.

**Strategy:** Given the significant cuts to public expenditure and in particular to local government funding, the Authority’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.

By doing so, the Authority is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal 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. Arlingclose will assist the Authority with this ‘cost of carry’ and breakeven analysis. Its output may determine whether the Authority borrows additional sums at long-term fixed rates in 2016/17 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

Alternatively, the Authority may arrange forward starting loans during 2016/17, 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 Authority may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages.

**Sources:** The approved sources of long-term and short-term borrowing are:

* Government Loans Fund (via the Department of Finance and Personnel, DFP)
* any institution approved for investments as specified by the D.O.E. guidance.
* any other bank or building society authorised to operate in the UK

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

* operating and finance leases
* hire purchase
* sale and leaseback

The Authority has previously raised all of its long-term borrowing from the Government Loans Fund but it continues to investigate other sources of finance, such as local authority loans and bank loans that may be available at more favourable rates.

**Short-term and Variable Rate loans**: These loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

**Debt Rescheduling:** The DFP allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. The Authority 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.

**Investment Strategy**

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority’s investment balance has ranged between £2.0 and £4.5 million, and similar levels are expected to be maintained in the forthcoming year.

**Objectives:** Both the CIPFA Code and the DOE Guidance require the Authority 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 Authority’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 receiving unsuitably low investment income.

**Strategy:** Given the increasing risk and continued low returns from short-term unsecured bank investments, the Authority will continue to hold surplus funds in Bank Deposits during 2016/2017. The majority of the Authorities surplus cash is currently invested in short-term unsecured bank deposits, and money market funds.

**Approved Counterparties:** The Authority may invest its surplus funds with Banks only.

**Credit Rating:** Investment decisions are made by reference to the lowest published long-term credit rating from Fitch, Moody’s or Standard & Poor’s. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

**Banks Unsecured:** Accounts, deposits.

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. Unsecured investment will not be made with banks rated below BBB.

**Risk Assessment and Credit Ratings**: Credit ratings are obtained and monitored by the Authority’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.

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 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**: The Authority understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations, in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

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 Authority 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 Authority’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.

**Specified Investments**: The DOE Guidance defines specified investments as those:

* denominated in pound sterling,
* due to be repaid within 12 months of arrangement,
* not defined as capital expenditure by legislation,
* invested with one of:
	+ the UK Government,
	+ a UK local authority, parish council or community council, or
	+ a body or investment scheme of “high credit rating”, and
* where the principal sum to be repaid at maturity is the same as the initial sum invested, other than investments in the UK Government.

The Authority defines “high credit rating” organisations and securities as those having a credit rating of [A-] or higher that are domiciled in the UK or a foreign country with a sovereign rating of [AA+] or higher. For money market funds and other pooled funds “high credit rating” is defined as those having a credit rating of [A-] or higher.

**Non-specified Investments**: The Authority does not intend to make any investments in non-specified investments.

**Investment Limits**: The Authority’s revenue reserves available to cover investment losses are forecast to be £8 million on 31st March 2016. In order that no more than 25% of available reserves will be 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 £2 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

Table 2: Investment Limits

|  |  |
| --- | --- |
|  | **Cash limit** |
| Any single organisation, except the UK Central Government | £2m each |
| UK Central Government | unlimited |
| Any group of organisations under the same ownership | £2m per group |

**Liquidity Management**: The Authority uses spread sheets for cash flow 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 Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Authority’s medium term financial plan and cash flow forecast.

**Treasury Management Indicators**

The Authority measures and manages its exposures to treasury management risks using the following indicators.

**Security:** The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the credit rating of its investment portfolio.

**Liquidity:** The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling six month period, without additional borrowing.

|  |  |
| --- | --- |
|  | **Target** |
| Total cash available within 6 months | £5m |

**Interest Rate Exposures**: This indicator is set to control the Authority’s exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as [the amount / the proportion] of net [principal borrowed / interest payable] will be:

|  |  |  |  |
| --- | --- | --- | --- |
|  | **2016/17** | **2017/18** | **2018/19** |
| Upper limit on fixed interest rate exposure | 3.0% | 3.5% | 4.0% |
| Upper limit on variable interest rate exposure | n/a | n/a | n/a |

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months in the case of investments and for the life of the loan in case of borrowings, measured from the start of the financial year or the transaction date if later.

**Maturity Structure of Borrowing:** This indicator is set to control the Authority’s exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

|  |  |  |
| --- | --- | --- |
|  | **Upper** | **Lower** |
| Under 12 months | 8.1% | 8.1% |
| 12 months and within 24 months | 8.1% | 8.1% |
| 24 months and within 5 years | 20.9% | 20.9% |
| 5 years and within 10 years | 26.5% | 26.5% |
| 10 years and above | 36.3% | 36.3% |

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.

**Other Items**

There are a number of additional items that the Authority is obliged by CIPFA or the DOE to include in its Treasury Management Strategy.

**Policy on Use of Financial Derivatives:** In the absence of any legal power to do so, the Authority will not use standalone financial derivatives (such as swaps, forwards, futures and options). Derivatives embedded into loans and investments, including pooled funds and forward starting transactions, may be used, and the risks that they present will be managed in line with the overall treasury risk management strategy.

**Investment Training:** The needs of the Authority’s treasury management staff for training in investment management are assessed regularly and additionally when the responsibilities of individual members of staff change.

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

**Investment Advisers:** The Authority has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues.

**Investment of Money Borrowed in Advance of Need**: The Authority may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Authority is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Authority’s overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £81.2 million for 2016/2017. The maximum period between borrowing and expenditure is expected to be two years, although the Authority is not required to link particular loans with particular items of expenditure.

**Financial Implications**

The budget for investment income in 2016/17 is £0 million, based on an average investment portfolio of £4 million at an interest rate of 0.2%. The budget for debt interest paid in 2016/17 is £2.5 million, based on an average debt portfolio of £68.2 million at an average interest rate of 3.67%. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

**Other Options Considered**

The DOE Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Head of Finance believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

|  |  |  |
| --- | --- | --- |
| **Alternative** | **Impact on income and expenditure** | **Impact on risk management** |
| Invest in a narrower range of counterparties and/or for shorter times | Interest income will be lower | Lower chance of losses from credit related defaults, but any such losses may be greater |
| Invest in a wider range of counterparties and/or for longer times | Interest income will be higher | Increased risk of losses from credit related defaults, but any such losses may be smaller |
| Borrow additional sums at long-term fixed interest rates | Debt interest costs will rise; this is unlikely to be offset by higher investment income | Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain |
| Borrow short-term or variable loans instead of 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 November 2015**

**Underlying assumptions:**

* UK economic growth softened in Q3 2015 but remained reasonably robust; the first estimate for the quarter was 0.5% and year-on-year growth fell slightly to 2.3%. Negative construction output growth offset fairly strong services output, however survey estimates suggest upwards revisions to construction may be in the pipeline.
* Household spending has been the main driver of GDP growth through 2014 and 2015 and remains key to growth. Consumption will continue to be supported by real wage and disposable income growth.
* Annual average earnings growth was 3.0% (including bonuses) in the three months to August. Given low inflation, real earnings and income growth continue to run at relatively strong levels and could feed directly into unit labour costs and households' disposable income. Improving productivity growth should support pay growth in the medium term. The development of wage growth is one of the factors being closely monitored by the MPC.
* Business investment indicators continue to signal strong growth. However the outlook for business investment may be tempered by the looming EU referendum, increasing uncertainties surrounding global growth and recent financial market shocks.
* Inflation is currently very low and, with a further fall in commodity prices, will likely remain so over the next 12 months. The CPI rate is likely to rise towards the end of 2016.
* China's growth has slowed and its economy is performing below expectations, which in turn will dampen activity in countries with which it has close economic ties; its slowdown and emerging market weakness will reduce demand for commodities. Other possible currency interventions following China's recent devaluation will keep sterling strong against many global currencies and depress imported inflation.
* Strong US labour market data and other economic indicators suggest recent global turbulence has not knocked the American recovery off course. Although the timing of the first rise in official interest rates remains uncertain, a rate rise by the Federal Reserve seems significantly more likely in December given recent data and rhetoric by committee members.
* Longer term rates will be tempered by international uncertainties and weaker global inflation pressure.

**Forecast:**

* Arlingclose forecasts the first rise in UK Bank Rate in Q3 2016. Further weakness in inflation, and the MPC's expectations for its path; suggest policy tightening will be pushed back into the second half of the year. Risks remain weighted to the downside. Arlingclose projects a slow rise in Bank Rate, the appropriate level of which will be lower than the previous norm and will be between 2 and 3%.
* The projection is for a shallow upward path for medium term gilt yields, with continuing concerns about the Eurozone, emerging markets and other geo-political events, weighing on risk appetite, while inflation expectations remain subdued.
* The uncertainties surrounding the timing of UK and US monetary policy tightening, and global growth weakness, are likely to prompt short term volatility in gilt yields.



**Appendix B – Existing Investment & Debt Portfolio Position**

|  |  |  |
| --- | --- | --- |
|  | 31 January 2016**Actual Portfolio****£m** | 31 January 2016**Average Rate****%** |
| **External Borrowing:**Government – Fixed RateGovernment – Variable Rate | 52.00.0 | 3.970.00 |
| **Total Gross External Debt** | **52.0** | **3.97** |
| **Investments**:Monies on Bank Deposit/Call | 4.5 | 0.2 |
| **Total Investments** | **4.5** | **0.2** |
| **Net Debt** | **47.5** |  |