Treasury Management Strategy Statement and Prudential Indicators 2017/18 to 2020/21

Key issues and decisions

To set the Council's prudential indicators for 2017/18 to 2020/21, approve the minimum revenue provision (MRP) policy for 2017/18 and agree the treasury management strategy for 2017/18.

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. On 12 July 2016, as a result of changes in the economic and regulatory environment, specifically the combination of increased counterparty risk (less security arising from new bail in regulations) and further downward pressure on the interest rate environment, a revised treasury management strategy was approved by full council. This resulted in the adoption of a more focused strategy of internal borrowing over the short term and a move away from long term borrowing towards short term borrowing in order to minimise borrowing costs and unnecessary cash balances. A revised strategy may be brought to full council for approval should circumstances demand.

2.3. Outstanding long term debt has stayed constant during 2016/17. Financial and geopolitical concerns (including the pending UK exit from the EU and the monetary policy response from the Bank of England) have led to a sharp dip in gilts yields and therefore the cost of long term and short term debt, and has thus validated the revised strategy.

2.4. The proposed position can be summarised as follows.

- A continuation of the existing strategy to take advantage of the unprecedented low interest rates to borrow externally only when required for liquidity purposes and for the short term, whilst minimising surplus cash balances;
- Maintain the existing counterparty, duration and investment instrument criteria for the management of any surplus cash balances;
- In addition, a review of the calculation of the annual Minimum Revenue Provision (MRP) has been undertaken during 2016/17. Changes to the method of calculation are proposed in the policy (Appendix 12). The revised calculation continues to ensure that the Council makes a prudent provision for the repayment of its external debt but does not put unnecessary pressure on the Council's revenue budget.

Reporting requirements

2.5. 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;
  - a 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.

2.6. 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.

2.7. The Council employs Arlingclose as its advisor on all treasury aspects. The monitoring reports will update the Audit and Governance Committee on Arlingclose's progress and performance in advising council officers.

Treasury management strategy for 2017/18

2.8. The strategy for 2017/18 covers two main areas:

- Capital:
  - the capital plans and the prudential indicators;
  - the minimum revenue provision (MRP) strategy.

- Treasury Management:
  - the current economic position;
  - the borrowing strategy;
  - treasury indicators which limit the treasury risk and activities of the Council;
  - the investment strategy; and
  - creditworthiness policy.

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.

Capital

2.10. 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 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.

2.11. 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.

2.12. Cash being held for other purposes, e.g., earmarked reserves or working capital, can be utilised 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.

2.13. 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 related capital expenditure and may be deferred or borrowed in advance of need. 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.

2.14. 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 2016, with forward projections:

Table 2.1: Current and projected portfolio position

External debt	2015/16 Actual £m	2016/17 Projected £m	2017/18 £m	2018/19 £m	2019/20 £m
Capital Finance Requirement at 31 March	**903.8**	**1,084.0**	**1,143.7**	**1,154.7**	**1,124.8**
Less Other Long Term Liabilities	160.5	186.7	182.5	162.7	144.1
Borrowing Requirement	743.3	897.3	961.2	992.0	980.7
Actual External Debt at 31 March	429.3	429.3	429.3	429.3	429.3
Under/(over) borrowing	**314.0**	**468.0**	**531.9**	**562.7**	**551.4**
Net Financing Need	-	37.6	50.3	37.6	7..4

2.15. The table shows the actual external debt (PWLB, the £10m Barclays loan and balances held on behalf of the Police) against the underlying capital borrowing need, the majority of which is held with the Public Works Loans Board (PWLB). The external debt does not include any short term liquidity loans. The authority has adopted a treasury management strategy that favours fixed rate borrowing to provide certainty over borrowing costs and rates of interest. Net financing need will be met by short term liquidity borrowing.

2.16. The Council is currently operating 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 2017, the projected level of under-borrowing amounts to £468.0m This strategy is designed to limit the net cost of borrowing by utilising existing balances as well as reducing the overall exposure to counterparty risks by reducing available investment balances.

2.17. Within the prudential indicators, there are a number of key indicators to ensure that the Council operates 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.

2.18. 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.

Capital prudential indicators 2017/18 to 2020/21

2.19. 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.

2.20. 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.

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

Minimum revenue provision

2.22. 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) and is the method by which local authorities charge their revenue accounts over time with the cost of their capital expenditure which is funded by borrowing. The Council has a statutory obligation to make a prudent provision for the repayment of its external debt, the Council's policy on (MRP) is shown in Appendix 12.

Economic Environment

2.23. The Treasury Strategy is heavily influenced by the economic environment and particularly in relation to interest rates, for both borrowing and investment. The council employs Arlingclose as an external treasury advisor, one key area is to assist the Council to formulate a view on interest rates. Table 2.2 provides Arlingclose's central case for interest rates.

Table 2.2: Prospects for interest rates

	Bank Base Rate %	PWLB borrowing rates 5 year %	10 year %	20 year %	50 year %
March 2017	0.25	1.30	1.75	2.30	2.20
June 2017	0.25	1.25	1.70	2.25	2.15
September 2017	0.25	1.25	1.70	2.25	2.15
December 2017	0.25	1.25	1.70	2.25	2.15
March 2018	0.25	1.30	1.75	2.30	2.20
June 2018	0.25	1.30	1.75	2.30	2.20
September 2018	0.25	1.30	1.75	2.30	2.20
December 2018	0.25	1.35	1.80	2.35	2.25
March 2019	0.25	1.40	1.85	2.40	2.30
June 2019	0.25	1.45	1.90	2.45	2.35
September 2019	0.25	1.50	1.95	2.50	2.40
December 2019	0.25	1.55	2.00	2.55	2.45
March 2020	0.25	1.60	2.05	2.60	2.50

2.24. A major external influence on the Authority's treasury management strategy for 2017/18 will be the UK's progress in negotiating a smooth exit from the European Union. Financial markets, wrong-footed by the referendum outcome, have since been weighed down by uncertainty (subject to some clarification in January 2017) over whether leaving the European Union also means leaving the single market. Negotiations are expected to formally start once the UK triggers Article 50, expected in March 2017 and last for at least two years. Uncertainty over the UK's future economic prospects will therefore remain throughout 2017/18.

2.25. The fall and continuing weakness in Sterling and the near doubling in the price of oil in 2016 have combined to drive inflation expectations higher. The Bank of England is forecasting that Consumer Price Inflation (CPI) will breach its 2% target in 2017, the first time since late 2013, but the Bank is expected to look through short term inflation overshoots over the course of 2017/18 when setting interest rates so as to avoid derailing the economy.

2.26. Initial post-referendum economic data showed that the feared collapse in business and consumer confidence had not immediately led to lower GDP growth. However, the prospect of a leaving the single market has dented business confidence and resulted in a delay in new business investment and, unless counteracted by higher public spending or retail sales, will weaken economic growth in 2017/18.

2.27. Looking overseas, with the US economy and its labour market showing steady improvement, the US Federal Reserve increased interest rates in December 2016. The Eurozone meanwhile has continued to struggle with very low inflation and lack of momentum in growth, and the European Central Bank has left the door open for further monetary action.

2.28. The impact of political risk on financial markets remains significant over the next year. With challenges such as immigration, the rise of populist, anti-establishment parties and negative interest rates resulting in savers being paid nothing for their frugal efforts or even penalised for them, the French presidential and general elections (April to June 2017) and the German federal elections (August to October 2017) have the potential for upsets.

2.29. Markets have expressed concern over the financial viability of a number of European banks recently. Sluggish economies and continuing fines for pre-crisis behaviour have weighed on bank profits, and any future slowdown will exacerbate concerns in this regard.

2.30. Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the European Union, Switzerland and USA, while Australia and Canada are progressing with their own plans. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the authority. Returns from cash deposits, however, continue to fall.

2.31. The Authority's treasury advisor Arlingclose's central case is for the UK Bank Rate to remain at 0.25% during 2017/18**.** The Bank of England has, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further falls in the bank rate look less likely. A negative UK bank rate is currently perceived by some policymakers to be counterproductive but, although a low probability, cannot be entirely ruled out in the medium term, particularly if the UK enters recession as a result of sharp falls in GDP growth and concerns over leaving the European Union.

2.32. Since the US presidential election, gilt yields have risen, but remain at low levels. The Arlingclose central case is for yields to decline when the Government triggers Article 50. Long-term economic fundamentals remain weak, and the quantitative easing (QE) stimulus provided by central banks globally has only delayed the fallout from the build-up of public and private sector debt. The Bank of England has defended QE as a monetary policy tool, and further QE in support of the UK economy in 2017/18 remains a possibility in order to keep long-term interest rates low.

2.33. Against this background and the risks within the economic forecast, caution will be adopted with the 2017/18 treasury operations. Markets will continue to be monitored carefully and the Council will adopt a pragmatic approach to changing circumstances in relation to its borrowing strategy. Further analysis of the UK and global economic outlook is shown as Appendix 10.

Borrowing strategy

2.34. The Authority currently holds £397.2m of long term loans as part of its strategy for funding previous years' capital programmes. The authority's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required.

2.35. Given the significant budgetary pressure facing the Council both from sources of funding and service demands, the authority's borrowing strategy continues to address the key issue of affordability without compromising the long-term stability of the debt portfolio.

2.36. The proposed borrowing strategy for 2017/18 will be a continuation of the use of internal and short term external borrowing to meet the capital strategy. With the large gap between short term and long term interest rates likely to continue for the medium term there is a significant advantage for the Council to utilise short term borrowing.

2.37. By doing so, the authority is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal and short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates may rise. Arlingclose will assist the authority with this 'cost of carry' and breakeven analysis. Significant changes in current or forecast interest rates may mean that longer term borrowing becomes more cost effective, but this outcome is not expected.

2.38. Alternatively, the authority may arrange forward starting loans during 2017/18, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

Sources of borrowing

2.39. The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds (except Surrey Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues
- UK Local Authorities and other public bodies.

2.40. The Authority has previously raised the majority of its long-term borrowing from the PWLB. For short term borrowing the Council will likely use other sources rather than the PWLB, such as other local authorities, public bodies and pension funds as the cost of borrowing is significantly lower in the short term.

Municipal Bond Agency

2.41. The UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association (LGA) as an alternative source of funds to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a joint and several guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable.

LOBOs

2.42. The Authority held a £10m LOBO (Lender's Option Borrower's Option) loan where the lender had the option to propose an increase in the interest rate as set dates, following which the authority had the option to either accept the new rate or to repay the loan at no additional cost. This LOBO has since been converted into a fixed term, fixed rate loan for the original duration of the instrument and is now classified in the authority's balance sheet as a fixed rate bank loan.

Debt Rescheduling

2.43. The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Authority may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

Treasury management limits on activity

2.44. There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function, thereby managing risk and limiting exposure to 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.

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

Table 2.3: Treasury indicators and limits

	2017/18 to 2021/22		2016/17 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%**

UK Treasury Management Delegation

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

Investment Strategy

2.47. The Authority is currently operating with limited investment funds. The strategy of internal borrowing, supplemented by short term borrowing when necessary has significantly reduced current and forecast investment balances for the year.

2.48. Both the CIPFA Code and the CLG Guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the optimal rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

2.49. If the UK enters into a recession in 2017/18, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which may feed through to negative interest rates on many low risk, short-term investment options. This situation already exists in a number of other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

2.50. Given the increasing risk and lower returns from short-term unsecured bank investments, the authority will aim to place its surplus cash balances in secure, liquid asset classes during 2017/18. All of the authority's surplus cash is currently invested in short-term deposits with local authorities, money market or enhanced cash funds

2.51. The borrowing strategy as outlined will lead to reduced investment balances and a requirement to maintain readily accessible funds to limit the amount of borrowing required.

2.52. The Director of Finance, under delegated powers, will undertake the most appropriate form of investments depending on the 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 duration 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, followed by the availability or liquidity of the funds with the yield or return on the investment is also a key consideration. 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 three agencies with two 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.

2.56. Any counterparty failing to meet the criteria would be omitted from the counterparty 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.

2.57. The criteria for investment counterparties and instruments is set out below (both specified and non-specified investments).

- **Bank/Building Society Unsecured**: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.
  The council will only use banks meet the following criteria
    - Short term: F1/P1/A1 (Fitch, Moodys, S&P)
    - Long term A-/A3/A-
    - UK domiciled
    - are non-UK and domiciled in a country which has a minimum sovereign long term rating of AAA
    - HSBC as the Council' main bank provider for transactional purposes with minimal overnight balances if the bank does not meet the credit rating criteria above.
    - Bank subsidiaries where the parent bank has provided an appropriate guarantee and meets the rating criteria.

- **Bank/Building Society Secured (Covered Bonds):** These investments are secured on the bank's assets, which limit the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. The combined secured and unsecured investments in any one bank will not exceed £20m. A minimum rating of AAA (or equivalent) from two of the three rating agencies.

- **Money Market Funds:** An open ended fund that invests in short term debt securities, offers same-day liquidity and very low volatility. The use of Money Market Funds is restricted to funds with AAA ratings (from two of the three rating agencies) up to a maximum of £175m (with a maximum of £25m per Money Market Fund)

- **Government:** Loans, bonds and bills issued or guaranteed by UK government, local authorities and supranational banks. These investments are not subject to bail-in, and there is a minimal risk of insolvency. Deposits with a single local authority or public body are limited to £20m, with no such limit in place for a UK national government body, e.g DMO.

- **Corporates:** Corporate bonds issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. A minimum rating of A- (or equivalent) from two of the three rating agencies with a maximum exposure of £20m.

- **Enhanced Cash/Bond Funds:** Criteria for suitable funds is a fund credit quality (FCQ) rating of AAA and a fund volatility rating (FVR) of S1 (or equivalent) from one of the three main rating agencies (Fitch, Moody's or Standard & Poor's) with a maximum combined limit of £20m for enhanced cash/bond funds.

- **Pooled Property Funds:** Shares in diversified property investment vehicles. Property funds offer enhanced returns over the longer term, but are more volatile in the short term. The funds have no defined maturity date, but are available for withdrawal after a notice period. The strategy has set a maximum combined limit of £20m for pooled property funds.

Country restrictions

2.58. 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 up to a maximum of £40m per country. This restriction does not apply to the UK, which has seen its AAA rating reduced. The following counties are rated AAA:

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

Time and monetary limits applying to investments

2.59. 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 day**: Unsecured Banks Building Societies A- and above
- **6 months:** Unsecured Banks Building Societies A and above
- **13 months:** Unsecured Banks Building Societies AA- and above
- **2 years**: Corporate Bonds
- **5 years:** Bank/Building Society (Secured) Covered Bonds, Debt Management Office, Supranational Institutions, Local Authority

2.60. Further internal restrictions may be applied based upon market conditions or recommendations from Arlingclose.

2.61. The proposed criteria for specified and non-specified investments are shown in table 2.4

Table 2.4: Effective Counterparty Limits

Type	Fitch		Moody's		S&P			
	Short Term	Long Term	Short Term	Long Term	Short Term	Long Term	Maximum Value	Maximum Term
Bank/Building Society (Unsecured)	F1	A-	P-1	A3	A1	A-	£20m	100 days
Bank/Building Society (Unsecured)	F1	A	P-1	A	A1	A	£20m	6 months
Bank/Building Society (Unsecured)	F1+	AA-	P-1	Aa3	A1+	AA-	£20m	13 months
Corporate Bonds	A-		A3		A-		£20m	2 years
Bank/Building Society (Secured) Covered Bonds	AAA		Aaa		AAA		£20m	5 years
Money Market Funds	AAA		Aaa		AAA		£25m	n/a
Enhanced Cash / Bond Funds	AAA / v1		Aaa-bf		AAAf / s1		£20m	n/a
Debt Management Office							Unlimited	2 years
Supranational Institutions							£20m	2 years
Local Authority							£20m	2 years
Pooled Investment Property Funds							£20m	n/a

Use of additional information other than credit ratings

2.62. 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.

Investment returns expectations

2.63. The Bank Rate is forecast by Arlingclose to remain unchanged at 0.25% for some considerable time. Arlingclose forecasts the financial year ends (March) as follows:

2016/17	2017/18	2018/19	2019/20
0.25%	0.25%	0.25%	0.25%

2.64. 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.

2.65. 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:

2016/17	0.40%
2017/18	0.40%
2018/19	0.40%
2019/20	0.65%

Specified Investments

2.66. 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.

2.67. 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 Investment Limits

2.68. 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 2.5 below.

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

Table 2.5: Non Specified Investment Limits

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

Investment risk benchmarking

2.70. 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

2.71. 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

2.72. The Council currently restricts deposits with each counterparty to term deposits only, the length of which is based upon individual assessment of each counterparty. In respect of its liquidity, the Council seeks to maintain the following:

- Bank overdraft: £100,000;
- No minimum target relating to liquid short term deposits;
- Weighted average life benchmark is expected to be less than three months.

Yield

2.73. 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

2.74. 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).

2.75. 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.

2.76. 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

2.77. 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.

2.78. 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

2.79. 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.

2.80. These indicators will be reported to the Audit & Governance Committee in the quarterly and half yearly reports, due after 30 September 2017, and the treasury management outturn report for 2017/18.

End of year investment report

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

Training

2.82. 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 regular newsletters and regular update calls/meetings will be held with Arlingclose.

2.83. 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.

External fund managers

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

Lead/contact officer:

Treasury	Phil Triggs, Strategic Finance Manager, Pension Fund & Treasury 020 8541 9894
Capital	Wai Lok, Senior Accountant 020 8541 7756

Appendices:

Appendix 8	Treasury Management Policy
Appendix 9	Prudential indicators – 2017/18 – 2020/21
Appendix 10	Global economic outlook and the UK economy
Appendix 11	Treasury management scheme of delegation
Appendix 12	Annual minimum revenue provision 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

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