Item: 7

Policy and Resources Committee: 20 February 2018.

Treasury Management Strategy Statement and Annual Investment Strategy.

Report by Head of Finance.

1. Purpose of Report

To consider the treasury management strategy statement and annual investment strategy for financial year 2018 to 2019.

2. Recommendations

It is recommended:

That the Treasury Management Strategy Statement and Annual Investment Strategy, attached as Appendix 1 to this report, be approved for financial year 2018 to 2019.

3. Policy Aspects

This report relates to the Council complying with its governance and financial processes and procedures and therefore does not relate specifically to progressing the Council's priorities.

4. Background

4.1.

Section 21 of the Financial Regulations confirms that the Council has adopted the key recommendations of CIPFA's Treasury Management in the Public Sector Code of Practice (the Code).

4.2.

The Local Government in Scotland Act 2003 and supporting regulations require the Council to "have regard to":

4.2.1

The 'Prudential Code for Capital Finance in Local Authorities' published by the Chartered Institute of Public Finance and Accountancy (CIPFA) in 2009 which requires the Council to set Prudential and Treasury Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

4.2.2.

The ‘Treasury Management in the Public Services: Code of Practice and Cross-sectoral Guidance Notes’ published by CIPFA in 2009 which requires the Council to set out its treasury management strategy for borrowing and investment and how it will give priority to security and liquidity in managing its investments.

4.3.

A principle focus of the codes of practice referred to above is an expanded definition of treasury management to include investment activities, together with a requirement to assess the creditworthiness of counterparties with a view to minimising the risk to councils when considering investment decisions.

4.4.

The Local Government Investment (Scotland) Regulations 2010 permits local authorities to make investments subject to them gaining the consent of Scottish Ministers. Finance circular 5/2010 sets out the terms of that consent, and requires local authorities to again “have regard to” the codes of practice referred to above when managing their investments.

4.5.

This regulation not only provides greater autonomy to local authorities to manage their own investment activities, but also requires local authorities to consider the totality of their investment activity. As such, this regulation covers a much wider remit than the traditional view of treasury management.

4.6.

The consent applies to a range of investments, and covers for example the investment of temporary surplus funds with banks and similar institutions, shareholdings in companies or joint ventures and loans to group undertakings and third parties. It also covers the Council’s Strategic Reserve Fund, including investment properties.

5. Treasury Strategy Requirements.

5.1.

The Council’s investment priorities can be summarised as maintaining:

- The security of capital.
- The liquidity of its investments.

5.2.

The Council aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is relatively low in order to give priority to security of its investments. This is in keeping with the nature of the Strategic Reserve Fund, which is to provide for the benefit of Orkney and its inhabitants, whilst having regard to the Fund’s long term commitments in terms of the terminal decline and decommissioning of the Flotta Oil Terminal in the future.

5.3.

By contrast, however it is notable that an increasing focus within the investment strategy for the Strategic Reserve Fund is given towards being able to generate sufficient income from investments activities so as to be able to meet both the short term funding commitments on the Fund, while at the same time maintaining the value of the Fund in real terms. It is considered that while this approach aims to ensure the affordability of the Fund going forward, an additional investment risk is actively being taken by the Council, partly to take advantage of opportunities as they arise in the financial markets, but also to compensate for the volatility of investment returns.

5.4.

A key area of the investment regulations, referred to at section 4.4 above, is the requirement for local authorities to set out in their Strategy the types of investment that they will permit in the financial year, otherwise known as permitted investments. The Council is required to set a limit to the amounts that may be held in such investments at any time in the year. Some types of investment may be classed as unlimited, but the reasons for doing so must be set out in the Strategy and be consistent with risk assessments undertaken. A list of permitted investments is detailed in Appendix 5.5 to the Treasury Management Strategy Statement and Annual Investment Strategy, attached as Appendix 1 to this report.

5.5.

From the Prudential Code, it is clear that a local authority must not borrow more than, or in advance of, need purely to profit from the investments of the extra sums borrowed. In terms of conditions under which borrowing may be taken early a requirement exists to demonstrate that, over the medium term, borrowing will only be for a capital purpose. In other words, the Council is required to demonstrate that borrowing does not, except in the short term, exceed the total capital financing requirement for the current and next two financial years. This effectively sets a limit on the total amount of borrowing that is acceptable under the Code to provide flexibility in treasury management, but also ensure that any borrowing is for capital purposes only. The Council’s policy on borrowing in advance of need is set out in paragraph 3.5 of the Treasury Management Strategy Statement and Annual Investment Strategy.

5.6.

In terms of reporting requirements, it should be noted that the Annual Investment Strategy and Annual Investment Report are central to the consent from Scottish Ministers, as is the requirement to produce an annual treasury management strategy and annual report within the CIPFA Treasury Code. The Authority's net treasury position is determined by the relationship between its capital financing requirement (the need to borrow) and its balances and reserves (the potential to invest). As such, an integrated strategy covering capital investment, borrowing and the investment of surplus funds is recommended by Scottish Ministers. A mid-year report followed by an outturn report at the end of the financial year covering the same elements is also required.

5.7.

While the investment regulations do allow for the treasury management and investment strategies to be determined at a local level, it is clear that with this greater freedom comes greater responsibility, and the onus remains very much on local authorities to act prudently with regard to their investment and treasury activities at all times.

5.8.

The main points to note from the Treasury Management Strategy and Annual Investment Strategy for 2018 to 2019, attached as Appendix 1 to this report, are summarised as follows:

5.8.1.

The key issue now is that the period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the United States, and more recently in the United Kingdom, on reversing those measures, namely by raising central rates and reducing central banks' holdings of government and other debt.

5.8.2.

The Monetary Policy Committee delivered a 0.25% increase in Bank Rate at its meeting on 2 November 2017. This removed the emergency cut imposed in August 2016 following the EU referendum. The Monetary Policy Committee has also given forward guidance that they expect to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%.

5.8.3.

World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October 2017, the International Monetary Fund upgraded its forecast for world growth from 3.2% to 3.6% for 2017 and 3.7% for 2018.

5.8.4.

The counterparty limit for the Council's treasury management, or cash balances, has been amended downwards from 25% or £15,000,000 to 25% or £10,000,000 for any one institution or group at any one time. This reflects in particular the steady reduction in the size of these balances and the need to maintain adequate diversification within the portfolio of temporary loan deposits that are managed in-house. This limit does not apply to the Council's portfolio of investments held under the Strategic Reserve Fund that are managed by external fund managers under separate Investment Management agreements.

5.8.5.

The Bank of England Inflation Reports during 2017 have clearly flagged up that it expected Consumer Price Index inflation to peak at just under 3% in 2017, before falling back to nearer its target rate of 2% in two years' time.

5.8.6.

The Annual Investment Strategy has been updated to reflect the outcome of the annual review of the Strategic Reserve Fund which was considered by the Policy and Resources Committee on 13 February 2018, as part of the budget setting process.

5.8.7.

The Council's existing capital programme includes approved capital project expenditure of £60,717,000 over the 3 year period 2018 to 2021, with an identified capital financing borrowing requirement of £23,529,000.

5.8.8.

The Council's net capital financing requirement is forecast to increase from £53,538,000 to £70,435,000 over the 3 year period from 2018 to 2021, being a net increase of £16,897,000 after allowing for the repayment of principal.

5.8.9.

In terms of core funds and expected investment balances, the Council's resources and anticipated cash flow balances are forecast to increase from £241,504,000 to £253,963,000 or by £12,459,000 over the 3 year period 2018 to 2021.

5.9.

The affordability of the capital programme relative to the Council's overall finances over the 3 year period 2018 to 2021 can be measured as the ratio of cost of capital, or loan charges, relative to net revenue stream:

- General Fund Services – 2.0% increasing to 2.7%.
- Scapa Flow Oil Port – 4.7% increasing to 14.6%.
- Miscellaneous Piers – 16.9% increasing to 18.1%.
- Housing Revenue Account – 33.1% increasing to 34.9%.

5.10.

While the ratio for General Fund Services is still considered to be relatively low, with an increase of only 0.7% over the period, this can be attributed directly to the Council's past policy of accelerating debt repayments. By contrast, however, the Housing Revenue Account is forecast to increase by 1.8% to 34.9% which is equivalent to approximately one-third of all rent income being committed to servicing the long term debt associated with the Council's house building strategy. This is considered to represent a significant commitment on the Housing Revenue Account and as such 35% should be regarded as the upper limit for the cost of capital relative to net revenue on the Housing Revenue Account for the term of the current 5 year capital programme.

5.11.

The significant increase on the cost of capital being incurred by Scapa Flow Oil Port can be attributed to the planned expenditure of £10,250,000 on a new pilot boat and tug.

5.12.

The General Capital Grant for financial year 2018 to 2019 has been confirmed as £6,419,000, which is £513,000 lower than the settlement for financial year 2017 to 2018. The General Capital Grant for 2016 to 2017 included a reduction of £1,198,000 which the Scottish Government has indicated will only be added to the Local Government's capital share in the next Spending Review over the period 2018 to 2020. This uncertainty therefore has the potential to impact on the Council's capital financing requirement going forward.

5.13.

The Council's authorised limit for external debt is scheduled to remain at £75,000,000 over the 3 year period 2018 to 2021, with operational boundary for external debt remaining at £60,000,000 across the same period. As a key prudential indicator, the authorised limit represents a control on the maximum level of borrowing and as a limit beyond which external debt is prohibited. This limit is set or revised by the Council. As such, this represents a level of external debt that could be afforded in the short term, but is not sustainable over the longer term.

5.14.

By contrast, the operational boundary represents a limit beyond which external debt is not normally expected to exceed and, in effect, represents the extent of the authority delegated to the Head of Finance. Accordingly, with existing Public Works Loan Board borrowings of £30,000,000 as at 31 March 2018, and £5,000,000 due to be repaid in May 2018, the Head of Finance would be authorised to respond to favourable movements in the financial markets and effect additional borrowing of up to £35,000,000.

6. Equalities Impact

An Equality Impact Assessment has been carried out and is attached as Appendix 2 to this report.

7. Financial Implications

A requirement exists for the Council to adopt a Treasury Management Policy and thereafter approve a Treasury Management Strategy and Annual Investment Strategy each year.

8. Legal Aspects

8.1.

It is the duty of a local authority to make arrangements which secure best value. Treasury Management arrangements help the Council comply with this obligation.

8.2.

Section 40 of the Local Government in Scotland Act 2003 provides local authorities with the power to invest money in accordance with regulations made by Scottish Ministers.

8.3.

Section 95 of the Local Government Act 1973 states that every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that the proper officer has responsibility for the administration of those affairs.

9. Contact Officers

Gareth Waterson, Head of Finance, extension 2103, Email gareth.waterson@orkney.gov.uk

Colin Kemp, Corporate Finance Senior Manager, extension 2106, Email colin.kemp@orkney.gov.uk

10. Appendices

Appendix 1: Treasury Management Strategy Statement and Annual Investment Strategy for 2018 to 2019.

Appendix 2: Equality Impact Assessment.