

**Agenda Item No 8b**

**DERBYSHIRE COUNTY COUNCIL**

**COUNCIL**

**7 December 2016**

**Report of the Director of Finance**

**TREASURY MANAGEMENT STRATEGY**

**1 Purpose of the Report**

To ask Council to approve the revised Treasury Management Strategy 2016-17.

**2 Information and Analysis**

On 10 February 2016 Council approved the Treasury Management Strategy 2016-17 alongside the Prudential Code for Capital Finance and Capital Programme Approvals.

It is proposed to amend the Treasury Management Strategy to reflect a number of initiatives that have developed since February 2016, details of which are set out below.

**Drakelow Developments Limited**

Cabinet on 26 July 2016 considered a report in respect of Walton-upon-Trent Bypass and Bridge. The project requires financial support in order to progress which will comprise a loan being made to Drakelow Developments for the purposes of constructing the bypass and river crossing. This would be payable over a period up to ten years and secured through a charge against Drakelow Development's assets.

**Derby Teaching Hospitals NHS Foundation Trust**

The Council has been approached by Derby Teaching Hospitals to help in two ways. Due to the way NHS trusts are funded it would be beneficial to both the Council and the trust for the Council to lend the trust up to £25m each financial year repayable on the 31 March of each year. It is estimated this would generate around £90,000 per year in additional interest for the Council.

The second proposition would be for the Council to use its Public Works Loan Board borrowing powers to help the trust improve Accident and Emergency services in the Royal Derby Hospital. The total loan value is not yet known

but is estimated at around £10m. This would be revenue neutral to the Council.

## **Derbyshire Developments Limited**

On 26 July 2016, Cabinet considered a report regarding the establishment of Derbyshire Developments Limited. Initially, the company will develop residential housing to sell (or let) in the open market with affordable housing as required to satisfy local planning requirements.

## **Revised Strategy**

The three initiatives outlined above have been reflected in the revised Strategy. No further changes have been made to the Strategy since that approved by full Council in February.

A copy of the revised Treasury Management Strategy is shown at Appendix One.

The revised Treasury Management Strategy was considered by Cabinet on 22 November 2016 and commended the amendments to full Council.

## **3 Social Value Considerations**

The report does not involve the commissioning or procurement of services or goods so it is not possible to reference the consideration of social value in such a context.

## **4 Other Considerations**

In preparing this report the relevance of the following factors has been considered: financial, legal, prevention of crime and disorder, equality and diversity, human resources, environmental, health, property and transport considerations.

## **5 Background Papers**

Prudential Code for Capital Finance, Capital Programme Approvals and Treasury Management Strategy 2016-17.

Papers held in Technical Section, Corporate Finance, Room 137.

## **6 Officer's Recommendation**

That Council approves the revised Treasury Management Strategy 2016-17.

PETER HANDFORD  
Director of Finance

# **DERBYSHIRE COUNTY COUNCIL**

## **TREASURY MANAGEMENT STRATEGY 2016-17**

**PAGE**

<b>1</b>	<b>Introduction</b>	<b>1</b>
<b>2</b>	<b>External Context</b>	<b>1</b>
<b>3</b>	<b>Local Context</b>	<b>3</b>
<b>4</b>	<b>Borrowing Strategy</b>	<b>5</b>
<b>5</b>	<b>Investment Strategy</b>	<b>8</b>
<b>6</b>	<b>Treasury Management Indicators</b>	<b>15</b>
<b>7</b>	<b>Other Items</b>	<b>16</b>
<b>Appendix A</b>	<b>Arlingclose Interest Rate Forecast – Nov 2015</b>	<b>19</b>
<b>Appendix B</b>	<b>Credit Ratings</b>	<b>20</b>
<b>Appendix C</b>	<b>UK High St Banks &amp; Building Societies Long Term Ratings</b>	<b>21</b>
<b>Appendix D</b>	<b>Clauses to be Adopted</b>	<b>22</b>
<b>Appendix E</b>	<b>Treasury Management Practices</b>	<b>23</b>
<b>Appendix F</b>	<b>Treasury Management Policy Statement</b>	<b>24</b>

## 1 Introduction

The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

In April 2002 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code last revised in 2011) which requires the Authority to approve a treasury management strategy before the start of each financial year.

In addition, the Department for Communities and Local Government (CLG) issued revised *Guidance on Local Authority Investments* in March 2010 that requires the Authority to approve an investment strategy before the start of each financial year.

This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to both the CIPFA Code and the CLG Guidance.

## 2 External Context

**Economic background:** Domestic demand has grown robustly, supported by sustained real income growth and a gradual decline in private sector savings. Low oil and commodity prices were a notable feature of 2015, and contributed to annual CPI inflation falling to 0.1% in November. Wages are growing at 2.4% a year, and the unemployment rate has dropped to 5.2%. These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was an encouraging 2.3% a year in the third quarter of 2015. Although speeches by the Bank of England's Monetary Policy Committee (MPC) members sent signals that some were willing to countenance higher interest rates, the MPC held policy rates at 0.5% for the 82nd consecutive month at its meeting in December 2015. Quantitative easing (QE) has been maintained at £375bn since July 2012.

The outcome of the UK general election, which was largely fought over the parties' approach to dealing with the deficit in the public finances, and put the key issue of the UK's relationship with the EU at the heart of future politics. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

China's growth has slowed and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. US domestic growth has accelerated but the globally sensitive sectors of the US economy have slowed. Strong US labour market data and other economic indicators however suggest recent global turbulence has not knocked the American recovery off course. In December 2015, the Federal Reserve finally raised US policy rates by 0.25%. The accompanying statement

emphasised that money tightening would be gradual and data dependent. In contrast, the European Central Bank finally embarked on QE in 2015 to counter the perils of deflation.

**Credit outlook:** The varying fortunes of different parts of the global economy are reflected in market indicators of credit risk. UK Banks operating in the Far East and parts of mainland Europe have seen their perceived risk increase, while those with a more domestic focus continue to show improvement. The sale of most of the government's stake in Lloyds and the first sale of its shares in RBS have generally been seen as credit positive.

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 UK, USA and Germany. The rest of the European Union will follow suit in January 2016, while Australia, Canada and Switzerland are well advanced with their own plans. Meanwhile, changes to the UK Financial Services Compensation Scheme and similar European schemes in July 2015 mean that most private sector investors are now partially or fully exempt from contributing to a bail-in. 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 remain stubbornly low.

**Interest rate forecast:** The Authority's treasury advisor Arlingclose projects the first 0.25% increase in UK Bank Rate in the third quarter of 2016, rising by 0.5% a year thereafter, finally settling between 2% and 3% in several years' time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted towards the downside.

A shallow upward path for medium term gilt yields is forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Arlingclose projects the 10 year gilt yield to rise from its current 2.0% level by around 0.3% a year. The uncertainties surrounding the timing of UK and US interest rate rises are likely to prompt short-term volatility in gilt yields.

A more detailed economic and interest rate forecast provided by Arlingclose is attached at **Appendix A**.

For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.75% and that new long-term loans will be borrowed at an average rate of 3.5%.

### 3 Local Context

The Authority currently has £385m of external borrowing and £319m of investments. The Authority's net debt position is detailed in Table 1.

**Table 1 – Existing Borrowing & Investment Portfolio**

	<b>31.12.15 Actual Portfolio £m</b>	<b>31.12.15 Average Rate %</b>
<b>External Borrowing:</b>		
PWLB – Fixed Rate	332	4.79
LOBO Loans	28	4.69
Temporary Loans (D2N2)	25	0.75
<b>Total External Borrowing</b>	<b>385</b>	<b>4.52</b>
<b>Investments:</b>		
Managed in-house:		
Short-term investments	248	0.71
Long-term investments	36	1.61
Managed externally:		
Money market funds	30	0.59
Pooled Funds	5	4.72
<b>Total Investments</b>	<b>319</b>	<b>0.87</b>
<b>External Borrowing less Investments</b>	<b>66</b>	
<b>Other Long Term Liabilities:</b>		
PFI	80	
Finance Leases	5	
Transferred Debt In (Derby City)	4	
<b>Total Other Long Term Liabilities</b>	<b>89</b>	
Less Transferred Debt (Derby City)	(33)	
<b>Net Debt Position</b>	<b>122</b>	

**Table 2 - Balance Sheet Summary and Forecast**

	<b>31.3.15 Actual £m</b>	<b>31.3.16 Estimate £m</b>	<b>31.3.17 Estimate £m</b>	<b>31.3.18 Estimate £m</b>	<b>31.3.19 Estimate £m</b>
<b>Capital Financing Requirement (CFR)</b>	492	502	586	653	650
Less: Other debt liabilities * (Excludes D2N2)	-89	-86	-83	-80	-76
<b>Borrowing CFR</b>	<b>403</b>	<b>416</b>	<b>503</b>	<b>573</b>	<b>574</b>
Less: External borrowing **	365	350	337	332	324
<b>Internal borrowing***</b>	<b>38</b>	<b>66</b>	<b>166</b>	<b>241</b>	<b>250</b>
Less: Usable reserves	-260	-195	-152	-101	-90
Less: Working capital	-33	-33	-33	-33	-33
<b>Investments (Borrowing)</b>	<b>255</b>	<b>162</b>	<b>19</b>	<b>-107</b>	<b>-127</b>

\* Other debt liabilities comprise of PFI liabilities (£80m), Finance Leases (£5m) and Transferred Debt (£4m).

\*\* Derby City Council is considering repayment of £30m of transferred debt.

\*\*\* The Authority's internal borrowing limit is currently 25% of the CFR.

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Authority's current strategy is to use internal borrowing to maintain borrowing and investments below their underlying levels, subject to holding a minimum investment balance of £30m (1 month's salaries).

The Authority has an increasing CFR due to the capital programme. Investments are forecast to reduce to £19m by 31 March 2017, as capital receipts are used to finance capital expenditure and usable reserves are utilised to finance the revenue budget.

The Authority may need to increase the internal borrowing limit or alternatively take additional external borrowing to fund the CFR by 31 March 2017.

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. Table 2 shows that the Authority expects to comply with this recommendation during 2016-17.



## 4 Borrowing Strategy

At 31 December 2015, the Authority held £360m of fixed term loans, with a further £10m to be repaid on 31 March 2016 (£365m 31 March 2015) as part of its strategy for funding previous years' capital programmes (a temporary revenue loan of £25m from D2N2 is excluded). The balance sheet forecast in Table 2 shows that the Authority will require additional borrowing (external or internal) in 2016-17. The Authority may also borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £615m.

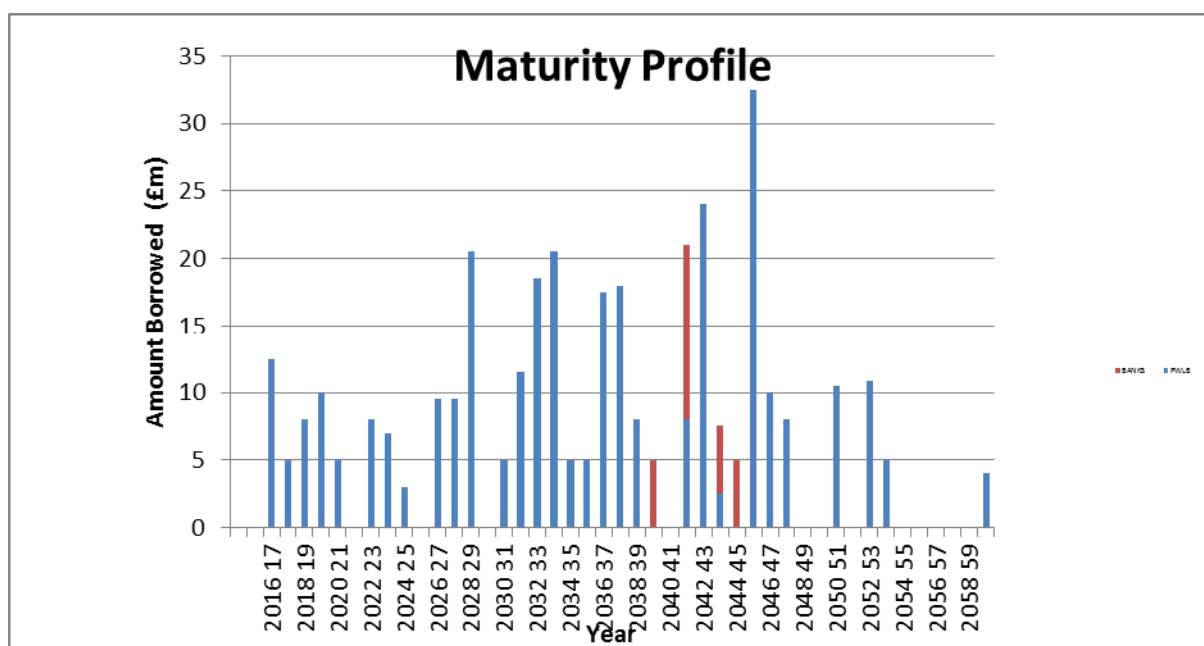
**Objectives:** The Authority's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Authority's long-term plans change is a secondary objective.

**Strategy:** Given the significant cuts to public expenditure and in particular to local government funding, the Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

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 borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. The Authority will monitor this 'cost of carry' and breakeven analysis. Its output may determine whether the Authority borrows additional sums at long-term fixed rates in 2016-17 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

In addition, the Authority may borrow short-term loans (normally for up to 35 days) to cover unexpected cash flow shortages.

The Authority's maturity profile at 31 March 2016 is shown below. The maturity profile is the rate at which long term loans have to be repaid to the PWLB (or other lenders). It would be imprudent to have a large proportion of repayments due in any particular year, thus a good spread of redemptions is desirable.



The average redemption per year is £8.0m (2.3%) of the total debt, with a maximum redemption of £32.5m (9.3%) in 2045-46. The average duration of all the Authority's loans is approximately 20 years. Any new borrowing would be targeted for maturity in those years with nil/low repayments.

**Sources of Borrowing:** The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- Other UK Local Authorities
- Banks or Building Societies authorised to operate in the UK (including non UK banks)
- UK public and private sector pension funds (except for the Derbyshire Pension Fund)
- Capital market bond investors
- UK Municipal Bond Agency plc and other special purpose companies created to enable local authority bond issues
- D2N2 Local Economic Partnership
- Internal borrowing (see above)

In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

The Authority has previously raised the majority of its long-term borrowing from the PWLB but it continues to investigate other sources of finance, such as local authority loans, bank loans, that may be available at more favourable rates.

## PWLB

In December 2014, the CLG announced HM Treasury would take the necessary steps to abolish the PWLB. The CLG have stated it will have no impact on existing loans held by Local Authorities or the government's policy on local authority borrowing. HM Treasury clarified that local authorities will continue to have access to an identical range of borrowing facilities and terms that currently exist with the PWLB albeit under a different body so that local authorities will continue to access borrowing at rates which offer good value for money.

**LGA Bond Agency:** UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative 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 may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans; there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to Cabinet.

**LOBOs:** The Authority holds £28m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. All 5 LOBOs have options during 2016-17, and although the Authority understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Authority will take the option to repay LOBO loans at no cost if it has the opportunity to do so.

**Short-term and Variable Rate loans:** These loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

**Debt Rescheduling:** 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.

## 5 Investment Strategy

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's investment balance has ranged between £270 million and £394 million, although these levels are expected to fall significantly as reserves are utilised in the forthcoming year.

**Objectives:** 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 highest 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.

**Strategy:** Given the increasing risk and continued low returns from short-term unsecured bank investments, the Authority aims to further diversify into more secure and/or higher yielding asset classes during 2016-17. The majority of the Authority's surplus cash is currently invested in short-term unsecured bank deposits, certificates of deposit and money market funds. This diversification will therefore represent a substantial change in strategy over the coming year, although remaining within the current Treasury Management approvals.

**Approved Counterparties:** The Authority may invest its surplus funds with any of the counterparty types in Table 3 below, subject to the cash limits (per counterparty) and the time limits shown.

**Table 3: Approved Investment Counterparties and Limits**

<b>Credit Rating*</b>	<b>UK Banks**</b>	<b>Non UK Banks***</b>	<b>Government Other LA's</b>	<b>Corporates</b>	<b>Registered Providers</b>
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£30m + £10m 5 years	£10m + £10m 5 years	£50m + £10m 25 years	£10m + £10m 5 years	£10m + £10m 5 years
AA+	£30m + £10m 5 years	£10m + £10m 5 years	£50m + £10m 20 years	£10m + £10m 5 years	£10m + £10m 5 years
AA	£30m + £10m 4 years	£10m + £10m 4 years	£50m + £10m 15 years	£10m + £10m 4 years	£10m + £10m 4 years
AA-	£30m + £10m 3 years	£10m + £10m 3 years	£50m + £10m 10 years	£10m + £10m 3 years	£10m + £10m 3 years
A+	£30m + £10m 2 years	£10m + £10m 2 years	£25m + £10m 5 years	£10m + £10m 2 years	£10m + £10m 2 years
A	£30m + £10m 13 months	£10m + £10m 13 months	£25m + £10m 5 years	£10m + £10m 13 months	£10m + £10m 13 months
A-	£30m + £10m 6 months	£10m + £10m 6 months	£25m + £10m 5 years	£10m + £10m 6 months	£10m + £10m 6 months
BBB+	£10m + £10m 100 days	n/a	£10m + £5m 13 months	£5m + £5m 100 days	£5m + £5m 100 days
BBB or BBB-	£10m + £10m next day only	n/a	n/a	n/a	n/a
None (Challenger Banks & Unrated Building Societies	£1m 6 months	n/a	n/a	n/a	n/a
Pooled funds	£20m + £10m per fund				
Unrated Bodies	To be approved by Cabinet on a case by case basis				

NB: An excess of the counterparty limit due to accrued interest is permitted.

The proposed Treasury Management strategy is also designed to accommodate the requirements of the Pension Fund (£10m per counterparty). The counterparty limits will be segmented into County and Pension fund. This

may require a period of transition until the individual cash requirements of the Pension Fund are ascertained.

Approval to adopt this strategy is obtained from the Pensions and Investments Committee.

- \* **Credit Rating:** Investment decisions are made by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. **Where available, the credit rating relevant to the specific investment or class of investment is used**, otherwise the counterparty credit rating is used.

The credit ratings in the table above are based upon Fitch's Credit Ratings (as an example). These ratings are explained in further detail in Appendix A.

The current credit ratings of the main UK High Street banks and building societies for all 3 credit rating agencies are shown in Appendix B.

**UK Banks Unsecured:** Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies. 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. Unsecured investments with banks rated BBB or lower are restricted to overnight deposits at the Authority's current account banks (Lloyds Bank (main) and Barclays Bank (contingency)).

**Non-UK Banks:** Non UK Banks have an additional requirement that the sovereign rating of its country of domicile must be a minimum of AA+ (The UK has a sovereign rating of AA+). Unsecured investment with banks rated BBB+ or lower are restricted to overnight deposits at the Pension Funds custodian banks (BNP Paribas/BNY Mellon).

**Banks Secured:** Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

- \*\* Lloyds Bank covered bond (secured by collateral) is rated at AAA by Fitch, whilst an unsecured bank deposit is rated as A+ (5 notches below).

\*\*\* Bank of Nova Scotia (Canadian) covered bond (secured by collateral) is rated at AAA by Fitch, whilst an unsecured bank deposit is rated as AA- (4 notches below).

**Government:** Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years. Investments with Other Local Authorities are significant (£118m at 31 December 2015). The Authority will distinguish between Upper Tier (Counties, Unitaries, London Boroughs, Scottish, Welsh & Northern Irish) and Lower Tier (Boroughs & Districts) Authorities. Investments to Fire, Police, Transport and Local Authority Pension funds will also be considered.

**Corporates:** Loans, bonds and commercial paper 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. Loans to unrated companies will only be made as part of a diversified pool in order to spread the risk widely.

**Registered Providers:** Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services, they retain a high likelihood of receiving government support if needed.

**Pooled Funds:** Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Money Market Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

**Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term.** These allow the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives will be monitored regularly.

### **The Council's Main Bank Account - Lloyds Bank**

It is requested that the additional limit of £20m for operational and transactional purposes at the Council's main bank should be increased to £30m to cover D2N2 LEP. These deposits are to the next banking day only.

## **The Pension Fund's Custodian Account - BNP Paribas (formerly BNY Mellon)**

It is requested that the limit of £20m for operational and transactional requirements at BNP Paribas be increased by £10m to £30m (overnight).

It is requested that the additional limit of US\$20m for Wellington (the US Fund Manager) at BNP Paribas be amended to the US\$ equivalent of £20 million (overnight).

It is requested to maintain the £1m limit at BNY Mellon until the Pension Fund's account with the previous custodian is closed.

## **D2N2 Local Economic Partnership**

The Council has successfully tendered to be the accountable body for the D2N2 LEP. It is recommended that the £20m deposit limit with the Council be increased to £60m. This limit will be kept under review as the role of accounting body develops.

**Risk Assessment and Credit Ratings:** Credit ratings are obtained and monitored by the Authority's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the Authority's minimum approved rating criteria (BBB), then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

**Other Information on the Security of Investments:** The Authority understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.



When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Authority will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Authority's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

**Specified Investments:** 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".

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 AA+ or higher. For money market funds and other pooled funds "high credit quality" is defined as those having a credit rating of A- or higher.

**Non-specified Investments:** Any investment not meeting the definition of a specified investment is classed as non-specified. 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 4 below.

**Table 4: Non-Specified Investment Limits**

	<b>Cash limit</b>
Total long-term investments	£100m
Total investments without credit ratings or rated below A-	£100m
The Pension Fund's Custodian Bank (BNP Paribas) In House £20m, Wellington US\$ 20m	£30m + £20m US\$ equivalent
Total non-specified investments	£200m + £50m

**Investment Limits:** The Authority's revenue reserves available to cover investment losses are forecast to be £195m on 31 March 2016. In order that no more than approximately 20% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £30m County fund plus £10m Pension fund and accrued interest.

- \* The Council's principle bankers (Lloyds) have an additional £20m available (overnight) for operational and liquidity purposes. A further £10m limit is requested for the operational and liquidity purposes of D2N2 (overnight).

A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below:

**Table 5: Investment Limits**

	<b>Cash limit</b>
UK Central Government	Unlimited
Any single organisation, except the UK Central Government	£30m + £10m each
Any group of organisations under the same ownership	£30m + £10m per group
Any group of pooled funds under the same management	£20m + £10m per manager
Negotiable instruments held in a broker's nominee account	£100m per broker
Foreign countries	£100m + £100m in total
Registered Providers	£50m in total
Unsecured investments with Building Societies	£100m + £50m in total
Loans to unrated bodies	£60m in total
Money Market Funds	£100m + £100m in total

**Liquidity Management:** The Authority uses purpose-built cash flow forecasting software (Logotech PSTM) to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Authority's medium term financial plan and cash flow forecast.

## 6 Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

**Security:** The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target
Portfolio average credit rating	A

**Liquidity:** The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling one month period, without additional borrowing.

	Target
Total cash available within 35 days	£30m

**Interest Rate Exposures:** This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

Borrowing	2015-16	2016-17	2017-18
Upper limit on fixed interest rate exposure	100%	100%	100%
Upper limit on variable interest rate exposure	40%	40%	40%

Investments	2015-16	2016-17	2017-18
Upper limit on fixed interest rate exposure	25%	25%	25%
Upper limit on variable interest rate exposure	100%	100%	100%

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

**Maturity Structure of Borrowing:** This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper	Lower
Under 12 months	15%	0%
12 months and within 24 months	15%	0%
24 months and within 5 years	40%	0%
5 years and within 10 years	40%	0%
10 years and within 20 years	40%	10%
20 years and within 30 years	40%	10%
30 years & above	40%	10%

Time periods start on the first day of each financial year. The maturity date of the borrowing is the date when repayment of the loan is due. The Authority £28m of LOBO loans mature between 2039 and 2045. The Authority will repay this borrowing early if the opportunity to do so at no additional cost arises.

**Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2016-17	2017-18	2018-19
Limit on principal invested beyond year end	£100m	£100m	£100m

## 7 Other Items

There are a number of additional items that the Authority is obliged by CIPFA or CLG to include in its Treasury Management Strategy.

**Policy on Use of Financial Derivatives:** 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).

The Authority will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to

reduce the overall level of the financial risks that the Authority is exposed to. 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.

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.

**Investment Training:** The needs of the Authority's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.

**Investment Advisers:** The Authority has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is reviewed regularly.

**Investment of Money Borrowed in Advance of Need:** The Authority may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Authority is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Authority's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £615m. The maximum period between borrowing and expenditure is expected to be 3 years, although the Authority is not required to link particular loans with particular items of expenditure.

## Financial Implications

The forecast for investment income in 2016-17 is £1.3m, based on an average investment portfolio of £175m at an interest rate of 0.75%. The forecast for debt interest paid in 2016-17 is £16.3m, based on an average debt portfolio of £350m at an average interest rate of 4.65%. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

## Other Options Considered

The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Finance believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses will be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses will be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs will be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long term costs will be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs will be less certain

## Appendix A

## Interest Rate Forecast - Arlingclose (November 2015)

## Forecast:

- Arlingclose forecasts the first rise in UK Bank Rate in Q3 2016. Further weakness in inflation, and the MPC's expectations for its path, suggest policy tightening will be pushed back into the second half of the year. Risks remain weighted to the downside. Arlingclose projects a slow rise in Bank Rate, the appropriate level of which will be lower than the previous norm and will be between 2 and 3%.
- The projection is for a shallow upward path for medium term gilt yields, with continuing concerns about the Eurozone, emerging markets and other geo-political events, weighing on risk appetite, while inflation expectations remain subdued.
- The uncertainties surrounding the timing of UK and US monetary policy tightening, and global growth weakness, are likely to prompt short term volatility in gilt yields.

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
<b>Official Bank Rate</b>													
Upside risk		0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	1.75
Downside risk				-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-1.00	-1.00	-1.25	-1.25
<b>3-month LIBID rate</b>													
Upside risk	0.20	0.30	0.30	0.30	0.35	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40
Arlingclose Central Case	0.55	0.60	0.70	0.80	0.95	1.05	1.15	1.30	1.40	1.55	1.65	1.80	1.85
Downside risk		-0.20	-0.30	-0.45	-0.55	-0.65	-0.80	-0.90	-1.05	-1.10	-1.20	-1.20	-1.20
<b>1-yr LIBID rate</b>													
Upside risk	0.25	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.45
Arlingclose Central Case	1.10	1.20	1.35	1.45	1.55	1.70	1.80	1.95	2.00	2.10	2.15	2.15	2.15
Downside risk	-0.15	-0.25	-0.35	-0.50	-0.60	-0.70	-0.85	-0.95	-1.10	-1.15	-1.25	-1.25	-1.25
<b>5-yr gilt yield</b>													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	1.50	1.55	1.60	1.70	1.80	1.90	2.00	2.10	2.20	2.25	2.30	2.35	2.35
Downside risk	-0.35	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25
<b>10-yr gilt yield</b>													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.00	2.05	2.10	2.20	2.30	2.40	2.50	2.60	2.65	2.70	2.75	2.80	2.80
Downside risk	-0.35	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25
<b>20-yr gilt yield</b>													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.45	2.50	2.55	2.55	2.60	2.65	2.70	2.75	2.80	2.85	2.90	2.95	2.95
Downside risk	-0.30	-0.40	-0.50	-0.55	-0.65	-0.75	-0.85	-0.95	-1.05	-1.10	-1.15	-1.20	-1.20
<b>50-yr gilt yield</b>													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.45	2.50	2.55	2.60	2.65	2.70	2.75	2.80	2.85	2.90	2.95	3.00	3.00
Downside risk	-0.25	-0.35	-0.45	-0.50	-0.60	-0.70	-0.80	-0.90	-1.00	-1.05	-1.10	-1.15	-1.15

**Appendix B****Credit Rating Definitions - Long Term (Fitch's)****AAA - Highest credit quality.**

'AAA' ratings denote the lowest expectation of default risk. They are assigned only in cases of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.

**AA - Very high credit quality**

'AA' ratings denote expectations of very low default risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.

**A - High credit quality**

'A' ratings denote expectations of low default risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to adverse business or economic conditions than is the case for higher ratings.

**BBB - Good credit quality.**

'BBB' ratings indicate that expectations of default risk are currently low. The capacity for payment of financial commitments is considered adequate but adverse business or economic conditions are more likely to impair this capacity.



## Appendix C

## UK High St Banks &amp; Building Societies

## Long Term Ratings

## a) UK Banks

Counterparty	Credit Rating Agency			Limit
	Fitch	Moody's	S&P	£m
Barclays	A	A2	A-	30
Close Brothers	A	AA3	n/a	30
HSBC	AA-	Aa2	AA-	30
Lloyds	A+	A1	A	30
Nat West	BBB+	A3	BBB+	10
Santander UK	A	A1	A	30
Standard Chartered	A+	AA2	A+	30
Yorkshire	A	Baa1	BBB+	10

## b) UK Building Societies

Building Society	Long term			Limit
	Fitch	Moody's	S&P	£m
Coventry	A	A2	n/a	30
Leeds	A-	A2	n/a	30
Nationwide	A	A1	A	30
Yorkshire	A-	Baa1	n/a	10

**Appendix D****Clauses to be formally adopted**

CIPFA recommends that all public service organisations adopt, as part of their standing orders, financial regulations, or other formal policy documents appropriate to their circumstances, the following four clauses:

1. This Council will create and maintain, as the cornerstones for effective treasury management:
  - a treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities
  - suitable treasury management practices (TMPs) setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

The content of the policy statement and TMPs will follow the recommendations contained in Sections 6 and 7 of the Treasury Management Code of Practice, subject only to amendment where necessary to reflect the particular circumstances of this Council. Such amendments will not result in the organisation materially deviating from the Code's key principles.

2. This Council will receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMPs.
3. This Council delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to Cabinet, and for the execution and administration of treasury management decisions to the Director of Finance, who will act in accordance with the organisation's policy statement and TMPs and, if he/she is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management.
4. This Council nominates the Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

## Appendix E

### Treasury Management Practices (TMPs)

CIPFA recommends that an organisation's treasury management practices (TMPs) include those of the following that are relevant to its treasury management powers and the scope of its treasury management activities.

TMP1	Risk management
TMP2	Performance measurement
TMP3	Decision-making and analysis
TMP4	Approved instruments, methods and techniques
TMP5	Organisation, clarity and segregation of responsibilities, and dealing arrangements
TMP6	Reporting requirements and management information arrangements
TMP7	Budgeting, accounting and audit arrangements
TMP8	Cash and cash flow management
TMP9	Money laundering
TMP10	Training and qualifications
TMP11	Use of external service providers
TMP12	Corporate governance

#### Note

TMPs are the detailed procedures which are held by the Director of Finance and are subject to regular review.

**Appendix F****The Treasury Management Policy Statement**

CIPFA recommends that the Council's treasury management policy statement adopts the following forms of words to define the policies and objectives of its treasury management activities:

1. This organisation defines its treasury management activities as:  
  
The management of the organisation'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.
2. This organisation regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.
3. This organisation acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.