Lincolnshire COUNTY COUNCIL
Working for a better future

Policy and Scrutiny

Open Report on behalf of Pete Moore
Executive Director of Finance & Public Protection

Report to:	**Value for Money Scrutiny Committee**
Date:	**28 February 2017**
Subject:	**Treasury Management Strategy Statement and Annual Investment Strategy 2017/18**

Summary:

The Treasury Management Strategy Statement is an annual statement that sets out the expected treasury activities for the forthcoming year 2017/18. It is prepared in accordance with the 2011 CIPFA Code of Practice for Treasury Management in the Public Sector, the requirements of which are included as part of Financial Regulations within the Constitution of the Council. These requirements were adopted by the Council in May 2011 as part of agreement to revisions to the Council's Constitution.

The Annual Investment Strategy is an annual statement that sets out the Council's policies for investing its surplus cash for the year ahead and has been prepared in accordance with the Local Government Act 2003, effective from 1st April 2004.

Actions Required:

That the report be noted and any comments passed onto the Executive Councillor with responsibilities for Finance.

1. Background

1. INTRODUCTION/BACKGROUND

1.1. Treasury Management

1.1.1. Treasury Management relates to the policies, strategies and processes associated with managing the short and long term cash and debt of the Council through appropriate borrowing and lending activity.

1.2. Relevant Treasury Management Regulation / Legislation

The Council's treasury management activities are governed by the 2011 CIPFA Code of Practice for Treasury Management in the Public Sector and subsequent amendments, whose key requirements were adopted by the Council in May 2011 as part of Financial Regulations -Section C.

1.2.1. The Local Government Act 2003, effective from 1st April 2004;

- ~ Requires the Council to have regard to the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next 3 years to ensure that the Council's capital investment plans (including borrowing plans) are affordable, prudent and sustainable.
- ~ Requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy that sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.
- ~ Gives the Council statutory power to invest for "any purpose relevant to its functions under any enactment, or for the purposes of the prudent management of its financial affairs", including investments made in the course of treasury management.

1.3. Purpose of Report

1.3.1. This report comprises the Treasury Management Strategy Statement for 2017/2018 as Section 2 and the Annual Investment Strategy for 2017/2018 as Section 3 and has been prepared in accordance with the CIPFA Code of Practice for Treasury Management 2011 and subsequent revisions.

- <u>Treasury Management Strategy Statement 2017/2018</u>

  The Treasury Management Strategy Statement is an annual statement that sets out the expected treasury activities for the forthcoming year 2017/2018.

- <u>The Annual Investment Strategy 2017/2018</u>

  The Annual Investment Strategy sets out the Council's policies for investing its surplus cash for the year 2017/2018 and for giving priority to the security and liquidity of its investments over the return on those investments. It forms the basis of the 'Approved Investment Criteria' followed by the Council when making its investments.

1.4. Reporting Arrangements

1.4.1. In accordance with the requirements of the revised Code, this Treasury Management Strategy and Annual Investment Strategy will be presented to the Value for Money Scrutiny Committee for scrutiny and then submitted to the Executive Councillor with responsibility for finance for approval prior to the start of the financial year.

1.4.2. Quarterly reports will then be presented to the Overview & Scrutiny Management Board throughout the financial year which will monitor and report on actual activity against the approved Strategy.

1.4.3. The aim of these reporting arrangements is to ensure that those with ultimate responsibility for the treasury management function appreciate fully the implications of treasury management policies and activities, and that those implementing policies and executing transactions have properly fulfilled their responsibilities with regard to delegation and reporting.

2. TREASURY MANAGEMENT STRATEGY STATEMENT 2017/2018

2.1. Introduction

2.1.1. The formulation of the annual Treasury Management Strategy involves determining the appropriate borrowing and investment decisions in light of the anticipated movement in interest rates. The strategy for 2017/2018 is therefore based upon the Treasury officers' current views on interest rates for the year ahead, supplemented with leading market forecasts provided by the Council's treasury management advisor, Capita Asset Services Ltd. The strategy covers the following areas:

- The current long term external borrowing/investment position;
- Borrowing requirement 2016/2017 to 2019/2020;
- Affordable borrowing limit for 2017/18 to 2019/20;
- Prudential indicators 2017/2018 to 2019/2020;
- Prospect for interest rates 2017 to 2020;
- Long term borrowing strategy 2017/2018;
- Debt rescheduling opportunities;
- Investment strategy 2017/2018;
- Short term (cash flow) borrowing strategy 2017/2018;
- Other current treasury issues.

2.2. Current Long Term External Borrowing & Investment Position

2.2.1. In order to place the Treasury Management Strategy in context, the Council's treasury portfolio position at 31.12.2016 comprised:

		Principal £million	Ave Rate %
Long Term Borrowing			
Opening Balance	31.03.16	480.099	4.077%
New Borrowing to	31.12.16	12.000	2.393%
Borrowing Repaid to	31.12.16	(15.354)	
Rescheduling:			
Borrowing Repaid Early to	31.12.16	0.0	
Borrowing Replaced	31.12.16	0.0	
Total Borrowing at	**31.12.16**	**476.745**	**4.068%**
Investments			
LCC at	31.12.16	276.950	
Pension Fund at	31.12.16	7.932	
Total Investments at	**31.12.16**	**284.882**	**0.605%**
Net Borrowing at	**31.12.16**	**188.740**	

2.3. Long Term Borrowing Requirement 2016/2017 to 2019/2020

2.3.1. The long term borrowing requirement for 2016/2017 to 2019/2020, as detailed in the Council Budget -2017/18 Report, which is to be considered by the County Council at its meeting on the 24th February 2017, is as follows:

Long Term Borrowing Requirement	2016/17 £m	2017/18 £m	2018/19 £m	2019/20 £m	Total £m
New Borrowing	50.353	48.844	37.641	52.631	**189.469**
Replacement Borrowing	15.354	15.354	35.497	14.354	**80.559**

2.3.2. Some of the 2016/17 borrowing requirement will be met by internal resources, not external borrowing. The balance of internal borrowing at the start of the year was £66.213m. Because of the internal borrowing undertaken, the Council's actual external borrowing position remains below its Capital Financing Requirement (CFR), a Prudential Indicator, which is a measure of the Council's underlying borrowing need.

2.3.3. This borrowing requirement falls within the Council's 'affordable borrowing limit' as outlined below.

2.4. Affordable Borrowing Limit for 2017/2018 to 2019/2020

2.4.1. The Council has a statutory duty, in accordance with the Local Government Act 2003, to determine and keep under review how much it can afford to borrow i.e. to determine its "Affordable Borrowing Limit".

2.4.2. The Council must have regard to the Prudential Code when setting its Affordable Borrowing Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax levels is acceptable. Both external borrowing and other forms of financing, such as finance leasing and private finance initiative arrangements (PFI) are included within this Affordable Borrowing Limit.

2.4.3. It is also a statutory requirement under Section 33 of the Local Government Finance Act 1992 for the Council to produce a balanced budget. This means that increases in capital expenditure must be limited to a level whereby increased capital finance costs are set to a level that is affordable within the projected income of the Council for the foreseeable future.

2.4.4. The Prudential Indicator for the 'Authorised Limit for External Debt', as required by the Prudential Code, is the statutory Affordable Borrowing Limit as determined under the 2003 Act, and this limit must be set on a rolling basis for the forthcoming financial year and two successive financial years. The Council's Authorised Limit For External Debt for 2017/18 to 2019/20 has been set as follows: -

	2017/18 £million	**2018/19 £million**	**2019/20 £million**
Borrowing	583.007	622.617	622.920
Other Long Term Liabilities	13.701	13.072	12.327
TOTAL	**596.708**	**635.689**	**635.247**

2.4.5. The County Finance Officer has responsibility to set the Authorised Limit for External Debt, to monitor the external debt level and to report to the Executive Councillor with responsibilities for finance, if he is of the view that the limit is likely to be breached. The Executive Councillor has then to decide to take appropriate action for the limit not to be breached or to raise the limit if prudent to do so.

2.5. Prudential Indicators for 2017/2018 to 2019/2020

2.5.1. Appendix A outlines the Council's Prudential Indicators that are relevant for the purposes of setting an integrated treasury management strategy.

2.5.2. They have been extracted from the comprehensive list of all Prudential Indicators proposed for the Council submitted, as per the requirements of the Prudential Code, with the Council Budget 2017/18 Report, which is to be considered at the meeting of the County Council on 24th February 2017.

2.6. Prospect for Interest Rates 2017-2020

2.6.1. The Council has appointed Capita Asset Services as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates taking into account the current outlook for the UK Economy. Appendix B draws together a number of current City Institution forecasts for short term and longer fixed interest rates. The following table gives the Capita central view.

Annual Average %	Bank Rate %	Money Rates %		PWLB Borrowing Rates % (Certainty Rate)		
		3 month	1 year	5 year	25 year	50 year
Mar 2017	0.25	0.30	0.70	1.60	2.90	2.70
June 2017	0.25	0.30	0.70	1.60	2.90	2.70
Sept 2017	0.25	0.30	0.70	1.60	2.90	2.70
Dec 2017	0.25	0.30	0.70	1.60	3.00	2.80
Mar 2018	0.25	0.30	0.70	1.70	3.00	2.80
June 2018	0.25	0.30	0.80	1.70	3.00	2.80
Sept 2018	0.25	0.30	0.80	1.70	3.10	2.90
Dec 2018	0.25	0.40	0.90	1.80	3.10	2.90
Mar 2019	0.25	0.50	1.00	1.80	3.20	3.00
Jun 2019	0.50	0.60	1.10	1.90	3.20	3.00
Sept 2019	0.50	0.70	1.20	1.90	3.30	3.10
Dec 2019	0.75	0.80	1.30	2.00	3.30	3.10
Mar 2020	0.75	0.90	1.40	2.00	3.40	3.20

Economic Commentary

2.6.2. UK GDP growth rate in 2013 (2.2%), 2014 (2.9%) and 2015 (1.8%) were some of the strongest rates among the G7 countries. The latest Bank of England forecast for growth in 2016 is 2.2% and for 2017 is back to 2% (having initially been pegged back to 0.8% after Brexit). Despite the Brexit vote in June 2016 and the uncertainty this has caused, this strong growth has been fuelled by consumer demand and confidence. It is unlikely that this will be sustainable going forward as household incomes fall and inflation starts to rise. Weak worldwide economic statistics and volatile financial markets have been flagged as concerns to this forecast.

2.6.3. CPI inflation rose above 1% for the first time in two years. Components such as petrol and food that react to exchange rate movements are having an upward effect on CPI. Higher prices on the high street are expected over the course of 2017. CPI is expected to peak around 3% by spring 2018, above the Bank of England 2% target level. The Bank of England is content with leaving interest rates on hold however, given uncertainty over the economic outlook and Brexit negotiations.

2.6.4. In the US, the Trump government has promised expansion of infrastructure expenditure in the US at the same time as promising to cut interest rates. Stock markets in the US reached record highs since the election. The Fed raised interest rates by 0.25% in December 2016 to 0.75%. The speed of increase in rates in the US is expected to diverge with that of the UK over the coming months.

2.6.5. In the Eurozone, the ECB announced its commitment to extend QE by another 9 months to December 2017 in an attempt to prop up the EU economies. There is potential for the Eurozone debt crisis to resurface, with Greece being a particular problem. Major EU Countries have elections coming up in the next year which could cause uncertainty, particularly with disagreement between EU countries on free movement of people prevailing.

2.6.6. A more detailed view of the current economic outlook is contained within Appendix C to this report.

2.6.7. The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

- Investment returns are likely to continue to remain low during 2017/18 and beyond;
- Borrowing interest rates have been on a generally downward trend during most of 2016 up to mid-August; they fell sharply to historically low levels after the Brexit referendum and then even further after the MPC meeting of the 4th August 2016 when a new package of QE purchasing of gilts was announced. Gilt yields have since risen sharply due to a rise in concerns around a 'hard Brexit', the fall in the value of sterling, and an increase in inflation expectations. They are forecast to rise further by around 0.50% in the next few years and will continue to be very volatile going forward. The policy of avoiding new borrowing by running down spare cash balances (internal borrowing) has served well over the last few years; however, this policy needs to be carefully reviewed to avoid incurring higher borrowing costs in later times when authorities will not be able to avoid new borrowing to finance capital expenditure and/or to refinance maturing debt.
- There will remain a cost of carry to any new long-term borrowing that causes a temporary increase in cash balances as this position will incur a revenue loss between borrowing costs and investment returns.

2.7. Long Term Borrowing Strategy 2017/2018

2.7.1. In view of the above forecast for interest rates the Council's borrowing strategy will be based upon the following information.

- Long term rates are difficult to predict for reasons already stated. They are forecast to rise gradually over 2017/18 by around 0.10% starting from current levels of 1.60% to 2.70%. At the time of writing suggested target rates for borrowing are as follows: 50 yr 2.70%, 25 yr – 2.90%, 10yr – 2.30% and 5 yr – 1.60%.

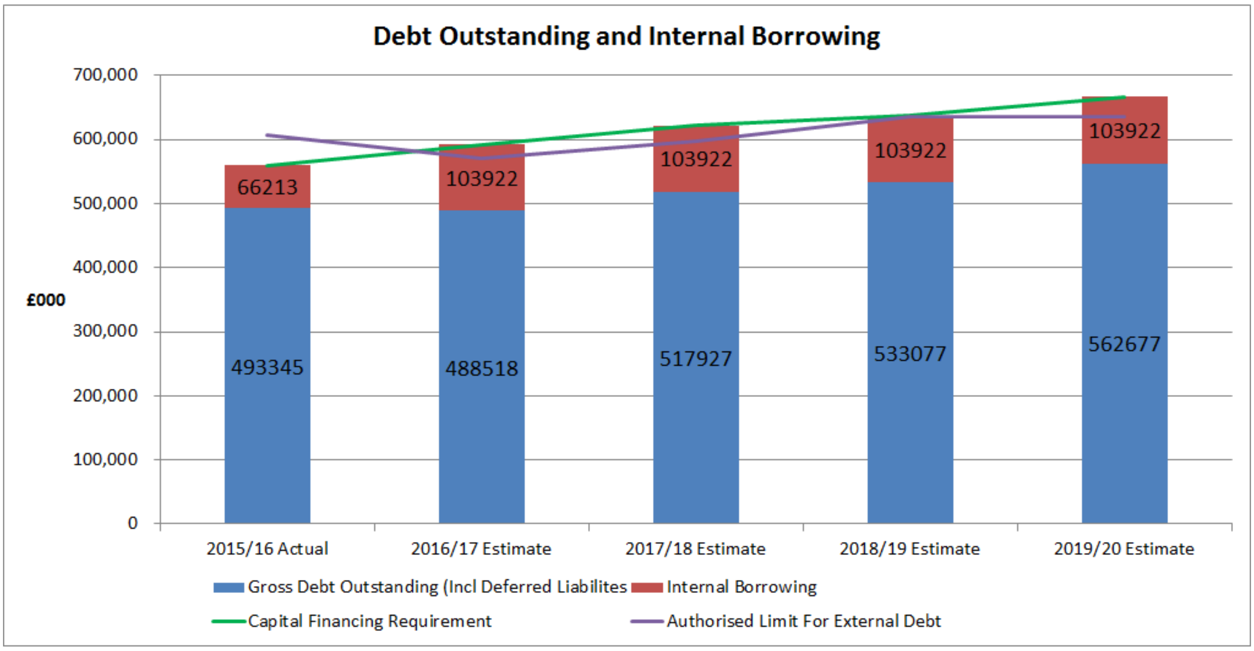
- The Council's Long Term Borrowing Maturity Profile as at 28th February 2017 can be seen as Appendix D. It shows actual maturities and also possible maturities from the LOBO debt taken. Gaps in the maturity profile are between 12 years and 36 years, then after 44 years. Any new borrowing taken should focus on these lengths at prevailing rates of interest.

- Market loans and LOBO[1] loans may be available at rates below PWLB rates. However an appropriate balance between PWLB and market debt should be maintained in the debt portfolio.

- Short term borrowing (up to 10 years) from the money market or other local authorities, at investment level rates, will be an available option.

<u>External V Internal Borrowing</u>

2.7.2. The Council is currently maintaining an ‘under-borrowed’ position, given its decision not to borrow externally in 2011/12 and subsequent years. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with external debt, and internal balances and cash flow have been used instead as a temporary measure (referred to as internal borrowing). This strategy has been prudent whilst investment returns are low and counterparty risk is high. The current position is shown in the graph below.



[1] A LOBO is a ‘Lender’s Option, Borrowers Option’ money market loan, whereby the Lender has the option to change the rate of a loan after a designated fixed period of time and the Borrower (LCC) has the option to accept this new rate or repay the loan. The fixed period of time is typically for 1 to 20 years and the total length of the LOBO is typically for 50 to 70 years.

2.7.3. The table below shows the comparison between the Council's gross and net debt positions at the year end from 2015/16 to 2019/20.

Comparison of gross and net debt at year end	2015/16 Actual £m	2016/17 Probable Outturn £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m
Actual External Debt (Gross)	480.099	476.745	506.792	522.696	553.069
Cash Balances (Investments)	224.873	151.079	133.108	133.608	133.708
Net Debt	255.226	325.666	373.684	399.088	419.361
Net Debt as % of Gross Debt	53.2%	68.3%	73.7%	74.4%	75.8%

2.7.4. The table shows that the difference between gross and net debt is the level of investments held by the Council. It shows that the level of investments should fall in 2016/17, reflecting the internal borrowing strategy taken to a level whereby opportunities for further internal borrowing from 2017/18 onwards are limited in order to maintain adequate balances for liquidity/cash flow requirements. The falling investment levels also reflect the planned use of reserves in the forthcoming years to meet budget shortfalls.

Minimum Revenue Provision / Repayment of Debt

2.7.5. New regulations in 2008 set a duty for the Council to set aside a minimum revenue provision (MRP) for the repayment of debt to the Revenue Account each year, which it considers to be prudent. Statutory guidance which accompanies the regulations provides options for calculating MRP. The aim is to ensure that debt is repaid over a period reasonably commensurate with the period over which the capital expenditure funded by borrowing provides benefits, or in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

2.7.6. The Council at its meeting on 13th February 2009 agreed to apply a **4% reducing balance calculation** for pre 2008 supported debt and the **average life method** of calculating MRP for 2009/10 onwards, as supported by the then Resources Policy Development Group (PDG) and the Council's External Auditors. Full details of the proposal from the Resources PDG 12 January 2009 can be found as Appendix E.

2.7.7. Revision of this policy was undertaken in 2016 to bring it up to date with current funding circumstances and capital expenditure plans. These revisions effective from 2016/17 are outlined below:

Pre 2008 Debt

Since the business rates reform in 2013/14, there is no component of grant determining an implicit level of support for debt repayment. For pre 2008 debt therefore, it was decided to change the MRP approach to a full repayment method and base this on a standard asset life of 50 years which equates to a flat rate of 2% per year until the debt is fully repaid over 50 years. In 2016/17 this alone reduces the MRP repayment from £8.8m to £4.4m, however as this is a full repayment approach the cost in future years will become more expensive than on the current approach from about year 19 onward.

Average Life Method-Annuity Calculation -2009/10 Debt Forward

As well as applying equal instalments of principal debt repayment over the asset lives of assets financed from borrowing, there is also the opportunity to calculate debt repayment using an annuity calculation for those assets. With an annuity, a fixed repayment consists of primarily all interest in early years and principal repayment increases in later years. This method therefore has the advantage of linking MRP to the flow of benefits from as asset where the benefits of those assets are expected to increase in later years. It was therefore decided to use the annuity method on those assets/projects financed by borrowing where we can make this link, such as Infrastructure Spending (Lincoln Eastern Bypass, East-West Link, Relief Road Projects etc). The cost again in future years will eventually be more expensive than the current approach.

Reviewing the Date of Financing

The guidance allows Councils not to start charging MRP until an asset becomes operational. The Council has four large highway schemes which are due to take a number of years to complete. It is therefore proposed that from 2016/17 these four major schemes will not be financed until they become operational. This represents around £90m of funding by borrowing and in the short term this will reduce the MRP charge by £1m to £2m, but is only a deferral of these costs.

The Council's external Auditors KPMG confirmed that they had no concerns with this revision to MRP strategy.

Over the next four years the reduction to MRP from these revisions would be £15.640m. These revenue budget savings from this revised policy are reflected in the Council Budget 2017/18 which is to be considered by the County Council at its meeting on the 24th February 2017.

2.7.8. The table below shows the revised estimates for asset lives now used under the MRP policy:

Type of Asset	**Estimated Asset Life in Years**
Land	50
Construction	70 Revised from 40
Matched Funding	25 Revised from 41
Repair & Maintenance	20
Infrastructure	120 Revised from 60
Road Maintenance	20
Bridges	120
Integrated Transport	20
Waste Transfer Plant	40
Heavy Engineering Equipment	30
Vehicles	5
Long Life Specialist Vehicles	15
Equipment	5
IT	4
ERP Finance System	10 New
Mosaic	10 New
Broadband	10 Revised from 15

2.7.9. The Council's policy is to repay external debt at the MRP level and as a measure of affordability the following voluntary Prudential Indicator Limit has been set:

'**MRP and Interest as a percentage of the Councils Income will not exceed 10%'.**

Borrowing in Advance of Need

2.7.10. The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Council can ensure the security of such funds. In determining whether borrowing will be undertaken in advance of need the Council will:

- ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need.

- ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered.
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow.
- consider the merits and demerits of alternative forms of funding.
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use.
- limit borrowing in advance to no more than 25% of the expected increase in borrowing need (CFR) over the three year planning period. (Voluntary Prudential Indicator).

2.7.11. Given the factors detailed in 2.7 above, the following borrowing strategy will be adopted for 2017/18:

The Council will take new borrowing from the PWLB in all periods with the aim of achieving an even spread of maturity profile and keeping an increase in the average cost of the Council's debt to a minimum. Target levels will be monitored and timing of borrowing taken will coincide with any reduced rate opportunity below the target levels identified.

Consideration will be given to borrowing market loans or LOBOs, to fit into the above maturity strategy, in order to take advantage of the lower rates offered on these loans. This proportion limited to no more than 10% of total external borrowing for each of market loans and LOBOs.

Short term borrowing from the money markets or other local authorities will be considered if appropriate.

Borrowing in advance of need will be undertaken during the year if considered appropriate following the Council's policy as detailed in 2.7.10 above.

2.7.12. To support the above strategy, prevailing interest rates and market forecasts will be continually monitored throughout the year and appropriate borrowing actions, including debt rescheduling if appropriate, will be taken in response to any sharp rise or fall in long and short term interest rates occurring throughout the year.

2.8. Debt Rescheduling

2.8.1. Debt rescheduling involves repaying existing loans and replacing these with new loans at different terms for the prime objective of generating financial savings on interest paid.

2.8.2. The Council's Financial Strategy states that 'the Council will actively pursue debt rescheduling to the extent that it will generate financial savings without adding significantly to the overall debt burden'.

2.8.3. To date interest savings have been made by rescheduling existing PWLB EIP[2] loans into PWLB maturity[3] loans. At 31st March 2017 £17.577 million of EIP debt, from the Council's total debt portfolio of £476.745 million, remains to be rescheduled given the opportunity.

2.8.4. Repaying debt early does incur a premium[4] or discount[5] depending on the current level of interest rates compared to the rate of interest on the debt repaid. The timing of any rescheduling during the year will take place to minimise premium or maximise the discount available. This is achieved by repaying loans at a peak in current interest rate levels to reduce the amount of premium due and locking into replacement loans at a trough in current interest rates. This strategy can incur an interest cost due to the delay in replacing debt repaid or interest can be made by borrowing in advance of repaying debt. There is also a level of interest rate risk of any timing decision.

2.8.5. Where possible suitable loans will be selected for rescheduling that match out both premium and discounts, thereby eliminating the cash impact to the Council. Any positions taken via rescheduling will be in accordance with the borrowing strategy position outlined in Section 2.7 above.

2.8.6. The appropriate timing of any rescheduling will be monitored throughout 2017/18 by the Council and Capita Asset Services Ltd. However, PWLB to PWLB debt restructuring is now much less attractive because of the large premiums that would be incurred due to

[2] With EIP loans, an equal amount of principal is repaid on a half yearly basis throughout the term of the loan with interest calculated on the reducing balance, hence total payments reduce over the lifetime of the loan.

[3] With Maturity loans, only interest repayments are made during the life of the loan and repayment of principal is made in full at the end of the loan period.

[4] A premium is incurred on repaying a loan early when the interest rate of the loan to be repaid is higher than the current rate available for the remaining duration of the existing loan.

[5] A discount is incurred on repaying a loan early when the interest rate of the loan to be repaid is lower than the current rate available for the remaining duration of the existing loan.

the introduction by the PWLB in 2007 of a spread between the rates applied to new borrowing and repayment of debt.

2.9. Investment Strategy 2016/2017

2.9.1. Bank Rate is forecast to remain flat for the whole of 2017/18 and 2018/19, with no increase expected until June 2019. The risk to this forecast is also weighted towards the downside, given the uncertainty over the final terms of Brexit. Expected interest returns are therefore forecast to drop to historically low levels over the next two years.

2.9.2. Investments of up to 2 years are considered acceptable to good quality counterparties, limits permitting, where acceptable rates are achievable and sufficient liquidity is available as a way of enhancing investment return.

2.9.3. The Council's investment level is forecast to be around £150 million net of Pension Fund cash in 2016/17, of which around £80 million can be identified as 'core' balances which will be available to invest for longer periods of investment. The remaining balance of cash is cash-flow driven.

2.9.4. The Council's investment priorities are:

(a) the security of capital and
(b) the liquidity of its investments

The Council will aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity and hence has a low risk appetite for placing investments.

2.9.5. Given these factors above, the following investment strategy will be adopted for 2017/18:

For the element of the Council's investment portfolio that represents 'core' balances, investments will be made in all periods of 3 months to 2 years, to acceptable counterparties, to lock into rates in excess of the predicted base rate level. The Council will avoid locking into longer term deals (beyond 1 year) while investment rates are down at historically low levels unless exceptionally attractive rates are available which make longer term deals worthwhile. Extensive use of

Bank Business Reserve Accounts and Money Market Funds[6] will be made, that offer returns close to or in excess of base rate level, for the Council's 'core' cash and cash flow generated balances. The target investment return for investments for 2017/18 is the weighted 7 day/3 month LIBID benchmark that reflects the risk parameters of the investment portfolio. This is a relative benchmark which moves with the markets, but as an indication the benchmark rate at 31st December 2016 was 0.33%.

Investment in Certificates of Deposit[7], Treasury Bills[8], Dated Bonds held to maturity[9] and Repo[10] will also be considered where appropriate.

Short dated deposits (overnight to 1 month) will also be made for the Council's cash-flow generated balances in order to benefit from compounding of interest.

2.9.6. In addition to the above strategy, prevailing interest rates and market forecasts will be continually monitored throughout the year and appropriate investment actions will be taken in response to any sharp rise or fall in long and short-term interest rates occurring throughout the year.

2.9.7. All Investments will be made in accordance with the Council's Annual Investment Strategy, as outlined in Section 3 of this report and with the institutions identified in the Council's approved counterparty investment list.

[6] Pooled investment vehicles offering returns equivalent of up to 1 month cash deposits whose assets comprise of cash type investments such as Certificates of Deposit, Commercial Paper and Cash Deposits.

[7] A bearer instrument which certifies that a sum of money has been deposited with the bank issuing the certificate at a fixed yield and on the stated maturity date the deposit is repaid with interest. The maturity length is typically from 1 month to 1 year.

[8] Short term securities issued by HM Treasury on a discounted basis i.e. issued below 100, with 100 being received on maturity with the difference equalling the interest return.

[9] A debt security instrument that governments, supranationals, and companies sell to investors (issue) to finance a variety of projects and activities. The investor buys the bond and receives fixed or variable coupons (interest) in return. Bonds can be dated (mature/repayable on a certain date) or non-dated (never mature). Bonds are tradeable (can be bought and sold) and hence the price of a bond fluctuates over its life. The total yield (return) on a bond for investor equals the npv of the cashflows (e.g. price paid, coupons received, nominal value received on maturity).

[10] A Repo is a form of securitised lending based on a Global Master Repo Agreement (GMRA 2000). Collateral is pledged against each loan made under a Repo Agreement, usually consisting of Gilts or Treasury Bills or acceptable Corporate Bonds. This collateral passes to the Lender in the case of a default of the loan with the original Counterparty.

2.10. Short Term (Cash Flow) Borrowing Strategy 2017/2018

2.10.1. During 2017/2018, when short term interest rates for temporary borrowing are significantly lower than yields earned on the Council's Call Accounts and Money Market Funds, then if required for cash flow purposes, temporary short term borrowing will be taken instead of drawing on investments, in order to minimise the loss of interest from withdrawing funds at higher rates or to cover

2.11. Other Current Treasury Issues

2.11.1. Long Term Borrowing – School Loans Scheme 2016/17

Long Term Borrowing from the PWLB on behalf of schools as part of the schools loan scheme will be undertaken throughout 2016/2017 as and when required and on terms requested by schools.

2.11.2. Policy on the Use of External Service Providers

The Council uses Capita Asset Services Ltd as its external treasury management advisers.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

2.11.3. Pension Fund Cash

In line with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 which were implemented on 1st January 2010, effective from 1st April 2010, an agreement has been drawn up governing the procedures that were already in place for the pooling of Pension Fund cash with Council balances for investment.

3. ANNUAL INVESTMENT STRATEGY 2017/2018

3.1. In accordance with Section 15(1) of the Local Government Act 2003, Lincolnshire County Council has adhered to the Guidance on Local Government Investments issued by the Secretary of State, and as such has produced its Annual Investment Strategy for 2017/2018 detailed below.

3.2. The Council's investment priorities will be security first, liquidity second, and then return. The intention of the Strategy is to provide security of investment and minimisation of risk. The aim of the Strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk. Investment instruments identified for use in 2017/2018 under Specified and Non-Specified investment categories are detailed below.

3.3. Specified Investments

3.3.1. In accordance with CLG Guidance on Local Government Investments, this Council will invest its surplus funds throughout the year in the following specified investments, which it regards as offering high security and high liquidity.

- Investments made in sterling, which mature within and including 12 months (such investments to include fixed, callable or forward term deposits as appropriate[11], Certificates of Deposit, Treasury Bills, Dated Bonds and Repo), with the following categories: -

    - UK Government/ Supranationals/ Multilateral Development Banks
    - Local Authorities
    - Body or Investment Scheme meeting the required level of credit quality as determined by credit rating agencies. Lincolnshire County Council has determined this required level of credit quality to be as follows: -

[11] Fixed Deposit : Investment fixed for specific term at specific rate.
Callable Deposit : Investment whereby borrower has option to pay back deposit at specific intervals.
Forward Deposit : Investment whereby period, rate and amount are agreed in advance of a future date. The forward period plus the deal period to be within the maturity limit allowed.

Body or Investment Scheme	Capita Weighted Credit Colour Band	Minimum Acceptable Credit Rating +
Bank, Building Society or Corporate	Blue (Nationalised / Semi Nationalised UK Banks only)	Long Term Rating (Any two Rating Agencies): A+
	Orange	
	Red	Sovereign Rating (Any two Rating Agencies): AA-
	Green	
Money Market Funds		Long Term Rating (Moodys): Aaa/MR1+ or (Fitch): AAA or (S & P): AAAm

+For definition of credit ratings see Appendix F.

This Council uses the creditworthiness service provided by Capita Asset Services, its treasury management advisor. This service has been progressively enhanced and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys and Standard and Poors, forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays:

- Credit watches and credit outlooks from credit rating agencies –see Appendix F for definition.
- Credit default swap (CDS) spreads to give early warning of likely changes in credit ratings – see Appendix F for definition.

This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. Rating Agency information and CDS spreads are monitored on a real time basis with knowledge of any changes sent electronically by Capita as soon as they are detected. The Council is satisfied that this service gives an improved level of security for its investments. It is also a service which the Council would not be able to replicate using in house resources.

Additional Minimum Rating Criteria/Limits in Place –set by Council

In addition to the Capita creditworthiness recommendations, the Council has also set further minimum credit requirements that restrict the number of acceptable counterparties further and is therefore deemed prudent.

- A minimum Sovereign (Country) Rating from a minimum of two rating agencies of AA-.*
- A minimum Long Term Rating from a minimum of two rating agencies of A+ or equivalent.**
- A limit of a maximum of no more than 20% of total investments to be placed with any one bank/group, corporate or building society sector - to ensure diversification of investments. (With exception of Part UK Nationalised Banks which are deemed to bear same low risk as UK Government).

***Sovereign Rating**
Credit Rating Agencies have removed the effect of Sovereign Support from an entities individual rating. This now makes it more important to focus solely on the ratings of an entity itself within an investment strategy. A minimum Sovereign limit of AA- is in line with Capita's creditworthiness policy and allows greater depth and diversification to the Council's Counterparty list, while still maintaining the tenets of security and liquidity.

**Note: Barclays Bank plc does not currently meet the Council's minimum criteria and hence are not on the Council's Lending List. However it was appointed as the Council’s banker in April 2012 and therefore the Council does have a minimum financial exposure to Barclays on a daily basis. When it is not financially viable to make an investment, a cash balance will be left at the bank overnight, so long as Barclays Bank remains on Capita's recommended Counterparty list.

Duration and Limits
From the above methodology the following duration and amount limits have been assigned to each colour band. With Council balances due to fall as a result of falling reserves and internal borrowing, maximum amount limits have been assigned to different levels of balances as shown in the table below. This allows the Council to be more risk sensitive to falling balances going forward.

Capita Weighted Colour Band	Maximum Duration	Maximum Amount Based on Average Balance of		
		£200m	£150m	£100m
Blue***	1 Year	£40m	£30m	£25m
Orange	1 Year	£20m	£20m	£15m
Red	6 Months	£15m	£10m	£10m
Green	3 Months	£10m	£5m	£5m

*** <u>*Applies to nationalised or semi nationalised UK Banks*</u>:-

As a result of the banking crisis which started in 2008, Governments across the world had to inject capital directly into banks to support their capital ratios and to avoid failure of financial institutions. Several banks have been nationalised or part nationalised in this way.

These nationalised banks in the UK have credit ratings which do not conform to the credit criteria usually used by Councils to identify banks which are of high credit worthiness. As they are no longer separate institutions in their own right, their individual ratings, which assess their stand-alone financial strength, are impaired. However, it is considered that institutions that have been nationalised or part nationalised effectively take on the creditworthiness of the Government itself and as such UK nationalised or semi nationalised banks are included within the Councils acceptable investment criteria and will continue to do so as long as they remain semi nationalised.

At the time of writing, the only UK Bank falling into this category is now the Royal Bank of Scotland Group, which includes National Westminster Bank.

3.3.2. The County Finance Officer has delegated responsibility to produce an 'Approved Lending List' of acceptable counterparties to whom the Council will lend its surplus cash which comply with the specified investments detailed above and the non-specified investments detailed below. The credit ratings of counterparties are monitored on an ongoing basis. The Council is alerted to changes to ratings of all three agencies through its use of the Capita creditworthiness service.

- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- In addition to the use of Credit Ratings, the Council will be advised of information in movements in CDS prices of Counterparties against the iTraxx benchmark[12] and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or suspension from the Council's lending list.

3.3.3. Sole reliance will not be placed on the use of this external service. In addition, this Council will also use market data and market information, information on government support for banks and the credit ratings of that government support.

[12] iTraxx Senior Financials Index that measures the "average" level of the most liquid financial CDS prices in the CDS market.

3.4. Non-Specified Investments

3.4.1. In accordance with CLG Guidance on Local Government Investments, non-specified investments are those that do not meet the definition of specified investments as detailed above, and they are viewed as being higher risk.

3.4.2. Having assessed the acceptable level of risk involved in all non-specified investments, it is the decision of the County Finance Officer to allow the prudent investment in the following non-specified investments:

- Sterling investments for a maturity period greater than 12 months up to a maximum of 2 years, (such investments to include fixed, callable or forward deposits, certificates of deposit, treasury bills, dated bonds and Repo as appropriate).

3.4.3. The above non-specified investments may be made to any category as detailed in the specified investments above, with the exception of Bodies or Investment Schemes that will be restricted to the following level of credit worthiness criteria:

Body or Investment Scheme	Capita Weighted Credit Colour Band	Minimum Acceptable Credit Rating +
Bank, Building Society or Corporate	Purple	Long Term Rating (Any two Rating Agencies): A+
	Yellow	Sovereign Rating (Any two Rating Agencies): AA-

+ For definition of credit ratings see Appendix F.

The following duration and amount limits have been assigned to these colour bands based on average balances as follows:

Capita Weighted Colour Band	Maximum Duration	Maximum Amount Based on Average Balance of		
		£200m	£150m	£100m
Purple	2 Years	£25m	£20m	£15m
Yellow	2 Years	£20m	£20m	£15m

3.4.4. In line with the Prudential Code Indicator, the maximum amount of total investment that can be held in investments over 12 months at any one time is £40 million. This limit reflects a prudent proportion of the Council's estimated level of core cash balances available to invest for longer periods.

3.4.5. The Executive Councillor with responsibility for finance will be informed on any occasion when investments are lent for over 12 months.

3.5. Additions to Non-Specified Investment List

3.5.1. Proposals to invest in any other non-specified investment will be referred to the County Finance Officer for approval after first seeking the advice of the Authority's Treasury advisors, Capita Asset Services Ltd. If approved by the County Finance Officer, a recommendation for the change to the Annual Investment Strategy will be sought from the Executive Councillor with responsibility for finance.

3.6. Liquidity of Investments

3.6.1. In determining the amount of funds that can prudently be committed for more than 12 months, consideration will be given to the following factors:

- Long Term Cash Flow Forecasts of the Council - 3 years ahead showing:
    - Projected core cash balances over the term of proposed investment
    - Foreseeable spending needs over the term of proposed investment.
    - Level of provision for contingencies.
    - Acceptable level of reserves.

3.7. Training Needs for Treasury Management Staff

3.7.1. The importance of ensuring that all staff involved in the treasury management function are fully equipped to undertake the duties and responsibilities allocated to them are recognised by the Council. Consequently, the Council seeks to appoint individuals who are both capable and suitably experienced and also will provide training for staff to enable them to acquire and maintain an appropriate level of expertise, knowledge and skills.

All treasury management staff are encouraged to take any suitable training in treasury management provided by CIPFA, Capita Asset Services Ltd or other relevant market participant. Both the Treasury Manager and Treasury Officer for the Council have successfully gained the CIPFA/ACT qualification in International Treasury Management (Public Finance) (Cert ITM-PF).

2. Conclusion

The Treasury Management Strategy, determining appropriate borrowing and investment decisions, and the Annual Investment Strategy, outlining the Council's policy for investments, have been set for 2017/18 in light of the anticipated economic environment and movement of interest rates for the year ahead.

3. Consultation

a) Have Risks and Impact Analysis been carried out?

Yes

b) Risks and Impact Analysis

Risk & Impact Analysis for Treasury Management forms TMP1 of the Treasury Management Practices, as required by the CIPFA Code of Practice 2011. A Risk Register which details the main risks for Treasury Management has been completed and is reviewed annually. Both the TMPs and the Risk Register are held in the Treasury Files held on IMP at County Offices.

4. Appendices

These are listed below and attached at the back of the report	
Appendix A	Prudential and Treasury Indicator Table 2017/18 to 2019/20.
Appendix B	Interest Rate Forecast for 2017-2020.
Appendix C	Economic Background -Capita Asset Services.
Appendix D	Long Term Borrowing Maturity Profile at 28th February 2017.
Appendix E	Minimum Revenue Provision Policy.
Appendix F	Definition of Credit Ratings and Credit Default Swap Spreads

5. Background Papers

Document title	Where the document can be viewed
Council Budget 2017/18 -24th February 2017	Lincolnshire County Council, Finance & Public Protection
Minimum Revenue Provision -12th January 2009	Lincolnshire County Council, Finance & Public Protection
LCC Treasury Management Policy Statement and Treasury Management Practices	Treasury and Financial Strategy Section, Finance & Public Protection.

This report was written by Karen Tonge, who can be contacted on 01522 553639 or karen.tonge@lincolnshire.gov.uk.

This page is intentionally left blank