Local Members Interest
N/A

Cabinet – 30 January 2019

Treasury Management Strategy 2019/20

Recommendations of the Cabinet Member for Finance

Report of the Deputy Director of Finance (S151) and Director of Corporate Services

1. That Cabinet approve the 2019/20 Treasury Management Strategy, based on the revised 2017 CIPFA Codes (Prudential Code and Treasury Management Code), and revised 2018 MHCLG Guidance (on Local Government Investments and on Minimum Revenue Provision).

2. That, in accordance with the regulations, Cabinet recommends to the County Council, at its meeting on the 14 February 2019, the adoption of the Annual Investment Strategy (AIS) 2019/20 detailed in **paragraphs 65 to 113,** and **Appendix 2** and **Appendix 3** of this report.

3. That Cabinet approve policies on:

   a) reviewing the strategy;
   b) the use of external advisors;
   c) investment management training; and
   d) the use of financial derivatives.

   as described in **paragraphs 114 to 123** of this report.

4. That the Cabinet approve the proposed borrowing strategy for the 2019/20 financial year comprising:

   a) maximising the use of cash in lieu of borrowing as far as is practical;
   b) the ability to borrow new long-term loans where deemed appropriate;
   c) the use of cash to repay loans early, subject to market conditions; and
   d) a loan rescheduling strategy that is unlimited where this re-balances risk.

5. All the above to operate within the prudential limits set out in **Appendix 4** and to report to the Cabinet Member for Finance with respect to decisions made for raising new long-term loans, early loan repayment and loan rescheduling.

Introduction

6. Treasury management comprises the management of the County Council's cash flows, borrowings and investments, and their associated risks. The County Council is exposed to financial risks, including the effects on revenue from changing interest rates on borrowings and investments, and the risks of a potential loss of invested funds. Therefore it is essential that the County Council successfully identifies, monitors and controls financial risk as part of prudent financial management.

7. The County Council conducts its treasury risk management within the framework of the Chartered Institute of Public Finance and Accountancy's (CIPFA) revised *Treasury Management in the Public Services Code of Practice* (the CIPFA Code), published in December 2017. The CIPFA Code requires that the County Council approves a treasury management strategy before the start of each financial year. In addition, this report fulfils the County Council's legal obligation to have regard to the CIPFA Code under the *Local Government Act 2003.*

8. Any investments held for service purposes or for commercial profit i.e. the Council's non-treasury investments, are considered in a separate report. This (Non-Treasury) Commercial Investment Strategy 2019/20 report meets the requirements of the statutory guidance issued by the Ministry of Housing, Communities and Local Government's (MHCLG) in its revised *Guidance on Local Government Investments* published in February 2018.

Link to the Medium Term Financial Strategy (MTFS)

9. It is a statutory requirement under Section 33 of the Local Government Finance Act 1992 for the County Council to produce a balanced budget. In particular, Section 32 requires the calculation of a budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. Capital expenditure must not exceed an amount which can be afforded, in terms of interest charges and running costs for the foreseeable future.

10. The Local Government Act 2003 requires a local authority to have regard to the Prudential Code and to set Prudential Indicators for the next three years to ensure that its capital investment plans are affordable, prudent and sustainable. The Prudential Indicators are approved as part of the Medium Term Financial Strategy (MTFS), but the treasury indicators are included in this report as they require consideration as part of the Treasury Management Strategy.

11. The Treasury Management Strategy is a key element of the MTFS as the planned capital expenditure programme drives the borrowing required. This is explained further in the Borrowing Strategy from **paragraph 42** onwards.

External Context

Economic background

12. The UK's progress in negotiating an exit from the European Union (EU), together with any future trading arrangements, will continue to be a major influence on the County Council's treasury management strategy for 2019/20. The Office for Budget Responsibility (OBR), the government's independent official forecaster, warned of the risks of the UK economy going into recession if a Brexit deal is not negotiated with the EU.

13. However, the OBR's current UK growth forecasts are based on achieving an orderly withdrawal process; in October 2018, it predicted that the UK economy will grow by 1.6% in 2019, an improvement on the 1.3% it had projected in March 2019. The improved forecasts coincided with October's autumn budget statement that saw Chancellor Philip Hammond announce a fiscal giveaway of close to £15 billion for 2019.

14. In August 2018, expectations for inflation caused the Bank of England's Monetary Policy Committee (MPC) to vote unanimously for a rate rise of 0.25%, taking Bank Rate to 0.75%. UK Consumer Price Inflation did fall back to 2.4% in September 2018 from 2.7% in August, although higher import and energy prices continued to hold inflation above the BoE target of 2%. The November Inflation Report showed that further interest rate increases may be required to bring inflation down to the 2% target over the forecast horizon.

15. The US economy has continued to perform well, and the Federal Reserve has maintained its monetary tightening stance and pushed up its target range for the Fed Funds Rate in December 2018 by 0.25% to 2.25% - 2.5%. It is expected that there will be a further two rises in 2019. However, there is a risk that the US-China trade war, combined with a continued tightening of monetary policy, may contribute to a slowdown in global economic activity in 2019.

16. Although Europe experienced slower growth in 2018, the European Central Bank has started conditioning markets for the end of quantitative easing as well as the timing of the first interest rate hike. This is currently expected in 2019, with the timing and magnitude of further rate increases thereafter.

Credit outlook

17. The Bank Recovery and Resolution Directive (BRRD) from 2015 introduced a significant risk for local authorities. Under these rules, a failing bank will need to be 'bailed-in' by current investors instead of a 'bail out' by government. The risk of loss for local authorities in a bail-in situation is much greater, as any unsecured fixed-term deposits would be ranked near the bottom of the capital structure and would be one of the first to suffer losses.

18. As the risk under bail-in regulations has increased, the County Council will continue to follow the advice of Arlingclose. The full creditworthiness approach is outlined from **paragraph 104**.

19. Ring-fencing legislation adopted by UK financial regulators required the larger UK banks to separate their core retail banking activity from the rest of their business i.e. investment banking. The aim is to protect retail banking activity from unrelated risks elsewhere in the banking group, as occurred during the

global financial crisis. The big four UK banking groups - Barclays, HSBC, Lloyds and NatWest/Royal Bank of Scotland - have now divided their retail and investment banking divisions into separate legal entities. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.

20. In November 2018, the Bank of England released the results of its latest stress tests on seven of the UK's largest banks and building societies. The Bank believe that the tests showed that the UK banking system is resilient to deep recessions that are more severe than the recent global financial crisis. The Bank did not require any bank to raise additional capital.

21. European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading there. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be high if ever needed. The uncertainty caused by the protracted negotiations between the UK and EU is weighing on the creditworthiness for UK and European banks with substantial operations in both jurisdictions.

Interest rate forecast

22. In terms of treasury management, the Bank Rate is fundamental to the income received and it may also affect expenditure on loan interest where new loans are taken out or variable rate loans are held.

23. The County Council's treasury management adviser Arlingclose is forecasting two more Bank Rate hikes of 0.25% during 2019, to take official UK interest rates to 1.25%. The Bank of England's MPC continues to have a bias towards tighter monetary policy although it is has maintained further rate rises would be gradual and to a limited extent. Arlingclose believes that MPC members consider cutting Bank Rate from a higher level would be a more effective policy if some of the Brexit risks transpire.

24. The UK economic environment remains uncertain, primarily because the economy faces a challenging outlook as it exits the EU. At the time of writing, Prime Minister May had reached an agreement with the EU on transition and on future relations, that had been backed by her Cabinet. However, the deal had still to be approved by UK parliament with the possibility of a "no deal" Brexit still hanging over economic activity. As such, the risks to the interest rate forecast are considered firmly to the downside.

25. Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on the interest rate projections, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.5% and 2% respectively over the interest rate forecast horizon, however volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.

26. Due to the risks of financial market volatility, the treasury strategy retains the low risk approach adopted in recent years, based on prioritising security, liquidity and then yield.

Local Context

27. On 31 December 2018, the County Council held £482.7m of external borrowing and £115.4m of investments. The County Council's future requirements for borrowing and investments can be considered by reviewing its balance sheet forecasts.

Balance sheet

28. In terms of borrowing, the County Council discloses its Capital Financing Requirement (CFR) as part of its Statement of Accounts. This represents the underlying need to borrow for capital purposes i.e. the amounts that have been financed through external and internal borrowing rather than being permanently financed. As the CFR also includes capital expenditure that has been funded through Private Finance Initiatives (PFI), we remove PFI liabilities to calculate the County Council's Loans CFR.

29. If the Council borrows to fund additional capital expenditure, this will increase its Loans CFR; conversely repaying debt through the Minimum Revenue Provision (MRP) will reduce its Loans CFR. The table below shows forecasts for the County Council's Loans CFR and how this will be financed through external and internal borrowing:

	31.03.18 Actual £m	31.03.19 Estimate £m	31.03.20 Forecast £m	31.03.21 Forecast £m	31.03.22 Forecast £m
Loans CFR	574.9	590.9	587.0	567.5	547.3
Less: External borrowing	(482.7)	(467.7)	(467.6)	(467.6)	(463.6)
Internal / (over) borrowing	**92.2**	**123.2**	**119.4**	**99.9**	**83.7**

30. The table shows that the County Council's Loans CFR is due to decrease from 2019/20 primarily because of a substantially reduced capital programme in future years alongside repayments of external borrowing as they mature. The County Council's internal borrowing requirements move in line with the Loans CFR projections.

31. CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the County Council's total external borrowing should be lower than its highest forecast CFR over the next three years; the above table shows the County Council will comply with this recommendation during 2019/20 and going forward.

32. For investments, the County Council's total resources available are measured by its usable reserves and working capital less any amounts that have been internally borrowed. This is shown in the following table:

	31.03.18 Actual £m	31.03.19 Estimate £m	31.03.20 Forecast £m	31.03.21 Forecast £m	31.03.22 Forecast £m
Usable reserves	122.0	112.4	120.4	116.2	112.2
Working capital surplus*	18.6	0	0	0	0
Less Internal borrowing	(92.2)	(123.2)	(119.4)	(99.9)	(83.7)
Investments/ (New borrowing)	**48.4**	**(10.8)**	**1.0**	**16.3**	**28.5**

*the end of year working capital balance can fluctuate so the prudent assumption has been made to make this zero going forward

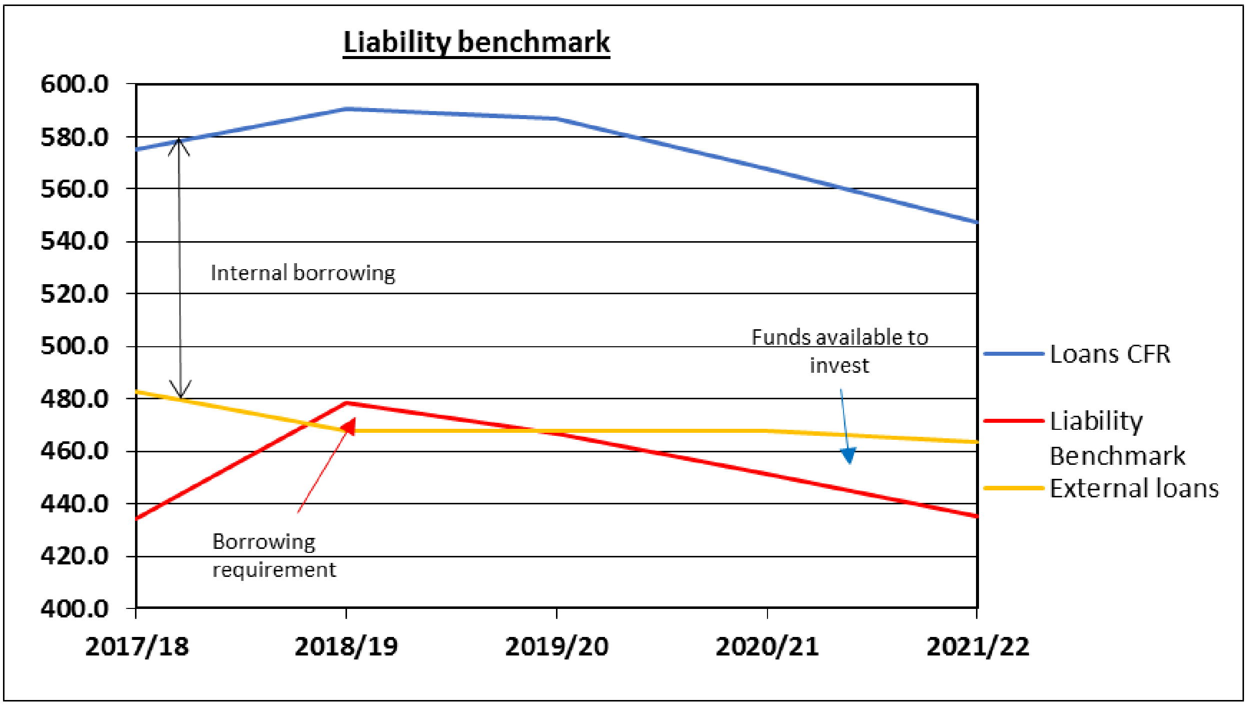
33. This demonstrates the County Council's recent strategy in using internal borrowing to reduce external borrowing and investment levels. The above table also indicates that the County Council may not have sufficient internal resources to cover the internal borrowing requirement in 2018/19 and may need to borrow temporarily from external sources. However, the internal borrowing requirements fall from 2019/20 onwards, meaning the County Council will have increasing investment balances in future years.

Liability benchmark

34. The CIPFA Prudential Code encourages local authorities to develop their own liability benchmark to manage treasury management risk. The liability benchmark represents the minimum amount of loans required to maintain cash balances at nil i.e. when all usable reserves and working capital surpluses are used to offset the amount of loans borrowed.

35. Forecasts for the liability benchmark can be used to predict when further borrowing may be required or when cash is available to invest. Forecasts for the County Council's liability benchmark is shown in the following table and chart:

	31.03.18 Actual £m	31.03.19 Estimate £m	31.03.20 Forecast £m	31.03.21 Forecast £m	31.03.22 Forecast £m
Loans CFR	574.9	590.9	587.0	567.5	547.3
Less: Usable reserves	(122.0)	(112.4)	(120.4)	(116.2)	(112.2)
Less: Working capital surplus	(18.6)	0	0	0	0
Liability benchmark	**434.3**	**478.5**	**466.6**	**451.3**	**435.1**



36. The chart shows that the County Councils Loans CFR (blue line) has been financed through a combination of external borrowing (yellow line) and internal borrowing (the difference between the yellow line and the blue line).

37. The chart indicates that by the end of 2018/19, the County Council's level of external loans will fall below the minimum required by the liability benchmark. This supports the analysis made in **paragraph 33,** that the County Council will need to borrow externally as it does not have sufficient usable reserves and working capital to cover the amounts required internally.

38. However, the borrowing requirement is considered to be temporary as the liability benchmark falls below the external loans level in 2019/20 and continues to fall in future years as the capital programme decreases and cash balances increase. This implies that the shortfall in 2018/19 can be covered through short term borrowing and that the County Council will have funds available to invest from 2019/20 onwards. Further information on the duration of borrowing is provided from **paragraph 42** onwards.

Policy framework

39. When assessing the various options for borrowing and investment it is still important to have a policy framework. The table that follows sets out three main elements.
- Objectives
- Economic considerations
- Relevant risks

40. The table compares borrowing and investments side by side to highlight the similarities and differences. For example, some of the economic considerations (i.e. the yield curve) are similar, whilst some aspects are different.

	Borrowing strategy	Investment strategy
Objectives	• Reduce the average rate (cost) of debt ensuring debt is affordable • Maintain medium term budget stability • Be able to respond to changes in the external environment	• Ensure security (to ensure bills can be paid) • Provide liquidity (i.e. to pay the bills as they fall due) • Earn interest
Economic considerations	• The shape of the whole yield curve* (the level of interest rates for different lengths of time) • The steepness of the yield curve • Forecast changes in interest rates • The relative position of interest rates to the average cost of the debt • The direction of travel for the level of overall debt in the future • Cash balances available to support the strategy	• The shape of the short-term yield curve* • Forecast changes in interest rates • Counterparty issues (credit worthiness) • Type of financial instrument • Risk in the financial environment
Relevant risks	• Security • Liquidity • Interest rate • Market risk • Refinancing • Regulatory and legal	• Security • Liquidity • Interest rate • Market risk • Refinancing • Regulatory and legal

*The yield curve is a fundamental concept; it represents the price paid by the County Council for its long-term loans or the price received for the money it invests.

41. The County Council's risk management for treasury borrowing and investments are part of a separate risk register that is currently being worked on.

Borrowing Strategy 2019/20

42. In 2019/20, the County Council will hold £467.7m of loans as part of its strategy for funding previous years capital programmes. The County Council would need to ensure total amounts borrowed does not exceed the authorised limit for borrowing of £881 million, as disclosed in **Appendix 4** and as part of the capital strategy.

Objectives

43. The primary objective for the County Council when considering borrowing money is to strike an appropriate balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. Although relatively low interest costs may be secured for the short term, it is more difficult to predict interest costs over the long term.

Strategy

44. Given the significant cuts to public services and to local government funding, the County Council continues to address the key issue of affordability without compromising the long-term stability of its debt portfolio. As short-term interest rates have been lower than long term rates, it has been more cost effective for the County Council to use its internal resources in lieu of borrowing in the short term.

45. The current economic environment continues to favour using cash in lieu of borrowing:
- There is a normal yield curve, so it is cheaper to use cash than to borrow.
- Due to bail-in legislation it is important to minimise investment risk as using cash reduces investment balances.
- Using cash within practical cash management limits would meet key parts of the current government guidance on local government investments i.e. managing the security and liquidity risks for investments.
- Interest rate forecasts shows the Bank Rate is still at a relatively low level and it is expected to remain well below the average debt rate for the next year and beyond. Continuing to use cash would meet the objective of bringing down the average rate of interest for borrowing and provide an opportunity to fund the capital programme at low cost.
- The medium/long term debt levels are forecast to fall.

46. In the past, cash balances have been sufficient to allow the strategy of using cash without the need to take further external loans, and the liability benchmark analysis at **paragraph 35** indicates that this will continue from 2019/20 onwards.

47. The County Council does recognise that there may be unexpected reductions in cash balances in the future. This could be due to:
- increases in the capital programme;
- budget pressures;
- changes in the County Council's cash funding because of structural changes; or
- LOBO loan call options being called.

48. Where additional liquidity is needed, the County Council can call upon short-term temporary loans raised from the money markets, including from other local authorities with surplus cash to invest. The County Council can also obtain long term loans of over one year, for example through the PWLB.

49. It is important to understand that when raising loans, not all of the funding gap needs to be closed with the new loans. A gap should be retained that continues to use available cash for the reasons outlined at **paragraph 45**. The proposed strategy aims to strike a balance between the liquidity needs of day to day cash management with the low risk approach that is maintained by using cash.

50. The County Council will monitor the benefits of internal borrowing on a regular basis as this strategy must be balanced against the possibility that long term borrowing costs may increase in future years, leading to additional costs incurred in deferring borrowing. The County Council will need to determine whether it borrows additional sums at long term fixed rates in 2019/20 with a view to keeping future interest costs low. To this end, the County Council will

use advice and analysis carried out by its treasury management advisor, Arlingclose.

Sources of borrowing

51. The approved sources of long term and short-term borrowing are:
- Public Works Loans Board (PWLB) and any successor body
- UK Municipal Bonds Agency Plc and any other special purpose companies created to enable local authority bond issues
- Other UK public sector bodies
- UK public pension funds (except the Staffordshire Pension Fund)
- Approved banks or building societies authorised to operate in the UK
- Any institutions approved for investments.

Long term loans

52. The County Council has previously raised the majority of its long term borrowing from the PWLB, a statutory body that issues loans to local authorities. Government consent is not required hence the PWLB continues to be the ‘lender of first resort’ because of the flexibility and ease of access. However local authorities are required by law to have regard to the Prudential Code and only borrow within relevant legislation and its borrowing powers.

53. In November 2016 the Government announced plans to transfer the powers of the PWLB to the Treasury. It is important to note that the reforms have had no real effect on the County Council’s existing PWLB loans or on local authority lending policy from Central Government.

54. The County Council currently holds £51m of long term borrowing in the form of LOBO (Lender’s Option Borrower’s Option) loans. The lender has the option to propose an increase in the interest rate at set dates, following which the County Council has the option to either accept the new rate or to repay the loan at no additional cost. £33m of these LOBO loans have such call options during 2019/20. Although the County Council understands that lenders are unlikely to exercise their options in the current low interest rate environment, there does remain an element of refinancing risk.

55. Under the current strategy the County Council will repay all LOBO loans where call options are exercised by the lender. In addition, the County Council will consider repaying LOBO loans where a loan restructuring opportunity becomes available and is considered financially advantageous (see **paragraph 60**).

56. Where the County Council is considering taking out long-term loans, the following observations are important.
- The County Council’s existing loan portfolio is very long-term as can be seen in the graph at **Appendix 5.** Taking shorter term loans would rebalance the portfolio.
- As stated already, the yield curve is normal, so shorter term loans are relatively cheaper.
- PWLB interest rates are higher than they were historically (see **paragraph 61**).

57. There are a number of sources for long term loans but the PWLB will continue to be the main option for the County Council. The decision to borrow long-term

will be taken by the Treasury Management Panel, chaired by the Deputy Director of Finance (S151), and reported to the Cabinet Member for Finance. This is because the optimum timing cannot be foreseen, and a decision often needs to be taken at short notice. Members will be kept informed via the outturn and half-year treasury management reports.

<u>Short term loans</u>

58. Short-term loans raised from money markets are typically under 6 months duration. These are low cost and the County Council can respond flexibly to liquidity pressures by raising these when needed. The disadvantage of short-term loans is one of availability and it can be difficult to raise them quickly from banks and building societies.

59. The local authority lending market has progressed considerably in recent years and funds are generally available in the short to medium term. However future availability cannot be predicted as loans raised depend upon other local authorities still having cash balances and being prepared to lend it to the County Council.

Loan restructuring

60. Movements in interest rates over time may provide opportunities to restructure the loan portfolio in one of two ways.
    - Replace existing loans with new loans at a lower rate (known as loan rescheduling).
    - Repay loans early without replacing the loans, although this would increase the use of cash.

61. In current market conditions, loan restructuring would be very expensive and unattractive for the County Council. This is because:
    - Gilt yields are still historically low. This would lead to large penalties to compensate the PWLB or its successor body if loans were repaid early; and
    - new loans are more expensive than in the past even though Gilt yields are so low. Since 2010 the Government has increased the margin on top of Gilts at which it onward lends to local government via the PWLB (the margin is now 1.00% but can be reduced by 0.20% if the PWLB Certainty Rate is applied).

62. The County Council's ability to adjust its loan portfolio through restructuring is only possible if:
    - the Government allow it; PWLB rules have been changed in the past with no notice; or
    - market conditions allow economic repayment.

63. In 2017/18, the County Council repaid £30.5m of its LOBO loans, funded through a combination of using available cash and raising shorter term PWLB loans. The LOBO loans restructure became financially feasible for the Council as the counterparty was actively looking to remove LOBO loans from its balance sheet and so was willing to significantly reduce the repayment penalty. Changes are being made to accounting standards and capital adequacy

regulations which means it may be costlier for banks to retain LOBO loans on their books.

64. As market conditions and regulations do change, it is proposed to allow loan restructuring. The decision will be delegated to the Treasury Management Panel, chaired by the Deputy Director of Finance (S151), and reported to the Cabinet Member for Finance.

Annual Investment Strategy (AIS) 2019/20

65. It is the Council's borrowing strategy that determines its investment strategy as implied in **paragraph 45**. The current economic environment of relatively low interest rates favours the use of cash instead of borrowing, hence balances available for investments are likely to be less.

66. Nevertheless, the County Council will hold significant invested funds at different points of the year; this usually represents income received in advance of expenditure plus balances and reserves held. In the past 12 months, the County Council's investment balance has ranged between £53.1 million and £171.1 million, and it will continue to hold some investment balances in the forthcoming year.

<u>Brexit risks</u>

67. In the UK's exit from the EU, there are substantial issues that remain unresolved, meaning that a number of potential outcomes still exist. One of the more critical outcomes for the UK economy would be a no-deal Brexit and the County Council has considered the possible repercussions of this in the context of its treasury risk management. In this respect, the County Council will continue to seek advice from its treasury management advisor, Arlingclose.

68. The Bank of England stress tests outlined at **paragraph 20** indicate the strongest UK banks can withstand a no-deal Brexit scenario. Arlingclose remain comfortable with banks used by money market funds (MMFs) for their underlying investments. Meanwhile investments held with central and local government are less exposed to such credit risk. Despite these assurances, a high-risk scenario is still a possibility in which case the County Council propose to use their account with central government's Debt Management Office (DMO), for any short-term investment needs.

69. The liquidity of funds from banks and MMFs domiciled outside the UK could be affected by unforeseen regulatory issues from a no-deal Brexit position. In this instance the County Council proposes not to hold the entirety of their liquid funds outside of the UK over the Brexit period.

<u>MiFID II</u>

70. Following the introduction of the second Markets in Financial Instruments Directive (MiFID II) regulations from January 2018, local authorities will automatically be treated as retail clients by financial services firms, unless they meet the criteria and 'opt up' to be professional clients. As a retail client, the County Council would receive enhanced protections, but this would also mean it may face increased costs and restricted access to certain products including money market funds, pooled funds, treasury bills and treasury advice.

71. The County Council meets the criteria set out under MiFID II and will continue to be treated as a professional client by regulated financial services firms in 2019/20.

Objectives

72. The CIPFA Code requires the local authorities to invest their funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield.

73. The County Council's objective when investing its money is to strike an appropriate balance between risk and return, thereby minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the County Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, to maintain the spending power of the sum invested.

Strategy

74. The main characteristics which can determine an investment strategy are:
- the credit risk of the counterparties invested with;
- the length of the investment; and
- the type of financial instrument that is used.

75. The County Council has taken a low risk approach to investment and the AIS for 2019/20 will continue in this vein. Short term unsecured bank investments have generally provided very low returns with the increasing risk from bail-in regulations (see **paragraph 17**). The County Council will continue to concentrate its short-term investments in more secure money market funds and government investments.

76. MHCLG Guidance on Local Government Investments specify the types of financial instruments that local authorities can invest in and the County Council has divided its approved investments into Standard Investments and Non-standard Investments.

Standard Investments

77. The County Council consider Standard Investments to be those made with approved counterparties that do not require further approval from the Treasury Management Panel or members. These investments tend to be for a period of less than a year and are those most frequently used by the County Council. Standard Investments can be invested with:
- UK Government – central government or local authority, parish council or community council
- short term money market funds (MMFs) recommended by the County Council's treasury advisor, Arlingclose.
- bank and building society investments recommended by the County Council's treasury advisor, Arlingclose

i) Government

78. The County Council invests with central government by using its Debt Management Account Deposit Facility (DMADF) account or by purchasing treasury bills. Funds held in the DMADF account are backed by the UK government so they are very secure; however returns tend to be lower than that received elsewhere.

79. The County Council invests in term deposits with local authorities which can provide a higher return depending on the availability of funds in the local authority lending market. Like central government investments, local government investments are not subject to bail in risk.

80. Although investments in the local authority lending market have a very low risk of insolvency, they are not completely without risk. The financial risks of a few local authorities have been documented in the press; the County Council will continue to monitor such developments and seek advice from Arlingclose where necessary.

ii) Money Market Funds (MMFs)

81. Money Market Funds have high credit quality and are pooled investment vehicles consisting of money market deposits and similar instruments. Short-term MMFs that offer same day liquidity can be used as an alternative to instant access bank accounts . Same day notice MMFs have been used by the County Council for some time as they have tended to provide greater security and a higher yield than bank accounts.

82. New EU regulations for MMFs have meant that existing funds will need to be compliant by January 2019. It is expected that most same day notice MMFs will convert from a Constant Net Asset Value (CNAV) to a Low Volatility Net Asset Value (LVNAV) structure.

83. The assets of LVNAV MMFs are marked to market, meaning the dealing NAV (unit price) may fluctuate. However, the new regulations confirm they will be allowed to maintain a constant dealing NAV provided they meet strict new criteria and minimum liquidity requirements. Public debt CNAV MMFs will still be available where 99.5% of assets are invested in government debt instruments.

84. The County Council will continue to consider same day notice MMFs for investment. MMFs that meet the criteria listed below will be considered to have sufficient high credit quality and be included on the County Council's Approved Lending List:

- Recommended by the County Council's treasury adviser, Arlingclose.
- Diversified – MMFs invest across many different investments meaning they achieve more diversification than the County Council could achieve on its own account.
- Short liquidity – cash can be accessed daily.
- Ring-fenced assets – the investments are owned by investors and not the fund management company.
- Custodian – the investments are managed by an independent bank known as a custodian, who operates at arms-length from the fund management company.

85. Like all treasury instruments, MMFs do carry an element of risk:

- The failure of one or more of an MMFs investments could lead to a run on MMFs, especially during a financial crisis, although the new MMF regulations do limit this risk to some extent.
- If the UK enters a recession, there is a possibility that the Bank Rate could be set to near or below zero. This could mean interest earned from MMFs could become negative after the deduction of their fee. In this instance, the County Council could move funds to an alternative category of investment.

iii) Bank and building society accounts

86. The County Council can make investments with approved banks and building societies by using call accounts, term deposits or certificates of deposits. Certificates of Deposit (CD's) are similar to fixed term deposits but a certificate is issued for a specified length of time and rate of interest, and can be sold in the secondary market if needed.

87. Investments held with banks and building societies run the risk of credit loss via a bail in, if the regulator determines that the bank is failing or likely to fail.

iv) Operational bank account

88. The County Council's banking provider is Lloyds Bank. Cash is retained with Lloyds Bank each night earning interest at a market rate; the amount retained will be set in line with the diversification policy set out at **paragraph 91** onwards.

89. In respect of the Bank ring-fencing legislation referred to in **paragraph 19**, Lloyds Bank has a relatively small investment banking operation meaning that 97% of the bank's assets remain within the 'retail' ring-fence. The County Council's business with Lloyds Bank will take place within the 'retail' ring-fence (Lloyds Bank Plc) and not form part of their investment banking operations (Lloyds Bank Corporate Markets).

90. Long term credit rating issued by the three major agencies indicate there have been upgrades for some ringfenced 'retail' banks and downgrades for some non-ringfenced 'investment' banks. Lloyds Bank Plc has seen a credit ratings upgrade; should the Lloyds credit rating fall, then small balances may be retained with the bank for operational efficiency. The County Council will continue to monitor Arlingclose's advice on bank credit risk and any changes will be determined by the Treasury Management Panel, chaired by the Deputy Director of Finance (S151).

Standard Investments diversification

91. Risks to investments, such as those discussed for MMFs in **paragraph 85**, point towards the fundamental need for diversification across counterparties and investment categories where possible. Diversification can help to protect the security of the investments by limiting the County Council's loss in the event of a counterparty default. However diversification will not protect the County Council from a systemic failure of the banking sector even if the risk of this has diminished following the bail-in banking regulations.

92. Diversification can be achieved by setting a maximum amount to be invested with each counterparty to limit risk and to ensure a spread of investments.

However this needs to consider that investment balances can change throughout the year. The limits shown below are based upon percentages of investments and the Treasury team will review and reset these limits at least once a month with reference to forecast future balances.

93. Investment diversification is proposed at two levels; firstly at investment category level:

Investment category	**Maximum % of total investments**
Government Investments	100%
Money Market Funds (MMF)	50%
Banks and Building Societies	50%

94. No limits are proposed for government investments as these may be utilised for all the County Council's investments in certain circumstances. MMFs investments may occasionally be as high as 100% when cash balances are low; this concedes that there may be no other investment available for small amounts when liquidity is necessary.

95. Secondly, diversification will also take place at investment counterparty level:

Banks and Building Societies Lower of:	
£m	Maximum investment as a proportion of total forecast cash balances
30	5% (unsecured) 10% (secured)

Individual MMF Lower of:	
Maximum investment as a share of the total size of the MMF	Maximum investment as a proportion of total forecast cash balances
0.50%	10%

96. Due to bail-in regulations, Arlingclose have recommended a limit of 10% of cash balances if investments are secured (e.g. covered bonds) and a limit of 5% if investments are unsecured (e.g. fixed term deposits).

97. It is proposed that the application of and any amendments to the investment diversification policy is delegated to the Treasury Management Panel, chaired by the Deputy Director of Finance (S151).

Non-standard Investments

98. The County Council considers Non-standard Investments as all other types of approved investment counterparties that are not included as part of Standard Investments i.e. those investments that are used less frequently and may require further approval from the Treasury Management Panel or members.

99. The Non-standard Investments proposed for use are listed below and do not present any additional security risk to the investments within Standard Investments:

i) Covered Bonds: issued by banks and building societies against mortgage assets they hold and are guaranteed by a separate group of companies. They are exempt from bail-in as their structure enables investors to have effective security over the mortgage assets, by being sold if needed.

ii) Repos (Repurchase Agreements): comprise the purchase of securities with the agreement to sell them back at a higher price in the future. Investments are exchanged for assets such as government bonds, which can be sold in the case of a loss.

iii) UK Government Gilts: similar to the DMADF account and Treasury Bills but are a longer-term investment that can be sold in the secondary market.

iv) Multilateral Development Bank Bonds: 'AAA' rated bonds created by institutions and backed by a group of countries. They can be sold in the secondary market if needed.

v) Collective Schemes: Examples include property and equity funds which have very different risk and return profiles to no notice MMF's. Enhanced MMF's are considered to be collective schemes; they typically have 3-5 day liquidity notice as they invest further along the yield curve. In 2016/17, the Treasury Management Panel approved a decision to invest in the Royal London Enhanced 'Cash Plus' MMF with a 3 day liquidity notice period.

100. Non-standard Investments that are subject to market risk (this is the risk that the value of the investment can go down as well as up) would usually be held until maturity. At maturity the investment and accrued interest would be paid in full. However some investments could be sold early if there were concerns over the borrower defaulting.

Non-Standard Investment diversification

101. Diversification of Non-standard Investments are equally important and the County Council has set the following investment amounts and duration limits, split into two groups (see **Appendix 2**).

- Long-term local authority loans and UK Government Gilts: these have a combined investment limit of £45m (up to 40 years duration) due to their similar high credit quality. The County Council has held £30m of long-term local authority investments since 2013.
- Other Non-standard Investments: these have an individual investment cap amount per asset class at £20m (up to 5 years duration) with an overall cap of £50m for this group.

102. This means a total of £95m can be invested in Non-standard Investments in 2019/20 and is reflected in **Appendix 4,** Prudential Indicator point 4. The decision to invest in Non-standard Investments will only be taken after due consideration by the Treasury Management Panel, chaired by the Deputy Director of Finance (S151) .

103. **Appendix 2** sets out the investment categories authorised for use in 2019/20 and **Appendix 3** lists the County Council's Lending List at the time of writing this report.

The Credit Management Strategy for 2019/20

104. Investments made by the County Council should be of 'high credit quality'. Although this can be difficult to define, credit ratings can be used as published by external credit rating agencies (the three main agencies are Moody's, Standard & Poors and Fitch). Credit ratings are monitored by and obtained from the County Council's treasury management adviser, Arlingclose, where available.

105. An important aspect of Arlingclose' service is the provision of credit advice. The treasury advisor provides information about suitable investments in the context of the current economic risk environment and incorporates the views of credit rating agencies. It is important to note that the County Council maintains the responsibility for the decisions it takes with its investments.

106. For 2019/20, the minimum credit-rating thresholds are set at a long-term rating of 'A- 'where available. Counterparties that are rated below this level are excluded. However credit ratings are not the only aspect of how creditworthiness is assessed by Arlingclose.

107. The following elements are also considered when considering creditworthiness:
- Potential government support.
- Credit Default Swap prices (CDS) (i.e. the cost of insuring against counterparty default).
- Share prices and bond yields.
- Balance sheet structure.
- Macro-economic factors.
- A subjective overlay, i.e. a judgement being made about whether the counterparty should be recommended or not.

108. Arlingclose will consider the above factors when determining their recommended investment counterparty list. Counterparties can be removed from this list based on changes to this information, so it is not solely based on credit rating changes.

109. The economic environment in the recent past has been very volatile, so Arlingclose have generally been cautious when providing advice. This has resulted in the use of investment counterparties with high quality credit characteristics, intended to insulate the County Council against further volatility.

110. Arlingclose will communicate credit rating changes and significant changes in other risk indicators to the Treasury team, together with any revisions to their recommendations. Such changes by Arlingclose are usually notified by e-mail, although in more urgent situations, this will be followed up by a telephone call.

111. As mentioned previously, the County Council remains responsible for its investment decisions. The Treasury Management Panel, chaired by the Deputy Director of Finance (S151) meet on a monthly basis and review any changes recommended by Arlingclose. In between these meetings, the Treasury team

may be required to make investment decisions at short notice upon the recommendation of Arlingclose. Where required, the Treasury team will implement these recommendations pending subsequent approval by the Treasury Management Panel, chaired by the Deputy Director of Finance (S151). On the rare occasion that Arlingclose do not make a firm recommendation, this will also be referred to the Panel for review.

112. Under stressed market conditions, additional Panel meetings may take place at very short notice after which the Panel may decide to adjust the County Council's investment risk profile. This may result in moving investments to lower risk counterparties or instruments.

Non-treasury investments

113. These are referred to as part of a separate investment strategy report titled '(Non-Treasury) Commercial Investment Strategy 2019/20'.

Review of strategy

114. The County Council will prepare a revised strategy when there are significant changes to the following factors:
- the economic environment;
- the financial risk environment;
- the budgetary position;
- the regulatory environment; or
- the appointment of a new treasury management advisor.

115. The responsibility for assessing these circumstances and proposing changes to the strategy is allocated to the Treasury Management Panel, chaired by the Deputy Director of Finance (S151).

Policy on the use of external service providers

116. Arlingclose were appointed as the County Council's external treasury management adviser from 1 April 2013 and their contract was renewed in 2017 following a tender process.

117. Arlingclose are contracted to provide information, technical accounting assistance and an investment advice service. The County Council recognises that responsibility for treasury management decisions remains with itself at all times.

118. An annual review of service quality is carried out by senior officers on the Treasury Management Panel. Arlingclose attend meetings bi-annually to discuss strategy and how well they are assisting the County Council to discharge its responsibilities.

Investment management training

119. Treasury management is a specialised area requiring high quality and well trained staff that have an up to date knowledge of current issues, legislation and treasury risk management techniques.

120. Officers who attend the Treasury Management Panel are senior qualified finance professionals. Treasury practitioners attend regular CIPFA and treasury consultant training seminars throughout the year and undertake a ‘My Performance Conversation’ assessment each year through which training needs are identified.

121. Member training is also important to introduce treasury concepts. The need for training events will be kept under review with sessions arranged in the future if necessary.

Policy on the use of financial derivatives

122. Local authorities have previously made use of financial derivatives embedded into loans and investments (e.g. those embedded in LOBO loans), in order to reduce rate risk or reduce costs/increase income. The introduction of the General Power of Competence in the Localism Act 2011 removed the uncertainty around the use of standalone derivatives (e.g. swaps, forwards and futures).

123. The County Council will only use standalone derivatives with an approved investment counterparty and where it can be clearly demonstrated that they reduce financial risk.

Appendix 1

Equalities implications: There are no equalities implications.

Legal implications: Approval of Prudential Indicators and an Annual Investment Strategy is necessary to meet the requirements of the Local Government Act 2003.

Resource and value for money implications: All resource implications are covered in the body of this report which links to the County Council's MTFS.

Risk implications: Risk is inherent in treasury management and is dealt with throughout the report.

Climate change implications: There are no direct climate change implications arising from treasury and investment strategy decisions.

Health impact assessment screening: There are no health impact assessment implications arising from this report.

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List of background papers

1. Treasury Management in the Public Services: Code of Practice (CIPFA) (2017)
2. Prudential Code for Capital Finance in Local Authorities (CIPFA) (2017)
3. The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
4. Statutory Guidance on Local Government Investments – Issued under Section 15(1) (a) of the Local Government Act 2003 (2018)
5. Statutory Guidance on Minimum Revenue Provision – Issued under section 21 (1A) of the Local Government Act 2003 (2018)
6. Localism Act 2011 – Guidance on the General Power of Competence in sections 1 to 6.

Appendix 2

Cabinet – 30 January 2019 - Investment categories authorised for use 2019/20

Investment	Standard	Non-standard	Comments
UK Government - Debt Management Account Deposit Facility (DMADF) (regulation investment)	**unlimited**	×	6 months maximum available
UK Government - Treasury Bills (T-Bills) (regulation investment)	**unlimited**	×	6 months maximum available
UK local authorities term deposits (regulation investment)	**unlimited**	**£45m across these categories**	Up to 40 years in duration (non-standard)
UK Government – Gilts	**unlimited**		
Money Market Funds	✓	×	50% of total investments in this category. Individual MMF - Lower of 0.50% of individual MMF size or 10% of total forecast cash balances per MMF
Term deposits with banks and building societies	✓	×	50% of total investments in this category. Lower of 5% (unsecured) or 10% (secured) of total forecast cash balances or £30m per counterparty
Certificates of deposit (banks / building societies)	×	**Maximum £20m per investment category and £50m in total across all categories**	Up to 5 years in duration (non-standard)
Bonds issued by Multilateral Development Banks	×		
Collective Investment Schemes	×		
Covered Bonds	×		
Repos (repurchase agreement)	×		

** Up to 12 months*

Appendix 3

Cabinet - 30 January 2019

County Council Lending List – January 2019	
	Maximum Time Limit
Regulation investments	
DMADF account	6 months
UK Government T-Bills	6 months
UK local authority	12 months
Banks and building societies	
Barclays	100 days
Lloyds	6 months
Nationwide	6 months
Santander	6 months
MMF	
Black Rock	same day
Insight	same day
Federated	same day
Aberdeen Standard	same day
State Street (SSGA)	same day
Enhanced MMF	
Royal London Cash Plus	3 day notice

Appendix 4

Cabinet – 30 January 2019

Prudential Indicators for Treasury Management

Indicator	Estimate 2019/20	Estimate 2020/21	Estimate 2021/22	Estimate 2022/23	Estimate 2023/24
1. External Debt	£m	£m	£m	£m	£m
Authorised Limit for borrowing	632	613	592	572	553
Authorised Limit for other liabilities	249	252	255	259	262
TOTAL	**881**	**865**	**847**	**831**	**815**
Operational Boundary for borrowing	515	522	525	521	516
Operational Boundary for other liabilities	249	252	255	259	262
TOTAL	**764**	**774**	**780**	**780**	**778**
External Loans	**468**	**468**	**464**	**459**	**454**
The Authorised Limit is the maximum level of external borrowing which should not be exceeded. It is linked to the estimated level of borrowing assumed in the capital programme. *The Operational Boundary represents an estimate of the day to day limit for treasury management borrowing activity based on the most likely i.e. prudent but not worst case scenario.* *"Other liabilities" relate to PFI schemes which are recorded in the County Council's accounts.*					
2.Interest Rate Exposures					
a. Upper Limit (Fixed)	£557m	£538m	£517m	£497m	£478m
b. Upper Limit (Variable)	(£118m)	(£135m)	(£146m)	(£161m)	(£170m)
The County Council has set upper limits of fixed and variable borrowing and investments.. The effect of setting these upper limits is to provide ranges within which the County Council will manage its exposure to fixed and variable rates of interest. Negative figures are shown in brackets; these relate to the 'high- point' of investments at a variable rate which are not offset by variable borrowings. The exposure to variable rate movements has been reduced by the use of cash in lieu of borrowing.					
3.Maturity Structure of Borrowing	Upper Limit	Lower Limit			
See **Appendix 5**					
This indicator relates to the amount of loans maturing in specified periods. The overarching principle is that steps should be taken from a risk management point of view to limit exposure to significant refinancing risk in any short period of time. The County Council currently applies the practice of ensuring that no more than 15% of its total gross fixed rate loans mature in any one financial year. *Because this is a complex situation for the County Council, involving PWLB loans, LOBO loans with uncertain call dates and the use of internal cash, specific indicators have not been set. Instead the County Council will manage its exposures within the limits shown in the graph at **Appendix 5**. This graph shows all LOBO call options on a cumulative basis; in fact the actual pattern of repayment, although uncertain, will not be of this magnitude.*					
4.Upper limit for total principal sums invested for longer than a year (from maturity)					
*This limit has been set at the total amount that could be invested in non-standard investments as per the County Council's policy (see **paragraph 101**) which is the maximum that could be invested for 1 year or over.*	£95m	£95m	£95m	£95m	£95m

Appendix 5

Cabinet – 30 January 2019

County Council maturity structure of debt