Cabinet

Agenda Item: 9

Ward:	All
Portfolio:	Finance
Meeting Date:	13 February 2017

Report Author(s): **Cllr Parham / Corporate Finance**

SUBJECT: **Treasury Management Strategy Statement and Annual Investment Strategy**

Report Sign off	**Seen by:**	**Name**	**Date**
	Chief Executive	Stuart Brown	Via CMT
	Legal	Donna Nolan	Via CMT
	Finance	Duncan Moss	30 January 2017
	Group Manager	Paul Deal	Via CMT
	Portfolio Holder	Cllr Parham	30 January 2017
	Ward Member(s)	ALL	N/A

Summary:	Approval is sought for the Treasury Management and Annual Investment Strategy for the forthcoming financial year 2017/18.
Recommendation:	**The Leader and Cabinet are recommended to agree and recommend to Full Council:** **1. The strategy as laid out in the report including only borrowing short term to cover shortfalls in cashflow;** **2. The prudential guidelines as laid out in the report;** **3. To approve MRP policy included in this report.**
Direct and/or indirect impact on service delivery to our customers and communities	The Treasury Management and Annual Investment Strategy impacts on all service delivery indirectly through the capital programme.
Contribution to Corporate Priorities:	This paper directly links to the Corporate Plan 2015-19 and its two main priorities.

Legal Implications:	In addition the Council is required by Regulation to have regard to the Prudential Code when exercising powers under the Local Government Act 2003.
Financial Implications:	Capital programme and the interest income achievable
Impact on Service Plans:	Effective Treasury Management provides support to the range of business and service level objectives that together help to deliver individual service plans and the overall Corporate Plan.
Value for Money:	All the Council's operations are subject to scrutiny under Value for Money. This is tested by Grant Thornton, our External Auditors.
Equalities Implications:	The implication are reviewed with the service plans and business case for the capital expenditure.
Risk Assessment and Adverse Impact on Corporate Actions:	The Strategy attempts to minimise the risks wherever possible.

1. INTRODUCTION

1.1 Background

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 short term cash flow is adequately planned, with 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 liquidity initially before considering investment return.

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.

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."

1.2 Reporting requirements

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

1. **Prudential and treasury indicators and treasury strategy** (this report)
   The first, and most important report covers:
   - the capital plans (including prudential indicators);
   - a minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
   - 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).

2. **A mid-year treasury management report**
   This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision. In addition, this council will receive quarterly update reports.

3. **An annual treasury report**
   This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

1.3 Treasury Management Strategy for 2017/18

The strategy for 2017/18 covers two main areas:

Capital issues

- the capital plans and the prudential indicators;
- the minimum revenue provision (MRP) policy.

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.

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

1.4 Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training. Training at Mendip has been undertaken by proxy when treasury management reports are presented and discussed at public meetings. Further training will be arranged as required. The training needs of treasury management officers are periodically reviewed.

1.5 Treasury management consultants

The council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

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 uses Capita Asset Services Treasury solutions as its external treasury management advisors. 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.

2 CAPITAL PRUDENTIAL INDICATORS 2017/18 – 2019/20

The council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

2.1 Capital expenditure

This prudential indicator is a summary of the council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle.

The Council is asked to approve the Capital Expenditure forecasts below:

	2015/16 Actual £000s	2016/17 Estimate £000s	2017/18 Estimate £000s	2018/19 Estimate £000s	2019/20 Estimate £000s
REFCUS	795	991	951	951	951
Property, Plant & Equipment	191	208	328	340	147
Intangible Assets	173	36	104	0	0
Other – waste vehicle lease	0	0	3,500	0	0
Total	**1,159**	**1,235**	**4,883**	**1,291**	**1,098**

*Revenue Expenditure Financed from Capital under Statute

The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

	2015/16 Actual £000s	2016/17 Estimate £000s	2017/18 Estimate £000s	2018/19 Estimate £000s	2019/20 Estimate £000s
Capital Expenditure	**1,159**	**1,235**	**4,883**	**1,291**	**1,098**
Financed by:					
Capital Receipts	521	39	41	43	45
Capital Grants	460	701	701	701	701
Direct Revenue Contribution	331	101	25	25	25
Total Financing	**1,312**	**841**	**767**	**769**	**770**
Net financing need	**(153)**	**394**	**4,116**	**522**	**328**
Cumulative financing need	**2,700**	**3,094**	**7,209**	**7,731**	**8,059**

2.2 The Council's borrowing need (the Capital Financing Requirement)

The second prudential indicator is the council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each assets life.

The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes.

The Council is asked to approve the CFR projections below:

Capital Financing Requirement (CFR)	2015/16 Actual £000s	2016/17 Estimate £000s	2017/18 Estimate £000s	2018/19 Estimate £000s	2019/20 Estimate £000s
Total CFR	2,417	2,811	6,927	7,449	7,776
Movement in CFR	(436)	394	4,116	522	328
Movement in CFR represented by					
Net financing need for the year (above)	(153)	394	4,116	522	328
Less MRP/VRP and other financing movements	(283)	(220)	(162)	(293)	(394)
Movement in CFR	**(436)**	**174**	**3,954**	**229**	**(66)**

2.3 Minimum revenue provision (MRP) policy statement

The council is required to pay off an element of the accumulated Capital Financing Requirement through a revenue charge (the minimum revenue provision - MRP), although it is also allowed to undertake additional voluntary payments if required (voluntary revenue provision - VRP).

CLG regulations have been issued which require Full Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision.

The Council is recommended to approve the following MRP Statement:

"The Council will continue to make provision at least equal to an annual 4% reducing balance method on all capital expenditure covered by government supported borrowing approvals.

Provision for the capital expenditure within the proposed Annual Service Capital Programme will be based on the nominal life of the asset delivered.

Provision for the capital expenditure within any proposed Investment Capital Programme will be based upon one the following options:

a. **the nominal life of the asset delivered (the default position)**
b. **any reduction in the valuation of the asset (assessed annually) being recovered over the remaining life of associated debt financing the investment.**

   If in subsequent years the value increased, the revised MRP would remain leading to excess provision set aside that can be used as a capital receipt enabling the council to invest further or reduce the overall capital financing costs"

2.4 Affordability prudential indicators

Prudential Indicators are also required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the council's overall finances.

The council is asked to approve the following indicators:

a. Ratio of financing costs to net revenue stream

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2015/16 Actual %	2016/17 Estimate %	2017/18 Estimate %	2018/19 Estimate %	2019/20 Estimate %
Total	1.37	0.93	0.59	1.34	2.09

The estimates of financing costs include current commitments and the proposals in this budget report.

b. Incremental impact of capital investment decisions on council tax

This indicator identifies the revenue costs associated with proposed changes to the five year indicative capital programme included in the budget report compared to the council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published beyond the next three year period.

	2015/16 Actual £	2016/17 Estimate £	2017/18 Estimate £	2018/19 Estimate £	2019/20 Estimate £
Council tax - band D	8.94	6.49	5.30	8.92	11.21

c. Treasury indicators for debt

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 they will impair the opportunities to reduce costs / improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments
- 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.

The Council is asked to approve the following treasury indicators and limits:

Interest rate exposures – UPPER Limit	2017/18	2018/19	2019/20
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	100%	100%	100%

Maturity structure of Fixed / Variable interest rate borrowing 2017/18		
	Lower	**Upper**
Under 12 months	0%	100%
12 months to 2 years	0%	100%
2 years to 5 years	0%	100%
5 years to 10 years	0%	100%
10 years to 20 years	0%	100%
20 years to 30 years	0%	100%
30 years to 40 years	0%	100%
40 years to 50 years	0%	100%

2.5 Core funds and expected investment balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end balances for each resource and anticipated day to day cash flow balances.

Year-end Resources	2015/16 Actual £000s	2016/17 Estimate £000s	2017/18 Estimate £000s	2018/19 Estimate £000s	2019/20 Estimate £000s
Fund Balances / reserves	7,400	7,747	9,574	7,751	7,842
Capital receipts (earmarked)	550	550	0	0	0
Capital grants (unapplied)	359	359	359	359	359
Total Core Funds	**8,309**	**8,656**	**9,933**	**8,110**	**8,201**

*Working capital balances shown are estimated year end; these may be higher mid-year

3 BORROWING

The capital expenditure plans set out in Section 2 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 / prudential indicators, the current and projected debt positions and the annual investment strategy.

The council currently has no external borrowing.

3.1 Current portfolio position

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 CFR in the preceding year plus the estimates of any additional CFR for 2017/18 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.

The Corporate Financial Advisor 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.

3.2 Treasury Indicators: limits to borrowing activity

The operational boundary.
This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

Operational boundary £m [1]	**2016/17 Estimate**	**2017/18 Estimate**	**2018/19 Estimate**	**2019/20 Estimate**
Debt	£38m	£38m	£38m	£38m
Other long term liabilities	0	0	0	0
Total	£38m	£38m	£38m	£38m

The authorised limit for external debt.
A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

[1] This limit reflects the proposal to undertake commercial investment during 2017/18 and not the proposed capital investment.

This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

The council is asked to approve the following authorised limit:

Authorised limit £m	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Debt	£40m	£40m	£40m	£40m
Other long term liabilities	0	0	0	0
Total	£40m	£40m	£40m	£40m

3.3 Borrowing strategy

The council is currently maintaining an 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. This strategy is prudent as investment returns are low and counterparty risk is still an issue that needs to be considered.

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 finance capital expenditure and/or to refinance maturing debt.

Against this background and the risks within the economic forecast, caution will be adopted with the 2017/18 treasury operations. The Corporate Finance Advisor will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- if it was felt that there was a significant risk of a sharp **FALL** in long and short term rates (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

- if it was felt that there was a significant risk of a much sharper **RISE** in long and short term rates than that currently forecast, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

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

3.4 Commercial Investment Programme

Since the recession in 2008 and the drop in interest rates there has been further pressure on the council's revenue budget. While investment returns on cash investments fell, the rental income from prime investment property portfolios remained strong.

The council has broad powers under either under Section 1 of the Local Government Act 2003 or under the General Power of Competence in Section 1 of the Localism Act 2011 to invest directly in land and commercial property, either for the purposes of any of its functions (which includes powers to acquire, sell and develop land for the benefit or improvement of the area), or for its treasury management purposes (to deliver a sound return under its investment strategy).

As such, to help cover the budget shortfall the Council faces, and the continued low return on cash investments, the Council is pursuing other sources of income including the investment in properties by purchasing high calibre property. This strategy adds flexibility to enable the Council to maximise its investment returns through a 'mixed portfolio' approach.

To facilitate this commercial investment, the Council has reviewed its borrowing capacity and increase the Authorised Limit to £40m. In order to maximise the return that can be achieved from this funding, it is key that all options are open including investment in land, assets, and organisations.

However, a strong degree of governance also needs to be in place to safeguard public funds and this will be achieved through the Phoenix Board, a cross party Member Board chaired by the Leader. It will provide oversight on the performance of the organisation in delivering the Transformation Programme; and will be responsible for the supporting policy framework. It will advise on and make decisions on emerging opportunities for transformational activity, including, but not limited to, new commercial partnerships; decisions on borrowing within the £40million approval of Full Council and investment decisions.

When considering investment property acquisitions, the council should look to ensure a positive commercial return (i.e. that the yield exceeds the cost of the debt financing or the interest available via Specified Investments) and that the associated long-term operating lease has strong covenants included to protect the council's interests. However, with the corporate objectives of economic development and health and wellbeing, the Phoenix Board will also have the discretion to buy assets that provide a community benefit if the overriding benefit of the purchase was to meet these strategic priorities.

The Phoenix Board will also have discretion to loan funds to third parties on a commercial basis subject to a detailed business case and risk analysis. This includes, but is not limited to, the Council's Arm's Length Trading company Shape Housing and its subsidiary companies. When considering this option, the business case should include an external credit assessment, such as Dun and Bradstreet, Creditsafe or Company Watch and specific advice from the Council's treasury management adviser. Also wherever possible, the debt should be secured against assets. The type of security will depend on what assets the borrower has and the value of those assets and whether the borrower has given security over the same asset to another party.

Overall, it is key that a mixed portfolio is achieved that provides a balance between risk and reward.

3.5 Policy on borrowing in advance of need

The benefit for the council to borrow in advance is that it is able to fix the interest rate at a point in time ahead of the actual need to make a payment. In a period of rising interest rates, this could be very beneficial. If however rates at the point in time the cash is required are lower, then the advanced borrowing agreement is not invoked.

By way of an example, the funding of the waste vehicles has been approved but payment will not be made until the autumn. The council could therefore fix the rate at the current interest rate and if the rates increase it will have saved.

However, the council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing 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.

Borrowing in advance will be made within the constraints that:

- It will be limited to no more than 100% of the expected increase in borrowing need (CFR) over the three year planning period; and
- The authority would not look to borrow more than 18 months in advance of need.

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

3.6 Prospects for interest rates

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. The following table gives their central view.

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.60%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB rate	2.70%	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%

The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Monetary policy action by the central banks of major economies reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some countries, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.

- Major national polls:
    - Italian constitutional referendum 4 December 2016 resulted in a 'No' vote which led to the resignation of Prime Minister Renzi. This means that Italy needs to appoint a new government.
    - Spain has a minority government with only 137 seats out of 350 after already having had two inconclusive general elections in 2015 and 2016. This is potentially highly unstable.
    - Dutch general election 15 March 2017;
    - French presidential election April/May 2017;
    - French National Assembly election June 2017;
    - German Federal election August – October 2017.
- A resurgence of the Eurozone sovereign debt crisis, with Greece being a particular problem, and stress arising from disagreement between EU countries on free movement of people and how to handle a huge influx of immigrants and terrorist threats
- Weak capitalisation of some European banks, especially Italian.
- Geopolitical risks in Europe, the Middle East and Asia, causing a significant increase in safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.

Upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates, include: -

- UK inflation rising to significantly higher levels than in the wider EU and in the US, causing an increase in the inflation premium in gilt yields.
- A rise in US Treasury yields as a result of Fed. funds rate increases and rising inflation expectations in the USA, dragging UK gilt yields upwards.
- The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- A downward revision to the UK's sovereign credit rating undermining investor confidence in holding sovereign debt (gilts).

Investment and borrowing rates forecasts are that: -

- Investment returns are likely to remain low during 2017/18 and beyond;
- Borrowing interest rates have been on a generally downward trend during most of 2016 up to mid-August; they fell sharply to historically phenomenally low levels after the referendum and then even further after the MPC meeting of 4th August when a new package of quantitative easing purchasing of gilts was announced. Gilt yields have since risen sharply due to a rise in concerns around a 'hard Brexit', the fall in the value of sterling, and an increase in inflation expectations.

A summary of the economic climate is included within **Appendix 1.**

3.7 Debt rescheduling

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 (premiums incurred).

The reasons for any rescheduling to take place will include:

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

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.

All rescheduling will be reported to the Cabinet, at the earliest meeting following its action.

4 Annual Investment Strategy

4.1 Investment policy

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.

In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

Ratings will not be the sole determinant of the quality of an institution; 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. 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, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

Investment instruments identified for use in the financial year are listed in **Appendix 2** under the ‘specified’ and ‘non-specified’ investments categories. Counterparty limits will be as set through the council’s treasury management practices – schedules.

4.2 Ethical Investment Policy

Historically, the Council has not included ethical criteria when determining its investment criteria. The investment environment can be very fast moving, so there is a need to ensure that any investment criteria are objective, such as credit ratings. It is difficult to gain an objective assessment of the ethical standing of a potential counterparty, particularly to a tight timescale.

Ethical considerations are difficult to evaluate subjectively, and would also need to be applied to the counterparty list after taking into account security and liquidity issues. The Council’s current counterparty list is, due to the high credit quality criteria used by the Council, very small, and therefore does not encompass those organisations which promote themselves as ethical. However, none of the organisations on the counterparty list have given cause for concern regarding the ethical nature of their business.

Furthermore, the Council will not knowingly invest <u>directly</u> in businesses whose activities and practices pose a risk of serious harm to individuals or groups, or whose activities are inconsistent with the Council’s mission and values. This would include avoiding direct investment in institutions with material links to:

- Human rights abuse (e.g. child labour, political oppression)
- Environmentally harmful activities (e.g. pollutions, destruction of habitat, fossil fuels)
- Socially harmful activities (e.g. tobacco, gambling)

4.3 Creditworthiness policy

This council applies the creditworthiness service provided by Capita Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody’s and Standard and Poor’s. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- credit default swap (CDS) spreads to give early warning of likely changes in credit ratings;
- sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines Credit Ratings, Credit Watches And Credit Outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the council to determine the suggested duration for investments. The council will therefore use counterparties within the following durational bands:

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour

Key:

- Yellow 5 years
- Dark pink 5 years for Enhanced money market funds (EMMFs) with a credit score of 1.25
- Light pink 5 years for Enhanced money market funds (EMMFs) with a credit score of 1.5
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days
- No colour not to be used

	Colour (and long term rating where applicable)	Greater of Money / % Limit	Time Limit
Banks *	yellow	£5m / 10%	5 yrs
Banks	purple	£5m / 10%	2 yrs
Banks	orange	£5m / 10%	1 yr
Banks – part nationalised	blue	£5m / 20%	1 yr
Banks	red	£5m / 20%	6 mths
Banks	green	£5m / 20%	100 days
Banks	No colour	Not to be used	
Limit 3 category – Council's banker (not meeting Banks 1)	blue	£5m / 20%	1 day
Other institutions limit	-	Not to be used	
DMADF	AAA	unlimited	6 months
Local authorities	n/a	£5m / 20%	1 yr
Money market funds	AAA	£5m / 20%	liquid
Enhanced money market funds with a credit score of 1.25	Dark pink / AAA	£5m / 20%	liquid
Enhanced money market funds with a credit score of 1.5	Light pink / AAA	£5m / 20%	liquid

4.4 Investment risk benchmarking

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.

The Capita Asset Services' creditworthiness service uses a wider array of information than just primary ratings. Furthermore, by using a risk weighted scoring system, it does not give undue preponderance to just one agency's ratings.

Typically the minimum credit ratings criteria the council use will be a Short Term rating (Fitch or equivalents) of F1 and a Long Term rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored weekly. The council is alerted to changes to ratings of all three agencies through its use of the Capita Asset Services' creditworthiness service.

- if a downgrade results in the counterparty / investment scheme no longer meeting the council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the council will be advised of information in movements in credit default swap spreads against the iTraxx[2] benchmark and other market data on a daily basis via its Passport website, provided exclusively to it by Capita Asset Services. Extreme market movements may result in downgrade of an institution or removal from the council's lending list.

Sole reliance will not be placed on the use of this external service. In addition this council will also use market data and market information, information on any external support for banks to help support its decision making process.

4.5 Country limits

The council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch. The list of countries that qualify using this credit criteria as at the date of this report are shown in **Appendix 3**. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

4.6 Investment strategy

In-house funds.
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).

Investment returns expectations.
Bank Rate is forecast to stay flat at 0.25% until Quarter 2 of 2019 and not to rise above 0.75% by Quarter 1 of 2020. Bank Rate forecasts for financial year ends (March) are:

- 2016/17 0.25%
- 2017/18 0.25%
- 2018/19 0.25%
- 2019/20 0.50%

[2] **iTraxx** (Thomson Reuters Eikon code '**ITRAXX**'; Bloomberg code 'ITRX') is the brand name for the family of credit default swap index products covering regions of Europe, Australia, Japan and non-Japan Asia.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year are as follows:

- 2017/18 0.25%
- 2018/19 0.25%
- 2019/20 0.50%
- 2020/21 0.75%
- 2021/22 1.00%
- 2022/23 1.50%
- 2023/24 1.75%
- Later years 2.75%

The overall balance of risks to these forecasts is currently probably slightly skewed to the downside in view of the uncertainty over the final terms of Brexit. If growth expectations disappoint and inflationary pressures are minimal, the start of increases in Bank Rate could be pushed back. On the other hand, should the pace of growth quicken and / or forecasts for increases in inflation rise, there could be an upside risk i.e. Bank Rate increases occur earlier and / or at a quicker pace.

<u>Investment treasury indicator and limit</u>
Total principal funds invested for greater than 364 days. These limits are set with regard to the council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The council is asked to approve the treasury indicator and limit: -

Maximum principal sums invested > 364 days			
	2017/18	**2018/19**	**2019/20**
Principal sums invested > 364 days within the service capital programme	£5m / 10%	£5m / 10%	£5m / 10%

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 deposits (overnight to 100 days) in order to benefit from the compounding of interest.

4.7 End of year investment report

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

5 RECOMMENDATION

The Leader and Cabinet are recommended to agree and recommend to Full Council:

1. The strategy as laid out in the report including only borrowing short term to cover shortfalls in cash flow;
2. The prudential guidelines as laid out in the report;
3. To approve MRP policy included in this report.

Contact Officer: **Paul Deal**
Ext No: **0300 303 8588**

Background Papers
Prudential Guidelines – CIPFA
CIPFA Treasury Management Code of Practice

APPENDIX 1 – ECONOMIC BACKGROUND

The Monetary Policy Committee, (MPC), cut Bank Rate from 0.50% to 0.25% on 4th August in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016. It also gave a strong steer that it was likely to cut Bank Rate again by the end of the year. However, economic data since August has indicated much stronger growth in the second half 2016 than that forecast; also, inflation forecasts have risen substantially as a result of a continuation of the sharp fall in the value of sterling since early August. Consequently, Bank Rate was not cut again in November or December and, on current trends, it now appears unlikely that there will be another cut, although that cannot be completely ruled out if there was a significant dip downwards in economic growth.

During the two-year period 2017 – 2019, when the UK is negotiating the terms for withdrawal from the EU, it is likely that the MPC will do nothing to dampen growth prospects, (i.e. by raising Bank Rate), which will already be adversely impacted by the uncertainties of what form Brexit will eventually take. Accordingly, a first increase to 0.50% is not tentatively pencilled in until Quarter 2 2019, after those negotiations have been concluded, (though the period for negotiations could be extended). However, if strong domestically generated inflation, (e.g. from wage increases within the UK), were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected that at some point, there would be a start to a switch back from bonds to equities after a historic long term trend over about the last twenty five years of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial quantitative easing purchases of bonds, added further impetus to this downward trend in bond yields and rising prices of bonds.

The opposite side of this coin has been a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election, has called into question whether, or when, this trend has, or may, reverse, especially when America is likely to lead the way in reversing monetary policy.

Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as strong economic growth becomes more firmly established. The expected substantial rise in the Fed. rate over the next few years may make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US would be likely to exert some upward pressure on bond yields in other developed countries but the degree of that upward pressure is likely to be dampened by how strong, or weak, the prospects for economic growth and rising inflation are in each country, and on the degree of progress in the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

PWLB rates and gilt yields have been experiencing exceptional levels of volatility that have been highly correlated to geo-political, sovereign debt crisis and emerging market developments. It is likely that these exceptional levels of volatility could continue to occur for the foreseeable future.

The overall balance of risks to economic recovery in the UK is to the downside, particularly in view of the current uncertainty over the final terms of Brexit and the timetable for its implementation.

APPENDIX 2 – CREDIT RATINGS

Organisations and Countries are rated on a scale from AAA to D on their ability to fulfil their financial commitments, based on previous dealings. Intermediate ratings are offered at each level between AA and CCC (e.g., BBB+, BBB and BBB−). For some borrowers, the company may also offer guidance (termed a "credit watch") as to whether it is likely to be upgraded (positive), downgraded (negative) or uncertain (neutral).

Long-term credit ratings

- **AAA:** An obligor rated 'AAA' has extremely strong capacity to meet its financial commitments. 'AAA' is the highest issuer credit rating assigned by Standard & Poor's.
- **AA:** An obligor rated 'AA' has very strong capacity to meet its financial commitments. It differs from the highest-rated obligors only to a small degree. Includes:
    - **AA+:** equivalent to Moody's Aa1 (high quality, with very low credit risk, but susceptibility to long-term risks appears somewhat greater)
    - **AA:** equivalent to Aa2
    - **AA−:** equivalent to Aa3
- **A:** An obligor rated 'A' has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories.
    - **A+:** equivalent to A1
    - **A:** equivalent to A2
- **BBB:** An obligor rated 'BBB' has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.

Non-Investment Grade (also known as speculative-grade)

- **BB:** An obligor rated 'BB' is less vulnerable in the near term than other lower-rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitments.
- **B:** An obligor rated 'B' is more vulnerable than the obligors rated 'BB', but the obligor currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
- **CCC:** An obligor rated 'CCC' is currently vulnerable, and is dependent upon favourable business, financial, and economic conditions to meet its financial commitments.
- **CC:** An obligor rated 'CC' is currently highly vulnerable.
- **C:** highly vulnerable, perhaps in bankruptcy or in arrears but still continuing to pay out on obligations

- **R:** An obligor rated 'R' is under regulatory supervision owing to its financial condition. During the pendency of the regulatory supervision, the regulators may have the power to favor one class of obligations over others or pay some obligations and not others.
- **SD:** has selectively defaulted on some obligations
- **D:** has defaulted on obligations and S&P believes that it will generally default on most or all obligations
- **NR:** not rated

Short-term issue credit ratings

Specific issues are rated on a scale from A-1 to D. Within the A-1 category the Organisation or Country can be designated with a plus sign (+). This indicates that the issuer's commitment to meet its obligation is very strong. Country risk and currency of repayment of the obligor to meet the issue obligation are factored into the credit analysis and reflected in the issue rating.

- **A-1:** obligor's capacity to meet its financial commitment on the obligation is strong
- **A-2:** is susceptible to adverse economic conditions however the obligor's capacity to meet its financial commitment on the obligation is satisfactory
- **A-3:** adverse economic conditions are likely to weaken the obligor's capacity to meet its financial commitment on the obligation
- **B:** has significant speculative characteristics. The obligor currently has the capacity to meet its financial obligation but faces major ongoing uncertainties that could impact its financial commitment on the obligation
- **C:** currently vulnerable to non-payment and is dependent upon favourable business, financial and economic conditions for the obligor to meet its financial commitment on the obligation
- **D:** is in payment default. Obligation not made on due date and grace period may not have expired. The rating is also used upon the filing of a bankruptcy petition.

APPENDIX 3 – INVESTMENT INSTRUMENTS

12 Treasury Management Practices (TMP) accompany the treasury management strategy. In a change to previous years, the minimum requirement is now to only show those TMP's that have changed since the previous strategy was approved.

Treasury Management Practice (Tmp1) – Credit and Counterparty Risk Management (Option 1)

<u>Specified Investments:</u>
All such investments will be sterling denominated, with maturities up to maximum of 1 year, meeting the minimum 'high' quality criteria where applicable.

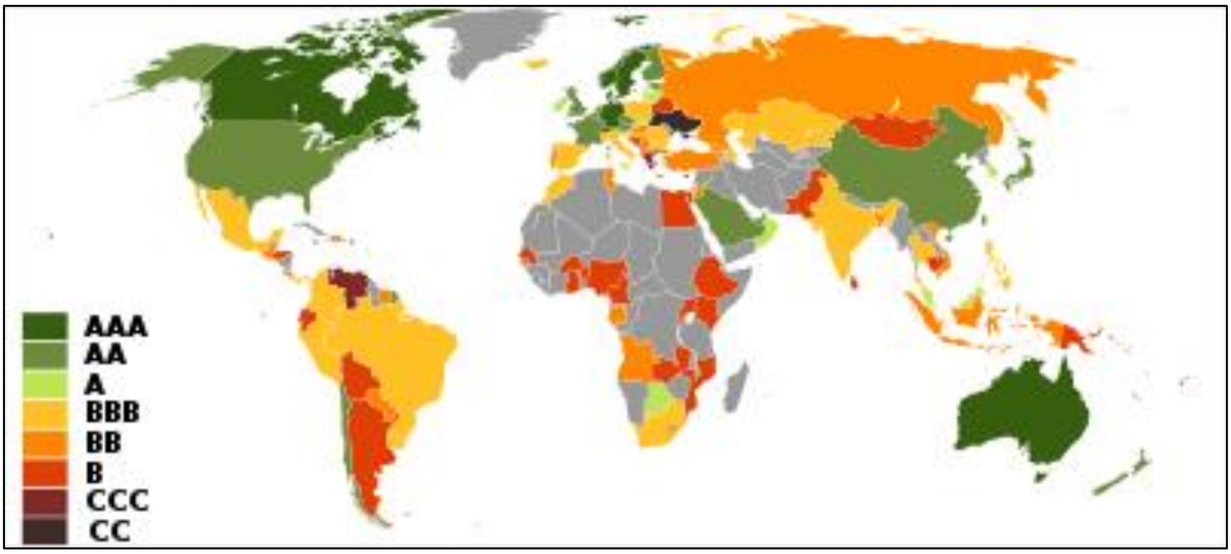
<u>Non-Specified Investments:</u>
These are any investments which do not meet the specified investment criteria. A maximum of £40m ** will be held in aggregate in non-specified investment.

A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories. The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

	Maximum % of total investments / £ limit per institution	**Minimum credit criteria / colour band**	**Maximum maturity period**
DMADF – UK Government	100%	N/A	6 months
UK Government gilts	100%	UK sovereign rating	12 months
UK Government Treasury bills	100%	UK sovereign rating	12 months
Bonds issued by multilateral development banks	100%	AAA	6 months
Money Market Funds	100%	AAA	Liquid
Enhanced Cash Funds with a credit score of 1.25	100%	AAA	Liquid
Enhanced Cash Funds with a credit score of 1.5	100%	AAA	Liquid
Local authorities	100%	N/A	12 months
Term deposits with banks and building societies	10%	Blue Orange Red Green No Colour	12 months 12 months 6 months 100 days Not for use
CDs or corporate bonds with banks and building societies	100%	Blue Orange Red Green No Colour	12 months 12 months 6 months 100 days Not for use
Gilt funds	100%	UK sovereign rating	

APPENDIX 4 – APPROVED COUNTRIES FOR INVESTMENTS

This list is based on those countries which have sovereign ratings of AA- or higher (we show the lowest rating from Fitch, Moody's and S&P) and also, (except - at the time of writing - for Norway and Luxembourg), have banks operating in sterling markets which have credit ratings of green or above in the Capita Asset Services credit worthiness service.



An illustrative example of World Countries Credit Ratings by Standard & Poor's Foreign Rating – it may not be accurate at the time of approving this strategy.

AAA	AA+	AA	AA-
• Australia • Canada • Denmark • Germany • Luxembourg • Netherlands • Norway • Singapore • Sweden • Switzerland	• Finland • Hong Kong • U.S.A.	• Abu Dhabi (UAE) • France • Qatar • U.K.	• Belgium

This table is as at 17th January 2017.

APPENDIX 5 – TREASURY MANAGEMENT SCHEME OF DELEGATION

TREASURY MANAGEMENT SCHEME OF DELEGATION

(i) <u>Full Council</u>

- receiving and reviewing reports on treasury management policies, practices and activities;
- approval of annual strategy.

(ii) <u>Boards/committees/council/responsible body</u>

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- budget consideration and approval;
- approval of the division of responsibilities;
- receiving and reviewing regular monitoring reports and acting on recommendations;
- approving the selection of external service providers and agreeing terms of appointment.

(iii) <u>Body/person(s) with responsibility for scrutiny</u>

- reviewing the treasury management policy and procedures and making recommendations to the responsible body.

APPENDIX 6 – THE TREASURY MANAGEMENT ROLE OF THE SECTION 151 OFFICER

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THE TREASURY MANAGEMENT ROLE OF THE SECTION 151 OFFICER

The S151 (responsible) officer is responsible for:

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.

APPENDIX 7 – GLOSSARY

Bank Rate - The official Bank Rate paid on commercial bank reserves, i.e. reserves placed by commercial banks with the Bank of England as part of the Bank's operations to reduce volatility in short term interest rates in the money markets.

Borrowing / Investment Portfolio - A list of loans or investments held by the Council.

Borrowing Requirement/Financing Need - The amount that the Council needs to borrow to finance capital expenditure and manage debt.

Call Account – A bank deposit account where funds can be withdrawn at any time.

Capital Financing Requirement (CFR) - The Capital Financing Requirement reflects the Council's underlying need to borrow for capital purposes. Thus, if new capital expenditure is incurred and not financed from sources other than by borrowing, the CFR will increase by the amount of that expenditure. Borrowing, up to the value of the CFR, may be either from internal cash balances or externally, such as from the PWLB.

CIPFA Code of Practice on Treasury Management - A code of practice issued by CIPFA detailing best practice for managing the treasury management function.

Counterparty - Banks, Building Societies and other financial institutions that the Council transacts with for borrowing and lending.

Credit Default Swaps (CDS) - A contract between two counterparties in which the buyer of the contract makes quarterly payments to the seller of the contract in exchange for a payoff if there is a credit event (e.g. default) of the reference entity (i.e. the third party on whom the contract is based). The contract essentially provides a means of insurance to the buyer of the CDS against default by a borrower. The "spread" (effectively the premium paid by the CDS buyer) provides an indication of the perceived risk of a default occurring.

Credit Ratings - A scoring system used by credit rating agencies such as Fitch, Moody's and Standard and Poor's to indicate the creditworthiness and other factors of a Governments, banks, building societies and other financial institutions.

Creditworthiness - How highly rated an institution is according to its credit rating.

Dealing - Is the process of carrying out transactions with a counterparty, including agreeing the terms of an investment. This is usually conducted through a Money Market Broker.

Debt Rescheduling - Refinancing loans on different terms and rates to the original loan.

Fitch Ratings - A credit rating agency.

Fund Manager - The individual responsible for making decisions related to any portfolio of investments in accordance with the stated goals of the fund.

Gilts - Also known as Gilt-edged Securities. UK central Government debt. It may be dated (redeemable) or undated. Undated gilts are perpetual debt, paying a fixed periodic coupon but having no final redemption date. Gilt yields are conventionally quoted in the UK markets on a semi-annual basis.

Limits for External Debt - A Prudential Indicator prescribed by the Prudential Code sets limits on the total amount of debt the Council could afford.

Liquidity - Access to cash that is readily available.

Maturity - The date when an investment is repaid or the period covered by a fixed term investment.

Minimum Revenue Provision (MRP) - The minimum amount, which must be charged to an authority's revenue account each year for the prudent repayment of debt.

Money Market Funds - Open ended collective investment fund that invests in highly-liquid short-term financial instruments (with maturities typically 90 days to less than one year).

Moody's - A credit rating agency.

Non-Specified Investments - Investments deemed to have a greater potential of risk, such as investments for longer than one year or with institutions that do not have credit ratings, like some Building Societies. Limits must be set on the amounts that may be held in such investments at any one time during

Portfolio - A number of different assets, liabilities, or assets and liabilities together, considered as a whole. For example, a diversified investment portfolio. An investor in such a portfolio might hold a number of different investment assets within the portfolio, with the objectives of growing the total value of the portfolio and limiting the risk of losses.

Prudential Code for Capital Finance in Local Authorities - The capital finance system is based on the Prudential Code developed by CIPFA. The key feature of the system is that local authorities should determine the level of their capital investment and how much they borrow to finance that investment based on their own assessment of what they can afford.

Prudential Indicators - The key objectives of the Prudential Code are to ensure that the capital investment plans are affordable, sustainable and prudent. As part of this framework, the
Prudential Code sets out several indicators that must be used to demonstrate this.

Public Works Loan Board (PWLB) - A central government agency which provides loans to local authorities and other prescribed institutions at interest rates slightly higher than those at which the Government itself can borrow.

Revenue Expenditure Financed by Capital under Statute (REFCUS) - Expenditure that may be classified under legislation as capital but does not result in the creation of a fixed asset on the Balance Sheet.

Security - Placing cash in highly rated institutions.

Sovereign Debt Rating - Assessment of the international rating agencies of the likelihood that a particular country will default on its loans.

Specified Investments - Investments that offer high security and liquidity. They must have a maturity of no longer than 364 days.

Standard and Poor's - A credit rating agency.

UK Government Investments - Debt Management Office (DMO) deposits and bonds (gilts) for which maturity date at time of purchase is less than 365 days away.

Yield - The rate of return on the current market value of an asset or liability, usually expressed as a percentage per annum. For example, today's yield to maturity of a bond measures the total return to an investor in the bond, reflecting both the interest income over the life of the bond and any capital gain (or loss) from today's market value to the redemption amount payable at maturity.