Cabinet Meeting on Wednesday 21 August 2019

Treasury Management Report for the Year Ended 31 March 2019

Mike Sutherland, Cabinet Member for Finance and Corporate Matters said,

"The UK economy faced an increasingly uncertain environment, as the risk of a no deal Brexit grew against a backdrop of slowing global economic growth. Consequently, the County Council retained its Treasury Management Policy of using internal cash balances instead of borrowing money. This has delivered significant savings for taxpayers, as the infrastructure to deliver more skilled, better-paid jobs is being funded at a lower cost."

Report Summary:

1. This report describes the County Council's investment and borrowing activity during 2018/19. It considers both borrowing and investment decisions taken throughout the year in light of the interest rates and economic conditions prevailing at the time.

2. These activities involve large sums of money and reflect the huge scale of the County Council's operations. As at the 31 March 2019, the County Council's overall debt level stood at £576 million, which reflects capital expenditure decisions made in the past. Temporary investments totalled £109 million.

3. Our treasury management activities were carried out prudently during the year and our policy of funding new borrowing from internal cash balances continues to generate significant savings.

4. As well as being prudent, our low risk investment strategy which focuses on lending to low risk institutions and the need for liquidity and diversification, will ensure the County Council is strategically placed to deal with any market challenges arising from negotiations for the UK to leave the European Union.

Recommendation(s)

I recommend that:

a. the treasury management activities for the year ended 31 March 2019, including the Prudential Indicators outturn detailed in **Appendix 4**, be noted.

b. Cabinet approve the use of the Minimum Revenue Provision at 31 March 2019 as set out in **paragraphs 30 and 31**.

c. Cabinet note the current Annual Investment Strategy is considered prudent and sufficiently robust to meet any market challenges created by the UK's decision to leave the European Union (**paragraph 37**) and that Officers will continue to monitor the position.

Local Members Interest If report is relevant to ALL Members, type 'N/A' into table and delete what is not required	
Insert Members Name	Insert Electoral Division

Cabinet – Wednesday 21 August 2019

Treasury Management Report for the Year Ended 31 March 2019

Recommendations of the Cabinet Member for Finance and Corporate Matters

I recommend that:

a. the treasury management activities for the year ended 31 March 2019, including the Prudential Indicators outturn detailed in **Appendix 4**, be noted.

b. Cabinet approve the use of the Minimum Revenue Provision at 31 March 2019 as set out in **paragraphs 30 and 31**.

c. Cabinet note the current Annual Investment Strategy is considered prudent and sufficiently robust to meet any market challenges created by the UK's decision to leave the European Union (**paragraph 37**) and that Officers will continue to monitor the position.

Report of the County Treasurer

Reasons for Recommendations:

1. At their meeting on 18 January 2012, Cabinet adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code).

2. Treasury risk management at the County Council is conducted within the framework of the revised 2017 Edition of the CIPFA Code. This requires the County Council to approve a treasury management strategy before the start of each financial year and, as a minimum, provide a semi-annual and annual treasury outturn report. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

3. This report provides a summary of the County Council's treasury management activities for 2018/19, in the context of the strategy for the year, which was agreed by Cabinet on 17 January 2018. It considers both the borrowing and investment decisions taken throughout the year in the light of the interest rates and economic conditions prevailing at the time.

External context

4. Following strong growth in early 2018, global economic activity slowed notably in the second half of the year. According to the International Monetary Fund (IMF), global growth remained strong at 3.8% in the first half of 2018 but dropped to 3.2% for the remainder of the year. Conditions then eased at the start of 2019, with forecasts for a period of stabilisation followed by gradual recovery, indicating 3.3% growth for 2019.

5. The first quarter of 2018/19 saw gains for global equities, mainly due to positive earnings and economic data in the US. This was despite an unsettled geopolitical backdrop as the Trump administration made moves to impose tariffs on Chinese imports and withdraw from the Iran nuclear accord. UK equities performed strongly in this quarter as the Bank of England moved away from an expected rate rise. However, investor sentiment for the UK economy remained fragile as the Bank reduced 2018 growth forecasts from 1.8% to 1.4%. In Europe, steady economic growth was overshadowed by political risk, as a change in government in Italy raised the threat of their exit from the Euro.

6. Global equities continued to make gains in the second quarter as the US significantly outperformed the other major regions. Stability in growth and employment figures allowed the Federal Reserve (Fed) to raise rates by 25 basis points with an outlook for further gradual rate hikes. Growth continued to outweigh the escalating ‘trade war’ as the US targeted $250 billion of Chinese goods for tariffs. In the UK, fears of a ‘no deal’ Brexit further depressed equity prices and the value of sterling. However, the near-term outlook for the UK economy improved, and the prospect of domestic inflation prompted the Bank of England to increase interest rates to 0.75% in August 2018. European equities posted modest gains due to concerns over the impact of trade wars and potential US tariffs on cars.

7. Gains made in global equities during the first half of 2018/19 were wiped out in the third quarter, described as one of the worst quarters in many years with concerns over global trade and slowing economic growth. US equities declined significantly, with the S&P 500 index falling by 13.5%, as fears over economic momentum, slower earnings growth and the US-China trade dispute took hold. Although the Fed raised interest rates in December, it signalled a more cautious view for the coming months. UK equities fell sharply in line with global equities, not helped by worries over a ‘no deal’ Brexit. The UK’s draft EU Withdrawal Agreement triggered another period of intense political uncertainty, as several ministers resigned and Prime Minister May endured a no confidence vote on her leadership by the Conservative Party. European equities also performed poorly due to the global outlook, whilst data indicated momentum was slowing in the eurozone economy.

8. The final quarter of 2018/19 saw a rebound in global equity markets as concerns over the US-China trade dispute eased and major central banks stepped away from tighter monetary policy. The MSCI World index made positive returns of 12.5% in Q1 2019 whereas it had dropped by 13.4 % in Q4 2018. US equities made substantial gains as the US government suspended

planned tariff hikes on Chinese goods, and the Fed confirmed no further interest rate hikes were likely in 2019. UK equities rallied alongside global equities and were further boosted by the delay in Brexit to October 2019, fuelling hopes that a disorderly exit from the EU could be avoided. However, the outlook for the global economy remained uncertain as global growth projections for 2019 were revised down.

Long-term borrowing 2018/19

9. The Treasury Management Strategy Report for 2018/19, approved by Cabinet on 17 January 2018, outlined the long-term borrowing strategy for the year, which was:

   "Maximising the use of cash in lieu of borrowing as far as is practical with the ability to borrow new long-term loans, where deemed appropriate."

10. The ability to borrow new loans was as a result of unexpected changes in;
    - the capital programme;
    - the level of cash balances; and
    - the repayment of Lender Option Borrower Option loans (LOBOs).

11. The following table summarises the use of cash for 2018/19:

2018/19	**£m**
Balance funded from cash brought forward	**92.247**
New debt	22.839
Minimum Revenue Provision (MRP) *	(21.521)
Loan repayments at maturity	15.034
Loans taken out	0
Balance funded from cash carried forward	**108.599**

* *£19.421m of the MRP is payable by the County Council, but the treasury team manage the entire position, including MRP for transferred services.*

12. In 2018/19, the amount of debt funded from internal cash balances has increased from £92.247m at the start of the financial year to £108.599m by the end of the year. New debt created was more than MRP and there were significant loan amounts maturing meaning that the overall use of cash increased.

13. The strategy of using cash continues to rely upon two main factors:
    - interest rates, and in particular the difference between short-term investment rates and longer term borrowing rates; and
    - having cash available to fund the strategy.

Interest rates

14. Bank rate, set by the Bank of England, was increased by 25 basis points to 0.75% in August 2018. Investment rates are not necessarily pegged to this rate as they reflect supply and demand and the markets assessment of future interest rates. The Investment rates for up to 3 months in duration were generally above Bank rate in 2018/19.

15. To maintain inflation below their 2% target, the Bank of England have continued with their monetary policy stance of gradual increases in Bank Rate over the forecast period. However, the Bank is aware that downside risks to global growth have increased and the likelihood of a no deal Brexit has risen. Therefore, they have left their monetary policy options open in that interest rates could decrease or increase depending on the path that Brexit follows.

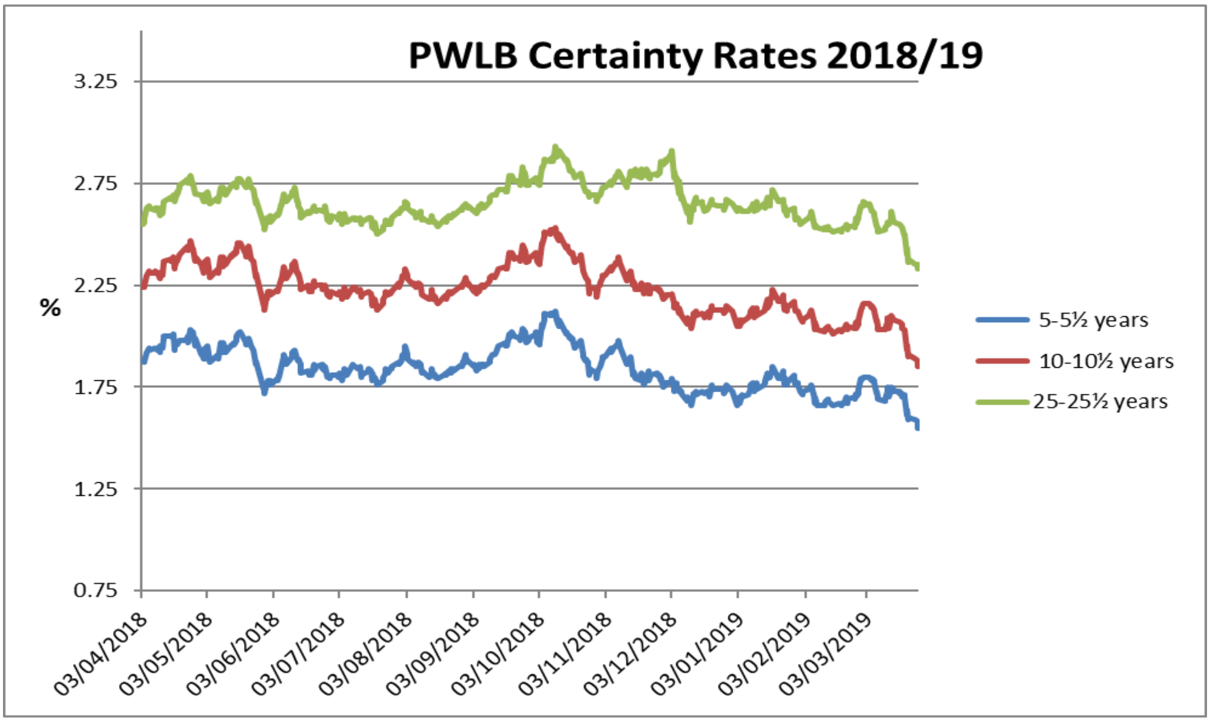
16. Arlingclose, the County Council's treasury advisor, expect the Bank of England to maintain Bank Rate at 0.75% for the foreseeable future. However, they still believe the UK economy faces significant challenges from Brexit risks and the global economy and their forecast may change, with more risks to the downside.

17. Whilst the economic future is not certain, the strategy of using cash remains supported by the current economic situation and the forecast for relatively low interest rates in the future.

18. Longer term interest rates are more relevant when the County Council wants to take up a new loan; these are mainly sourced from the Public Works Loan Board (PWLB) whose loan interest rates vary daily reflecting changes in gilt yields in the UK Government bond market.

19. In November 2016 the Government announced plans for reforms to transfer the powers of the PWLB to the Treasury. Although there has been no progress in doing this, it is important to note that the reforms should have no real effect on the County Council's existing PWLB loans or on local authority lending policy from Central Government.

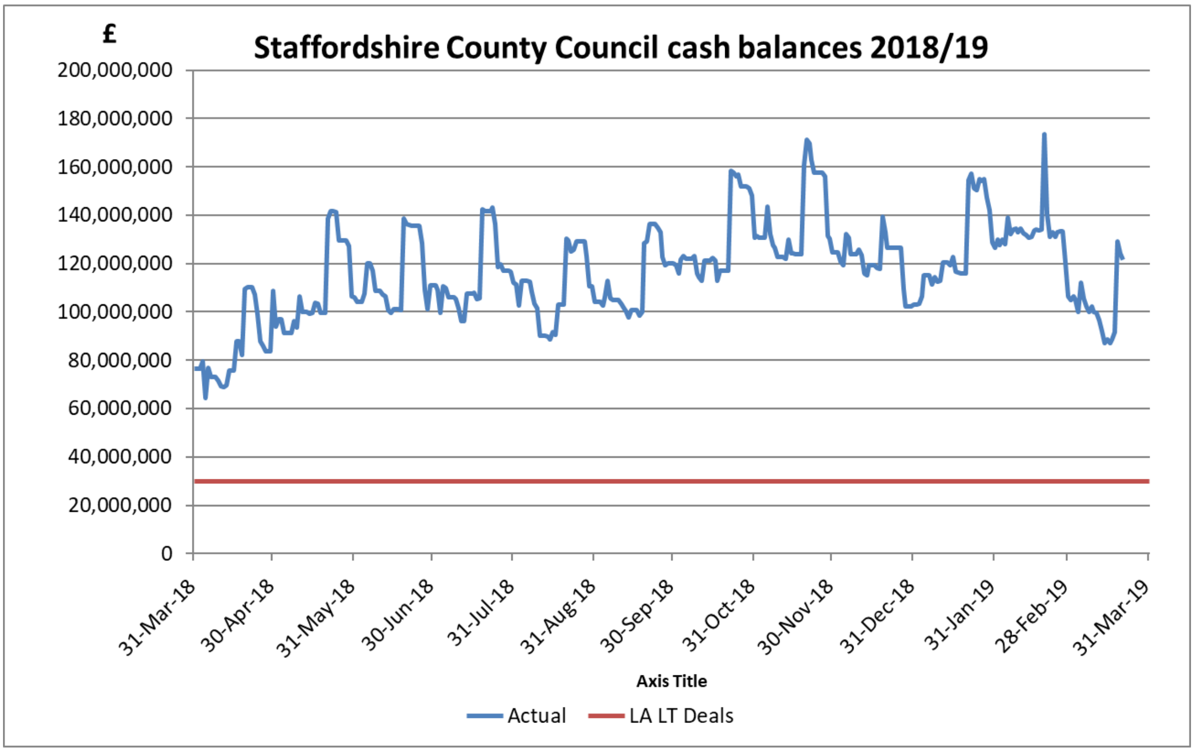
20. The following chart shows PWLB interest rates (at certainty rate) for three indicative loans throughout 2018/19:



21. The chart shows rates remained relatively stable in the first half of 2018/19, before declining in the second half of the year. PWLB loans are priced with reference to gilt yields and the fall in PWLB rates and thus gilt yields reflected expectations for Bank Rate not increasing. When Bank Rate is not expected to increase, demand and prices for existing UK Government debt will increase (when gilt prices increase, yields fall). As mentioned in **paragraph 16**, expectations for a Bank Rate increase had fallen due to a slow down in the global economy and increased risks of a no deal Brexit.

22. It is important to consider the relationship between short-term investment rates and longer term rates. If borrowing in the form of a loan is taken, the proceeds have to be invested at rates significantly lower than the cost of the borrowing. At the moment this difference would be around 1.62% and therefore avoiding new loans results in a significant saving (**see paragraph 25**).

23. An equally important consideration to support the policy of using cash in lieu of borrowing, is whether cash is available. The following graph shows the investment balances for 2018/19 which were sufficient to fund the use of cash of £108.599m (**see paragraph 11**).



24. The following table shows the average interest rate incurred on the County Council's loan portfolio, and an adjustment to this to reflect the use of cash.

	2017/18 %	**2018/19 %**
Weighted average rate of interest for external loans	4.75%	4.65%
Adjusted for the use of cash	4.14%	4.20%

25. The average rate on external loans is lower than last year as there has been significant loan maturities in 2018/19. The rate has fallen further after the use of cash is included (although this is slightly higher than last year due to income lost from the higher use of cash, **see paragraph 11**). On average, internally funding from cash balances in lieu of borrowing has still saved the County Council £1.6 million in interest payments this year.

26. A graph illustrating the maturity profile of the long-term debt at 31 March 2019 is provided at **Appendix 2**.

27. The financing of the County Council's long-term debt at 31 March 2019 is summarised in the following table.

	£m	% of Total
PWLB fixed maturity loans and other	416.653	72
Lender Option Borrower Option (LOBO) loans	51.000	9
Internal funding from cash	108.599	19
Total debt position	**576.252**	**100**

Loan rescheduling in 2018/19

28. Movements in interest rates over time may provide opportunities to restructure the loan portfolio in one of two ways:
    - to replace existing loans with new loans at a lower rate (known as loan rescheduling); or
    - to repay loans early, without replacing the loans. This would increase the use of cash.

29. A combination of factors throughout 2018/19 meant that loan restructuring was not financially viable:
    - gilt yields were still near historical lows, which means a large penalty would be payable;
    - Government policy is to apply a margin to the early repayment of a PWLB loan, which further increases the penalty payable; and
    - the large gap between short-term interest rates and longer-term interest rates meant that no LOBO loans were called.

Annual provision for principal repayments (Minimum Revenue Provision)

30. Under the Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2008, local authorities are given some flexibility in making an annual revenue provision for the repayment of debt.

31. In accordance with the approved policy, the Minimum Revenue Provision of £21.521 million has been used to reduce the County Council's level of debt.

Annual Investment Strategy - Approved lending list

32. The Annual Investment Strategy (AIS) sets out the parties the County Council will lend its money to. The AIS sets out the requirements of government guidance and the CIPFA Code of Practice for Treasury Management. Both documents set out two prime risk issues:
    - the security of capital; and
    - the liquidity of investments.

33. The following characteristics underpin the AIS.
    - the use of regulation investments and counterparties recommended by the treasury adviser (high level of security);
    - the use of diversified sterling “AAA” Money Market Funds (MMFs) and same day liquidity accounts (high level of security and liquidity); and
    - a maximum duration of 12 months for bank and building society investments (high level of security).

Treasury Management activity 2018/19

Treasury Management Panel

34. The treasury team monitor the financial markets as part of a risk management strategy. Regular reports are provided to the County Treasurer, who chairs the Treasury Management Panel (‘the Panel’) which is attended by senior finance officers and treasury staff.

35. During the year, the Panel reviewed regular bank bail-in analysis reports provided by Arlingclose. Under the Bank Recovery and Resolution Directive (BRRD), a “bail in” of current investors will be forced upon a bank experiencing financial difficulties, instead of a government “bail out”. Bail-in legislation has increased the risk for a local authority as any unsecured fixed-term deposits would be ranked near the bottom of the capital structure, and therefore, one of the first to suffer losses.

36. The statutory deadline for UK Bank ringfencing passed on 1 January 2019, whereby all banks would need to implement their ringfencing restructuring programmes. Ring-fencing required the larger UK banks to separate their core retail banking activity from the rest of their business, to protect retail banking activity from unrelated risks originating elsewhere in the banking group or shocks affecting the global financial system. The Panel monitored developments in this area, including the effect on bank credit ratings, as some ringfenced ‘retail’ banks were upgraded and some non-ringfenced ‘investment’ banks were downgraded.

37. The Panel monitored Brexit developments, as the original deadline to leave the European Union in March 2019 was extended to October 2019. The Panel considered advice from the County Council’s treasury advisors, Arlingclose, on the implications of a no deal Brexit on short-term investments; foreign domiciled Money Market Funds (MMF) were perceived to have some liquidity risk in the

event of a no deal Brexit. As an alternative, the Panel ensured the Council had access to the Government's DMO deposit account facility with the flexibility to increase limits temporarily for UK domiciled MMFs, near to the original March deadline.

38. During the year, the Panel discussed the treasury reports required for 2019/20 from the revised CIPFA Codes of Practice on Treasury Management and the Prudential Code, and revised guidance on Local Government Investments and MRP from the Ministry of Housing, Communities and Local Government (MHCLG). In addition to the reports outlined in **paragraph 2**, the Panel approved two new reports for 2019/20; the Capital Strategy and the Commercial Investment Strategy.

39. The Commercial Investment Strategy will cover the requirements of MHCLG Guidance in relation to investments held for service purposes or for commercial profit. Although commercial investments could be considered for 2019/20, the Council's long term investment strategy in 2018/19 remained low risk, with a focus on safeguarding assets by investing in low risk institutions, and with a view to liquidity and diversification. The Panel considered there was no need to change this strategy during 2018/19.

40. The Panel also undertook the following activities during 2018/19:
    - reviewed the results of bank stress tests undertaken by the Bank of England.
    - considered and reviewed the local authority lending market in light of the financial troubles reported by some local authorities.

Credit risk management

41. The following table sets out the credit ratings awarded by credit rating agencies for the counterparties that the County Council was invested with at 31 March.

Credit Rating	31 March 2018	31 March 2019
	£m	**£m**
AAA	42.7	64.0
'A' range (including 'A+' and 'A-')	4.0	3.8
Local authorities	30.0	41.5
Total investments	**76.7**	**109.3**

42. The 2018/19 AIS set the minimum credit-rating of a counterparty at a long-term rating of 'A - ', where available. Counterparties rated below this level were automatically precluded from being on the lending list. From the table above, the highest rating ('AAA') was that given to MMFs, whilst the bank investments were graded in the 'A' range.

43. Whilst most local authorities are unrated by credit rating agencies, both regulations (which list local authorities as acceptable bodies to invest in) and their status as tax raising bodies make them highly creditworthy.

44. A copy of the current lending list (at the time of writing this report) is attached at **Appendix 3**.

Treasury Management Investment transactions

45. Surplus cash is invested in money market instruments to earn interest in accordance with the AIS. All investments must comply with Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 which ensure authorities cannot ‘speculate’ with public funds, for example, authorities cannot invest surplus cash directly in the stock market.

46. The AIS allows investments in Non-standard investments subject to approval from the Panel chaired by the County Treasurer. Collective Investment Schemes are a category within Non-standard investments that include Enhanced MMFs.

47. The Country Council has an investment in the Royal London Cash Plus MMF; this Enhanced MMF has the same characteristics as same day liquidity MMFs but has a 3-day notice period and recommended investment duration of at least 6 months, due to a longer investment horizon. The Royal London Cash Plus MMF has allowed the Council to earn an increased yield in a low interest rate environment.

48. New EU regulations for MMFs meant that existing funds had to be compliant by January 2019. As a result, the County Council’s same day notice MMFs converted from a Constant Net Asset Value (CNAV) to a Low Volatility Net Asset Value (LVNAV) structure. 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.

49. Following the merger of Standard Life Plc with Aberdeen Asset Management, the Standard Life MMF merged into the Aberdeen MMF in October 2018. Both MMFs were on the original recommended MMF list of the County Council’s treasury advisor, Arlingclose and they were comfortable with the merger. Consequently, the County Council retained its holding in the Standard Life MMF which became the Aberdeen MMF.

50. The following table summarises some key facts about the investment transactions over the last two years.

	2017/18	**2018/19**
Total Transactions in year	£1.624 billion	£2.303 billion
Total Interest receipts	£1.380 million	£1.735 million
Average return on investments	1.54%	1.49%
7-day LIBID ** (benchmark)	0.21%	0.51%
Additional return generated	1.33%	0.98%
* Adjusted without long-term local authority investments	0.29%	0.61%

** *London Interbank BID interest rate*

51. The previous table shows that the level of total investment transactions and total interest receipts in 2018/19 was higher than in the previous year. The total interest receipts figure includes interest receipts from £30m of local authority investments. These were made at an average rate of 4.02%, significantly higher than current market interest rates.

52. Although interest receipts were higher in 2018/19, the average return on investments was lower. This is because local authority investment interest receipts, which paid a higher rate of interest, formed a lower proportion of total interest receipts; hence when local authority investments are excluded, the yield was higher than in the previous year. The higher yield can be explained since market interest rates were higher for most of the year, from August 2018.

53. The long-term local authority investments were originally approved by Cabinet in 2013, for a maximum of £45m. Although the County Council made a number of short-term local authority investments during 2018/19, no further long-term investments were made due to a lack of demand from borrowers and the County Council having lower cash balances than when the original Cabinet decision was made.

54. Approved investments at 31 March 2019 stood at £109.328 million (£76.675 million at 31 March 2018) and these can be analysed as follows:

Long-term local authority	**£m**	**Term**
Derby City Council	7.500	28/11/2030
Derby City Council	7.500	28/11/2031
Redcar and Cleveland Borough Council	7.500	29/11/2032
Redcar and Cleveland Borough Council	7.500	29/11/2033
Short-term local authority		
Glasgow City Council	5.000	1 month
Wokingham Borough Council	5.000	1 month
Uttlesford District Council	1.500	1 month
Banks and building societies		
Lloyds (as banking provider)	3.828	Instant Access
Money Market Funds		
Black Rock	10.000	Instant Access
Insight	10.000	Instant Access
Federated	18.000	Instant Access
Aberdeen	11.000	Instant Access
State Street	10.000	Instant Access
Enhanced Money Market Funds		
Royal London Cash Plus	5.000	3-day notice
TOTAL	**109.328**	

Compliance with other matters

55. The following other matters can be confirmed:

(i) In accordance with financial regulations, the Treasury Management Panel, chaired by the County Treasurer and comprising other senior finance officers, met regularly to consider treasury matters;

(ii) All treasury related transactions were undertaken by authorised officers and within the limits approved by the County Council;

(iii) All investments were to counterparties on the approved lending list current at the time and fully met the requirements of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2008; and

(iv) The County Council operated within the limits and Prudential Indicators for treasury management as set out in the County Council's Treasury Management Practices. The outturn for all Prudential Indicators is shown in **Appendix 4**.

List of Background Documents

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.

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Appendix 1

Cabinet 21 August 2019

Equalities implications – There are no equalities implications arising from this report.

Legal implications – There are no legal implications arising from this report.

Resource and value for money implications – The resource and value for money implications are contained within the body of the report.

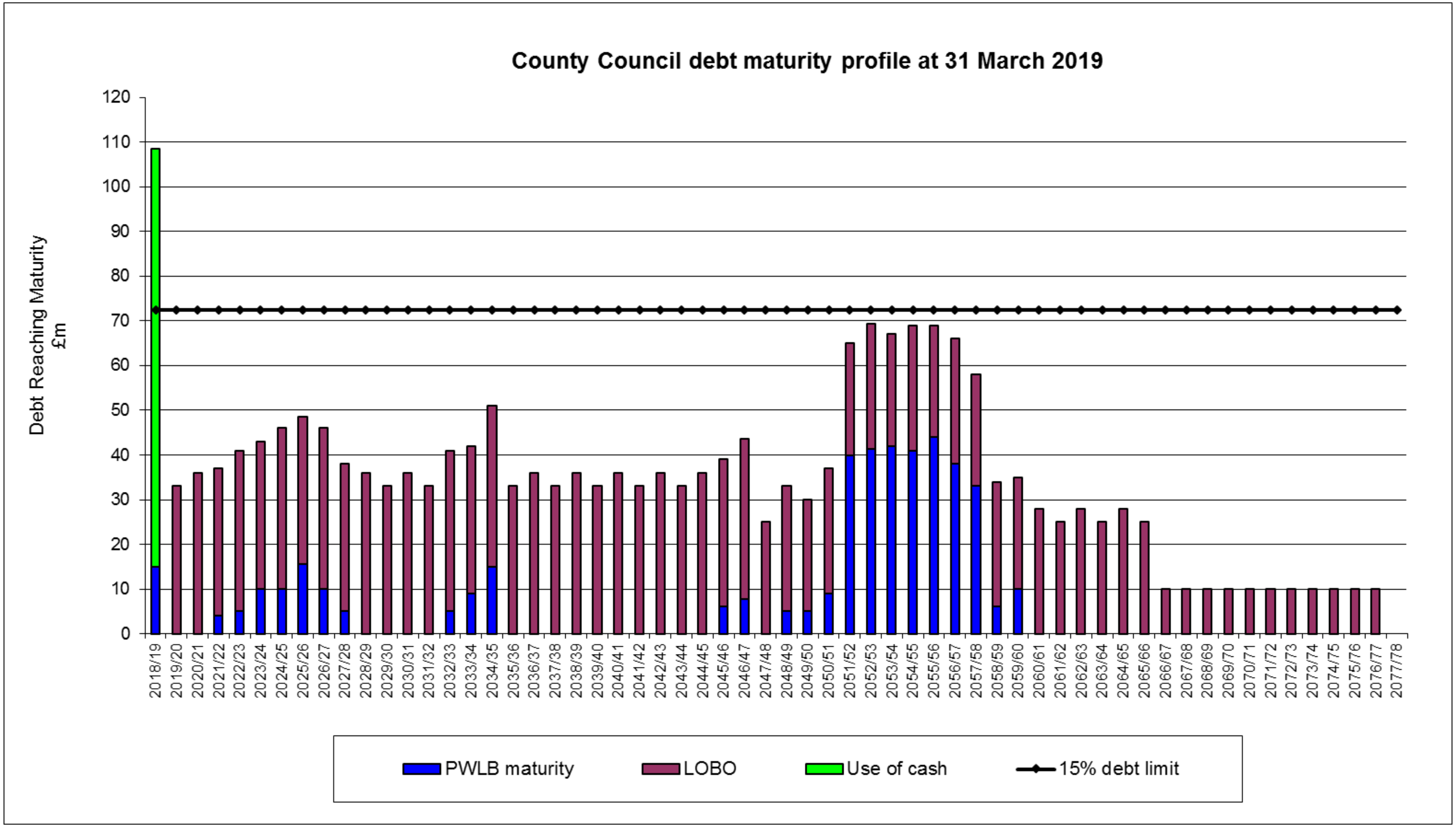
Risk implications – Counterparty, interest rate and refinancing risk arising because of treasury management activity have been considered in the body of this report.

Climate change implications – There are no climate change implications arising from this report.

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

Appendix 2

Cabinet 21 August 2019



Appendix 3

Cabinet 21 August 2019

Approved lending list - July 2019	
	Time limit
Regulation investments	
DMADF account	6 months
UK Government Treasury 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's	
Black Rock	same day
Insight	same day
Federated	same day
Aberdeen	same day
State Street	same day
Enhanced MMF's	
Royal London Cash Plus	3-day notice

Appendix 4

Cabinet 21 August 2019

Prudential Indicators for Treasury Management

Indicator	Estimate 2018/19	Actual Position at 31/03/19
1. External debt		
Authorised Limit for borrowing	£634m	£468m
Authorised Limit for other liabilities	£245m	£233m
TOTAL	**£879m**	**£716m**
Operational Boundary for borrowing	£538m	£468m
Operational Boundary for other liabilities	£245m	£233m
TOTAL	**£783m**	**£716m**
External loans	**£468m**	**£468m**
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)	£559m	£438m
b. Upper Limit (Variable)	(£144m)	(£80m)
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 using cash in lieu of borrowing.		
3. Maturity structure of borrowing		
See Graph at **Appendix 2**		
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 2**. 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 which is the maximum that could be invested for 1 year or over.	£95m	£30m