Treasury Management Strategy Statement and Prudential Indicators 2016/21

Key issues and decisions

To set the Council's prudential indicators for 2016/17 to 2020/21, approve the minimum revenue provision (MRP) policy for 2016/17 and agree the treasury management strategy for 2016/17.

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 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 and the period of continuing low interest rates for investments. With the Icelandic deposits now fully resolved, moving forward into 2016/17, a degree of change is proposed to the treasury management strategy with regard to the Council's managed increase in risk appetite. Officers have consulted with their advisors in order to present to full council a slightly less risk averse strategy with the intention of generating additional return within a managed risk environment.

2.3. 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.
- 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.
- Set the maximum amount in respect of any one counterparty to £20m with the exception of money market funds (£25m).
- Introduce three new investment categories: corporate bonds, covered bonds and pool investment property funds which could generate additional returns if utilised, while maintaining controlled credit risk.
- Increase the maximum term for high quality longer dated investments to two years for supranational institutions, local authorities, UK government, corporate bonds and five years for covered bonds, earning additional interest income without compromising liquidity risk.

Background

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

2.5. 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.

2.6. 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

2.7. 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 to set aside resources over time to repay the borrowing incurred to finance capital expenditure;
    - 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.

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

Treasury management strategy for 2016/17

2.9. The strategy for 2016/17 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.

2.10. 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

2.11. The Council has recently appointed Arlingclose as its external treasury management advisor. 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.

2.12. 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.

Training

2.13. 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. Arlingclose provides daily, weekly and quarterly newsletters and regular update calls/meetings will be held with Arlingclose.

2.14. 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 2016/17 to 2020/21

2.15. 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.

2.16. 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.

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

Borrowing

2.18. The capital expenditure plans set out in Appendix 5 of the budget report 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.

2.19. Capital expenditure can be financed from one or more of the following sources:

i. Cash from existing and/or new capital resources, e.g., capital grants, capital receipts from asset sales, revenue contributions or earmarked reserves;

ii. Cash raised by borrowing externally;

2.20. Cash being held for other purposes, e.g., earmarked reserves or working capital but used in the short term for capital investment. This is known as 'internal borrowing' as there will be a future need to borrow externally once the cash is required for the other purposes.

2.21. Under the CIPFA Prudential Code, an authority is responsible for deciding its own level of affordable borrowing within set prudential indicator limits. Borrowing does not have to take place immediately to finance its related capital expenditure and may be deferred or borrowed in advance of need within policy. The Council's primary objective when borrowing is to manage the balance between securing low interest rates, achieving cost certainty over the period for which funds are required, while ensuring that any 'cost of carry' does not place unnecessary pressure on the revenue budget. Cost of carry occurs when cash is borrowed in advance of need and then held in short term investments earning less interest than is being paid to borrow it initially.

2.22. The amount that notionally should have been borrowed is known as the capital financing requirement (CFR). The CFR and actual borrowing may be different at a point in time and the difference is either an under or over borrowing amount. Table 2.1 summarises the Council's position at 31 March 2015, with forward projections:

Table 2.1: Current portfolio position

	2014/15	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
	Actual	**Projected**	**← - - - - - - - - - -**		**Estimated**		**- - - - - - - - - - →**
External debt	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Capital Finance Requirement at 31 March	**781.6**	**870.9**	**916.4**	**950.3**	**943.9**	**903.2**	**857.8**
Less Other Long Term Liabilities	-102.8	-148.0	-174.5	-172.9	-153.6	-134.3	-114.9
Borrowing Requirement	678.8	722.9	741.9	777.4	790.3	768.9	742.9
Actual External Debt at 31 March	428.7	429.3	448.5	484.2	497.0	511.2	523.2
Under/(over) borrowing	**250.1**	**293.6**	**293.4**	**293.2**	**293.3**	**257.7**	**219.7**

2.23. The table shows the actual external debt (PWLB, LOBO and temporary loans) against the underlying capital borrowing need, the majority of which is held with the Public Works Loans Board (PWLB), with a single Lender Option Borrower Option (LOBO) loan. The authority has adopted a treasury management strategy that favours fixed rate borrowing to provide certainty over borrowing costs and rates of interest.

2.24. The Council is currently maintaining a significantly under-borrowed position. This means that 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 March 2016, the projected level of under-borrowing amounts to £293.6. 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.

2.25. It is likely that the Local Capital Finance Company Limited (also known as the Municipal Bond Agency) will be offering direct loans to local authorities in the near future. It is also hoped that the borrowing rates will be lower than those offered by the PWLB. It is recommended that the Council utilise this new source of borrowing when appropriate.

2.26. The Local Capital Finance Company Limited was set up during 2015 with the aim of reducing borrowing rates by up to a prudent 0.20% to 0.25% compared with the certainty rate provided by the PWLB. The Company will offer direct competition to the PWLB but, as a result, the PWLB could react by reducing its own margins, thereby making the Local Capital Finance Company Limited rate not compelling for local authority borrowers. Whilst it is difficult to predict the reaction to the establishment of the Local Capital Finance Company Limited, either way, it has the potential for local authorities to access lower borrowing rates.

2.27. 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 2016/17 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.

2.28. 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.

Prospects for interest rates

2.29. The Council has appointed Arlingclose 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 Arlingclose'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. The Council complies with this requirement. Appendix 10 sets out a summarised report on global economic outlook and the UK economy.

Table 2.2: Prospects for interest rates

		PWLB borrowing rates (including certainty rate adjustment)		
	Bank rate %	5 year %	20 year %	50 year %
December 2015	0.50	2.30	3.25	3.25
March 2016	0.50	2.35	3.30	3.30
June 2016	0.50	2.40	3.35	3.35
September 2016	0.75	2.50	3.35	3.40
December 2016	0.75	2.60	3.40	3.45
March 2017	1.00	2.70	3.45	3.50
June 2017	1.00	2.80	3.50	3.55
September 2017	1.25	2.90	3.55	3.60
December 2017	1.25	3.00	3.60	3.65
March 2018	1.50	3.05	3.65	3.70
June 2018	1.50	3.10	3.70	3.75
September 2018	1.75	3.15	3.75	3.80
December 2018	1.75	3.15	3.75	3.80

2.30. Investment returns are still likely to remain relatively low during 2016/17 and beyond. Borrowing rates have been volatile during 2015 as alternating bouts of good and bad news have promoted optimism, and then pessimism in financial markets as a result of geo-political events and the slowing Chinese economy. The closing weeks of 2015 and early into 2016 have seen gilt yields dip to historically low levels after inflation plunged, and a flight to quality from equities (especially in the oil sector), from the debt and equities of oil producing emerging market countries.

2.31. The policy of internal borrowing by utilising 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.

2.32. Officers continue to review the need to borrow, taking into consideration the potential increases in borrrowing costs, the need to finance new capital expenditure, refinancing maturing debt, and the cost of carry that might incur a revenue loss between borrowing costs and investment returns. Against this background and the risks within the economic forecast, caution will be adopted with the 2016/17 treasury operations. Markets will continue to be monitored carefully and the Council will adopt a pragmatic approach to changing circumstances in relation to its debt strategy.

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

UK Treasury Management Delegation

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

Borrowing strategy

2.35. 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 is not intended to hold permanently. The Council will give consideration to reversing this policy and fund its position from external sources prior to long term gilt yields and interest rates eventually rising, thus impacting on the cost of borrowing.

2.36. How the current internal borrowing gap will eventually be bridged will depend on market projections over 2016/17 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 until late 2016/early 2017, the Council still 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 when suitable opportunities arise.

2.37. 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.

2.38. There are two possible risks in 2016/17:

- 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 further 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.

2.39. 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 significantly (and into deflation territory) 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 importance of the longer term fixed interest rate economic forecasts.

2.40. Any decisions will be reported to the appropriate decision making body at the next available opportunity.

Treasury management limits on activity

2.41. 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.

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

Table 2.3: Treasury indicators and limits

	2016/17 to 2020/21		**2015/16 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	2%
10 years and above	25%	100%	387	98%
Total external borrowing			**397**	**100%**

Policy on borrowing in advance of need

2.43. 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

2.44. 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).

2.45. 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).

2.46. 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.

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

Annual investment strategy

Investment policy

2.48. The three major credit rating agencies made substantial revisions to their bank credit rating methodologies in 2015, reflecting the banking reform agenda in the UK and other advanced economies. Until last year, the rating agencies assessed the standalone credit strength of banks, and then added up to three “notches” to account for the likelihood that the relevant national government would bail-out a failed bank in order to protect investors.

2.49. Following the passing of UK domestic legislation in 2013 and an EU-wide directive in 2014 banning government bail-outs until there have been investor bail-ins, in 2015 the rating agencies removed most or all of these notches for government support. Moody’s retains one notch for the very largest banks reflecting a small chance that governments may ignore or rewrite the law if or when such an eventuality occurred; Fitch and Standard & Poor’s do not believe the chance of this is large enough to make any meaningful difference to banks’ credit strengths.

2.50. On its own, this would have seen many banks’ credit ratings fall. However, this effect was fully or partly offset by the introduction of notches for loss absorbency. This reflects the chance that, although a bank has failed and been bailed-in, there may be sufficient loss absorbing instruments ranking below the Council’s investment to protect the latter from any loss. Under the pre-reform framework, banks were likely to default on all their debts at the point of failure, even if the higher ranking ones were eventually repaid in full. Post-reform, bail-in is designed to enable failed banks to continue running without defaulting on all their debts. In many cases, the resulting credit ratings are therefore broadly unchanged.

2.51. As a result of these rating agency changes, the credit element of the future Arlingclose assessment methodology will focus solely on the Short and Long Term ratings of an institution. Furthermore, Arlingclose will utilise credit default swap (CDS) prices as an overlay to credit ratings.

2.52. 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.

2.53. 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 Arlingclose ratings service, potential counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

2.54. 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.

2.55. 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.

2.56. 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 change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes.

2.57. Current investment counterparties identified for use in the financial year using currently approved rating criteria are listed in Appendix 12. Counterparty monetary limits are also set out in this appendix. Recommended changes to criteria and monetary limits have already been set out in paragraph 2.3.

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

2.59. 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).

2.60. 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.

2.61. 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 Arlingclose on all active counterparties that comply with the criteria below.

2.62. 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):

- Short term: F1/P1/A1
- Long term: A-/A3/A-

- Banks (2): The Council's own banker (HSBC) 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 rating agencies. The upper limit of MMFs stands at £175m with a maximum £25m per fund.
- 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)
- Corporate bonds A- (or equivalent)
- Covered bonds (fully collaterised)
- Pooled investment property funds

Country and Sector Considerations

2.63. 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

2.64. 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.

Time and monetary limits applying to investments

2.65. It is recommended that the specific terms applicable to investment types will be limited as follows:

Overnight:	AAA rated money market funds, Call accounts, Enhanced cash/corporate bonds pooled funds
100 days	Unsecured Banks Building Societies A-
6 months	Unsecured Banks Building Societies A
13 months	Unsecured Banks Building Societies AA-
2 years	Corporate Bonds, Debt Management Office, Supranational Institutions, Local Authority
5 years	Bank/Building Society (Secured) Covered Bonds

2.66. Further internal restrictions may be applied on recommendations from Arlingclose.

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

Country limits

2.68. 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

2.69. 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 two years).

Instant access funds

2.70. The council will utilise Money Market Funds (up to the value of £175m).

Local authorities

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

Investment returns expectations

2.72. The Bank Rate is forecast by Arlingclose to remain unchanged at 0.5% before starting to rise from quarter 4 of 2016. Arlingclose forecasts the financial year ends (March) as:

2015/16	2016/17	2017/18	2018/19
0.50%	1.00%	1.50%	1.75%

2.73. 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.

2.74. 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	0.50%
2016/17	0.65%
2017/18	1.25%
2018/19	1.60%

2.75. 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 2016.

Investment treasury indicator and limit

2.76. 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.

2.77. When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Authority will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security.

2.78. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Authority's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office or invested in government treasury bills, for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

Specified Investments

2.79. The CLG Guidance defines specified investments as those:

- denominated in pound sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
  - the UK Government,
  - a UK local authority, parish council or community council, or
  - a body or investment scheme of "high credit quality".

2.80. The Authority defines “high credit quality” organisations and securities as those having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AAA. For money market funds and other pooled funds “high credit quality” is defined as those having a credit rating of AAA.

Non-specified Investments

2.81. Any investment not meeting the definition of a specified investment is classed as non-specified. For treasury purposes, the Authority does not intend to make any investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in table 3 below.

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

Table 2.4: Non Specified Investment Limits

	Cash limit
Total long-term investments	£40m
Total investments without credit ratings or rated below A-	£0m
Total investments (except pooled funds) with institutions domiciled in foreign countries rated below AAA	£0m
Total non-specified investments	£40m

2.83. This keeps the strategy within the Council’s desired level of prudent risk.

2.84. 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.

Investment risk benchmarking

2.85. 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

2.86. 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

Liquidity

2.87. 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. In order to provide a safety margin, a minimum core of £47m is currently in place. 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 four months.

Yield

2.88. 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.

Policy on Use of Financial Derivatives

2.89. Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

2.90. The Authority will only use standalone financial derivatives (such as swaps, forwards, futures and options) after taking expert advice, and where they can be clearly demonstrated to reduce the overall level of the financial risks to which the Authority is exposed. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

2.91. Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

Additional Portfolio of Investments

2.92. 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.

2.93. 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

2.94. 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 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.

2.95. These indicators will be reported to the Audit & Governance Committee in the quarterly and half yearly reports, due after 30 September 2016, and the treasury management outturn report for 2015/16.

End of year investment report

2.96. At the end of the financial year, the Council will report on its investment activity as part of its treasury management outturn report.

External fund managers

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

Minimum revenue provision

2.98. The Council is required to repay an element of the capital financing requirement each year through a revenue charge. This is known as the minimum revenue provision (MRP). The Council's policy on (MRP) is shown in Appendix 14.

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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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