Policy and Scrutiny

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

Report to:	**Overview and Scrutiny Management Board**
Date:	**01 March 2018**
Subject:	**Treasury Management Strategy Statement and Annual Investment Strategy 2018/19**

Summary:

The Treasury Management Strategy Statement is an annual statement that sets out the expected treasury activities for the forthcoming year 2018/19. It is prepared in accordance with the 2017 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. The decision to include the requirements of the Cipfa Code in the Constitution was adopted by the Council in 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 is defined by CIPFA as 'the management of the Council's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks'.

1.2. **Relevant Treasury Management Regulation / Legislation**

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

1.2.2. 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.

1.2.3. In December 2017 CIPFA published a revision to both the Code of Practice for Treasury Management and the Prudential Code. The prime reason of these revisions being to highlight the increased emergence of non-treasury investments held in other financial assets and property, primarily held for return by Councils. Such activity includes loans supporting service outcomes, investments in subsidiaries and investment property portfolios. CIPFA has emphasised that these investments, although not part of general treasury management activity, are the responsibility of the S151 Officer and should therefore be managed and subject to the same risk / return considerations as for treasury investments.

1.2.4. Following CIPFA's recommendation in the revised codes, details of these non-treasury investments will be included in an annual **Capital Strategy**, which will also set out the Council's risk appetite and specific policies and governance arrangements for these non-treasury investments. The purpose of the Capital Strategy will be to demonstrate that the Council takes capital expenditure and non-treasury investment decisions in line with service objectives and properly takes into account stewardship, value for money, prudence, sustainability and affordability. It will set out the long term context in which capital expenditure and investment decisions are made, the due diligence undertaken for non-treasury investments and will give due consideration to both risk and reward and impact on the achievement of priority outcomes. Reference to the Capital strategy will be made in the Budget 2018/19 report to be presented to Full Council on 23rd February 2018; however, the Capital Strategy itself will be presented to this Committee later in the year for scrutiny. It will then be presented to the Executive Councillor for Finance for approval as is the case with the Treasury Management Strategy Statement and Annual Investment Strategy 2018/19.

1.3. Purpose of Report

1.3.1. This report comprises the Treasury Management Strategy Statement for 2018/2019 as Section 2 and the Annual Investment Strategy for 2018/2019 as Section 3 and has been prepared in accordance with the CIPFA Code of Practice for Treasury Management 2017.

- Treasury Management Strategy Statement 2018/2019

  The Treasury Management Strategy Statement is an annual statement that sets out the expected treasury activities for the forthcoming year 2018/2019.

- The Annual Investment Strategy 2018/2019

  The Annual Investment Strategy sets out the Council's policies for investing its surplus cash for the year 2018/2019 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 treasury investments. It does not relate to the Council's non-treasury investments. The investment strategy followed by the Council for its non-treasury investments will be detailed in the forthcoming Capital Strategy 2018/2019.

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 Overview & Scrutiny Management Board for scrutiny and then submitted to the Executive Councillor with responsibility for finance for approval prior to the start of the financial year. The Capital Strategy will follow a similar path later in the 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 2018/2019

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 Capital & Revenue expenditure plans of the Council and the anticipated movement in interest rates. The strategy for 2018/2019 is therefore based upon the Capital & Revenue expenditure plans of the Council and 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, Link Asset Services Ltd. The strategy covers the following areas:

- The current long term external borrowing & investment position;
- Capital Expenditure Plans & Capital Financing (Borrowing) Requirement 2017/2018 to 2020/2021;
- Affordable borrowing limit for 2018/19 to 2020/2021;
- Revenue Provision for the Repayment of Debt Policy (MRP);
- Interest rate exposure – Borrowing;
- Performance –Borrowing;
- Borrowing in Advance of Need;
- Debt Rescheduling;
- Prospect for interest rates 2018 to 2021;
- Long term borrowing strategy 2018/2019;
- Investment strategy 2018/2019;
- Short term (cash flow) borrowing strategy 2018/2019;
- 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 31.12.2017 comprised:

		Principal £million	Ave Rate %
Long Term Borrowing			
Opening Balance	31.03.17	476.745	4.068%
New Borrowing to	31.12.17	0.000	
Borrowing Repaid to	31.12.17	(15.354)	
Rescheduling:			
Borrowing Repaid Early to	31.12.17	0.0	
Borrowing Replaced	31.12.17	0.0	
Total Borrowing at	**31.12.17**	**461.391**	**4.088%**
Investments*			
LCC at	31.12.17	291.093	
Pension Fund at	31.12.17	15.187	
Total Investments at	**31.12.17**	**306.280**	**0.540%**
Net Borrowing at	**31.12.17**	**155.111**	

* Note this balance excludes non-treasury investments.

2.3. Capital Expenditure Plans & Capital Financing (Borrowing) Requirement 2017/2018 to 2020/2021

2.3.1. The Council's capital expenditure plans are the key driver of treasury management activity as it sets the long term borrowing requirement plans for the Council.

2.3.2. The Council is required by regulation to comply with the CIPFA Prudential Code for Capital Finance in Local Authorities 2017 (referred to as the 'Prudential Code') when assessing the affordability, prudence and sustainability of its capital investment plans. It does this by setting a series of Prudential Indicators that ensure and demonstrate the Council's capital expenditure plans remain affordable, prudent and sustainable.

2.3.3. Appendix A shows a summary of the actual prudential indicators for 2016/17 and the estimated prudential indicators for 2017/18 through to 2020/21, which are submitted, as per the requirements of the Prudential Code, with the Council Budget 2018/19 Report, which is to be considered at the meeting of the County Council on 23rd February 2018.

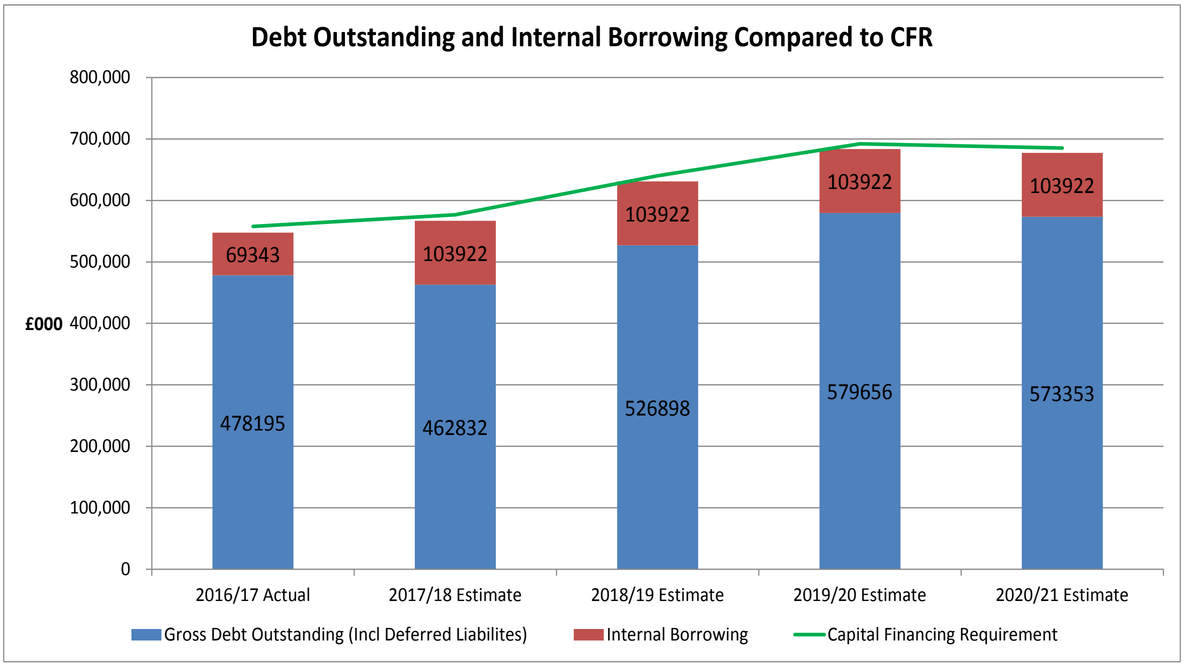
2.3.4. Extracted from these Prudential Indicators, shown in the table below, is the Council's **capital expenditure plans** for the reporting period and the element of this expenditure which is not to be financed straight away from cash resource or grants, hence to be financed at a future date by borrowing (**the borrowing requirement**). The table also shows the amount of external borrowing taken which is due to mature over the reporting period which impacts on the total indebtedness of the Council.

	Estimate 2017/18 £m	Estimate 2018/19 £m	Estimate 2019/20 £m	Estimate 2020/21 £m	Total £m
Capital Expenditure Plans	141.870	158.689	106.314	49.162	**456.035**
New Borrowing Requirement	36.548	84.076	76.675	20.124	**217.423**
Maturing Borrowing Requirement	15.354	35.497	14.354	14.354	**79.559**

Capital Financing Requirement

2.3.5. **The Capital Financing Requirement** (CFR) is another Prudential Indicator shown in Appendix A. It is a measure of the amount of capital expenditure that the Council has already spent that has yet to be funded from cash resources i.e. the Council's total indebtedness or need to borrow for capital financing purposes. Credit arrangements (finance leases and private finance initiatives) are also included in the CFR as they have the same practical impact as borrowing. The CFR is increased each year by the **new borrowing / credit arrangements** requirement, as highlighted in the table above, and reduced each year by the **Minimum Revenue Provision (MRP)**, (the Council's policy for the repayment of debt). This policy is outlined in Appendix B and explained later in this report at 2.5.

2.3.6. The graph below shows the actual CFR for 2016/17 and forward projections to 2020/21, compared to the actual level of external debt the Council holds. The difference between the CFR level and the external debt level is known as Internal Borrowing. This represents the amount of borrowing requirement being met by the Council's internal balances and cash flow rather than by taking external borrowing. This internal borrowing or 'under borrowed' strategy has been prudent whilst investment returns are low and counterparty risk is high. A level of £104m of internal borrowing is planned to 2020/2021; a level that the Council thinks is sustainable given projections of cash balances going forward. It should be noted however that the decision to turn internal borrowing into external debt can be made at any time given the right market conditions without affecting the level of the CFR.



2.3.7. The rising CFR shown in the graph above also indicates that borrowing requirement exceeds the minimum debt repayment requirement (MRP) each year until 2020/21, when it then falls below the MRP level and the CFR is forecast to slightly fall at this time.

2.3.8. The table below shows the comparison between the Council's forecasted gross and net debt positions at the year end from 2016/17 to 2020/21.

Comparison of gross and net debt at year end	2016/17 Actual £m	2017/18 Probable Outturn £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m
Actual External Debt (Gross)	478.195	462.832	526.898	579.656	573.353
Cash Balances (Investments)	237.517	250.214	247.638	213.842	213.842
Net Debt	240.678	212.618	279.260	365.814	359.511
Net Debt as % of Gross Debt	50.3%	45.9%	53.0%	63.1%	62.7%

2.3.9. The table shows that the difference between gross and net debt is the level of investments held by the Council. It shows that the levels of investments are forecasted to fall over the reporting period reflecting the planned use of reserves in the forthcoming years to meet budget shortfalls. The level of investment position is net of the internal borrowing level of £104m held. Given these figures, it is felt that further scope for increased internal borrowing is limited in order to maintain adequate balances for liquidity/cash flow requirements.

2.4. Affordable Borrowing Limit for 2018/2019 to 2020/2021

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 credit arrangements (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 2018/19 to 2020/21 is shown in the table below and it can be seen that the Council's actual external debt forecast in the table at 2.3.8 falls within these limits set.

	2018/19 £million	2019/20 £million	2020/21 £million
Borrowing	651.751	669.217	658.200
Other Long Term Liabilities	12.984	12.238	11.473
TOTAL	**664.735**	**681.455**	**669.673**

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. Revenue Provision for the Repayment of Debt Policy (MRP)

2.5.1. Financing capital expenditure by borrowing allows the Council to incur capital expenditure that it does not immediately fund from cash resources. Instead, the Council sets cash resource aside from the Revenue Budget each year to repay the borrowing. This practice is referred to as making minimum revenue provision (or MRP) for the repayment of debt.

2.5.2. Regulations in 2008 set a duty for the Council to set aside a minimum revenue provision (MRP) for the repayment of debt annually on a prudent basis. 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.

2.5.3. Appendix B outlines the methodology the Council follows to ensure this prudent provision for the repayment of debt using the Average Life of the Assets financed by borrowing method for new borrowing and a straight line repayment method for Pre 2008 debt. The revenue budget provision for MRP charges in 2018/19 has been completed on a basis consistent with this policy.

2.5.4. The Council's policy is to actually 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%'**

2.6. Interest Rate Exposure –Borrowing

2.6.1. Long term loans are usually secured at fixed rates of interest, to provide certainty over the cost of maintaining the loans over their lifetime. However up to **30%** of all borrowing could alternatively be secured at **variable rates of interest**. (This is a voluntary Prudential Indicator as shown in Appendix A). This may be appropriate if, for example, funding is required for a relatively short period, or if the Council wishes to defer locking into fixed rate loans because the interest rate forecast indicated that interest rates will be lower than the prevailing rate in the near term.

2.7. Performance –Borrowing

2.7.1. If long term borrowing is undertaken, performance will be assessed against the PWLB rate for the year for the application loan type and interest rate banding. CIPFA Treasury Management benchmarking will also be considered to compare with other Councils average borrowing rates for the year. Reducing or keeping increases to the average rate of the debt portfolio to a minimum will also be a target indicator.

2.7.2. Short term borrowing will be assessed against the average 7 Day London Interbank Offer Rate (7DLIBOR) for the year or the current yields on Money Market Funds/investments for short term borrowing for cash flow purposes.

2.8. Borrowing in Advance of Need

2.8.1. 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. This is a Voluntary Prudential Indicator as shown in Appendix A.

2.9. Debt Rescheduling

2.9.1. 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.

2.9.2. 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'.

2.9.3. To date interest savings have been made by rescheduling existing PWLB EIP[1] loans into PWLB maturity[2] loans. At 31st March 2018 £16.223 million of EIP debt, from the Council's total debt portfolio of £461.391 million will remain to be rescheduled given the opportunity.

2.9.4. Repaying debt early does incur a premium[3] or discount[4] 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.

2.9.5. 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 2.9 below.

2.9.6. The appropriate timing of any rescheduling will be monitored throughout 2018/19 by the Council and Link 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.

---

[1] 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.

[2] 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.

[3] 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.

[4] 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.

2.10. Prospect for Interest Rates 2018 to 2021

2.10.1. The Council has appointed Link 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 C draws together a number of current City Institution forecasts for short term and longer fixed interest rates. The following table gives the Link central view.

Annual Average %	Bank Rate %	Money Rates %		PWLB Borrowing Rates % (Certainty Rate)		
		3 month	1 year	5 year	25 year	50 year
Mar 2018	0.50	0.40	0.80	1.60	2.90	2.60
June 2018	0.50	0.40	0.80	1.60	3.00	2.70
Sept 2018	0.50	0.40	0.90	1.70	3.00	2.80
Dec 2018	0.75	0.60	1.00	1.80	3.10	2.90
Mar 2019	0.75	0.60	1.00	1.80	3.10	2.90
June 2019	0.75	0.60	1.10	1.90	3.20	3.00
Sept 2019	0.75	0.70	1.10	1.90	3.20	3.00
Dec 2019	1.00	0.90	1.30	2.00	3.30	3.10
Mar 2020	1.00	0.90	1.30	2.10	3.40	3.20
Jun 2020	1.00	1.00	1.40	2.10	3.50	3.30
Sept 2020	1.25	1.20	1.50	2.20	3.50	3.30
Dec 2020	1.25	1.20	1.50	2.30	3.60	3.40
Mar 2021	1.25	1.20	1.60	2.30	3.60	3.40

Economic Commentary

2.10.2. The following paragraphs set the backdrop to the Council's investment management activity in 2018/19 and subsequent years, by providing commentary on the economic outlook:

- **Global Economy**

World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October 2017, the International Monetary Fund upgraded its forecast for world growth from 3.2% to 3.7% in 2018. In addition, inflation prospects are generally muted and wage inflation has been subdued despite unemployment falling to historically low levels in the UK and US.

The central banks' monetary policies of the last ten years of lowering central interest rates and flooding the financial markets with liquidity through quantitative easing is coming towards its close and actions are now required to reverse these measures. It is crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. The potential for the central banks to get this timing, and the strength of action, wrong are now key risks.

- **UK Economy**

After strong economic growth in 2016, growth in 2017 was disappointing, mainly due to a sharp increase in inflation. This resulted in a reduction in consumer disposable income and spending power. However, there are encouraging signs of growth in the manufacturing sector, particularly as a result of increased demand for exports.

The Monetary Policy Committee (MPC) increased the bank rate from 0.25% to 0.50% in November 2017, and gave forward guidance that they expect to increase the Bank Rate only twice more in the next three years to reach 1.0% during 2020. This is consistent with previous statements that Bank Rate would only go up gradually and to a limited extent.

The above forecast will be liable to further amendment depending on how economic data and developments in the financial markets transpire over the next year. Geopolitical developments, especially in the EU, would also have a major impact.

The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.

- **US Economy**

Growth in the American economy remains erratic and volatile. Unemployment in the US has fallen to all-time lows, while wage inflation and inflationary pressures in general have been building. The Fed is already on a programme of interest rate increases with another four expected in 2018. US bond yields are likely to continue to rise as a result of this strategy which may exert upward pressure on UK bond yields going forward.

- **Eurozone**

The ECB cutting its main rate to -0.4% and embarking on a massive programme of QE led to improved growth in 2017. Inflation still remains weak however. It is therefore unlikely it will raise its central rate until 2019.

2.10.3. A more detailed view of the current economic outlook is contained within **Appendix D** to this report.

2.10.4. 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 2018/2019 but to be on a gently rising trend over the next few years.
- Borrowing interest rates increased sharply in June 2017 and again in September 2017 in reaction to the election and market expectations of Base Rate increases. Since this time rates have eased back and remained fairly flat since. With higher borrowing costs expected in years to come, internal borrowing strategies need to be monitored carefully to avoid having to take external borrowing when costs are higher.
- 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.

2.11. Long Term Borrowing Strategy 2018/2019

2.11.1. 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 2018/19 by around 0.20% to 0.30% starting from current levels of 1.90% to 2.80%. At the time of writing suggested target rates for taking borrowing show are as follows:

Period	Target Rate
50 Years	2.60%
25 Years	2.90%
10 Years	2.20%
5 Years	1.60%

- The Council's Long Term Borrowing Maturity Profile as at 1st March 2018 can be seen as Appendix E. It shows actual maturities and also possible maturities from the LOBO debt taken. Gaps in the maturity profile are between 12 years and 35 years, then after 43 years. Any new borrowing taken should focus on these lengths at prevailing rates of interest.

- Market loans and LOBO[5] 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.

2.11.2. Given the factors detailed above, the following **borrowing strategy** will be adopted for 2018/19:

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 above.

2.11.3. 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.

[5] 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.

2.12. Investment Strategy 2018/2019

2.12.1. Bank Rate is forecast to increase once to 0.75% from 0.50% by the end of 2018/2019. The risk to this forecast is also weighted towards the downside, given the uncertainty over the final terms of Brexit.

2.12.2. The Council's investment priorities are:

- **the security of capital and**
- **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.

2.12.3. 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.

Interest Rate Exposure -Investments

2.12.4. As a general guide, term deposits are usually at a fixed rate of interest, whereas amounts invested on call (to maintain sufficient liquidity in the investment portfolio) are usually at variable rates of interest. Fixed investments of up to 2 years are considered acceptable to good quality counterparties, limits permitting, where above market rates are achievable and sufficient liquidity is available, as a way of enhancing investment return. In a forecast rising interest rate scenario, fixed deposits should be pegged to coincide with the forecast increase periods at market levels. There are no upper limits set to variable rate investments.

Liquidity

2.12.5. Liquidity is defined as having adequate, but not excessive cash resources, borrowing arrangements and overdraft or standby facilities to ensure that funds are available, at all times, for the achievement of the Council's objectives. In this respect, the Council will seek to maintain liquid short-term deposits of at least **£25m** available within a week's notice.

2.12.6. The Council's investment level is forecast to be around £200 million net of Pension Fund cash in 2018/19, of which around £100 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.

Performance

2.12.7. The target investment return for investments for 2018/19 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 2017 was 0.22%.

2.12.8. The investment performance will also be compared against benchmarking data provided by both CIPFA and Link Asset Services.

Investment Strategy

2.12.9. Given these factors above, the following **investment strategy** will be adopted for 2018/19:

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 and forecast to rise, 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.

Investment in Certificates of Deposit[7], Treasury/LA Bills[8], Dated

[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.

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.

2.12.10. 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.

2.13. Short Term (Cash Flow) Borrowing Strategy 2018/2019

2.13.1. During 2018/2019, 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.

2.14. Other Current Treasury Issues

2.14.1. Money Market Funds (MMFs)

The Money Market Fund Regulation was published in June 2017, proposing reform to the current structure of MMFs in Europe. This reform will apply to **new funds** with effect from **21st July 2018** and to **existing funds by no later than 21st January 2019.**

Two types of MMF will be formed:

- **Short Term MMFs**- Short term funds that follow a maximum Weighted Average Maturity (WAM) of 60 days and a maximum Weighted Average Life (WAL) of 120 days.

[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.

- **Standard MMFs** – Longer dated funds that follow a WAM of 6 months and a maximum WAL of one year.

Three structural options will be formed:

- **Public Debt Constant Net Asset Value (CNAV) MMFs** –must invest 99.5% of assets into government instruments or cash.
- **Low Volatility Net Asset Value (LVNAV) MMFs** – permitted to maintain a constant dealing NAV provided that certain criteria is met.
- **Variable Net Asset Value (VNAV)** – Funds which price their assets using market pricing and therefore offer a fluctuation dealing NAV.

The Council will use **CNAV** and **LVNAV** Short Term MMFs with an **AAA** credit Rating that are denominated in Sterling and regulated within the EU. **VNAV** MMFs will not be used at the current time.

2.14.2. Markets in Financial Instruments Directive (MiFID II)

Under new banking regulations (referred to as MiFID II) which took effect from 3rd January 2018, all Councils are classified as retail counterparties in the market and will have to consider whether to opt up to professional status if meeting various qualitative and quantitative criteria set by the industry. The Council has met these criteria and has opted up to professional status where necessary with all its market participants to enable it to continue to invest in accordance with its Investments Strategy.

2.14.3. Accounting Arrangement for Financial Instruments –IFRS 9

International Financial Reporting Standard 9 (IFRS9) introduces new accounting arrangements for financial instruments from 1st April 2018. Some of the changes have the potential to impact on the Council's General Fund, particularly the requirement to charge movements in the fair value of certain financial instruments to the Revenue account, and to take a more forward looking approach to impairment losses. To ensure that the Council is protected from any adverse revenue impacts which may arise from complying with the new requirements, the accounting implications of new transactions will be carefully assessed before they are undertaken.

2.14.4. Long Term Borrowing – School Loans Scheme 2018/19

Long Term Borrowing from the PWLB on behalf of schools as part of the schools loan scheme will be undertaken throughout 2018/2019 as and when required and on terms requested by schools.

2.14.5. Policy on the Use of External Service Providers

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

The Council recognises that responsibility for treasury management decisions remains with the Council 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.

2.14.6. 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 2018/2019

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 2018/2019 detailed below. (Note this Annual Investment Strategy applies to the Councils treasury related investments only. The investment strategy dealing with non-treasury related investments will be included in the Capital Strategy 2018/19 which will be considered later in the year).

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.

3.3. The Council's surplus funds will be invested in 2018/19 according to the Secretary of State's definition of **Specified** and **Non-Specified investment** categories as detailed below.

Characteristics/Type	Counterparty Categories
Specified Investments	
Sterling deposits. Up to and including one year. Offering high security / high yield. Fixed, callable or forward term deposits as appropriate[11], Certificates of Deposit, Treasury/ Local Authority Bills, Dated Bonds and Repo.	UK Government/ Supranational/ Multilateral Development Banks. Local Authorities. Bodies or Investment Schemes meeting the Councils **minimum acceptable credit rating criteria for Specified Investments** (Includes Banks, Building Societies, Corporates, and Money Market Funds).
Characteristics/Type	**Counterparty Categories**
Non-Specified Investments	
Sterling deposits. Period greater than 12 months up to a maximum of 2 years. Higher risk than Specified Investments. Fixed, callable or forward term deposits as appropriate, Certificates of Deposit, Treasury/ Local Authority Bills, Dated Bonds and Repo.	UK Government/ Supranational/ Multilateral Development Banks. Local Authorities. Bodies or Investment Schemes meeting the Councils **minimum acceptable credit rating criteria for Non-Specified Investments** (Includes Banks, Building Societies, and Corporates).

3.4. For assessing its minimum acceptable credit rating criteria for both its specified and non-specified investments it uses the creditworthiness service provided by Link 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

[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.

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.
- Credit default swap (CDS) spreads to give early warning of likely changes in credit ratings.

3.5. 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

3.6. **Appendix F** details the definitions of Sovereign & Long Term Credit Ratings, Credit Default Swaps, Credit Watches and outlooks and MMF ratings.

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

3.7. 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 Link's creditworthiness policy and will allows greater depth and diversification to the Council's Counterparty list, while still maintaining the tenets of security and liquidity.

**Barclays Bank plc
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 Link's recommended Counterparty list.

*** Nationalised or semi nationalised UK Banks:-
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 were 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.

3.8. **Appendix G** summarises the duration and amount limits set for both the specified and non-specified investments based on the credit methodology outlined above. 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 derived from this criteria.

3.9. 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 Link 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.

3.10. 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. However sole reliance will not be placed on the use of this external service. In addition, this Council will also use market data and other market information, from various sources such as the internet, portals, brokers, government, CIPFA etc.

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

3.11. 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, as shown in Appendix A. This limit reflects a prudent proportion of the Council's estimated level of core cash balances available to invest for longer periods. The Executive Councillor with responsibility for Finance will be informed on any occasion when investments are lent for over 12 months.

Additions to Non-Specified Investment List

3.12. 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, Link 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.

Liquidity of Investments

3.13. 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.

Training Needs for Treasury Management Staff / Members with Responsibility for Treasury Management

3.14. 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 and it is the responsibility of the S151 Officer to implement the necessary arrangements to ensure this takes place.

3.15. 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.

3.16. All treasury management staff are encouraged to take any suitable training in treasury management provided by CIPFA, Link 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).

3.17. The Section 151 Officer will ensure that elected members tasked with treasury management responsibilities, including those responsible for scrutiny have access to training relevant to their needs and those responsibilities.

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 2018/19 in light of the anticipated economic environment and movement of interest rates for the year ahead. These strategies reflect the new requirements of the CIPFA Code recently published in 2017, including making reference to the new Capital Strategy required for 2018/2019.

3. Appendices

These are listed below and attached at the back of the report	
Appendix A	Prudential Indicator Table 2016/17 to 2020/21
Appendix B	Revenue Provision for the Repayment of Debt Policy (Minimum Revenue Provision)
Appendix C	Interest Rate Forecasts 2018-2021
Appendix D	Economic Background -Link Asset Services Ltd
Appendix E	Long Term Borrowing Maturity Profile at 01.03.2018
Appendix F	Definition of Credit Ratings and Credit Default Swap Spreads
Appendix G	Duration, Limits & Minimum Credit Criteria

4. Background Papers

Document title	Where the document can be viewed
Council Budget 2018/19 - 23rd February 2018	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