Treasury Management Strategy Statement 2015/16 and Prudential Indicators 2015-20

Key issues and decisions

To set the Council's prudential indicators for 2015/16 to 2019/20, approve the minimum revenue provision (MRP) policy for 2015/16 and agree the treasury management strategy for 2015/16.

Introduction

2.1. Each year the County Council is required to update and approve its policy framework and ongoing strategy for treasury management in order to reflect changes in market conditions, regulation, and the Council's financial position. It is a statutory requirement that the policy framework and strategy are approved by the Full County Council before the beginning of the financial year. This annex sets out updated versions of the Council's treasury management strategy statement and Appendix 8 sets out the Council's treasury management policy statement.

2.2. Since 2009/10 the Council's treasury management strategy has followed an extremely cautious approach as a direct result of the Council's experience with Icelandic banks. Moving forward into 2015/16, no significant changes are proposed to the treasury management strategy reflecting the current economic climate and Council's risk appetite. The proposed position can be summarised as follows.

- As a result of the continuation of unprecedented low investment interest rates, and in order to help reduce counterparty risk, maintain the minimum deposit balance at £47m. However, officers will keep a watching brief on the financial markets with a view to reversing the current internal borrowing policy, if the market conditions change and are favourable to the Council.
- Maintain the current counterparty list of institutions with which the Council will place short term investments, with the approved lending list reflecting market opinion as well as formal rating criteria.
- Maintain the monetary limit for the two instant access accounts at £60m since both have nationalised status and therefore minimum risk. This will be reassessed in the event that either institution has been fully refloated on the market, thus falling out of the Government's protection umbrella.
- Increase the allocation to AAA rated money market funds from £100m to £175m and the maximum individual AAA money market fund from £20m to £25m.
- Approve the Prudential Indicators in Appendix 9.
- Maintain the Schedule of Delegation as set out in Appendix 11.
- Maintain the Council's minimum revenue provision policy as set out in Appendix 14.

Background

2.3. The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with

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cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate security and liquidity initially before considering investment return.

2.4. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

2.5. The Chartered Institute Public Finance and Accountancy (CIPFA) defines treasury management as:
"The management of the local authority's 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."

Reporting requirements

2.6. The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actual outturn:

- treasury management policy, strategy statement and prudential indicators report (this report), consisting of:
    - the capital plans (including prudential indicators);
    - a minimum revenue provision (MRP) policy, indicating how the Council intends to fulfil its duty to make a prudent provision towards the reduction in the overall borrowing requirement,
    - the treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
    - an investment strategy (the parameters on how investments are to be managed).
- mid year treasury management update reports, consisting of:
    - update of progress on treasury and capital position
    - amendment of prudential indicators where necessary
    - view on whether the treasury strategy is on target or whether any policies require revision.
- an annual treasury management outturn report
    - details of the actual prudential and treasury indicators and actual treasury operations compared with the estimates within the strategy.

2.7. The treasury management policy, strategy statement and prudential indicators report is required to be adequately scrutinised before being recommended to the Full County Council. This role is undertaken by the Audit and Governance Committee.

Treasury management strategy for 2015/16

2.8. The strategy for 2015/16 covers two main areas:

- capital issues:
  - the capital plans and the prudential indicators;
  - the minimum revenue provision (MRP) strategy.
- treasury management issues:
  - the current treasury position;
  - treasury indicators which limit the treasury risk and activities of the Council;
  - prospects for interest rates;
  - the borrowing strategy;
  - policy on borrowing in advance of need;
  - debt rescheduling;
  - the investment strategy;
  - creditworthiness policy; and
  - policy on use of external service providers.

2.9. These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the Communities and Local Government (CLG) MRP Guidance, the CIPFA Treasury Management Code and the CLG Investment Guidance.

Treasury management consultant

2.10. The Council uses Capita Asset Services as its external treasury management advisors. 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.

2.11. 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 by the Audit and Governance Committee.

Training

2.12. Officers and members involved in the governance of the Council's treasury management function are required to participate in training. Officers are also expected to keep up to date with matters of relevance to the operation of the Council's treasury function. Officers continue to keep abreast of developments via the CIPFA Treasury Management Forum as well as through local authority networks.

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Capita Asset Services provides daily, weekly and quarterly newsletters and regular update calls/meetings are held with Capita Asset Services.

2.13. The CIPFA Treasury Management Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training. This especially applies to members responsible for scrutiny. Training will be arranged as required. The training needs of treasury management officers are periodically reviewed.

Capital prudential indicators 2015/16 to 2019/20

2.14. The Prudential Code plays a key role in capital finance in local authorities. The Prudential Code was developed as a professional code of practice to support local authorities in their decision making processes for capital expenditure and its financing. Local authorities are required by statutory regulation to have regard to the Prudential Code when carrying out their duties under Part 1 of the Local Government Act 2003.

2.15. The Council's capital expenditure plans are the key driver of treasury management activity. The framework of prudential indicators aims to ensure that an authority's capital investment plans are affordable, prudent and sustainable. As part of the strategic planning process, authorities are required, on a rolling basis, to calculate a range of indicators for the forthcoming budget year and two subsequent years. The prudential indicators in this report are calculated for the whole medium term financial plan (MTFP) period. Authorities are also required to monitor performance against indicators within the year as well as preparing indicators based on the statement of accounts at each year end. Indicators relate to capital expenditure, external debt and treasury management.

2.16. The prudential indicators are set out in Appendix 9.

Borrowing

2.17. The capital expenditure plans set out in Appendix 12 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury and prudential indicators, the current and projected debt positions and the annual investment strategy.

2.18. Table 2.1 summarises the Council's treasury portfolio position at 31 March 2014, with forward projections. The table shows the actual external debt against the underlying capital borrowing need (the capital financing requirement or CFR), highlighting any over or under borrowing. The authority has adopted a treasury management strategy that favours fixed rate borrowing to provide certainty over borrowing costs and rates of interest.

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Table 2.1: Current portfolio position

External debt	2013/14 Actual £m	2014/15 Projected £m	2015/16 ← - - - £m	2016/17 - - - £m	2017/18 Estimated £m	2018/19 - - - £m	2019/20 - - - → £m
Capital Finance Requirement at 31 March	**682**	**767**	**838**	**899**	**913**	**916**	**916**
Less Other Long Term Liabilities	-69	-80	-76	-72	-68	-63	-59
Borrowing Requirement	613	687	762	827	845	853	857
Actual External Debt at 31 March	400	486	557	618	631	634	633
Under/(over) borrowing	**213**	**201**	**205**	**209**	**214**	**219**	**224**

2.19. Within the prudential indicators, there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the capital finance requirement (CFR) in the preceding year plus the estimates of any additional CFR for 2015/16 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

2.20. The Director of Finance reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

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Prospects for interest rates

2.21. The Council has appointed Capita Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Table 2.2 provides Capita's central view on interest rates. For clarification, the Public Works Loans Board (PWLB) certainty rate is a 0.20% reduction to local authorities who provide the required information on their plans for long-term borrowing and associated capital spending. Table 2.2: Prospects for interest rates

Annual average	Bank rate %	PWLB borrowing rates (including certainty rate adjustment) 5 year %	25 year %	50 year %
December 2014	0.50	1.97	3.17	3.29
March 2015	0.50	2.20	3.40	3.40
June 2015	0.50	2.20	3.50	3.50
September 2015	0.50	2.30	3.70	3.70
December 2015	0.75	2.50	3.80	3.80
March 2016	0.75	2.60	4.00	4.00
June 2016	1.00	2.80	4.20	4.20
September 2016	1.00	2.90	4.30	4.30
December 2016	1.25	3.00	4.40	4.40
March 2017	1.25	3.20	4.50	4.50
June 2017	1.50	3.30	4.60	4.60
September 2017	1.75	3.40	4.70	4.70
December 2017	1.75	3.50	4.70	4.70
March 2018	2.00	3.60	4.80	4.80

2.22. Investment returns are still likely to remain relatively low during 2015/16 and beyond. Borrowing interest rates have been volatile during 2014 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. The closing weeks of 2014 and early into 2015 have seen gilt yields dip to historically remarkably low levels after inflation plunged, a flight to quality from equities (especially in the oil sector), from the debt and equities of oil producing emerging market countries, and an increase in the likelihood that the ECB will commence quantitative easing (purchase of EZ government debt) in early 2015.

2.23. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities will not be able to avoid new borrowing to fund new capital expenditure and/or to refinance maturing debt. There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns, as well as increased counterparty risk.

2.24. A commentary on the global economic outlook is shown as Appendix 10.

UK Treasury Management Delegation

2.25. The Treasury Management Scheme of Delegation is set out in Appendix 11.

Borrowing strategy

2.26. The Council is currently maintaining a significantly under-borrowed position. This means that the capital borrowing need (the capital financing requirement) has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. At 31 December 2014, the level of under-borrowing amounted to around £285m. This strategy is prudent and has proved to be extremely effective as investment returns are at a historic low and counterparty risk remains relatively high.

2.27. Against this background and the risks within the economic forecast, caution will be adopted with the 2015/16 treasury operations. The Director of Finance will monitor interest rates and gilt yields in financial markets, and adopt a pragmatic approach to changing circumstances.

2.28. The crucial question is how much longer this under-borrowing strategy will be appropriate and relevant. The Council's current policy of funding external borrowing from internal reserves, thus saving the difference between the cost of capital and the investment returns available in the money markets will not hold permanently. At some point in the medium term, the Council will be required to reverse this policy and fund its position from external sources as long term gilt yields and interest rates will eventually rise, thus impacting on the cost of borrowing.

2.29. How the current internal borrowing gap will eventually be bridged will depend on market projections over 2015/16 and beyond, and officers will take advice from the Council's treasury consultant as to the future directions of the market over the next year. In the current low interest rate environment, which is not expected to change in the immediate short term, the Council remains well placed to take advantage of its internal borrowing strategy in terms of funding capital expenditure from reserves, and then refinancing at the optimum time over the medium term future.

2.30. There remains an optimal opportunity to take advantage of financing for the long term at historically low rates, just prior to those long term rates rising upwards. The Council must be strategically poised to take advantage of this opportunity and will assess the timing carefully in order to take full advantage. It is expected that the return to external borrowing will take place on a gradual basis in order to reduce the impact of unanticipated market movements. This underlines the Council's need to maintain a cautious, and low risk approach and monitor on a daily basis the economic position against the Council's existing treasury position.

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2.31. There are two possible risks in 2015/16:

- The risk of a fall in long and short term rates (e.g. due to a marked increase of risks around a further relapse into recession or of risks of deflation). In this instance, long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.
- The risk of a sharper rise in long and short term rates than that currently forecast, perhaps arising from an increase in world economic activity, or an increase in inflationary expectations. In this instance, the portfolio position will be reappraised with the likely action that fixed rate funding will be drawn whilst interest rates are still lower than they will be in the next few years.

2.32. The UK is still benefitting from a "safe haven" status outside the global markets and the Eurozone, which has supported UK gilt prices and reduced further historically low gilt yields (which underpin PWLB borrowing rates). Moreover, the UK inflation position has reduced to below the Bank of England's Monetary Policy Committee's (MPC's) target of 2%. Any further reduction may have an impact on the financial markets view of gilt prices, with a further reduction in gilt (and therefore PWLB) rates. This highlights the higher importance of the longer term fixed interest rate economic forecasts.

2.33. Any decisions will be reported to the Audit and Governance Committee at the next available opportunity.

Treasury management limits on activity

2.34. There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive, then they will impair the opportunities to reduce costs and improve performance. The indicators are as follows:

- **Upper limits on variable interest rate exposure**
  This identifies a maximum limit for the level of debt (net of investments) taken out at variable rates of interest.
- **Upper limits on fixed interest rate exposure**
  This is similar to the previous indicator and covers a maximum limit on fixed interest rates.
- **Maturity structure of borrowing**
  These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

2.35. Cabinet is asked to recommend the Council approves the treasury indicators and limits in Table 2.3.

Table 2.3: Treasury indicators and limits

	2015/16 to 2019/20		2014/15 year end projection	
Upper limits on fixed interest rates	100%		100%	
Upper limits on variable interest rates	25%		0%	
Maturity structure of external borrowing	Lower	Upper	£m	
Under 12 months	0%	50%	0	0%
12 months to 2 years	0%	50%	0	0%
2 years to 5 years	0%	50%	0	0%
5 years to 10 years	0%	75%	10	3%
10 years and above	25%	100%	297	97%
Total external borrowing			**307**	**100%**

Policy on borrowing in advance of need

2.36. The Council will not borrow more than or in advance of its needs purely in order to benefit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved capital finance requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Debt rescheduling

2.37. As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (significant premiums can be incurred).

2.38. The reasons for any rescheduling to take place will include:

- the generation of cash savings or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- enhancing the balance of the portfolio (amend the maturity profile or the balance of volatility).

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2.39. Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt. Such a decision will be dependent on the level of the premium levied on the redemption.

2.40. All rescheduling will be reported to the Audit & Governance Committee at the earliest meeting following its action.

Annual investment strategy

Investment policy

2.41. The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some financial institutions with a ratings "uplift" due to implied levels of sovereign support. More recently, in response to the evolving regulatory regime, the agencies have indicated they may remove these "uplifts". This process may commence during 2014/15 and / or 2015/16. The actual timing of the changes is still subject to discussion, but this does mean immediate changes to the credit methodology are required.

2.42. It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of sovereign support that has been built into ratings through the financial crisis. The eventual removal of implied sovereign support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

2.43. Both Fitch and Moody's provide "standalone" credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody's has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments, both agencies have suggested going forward that these will be in line with their respective Long Term ratings. As such, there is no point monitoring both Long Term and these "standalone" ratings.

2.44. Furthermore, Fitch has already begun assessing its Support ratings, with a clear expectation that these will be lowered to 5, which is defined as "A bank for which there is a possibility of external support, but it cannot be relied upon." With all institutions likely to drop to these levels, there is little to no differentiation to be had by assessing Support ratings.

2.45. As a result of these rating agency changes, the credit element of the future Capita assessment methodology will focus solely on the Short and Long Term ratings of an institution. This is the same process for Standard & Poor's but a change to the use of Fitch and Moody's ratings. Furthermore, Capita continue to utilise credit default swap (CDS) prices as an overlay to ratings in the new methodology.

2.46. The Council's investment policy has regard to the CLG's Guidance on Local Government Investments (the Guidance) and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance

Notes (the CIPFA TM Code). The Council's investment priorities will be security first, liquidity second, then return as the third priority, in line with this guidance.

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2.47. In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on its lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings, watches and outlooks published by all three rating agencies (Fitch, Moody's and Standard & Poor's (S&P)). Using the Capita Asset Services ratings service, potential counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

2.48. Furthermore, the Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets.

2.49. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings. Other information sources used will include the financial press, e.g. Financial Times, share prices and other information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties. 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. The intention of the strategy is to provide security of investment and minimisation of risk.

2.50. Continuing regulatory changes in the banking sector are designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key ratings used to monitor counterparties being the Short Term and Long Term ratings only. Viability, Financial Strength and Support Ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes.

2.51. Current investment counterparties identified for use in the financial year using currently approved rating criteria are listed in Appendix 12 under the 'specified' and 'non-specified' investments categories. Counterparty monetary limits are also set out in this appendix. No changes to limits and criteria are recommended, given the Council's desired prudent risk level.

2.52. The Director of Finance, under delegated powers, will undertake the most appropriate form of investments depending on the prevailing risks and associated

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interest rates at the time. All investments will be made in accordance with the Council's treasury management policy and strategy, and prevailing legislation and regulations. If the list of counterparties and their time or value limits need to be revised, amendments will be recommended to the Audit & Governance Committee.

Creditworthiness policy

2.53. The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle, the Council will ensure it:

- maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security (this is set out in the specified and non-specified investment sections below); and
- has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed (these procedures also apply to the Council's prudential indicators covering the maximum principal sums invested).

2.54. The Director of Finance will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

2.55. The minimum rating criteria uses the lowest common denominator method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies with one meeting the Council's criteria and the other not, the institution will fall outside the lending criteria. Credit rating information is supplied by Capita Asset Services on all active counterparties that comply with the criteria below.

2.56. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notifications of likely changes), rating outlooks (notification of possible longer term changes) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance, a negative rating watch applying to a counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions. The criteria for providing a pool of high quality investment counterparties (both specified and non-specified investments) is summarised in Appendix 12.

- Banks (1): good credit quality. The Council will only use banks which:
  - are UK banks; or
  - are non-UK and domiciled in a country which has a minimum sovereign long term rating of AAA.

and have, as a minimum, the following Fitch, Moody's and S&P's credit ratings (where rated):

- o Short term: F1/P1/A1
- o Long term: A-/A3/A-
- o (N.B. Viability, Financial Strength and Support ratings have been removed and will not be considered in choosing counterparties.)

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- Banks (2): part nationalised UK banks. Lloyds Banking Group and Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.
- Banks (3): The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- Bank subsidiaries: The Council will use these where the parent bank has provided an appropriate guarantee and has the necessary ratings outlined above.
- Building societies: The Council will use all societies which meet the ratings for banks outlined above.
- Money Market Funds: AAA rated via two out three three rating agencies. It is recommended that this be increased from total £100m to £175m, maximum £25m per fund, in order to provide additional capacity in the possible event of counterparties dropping out of the Lending List.
- UK Government, including gilts and the Debt Management Account Deposit Facility (DMADF)
- Local authorities, parish councils etc
- Supranational institutions
- Enhanced Cash/Corporate bonds pooled funds: AAAs1 (or equivalent)

Country and Sector Considerations

2.57. Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part, the country selection will be chosen by the credit rating of the sovereign state in Banks 1 above. In addition,

- no more than £50m will be placed with any non-UK country at any time;
- AAA countries only apply as set out in Appendix 13;
- limits in place above will apply to a group of companies;
- sector limits will be monitored regularly for appropriateness.

Use of additional information other than credit ratings

2.58. Additional requirements under the Prudential Code require the Council to supplement credit rating information. Whilst the above criteria rely primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example credit default swaps, negative rating watches or outlooks) will be applied to compare the relative security of differing investment counterparties.

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Time and monetary limits applying to investments

2.59. All investments will be limited to 364 days. Further internal restrictions may be applied on recommendations from Capita Asset Services.

2.60. The proposed criteria for specified and non-specified investments are shown in Appendix 12 for approval.

Country limits

2.61. The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AAA from all three rating agencies. This restriction does not apply to the UK, which has seen its AAA rating reduced.

In-house funds

2.62. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

Instant access funds

2.63. The Council will seek to maximise its return on investments by retaining its call account deposits in part nationalised banks (Lloyds and RBS) which pay a slightly enhanced rate due to their weakened financial strength but remain supported by the UK Government. In addition, the council will utilise Money Market Funds (up to the value of £175m).

Local authorities

2.64. Loans will be offered to local authorities that seek to borrow cash from alternative sources to the PWLB.

Investment returns expectations

2.65. The Bank Rate is forecast by Capita Asset Services to remain unchanged at 0.5% before starting to rise from quarter 4 of 2015. Capita Asset Services forecasts the financial year ends (March) as:

2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
0.50%	0.75%	1.25%	2.00%	2.50%	2.50%

2.66. There are downside risks to these forecasts (i.e., the start of increases in Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if the Bank of England inflation forecasts for two years ahead exceed the Bank of England's 2% target rate.

2.67. The suggested budgeted investment earnings rates for returns on investments placed for periods up to three months during each financial year for the next three years are as follows:

2015/16	0.40%
2016/17	1.00%
2017/18	1.75%
2018/19	2.25%
2019/20	2.25%

2.68. In terms of how these estimate yields differ from last year's strategy, the date of the first rise in the Bank Rate to 0.75% is pushed out to December 2015. The possibility of counterparties falling off the Lending List as a result of tightening criteria by the rating agencies could also make the generation of enhanced yields challenging.

Investment treasury indicator and limit

2.69. This indicator concerns the total principal funds invested for greater than 364 days. This limit is set with regard to the Council's liquidity requirements and to reduce the need for early liquidation of an investment, and based on the availability of funds after each year end.

2.70. The Council is asked to approve the treasury indicator and limit.

Table 2.4: Maximum principal sum invested >364 Days

	2014/15 % of portfolio	**2015/16 % of portfolio**	**2016/17 % of portfolio**
Principal sums invested > 364 days	0	0	0

2.71. This means that no investments should be for longer than 364 days. This keeps the strategy within the Council's desired level of prudent risk.

2.72. For its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated overnight deposits.

Icelandic bank investments

2.73. The Council placed £20m of deposits with two failed Icelandic banks: Glitnir and Landsbanki. Of this £20m, the Council's exposure is £18.5m with the balance attributable to the Police and Crime Commissioner for Surrey. The Audit & Governance Committee receives regular reports on the prospects for recovery of the deposits that are at risk and the efforts being made by the Local Government Association (LGA) and its legal advisors in this regard.

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2.74. The current position is that the Landsbanki deposit recovery is complete. With regard to Glitnir, 84% of the deposits has been repaid. The balance owed on each deposit is shown in the Table 2.5. It should be noted that the balance has been placed in an escrow account awaiting repayment, and subject to the final processes of the Icelandic Winding Up Board.

Table 2.5: Balances owed on Icelandic bank deposits

Counterparty	Period (days)	Principal £000	Rate %	Principal repaid £000	Principal outstanding £000
Glitnir	364	5,000	6.25%	4,192	808
Glitnir	366	5,000	6.20%	4,193	807
		10,000		8,385	1,615

2.75. The remaining balance will be subject to exchange rate fluctuations when capital controls in Iceland have been lifted. Previous provision has been made within the Council's accounts for an irrecoverable amount regarding the Icelandic bank debt. It is anticipated that the position could be finally ascertained and closed at some juncture in 2015/16 with a final irrecoverable amount decided and included in the Council's accounts. The council holds £564k in a financial investment reserve.

Investment risk benchmarking

2.76. A development in the revised Code on Treasury Management and the CLG consultation paper, as part of the improvements to reporting, is the consideration and approval of security and liquidity benchmarks. Whereas yield benchmarks are currently widely used to assess investment performance, security and liquidity benchmarks are new reporting requirements. These benchmarks are simple guides to maximum risk, so they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or annual report.

Security

2.77. The Council's maximum security risk benchmark for the current portfolio, when compared with these historic default tables, is:

- 0.05% historic risk of default when compared to the whole portfolio

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Liquidity

2.78. The Council currently restricts deposits with each counterparty to term deposits only, the length of which is based upon individual assessment of each counterparty. The amount of available cash each day should never fall below £15m. A minimum core of £47m is currently in place. This provides a safety margin, to help ensure the Council need not borrow to fund daily expenditure. In respect of its liquidity, the Council seeks to maintain the following.

- Bank overdraft: £100,000
- Liquid short term deposits of at least £15m available with a day's notice
- Weighted average life benchmark is expected to be three months.

Yield

2.79. The Council benchmarks the return on deposits against the 7-Day LIBID (London Interbank Bid Rate), and reports on this as part of the treasury monitoring reports.

Additional Portfolio of Investments

2.80. On 23 July 2013, Cabinet approved a portfolio of investments, covering investment in property and assets and in new models for service delivery. This supports the Council's stated intentions of enhancing financial resilience in the longer term. These arrangements will allow for investment in schemes that will support economic growth in Surrey provided that these schemes are consistent with the Investment Strategy outlined in the Cabinet report of 23 July 2013.

2.81. The strategic approach to investment is based upon the following:

- prioritising use of the Council's cash reserves and balances to support income generating investment through a Revolving Investment and Infrastructure Fund (the Investment Fund) to meet the initial revenue costs of funding initiatives that will deliver savings and enhance income in the longer term (some of which may be used to replenish the Investment Fund);
- using the Investment Fund to support investments in order to generate additional income for the council that can be used to provide additional financial support for the delivery of functions and services;
- investing in a diversified and balanced portfolio to manage risk and secure an annual overall rate of return to the Council;
- investing in schemes that have the potential to support economic growth in the county;
- retaining assets where appropriate and undertaking effective property and asset management, and if necessary associated investment, to enhance income generation.

Performance indicators

2.82. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy and effectiveness of the treasury management function over the year. These are distinct historic indicators, as

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opposed to the prudential indicators, which are predominantly forward looking. The performance indicators to be used for the treasury management function are:

- borrowing: actual rate of borrowing for the year less than the year's average rate relevant to the loan period taken; and
- investments: internal returns above the 7-day LIBID rate.

2.83. These indicators will be reported to the Audit & Governance Committee in the quarterly and half yearly reports, due after 30 September 2015, and the Treasury Management Annual Report for 2014/15.

End of year investment report

2.84. At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Management Report.

External fund managers

2.85. The Council does not currently employ an external fund manager.

Minimum revenue provision

2.86. The Council's policy on minimum revenue provision (MRP) is shown in Appendix 14.

Lead/contact officer:

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Appendices:

Appendix 8	Treasury Management Policy
Appendix 9	Prudential indicators – summary
Appendix 10	Global economic outlook and the UK economy
Appendix 11	Treasury management scheme of delegation
Appendix 12	Institutions
Appendix 13	Approved countries for investments
Appendix 14	Annual minimum revenue provision (MRP) policy statement

Sources and background papers:

CIPFA Prudential Code for Capital Finance

CIPFA Treasury Management in the Public Services: Code of Practice

Investment guidelines under section 15(1)(a) of the Local Government Act 2003

Audit Commission: ‘Risk & Return: English Local Authorities and the Icelandic Banks

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