Policy and Scrutiny

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

Report to:	**Value for Money Scrutiny Committee**
Date:	**23 February 2015**
Subject:	**Treasury Management Strategy Statement and Annual Investment Strategy 2015/16**

Summary:

The Treasury Management Strategy Statement is an annual statement that sets out the expected treasury activities for the forthcoming year 2015/2016. 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 2015/2016 as Section 2 and the Annual Investment Strategy for 2015/2016 as Section 3 and has been prepared in accordance with the CIPFA Code of Practice for Treasury Management 2011 and subsequent revisions.

- Treasury Management Strategy Statement 2015/2016
  The Treasury Management Strategy Statement is an annual statement that sets out the expected treasury activities for the forthcoming year 2015/2016.

- The Annual Investment Strategy 2015/2016
  The Annual Investment Strategy sets out the Council's policies for investing its surplus cash for the year 2015/2016 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 Value for Money Scrutiny Committee 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 2015/2016

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 2015/2016 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 2014/2015 to 2017/2018;
- Affordable borrowing limit for 2015/16 to 2017/18;
- Prudential indicators 2015/2016 to 2017/2018;
- Prospect for interest rates 2015 to 2018;
- Long term borrowing strategy 2015/2016;
- Debt rescheduling opportunities;
- Investment strategy 2015/2016;
- Short term (cash flow) borrowing strategy 2015/2016;
- 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 31.12.2014 comprised:

		Principal £million	Ave Rate %
Long Term Borrowing			
Opening Balance	31.03.14	452.807	4.141
New Borrowing to	31.12.14	20.000	
Borrowing Repaid to	31.12.14	(6.354)	
Rescheduling:			
Borrowing Repaid Early to	31.12.14	0.0	
Borrowing Replaced	31.12.14	0.0	
Total Borrowing at	**31.12.14**	**466.453**	**4.137**
Investments			
LCC at	31.12.14	223.366	
Pension Fund at	31.12.14	2.769	
Total Investments at	**31.12.14**	**226.135**	**0.662**
Net Borrowing at	**31.12.14**	**240.318**	

2.3. Long Term Borrowing Requirement 2014/2015 to 2017/2018

2.3.1. The long term borrowing requirement for 2014/2015 to 2017/2018, as detailed in the Council Budget -2015/16 and Capital Programme Changes 2014/15 Report, which is to be considered by the County Council at its meeting on the 20th February 2015, is as follows:

Long Term Borrowing Requirement	2014/15 £m	2015/16 £m	2016/17 £m	2017/18 £m	Total £m
New Borrowing	35.700	73.862	67.798	26.112	**203.472**
Replacement Borrowing	11.354	11.354	15.354	15.354	**53.416**

2.3.2. It is intended that £7.031m of the 2014/15 borrowing requirement will be met by internal resources, not external borrowing bringing the balance of internal borrowing to £105m in total. 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 2015/2016 to 2017/2018

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 2015/16 to 2017/18 has been set as follows: -

	2015/16 £million	**2016/17 £million**	**2017/18 £million**
Borrowing	592.052	626.021	617.618
Other Long Term Liabilities	15.083	14.443	13.975
TOTAL	**607.135**	**640.464**	**631.593**

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 2015/2016 to 2017/2018

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 - 2015/16 and Capital Programme Changes 2014/15 Report, which is to be considered at the meeting of the County Council on 20th February 2015.

2.6. Prospect for Interest Rates 2015-2018

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 2015	0.50	0.50	0.90	2.20	3.40	3.40
June 2015	0.50	0.50	1.00	2.20	3.50	3.50
Sept 2015	0.50	0.60	1.10	2.30	3.70	3.70
Dec2015	0.75	0.80	1.30	2.50	3.80	3.80
Mar2016	0.75	0.90	1.40	2.60	4.00	4.00
June 2016	1.00	1.10	1.50	2.80	4.20	4.20
Sept 2016	1.00	1.10	1.60	2.90	4.30	4.30
Dec 2016	1.25	1.30	1.80	3.00	4.40	4.40
Mar 2017	1.25	1.40	1.90	3.20	4.50	4.50
Jun 2017	1.50	1.50	2.00	3.30	4.60	4.60
Sept 2017	1.75	1.80	2.30	3.40	4.70	4.70
Dec 2017	1.75	1.90	2.40	3.50	4.70	4.70
Mar 2018	2.00	2.10	2.60	3.60	4.80	4.80

Economic Commentary

2.6.2. UK GDP growth surged during 2013 and the first half of 2014. It has slowed down since then but still remains strong by UK standards and forecasts for 2015 and 2016 are 2.6% and 2.4% respectively. There needs to be a significant rebalancing of the economy away from consumer spending to manufacturing, business investment and exporting in order for this recovery to become more firmly established.

2.6.3. One drag on the economy has been that wage inflation has only recently stared to exceed CPI inflation, so enabling disposable income and living standards to start improving. Labour productivity must also improve significantly to enable wage rates to increase and further support consumer disposable income and economic growth.

2.6.4. The plunge in the price of oil brought CPI inflation down to a low of 1.0% in November 2014, the lowest rate since September 2002. Inflation is expected to stay around or below 1.0% for the best part of a year which will help improve consumer disposable income and so underpin economic growth in 2015.

2.6.5. Unemployment has been falling faster than expected which will eventually feed through into pressure for wage increases, though current views on the amount of slack in the labour market probably means that this will be unlikely to happen in 2015.

2.6.6. The US, the biggest world economy, has generated stunning growth rates of around 5% and it looks very much as if the US is now firmly on the path of full recovery from the financial crisis of 2008. Given this the US are expected to be the first major western economy to start on central rate increases by mid-2015.

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

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

- Greece has elected the radical left-wing Syriza party which is anti-EU and anti-austerity. If this results in Greece leaving the Euro, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect effects of the likely strengthening of anti-EU and anti-austerity political parties throughout the EU are much more difficult to quantify.

- The Eurozone has experienced a downturn in growth and inflation during the second half of 2014. Worries over the Ukraine situation, Middle East and Ebola have led to concerns that it is heading for a prolonged deflation and very weak growth. Sovereign debt difficulties for some countries still exist and so it is possible over the next few years that levels of government debt to GDP ratios could continue to rise resulting in loss of investor confidence. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;

- Investment returns are likely to remain relatively low during 2015/16 and beyond;

- Borrowing interest rates have risen during 2013 and are on a rising trend. The policy of avoiding new borrowing by running down spare cash balances (internal borrowing) has served well over the last few years, however, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future, when external borrowing has to be taken;

- There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

2.7. Long Term Borrowing Strategy 2015/2016

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 2015/16 and are on a rising trend in general, albeit from a lower starting point than previously predicted. At the time of writing suggested target rates are as follows: 50 yr 3.40%, 25 yr – 3.40%, 10yr – 2.80% and 5 yr – 2.20%.

- The Council's Long Term Borrowing Maturity Profile as at 23rd February 2015 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 15 years and 37 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 3 years) from the money market or other local authorities, at investment level rates, will be an available option.

[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.

External V Internal Borrowing

2.7.2. The Council is currently maintaining an 'under-borrowed' position, given its decision not to borrow externally in 2011/12 and to some extent since then. 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 as investment returns are low and counterparty risk is high.

2.7.3. The table below shows the comparison between the Council's gross and net debt positions at the year end from 2013/14 to 2017/18.

Comparison of gross and net debt at year end	**2013/14 Actual £m**	**2014/15 Probable Outturn £m**	**2015/16 Estimate £m**	**2016/17 Estimate £m**	**2017/18 Estimate £m**
Actual External Debt (Gross)	452.807	459.718	511.792	552.492	549.203
Cash Balances (Investments)	186.475	155.000	142.829	152.610	162.610
Net Debt	266.332	304.718	368.963	399.882	386.593
Net Debt as % of Gross Debt	58.8%	66.3%	72.1%	72.4%	70.4%

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 2014/15, reflecting the internal borrowing strategy taken to a level whereby opportunities for further internal borrowing from 2015/16 onwards are limited in order to maintain adequate balances for liquidity/cash flow requirements.

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.

2.7.6. The Council at its meeting on 13th February 2009 agreed to apply 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 certain asset lives under this policy was undertaken in 2013/14 to bring them in line with the depreciation policy applied for the Financial Statements. 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	40
Repair & Maintenance	20
Infrastructure	60
Road Maintenance	20
Bridges	120
Integrated Transport	20
Waste Transfer Plant	40
Heavy Engineering Equipment	30
Vehicles	4
Long Life Specialist Vehicles	15
Equipment	5
IT	4

2.7.8. 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

2.7.9. 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).

2.7.10. Given the factors detailed in 2.7 above, the following borrowing strategy will be adopted for 2015/16:

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 2.7.8 above.

2.7.11. 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 the time of writing £20.285 million of EIP debt, from the Council's total debt portfolio of £466.453 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 2015/16 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 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 2015/2016

2.9.1. A 0.25% increase in Bank Rate is forecast to come in the third quarter of 2015/16 around December 2015 and further increases in the year are not then expected. There is upside risk to this forecast if economic growth remains strong and unemployment continues to fall.

[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.

However, should the pace of growth fall back any increase could be stalled.

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.

2.9.3. The Council's investment level is forecast to be around £150 million net of Pension Fund cash in 2015/16, 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 2015/16:

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 or towards the end of the financial year 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 2015/16 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 2014 was 0.40%.

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

[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.

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.

2.10. Short Term (Cash Flow) Borrowing Strategy 2015/2016

2.10.1. During 2015/2016, 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. Non-Treasury Management Investment
A revolving credit facility of £158000 (€200000), over a period of 3 years, has been given to Incendi Ltd, a limited company to be set up by Lincolnshire Fire & Rescue for trading purposes, to be wholly owned by Lincolnshire County Council. This loan will provide cash flow to meet set up and initial trading costs. It is classified as a service investment rather than a treasury investment and is therefore outside of the specified/ non specified investment categories.

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[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).

2.11.2. Long Term Borrowing – School Loans Scheme 2015/16

Long Term Borrowing from the PWLB on behalf of schools as part of the schools loan scheme will be undertaken throughout 2015/2016 as and when required and on terms requested by schools.

2.11.3. Leasing Requirements – School IT and General Equipment

It is anticipated that up to £500,000 of School IT and general equipment can be leased in 2015/2016 as part of an agreed strategy for acquiring use of such equipment by schools. Three and five year finance leases will be arranged on behalf of the schools as required.

2.11.4. 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.

2.11.5. PWLB Governance Structure

The CLG announced in December 2014 that it will be abolishing the Public Works Loan Board (PWLB) Commissioners and renaming the PWLB in 2015 in conjunction with the current National Infrastructure Bill passing through the House of Lords. The PWLB is a Government department that provides borrowing to Local Authorities. The CLG have confirmed that current lending arrangements to Councils will remain in place.

2.11.6. 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 2015/2016

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 2015/2016 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 2015/2016 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[10], Certificates of Deposit, Treasury Bills and Dated Bonds), 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: -

[10] 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 (Fitch and equivalent Rating Agencies): A+
	Orange	
	Red	Sovereign Rating (Any two Rating Agencies): AAA
	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 AAA.*
- A minimum Long Term Rating by all 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).

*UK Sovereign Rating
The UK is excluded from this AAA minimum requirement, on the basis that being our domiciled country outweighs the extra risk presented by not having a AAA status.

**Long Term Rating
To mitigate the expected reduction in credit ratings of institutions by Rating Agencies in 2015, as a result of banking legislation relating to sovereign support withdrawal, the Council's additional minimum Long Term rating requirement has been reduced one level to A+ from AA-. This is to maintain a workable lending list in light of what will be downgrades due to legislative changes, not credit quality issues.

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 is a new approach which 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

*** *Applies to nationalised or semi nationalised UK Banks*:-
As a result of the banking crisis which started in 2008, Governments across the world have 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.

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[11] 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.

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

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.

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 and dated bonds 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 (Fitch and equivalent Rating Agencies): A+
	Yellow	Sovereign Rating (Any two Rating Agencies): AAA

+ 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, (new risk sensitive approach), 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.

3.7.2. 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).

4. 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 2015/16 in light of the anticipated economic environment and movement of interest rates for the year ahead.

5. Consultation

a) Policy Proofing Actions Required

Not applicable.

6. Appendices

These are listed below and attached at the back of the report	
Appendix A	Prudential and Treasury Indicator Table 2015/16 to 2017/18.
Appendix B	Interest Rate Forecast for 2015-2018.
Appendix C	Economic Background.
Appendix D	Long Term Borrowing Maturity Profile at 23-2-2015.
Appendix E	Minimum Revenue Provision Policy.
Appendix F	Definition of Credit Ratings and Credit Default Swap Spreads.

7. Background Papers

The following background papers as defined in the Local Government Act 1972 were relied upon in the writing of this report.

Document title	Where the document can be viewed
Council Budget 2015/16 and Capital Programme Change 2014/15 - 20th February 2015	Lincolnshire County Council, Finance & Public Protection
Minimum Revenue Provision - 12th January 2009	Lincolnshire County Council, Finance & Public Protection
LCC Treasury Management Policy	Treasury and Financial Strategy Section, Finance & Public Protection

Statement and Treasury Management Practices	

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