Agenda Item No 4(c)

DERBYSHIRE COUNTY COUNCIL

PENSIONS and INVESTMENTS COMMITTEE

25 April 2018

Report of the Director of Finance & ICT

TREASURY MANAGEMENT STRATEGY

1 Purpose of the Report

To seek approval to the adoption of a Treasury Management Strategy for the Derbyshire Pension Fund for 2018/19.

2 Information and Analysis

Derbyshire Pension Fund (the Fund) traditionally adopts the same Treasury Management Strategy as the County Council which places security of capital and liquidity ahead of investment return. Council approved the Treasury Management Strategy attached at Appendix 1 on 7 February 2018. For operational purposes the Fund predominantly uses the same list of counterparties as the County Council and has agreed a joint limit with the Council for each counterparty. Due to the Fund's differing liquidity requirements compared to the County Council, it does not invest in Pooled Funds (other than Money Market Funds) and Other Bodies (Non-Corporate) for treasury management purposes.

The Fund's current benchmark allocation to cash is 2% (about £90m at current asset values). The Fund generally needs to retain a higher level of instant access funds than the County Council. A major buying opportunity in the market could require immediate access to significant sums of cash for investment. Equally, it may be desirable to hold a higher defensive cash allocation because market valuations have become stretched or cash is held in order to meet future commitment drawdowns. The Fund's actual cash allocation at 31 March 2018 was 5.7%, equating to £264m.

The recommended Treasury Management Strategy for 2018/19 includes the following requirements:

- Security of capital and liquidity should be placed ahead of investment return;
- Sufficient funds should be retained on instant access accounts to ensure longer term investment strategy is not compromised by lack of liquidity;

- Subject to the above, consideration should be given to investment of a certain level of funds over a longer time frame;
- The maximum amount and duration by counterparty should be as per Table 3b on page 13 of the Treasury Management Strategy;
- Investments should be limited by type in accordance with Table 5b on page 18 of the Treasury Management Strategy; and
- Borrowings should be permitted only in exceptional circumstances and in accordance with the LGPS (Management and Investment of Funds) Regulations 2016. Borrowings are limited to the maximum amount required to meet the Fund's obligations, and should not exceed 90 days in duration.

3 Other Considerations

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

4 Officer's Recommendation

That the Treasury Management Strategy attached to this report be approved.

PETER HANDFORD

Director of Finance & ICT

Public

APPENDIX 1

DERBYSHIRE COUNTY COUNCIL

TREASURY MANAGEMENT STRATEGY 2018-19

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1 Introduction

In February 2012 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011Edition* (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year. CIPFA published a revised edition of the Treasury Management Code in December 2017. Arlingclose the Council's treasury management advisors have informed us that these revisions do not alter the requirements of the Treasury Management Strategy.

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. Again the DCLG have consulted on proposed changes to this guidance with a deadline for responses of 22 December 2017.

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.

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.

Revised strategy: In accordance with the CLG Guidance, the Authority will be asked to approve a revised Treasury Management Strategy Statement should the assumptions on which this report is based change significantly. Such circumstances would include, for example, a large unexpected change in interest rates, or in the Authority's capital programme or in the level of its investment balance.

2 External Context

Economic background: The major external influence on the Authority's treasury management strategy for 2018/19 will be the UK's progress in negotiating its exit from the European Union and agreeing future trading arrangements. The domestic economy has remained relatively robust since the surprise outcome of the 2016 referendum, but there are indications that uncertainty over the future is now weighing on growth. Transitional arrangements may prevent a cliff-edge, but will also extend the period of uncertainty for several years. Economic growth is therefore forecast to remain sluggish throughout 2018/19.

Consumer price inflation reached 3.0% in September 2017 as the post-referendum devaluation of sterling continued to feed through to imports. Unemployment continued to fall and the Bank of England's Monetary Policy Committee judged that the extent of spare capacity in the economy seemed limited and the pace at which the economy can grow without generating inflationary pressure had fallen over recent years. With its inflation-control mandate in mind, the Bank of England's Monetary Policy Committee raised official interest rates to 0.5% in November 2017.

In contrast, the US economy is performing well and the Federal Reserve is raising interest rates in regular steps to remove some of the emergency monetary stimulus it has provided for the past decade. The European Central Bank is yet to raise rates, but has started to taper its quantitative easing programme, signalling some confidence in the Eurozone economy.

Credit outlook: High profile bank failures in Italy and Portugal have reinforced concerns over the health of the European banking sector. Sluggish economies and fines for pre-crisis behaviour continue to weigh on bank profits, and any future economic slowdown will exacerbate concerns in this regard.

Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the European Union, Switzerland and USA, while Australia and Canada are progressing with their own plans. In addition, the largest UK banks will ring-fence their retail banking functions into separate legal entities during 2018. There remains some uncertainty over how these changes will impact upon the credit strength of the residual legal entities.

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 very low.

Interest rate forecast: The Authority's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.50% during 2018/19, following the rise from the historic low of 0.25%. The Monetary Policy Committee re-emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

Future expectations for higher short term interest rates are subdued and on-going decisions remain data dependant and negotiations on exiting the EU cast a shadow over monetary policy decisions. The risks to Arlingclose's forecast

are broadly balanced on both sides. The Arlingclose central case is for gilt yields to remain broadly stable across the medium term. Upward movement will be limited, although the UK government's seemingly deteriorating fiscal stance is an upside risk.

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 1%, and that new long-term loans will be borrowed at an average rate of 2.59% (20 Year PWLB maturity loan with Certainty Rate discount at 31/12/17).

3 Local Context

The Authority currently (31/12/17) has £374m of external borrowing and £301m of investments.

The Authority's net debt position is detailed in Table 1.

Forecast changes are shown in the balance sheet analysis Table 2.

Table 1 – Existing Borrowing & Investment Portfolio

	31.12.17 Actual Portfolio £m	31.12.17 Average Rate %
External borrowing:		
Public Works Loans Board (PWLB)	279	4.66
Banks (including LOBO's)	28	4.69
Other Local Authorities	10	0.35
D2N2	57	0.50
Total External Borrowing	**374**	**4.02**
Other long-term liabilities:		
Private Finance Initiative	74	
Finance Leases	5	
Transferred Debt	0	
Total other long-term liabilities	**79**	
Total gross external debt	**453**	
Treasury investments:		
Managed in-house:	170	0.69
Short-term investments	69	1.29
Long-term investments		
Managed externally:	41	0.59
Money market funds	18	4.07
Pooled Funds	**298**	**1.02**
Total treasury investments		
Net debt	**155**	

Non-treasury investments		
Investment property/Local Authority Mortgage Scheme (LAMS)	2	2.00
Loans to subsidiaries	1	5.50
Loans to local companies	0	n/a
Total non-treasury investments	**3**	**2.70**
Total investments	**301**	**1.04**

Table 2 - Balance Sheet Summary and Forecast

	31.3.17 Actual £m	31.3.18 Estimate £m	31.3.19 Estimate £m	31.3.20 Estimate £m	31.3.21 Estimate £m
Capital Financing Requirement (CFR)	468	527	571	597	624
Less: Other debt liabilities *	-79	-76	-72	-69	-66
Borrowing CFR	**389**	**451**	**499**	**528**	**558**
Less: External borrowing **	326	307	300	291	286
Internal borrowing* **	**63**	**144**	**199**	**237**	**272**
Less: Usable reserves	-303	-216	-175	-164	-159
Less: Working capital	-26	-26	-26	-26	-26
Investments (Borrowing)	**266**	**98**	**2**	**-47**	**-87**

* comprised of PFI liabilities (£74m) and finance leases (£5m).

** Derby City Council - £26m of transferred debt repaid 31 March 2017. D2N2 – The authority owed £14m to D2N2at 31 March 2017.

*** The Authority's internal borrowing limit is currently 40% 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 maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

The Authority has an increasing CFR due to the capital programme. Investments are forecast to reduce to £98m by 31 March 2019, as capital receipts are used to finance capital expenditure and usable reserves are utilised to finance the revenue budget. Investments are forecast to reduce to £2m by 31 March 2019, although slippage in the capital programme ranging from 25% to 35% is probable and will reduce the Authorities borrowing requirement.

It is recommended that the internal borrowing limit for the Authority is revised from 40% of the CFR to 50% of the Borrowing CFR. This limit will be kept under review. Research confirms a number of Local Authorities do not have any internal borrowing limits.

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 2018-19.

4 Borrowing Strategy

At 31 December 2017, the Authority held £307m of fixed term loans, a decrease of £31m on the previous year as part of its strategy for funding previous years' capital programmes (a temporary revenue loan of £57m from D2N2 and £10m from Thurrock Council are excluded). The balance sheet forecast in Table 2 predicts that the Authority will require additional borrowing in 2018-19. The Authority may also borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £628m.

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.

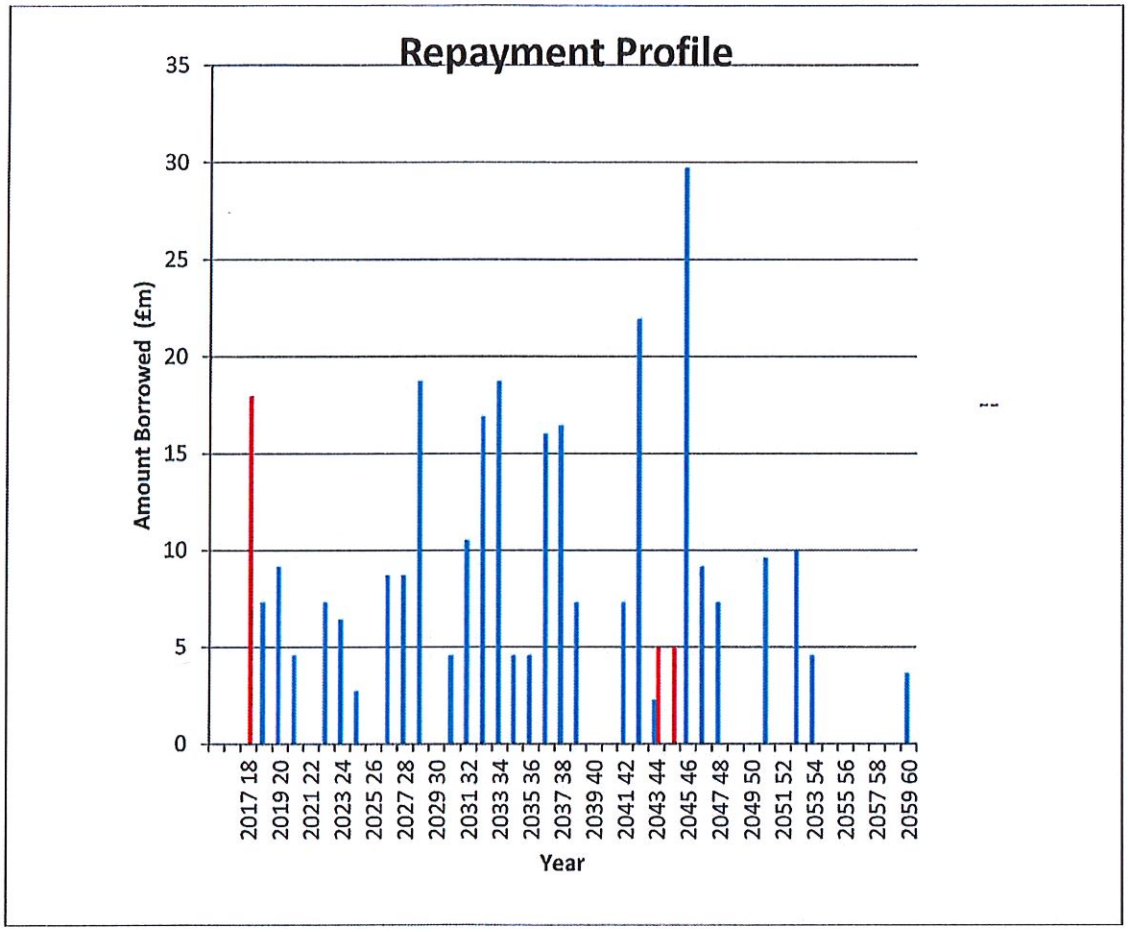
By doing so, the Authority is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. 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 2018-19 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

Alternatively, the Authority may arrange forward starting loans during 2018-19, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

In addition, the Authority may borrow short-term loans to cover unplanned cash flow shortages.

Maturity Profile

The Authority's maturity profile at 31 March 2018 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 maturities is desirable. The Authority currently has no short-term borrowing < 364 days repayable after 31 March 2018. The £18m of maturities in 2017-18 are the 3 LOBO's loans. These are technically callable every 6 months.



The average redemption is £8.2m per year over the next 37 years. The maximum redemption is £29.7m in 2045-46. The average duration of all the Authority's loans is approximately 19 years. Any new borrowing would be targeted for maturity in 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
- Any UK Local Authority
- Any other bank or building society authorised to operate in the UK
- 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 created to enable local authority bond issues
- D2N2 Local Economic Partnership
- Internal borrowing (see above)
- Any institution approved for investments (see below)

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.

Municipal Bonds 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 will be required to provide bond investors with a joint and several guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to Cabinet.

LOBOs: The Authority holds £18m 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 3 LOBOS have options during 2018-19, 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 this option to repay LOBO loans at no cost if it has the opportunity.

The Authority is currently in discussion with Commerzbank to repay £13m of LOBO's at preferential rates. This transaction should be completed by 31 March 2017.

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 current year, the Authority's investment balance has ranged between £269 million and £406 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. Where balances are expected to be invested for more than one year, the Authority will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

Negative Interest Rates: If the UK enters into a recession in 2018/19, there is a small chance that the Bank of England could set its Base rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

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 2018-19. This is especially the case for the estimated £25m (of reserves) that are available for longer-term investment. The majority of the Authority's surplus cash is currently invested in local authority loans, short-term unsecured bank deposits and money market funds. This diversification will therefore represent a continuation of the new strategy adopted in 2016/17.

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

The Pension Fund limits are detailed in Table 3b below. Approval to adopt this strategy is obtained from the Pensions and Investments Committee.

Table 3a: Approved Investment Counterparties and Limits (County Fund)

Credit Rating*	Banks Unsecured	Banks Secured	Government Other LA's	Corporates	Registered Providers
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£30m 5 years	£30m 20 years	£30m 50 years	£10m 20 years	£10m 20 years
AA+	£30m 5 years	£30m 10 years	£30m 25 years	£10m 10 years	£10m 10 years
AA	£30m 4 years	£30m 5 years	£30m 15 years	£10m 5 years	£10m 10 years
AA-	£30m 3 years	£30m 4 years	£30m 10 years	£10m 4 years	£10m 10 years
A+	£30m 2 years	£30m 3 years	£30m 5 years	£10m 3 years	£10m 5 years
A	£30m 13 months	£30m 2 years	£30m 5 years	£10m 2 years	£10m 5 years
A-	£30m 6 months	£30m 13 months	£30m 5 years	£10m 13 months	£10m 5 years
None	£1m 6 months	n/a	£30m 25 years	Individual Cabinet Approval	£10m 5 years
Pooled funds	£30m per fund				
Other Bodies (Non - Corporate)	Individual Cabinet Approval				

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

Operational bank accounts: The Authority may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Authority maintaining operational continuity

County Fund: It is requested that the existing additional overnight limit of £20 million for the County Fund be increased to £30m.

D2N2: It is requested that the existing overnight limit of £1m for D2N2 is maintained.

Derbyshire Developments Ltd: It is requested that existing overnight limit of £1m for Derbyshire Developments Ltd is maintained.

Table 3b: Approved Investment Counterparties and Limits (Pension Fund)

Credit Rating*	Banks Unsecured	Banks Secured	Government Other LA's
UK Govt	n/a	n/a	Unlimited 13 months
AAA	£10m 13 months	£20m 13 months	£20m 13 months
AA+	£10m 13 months	£20m 13 months	£20m 13 months
AA	£10m 13 months	£20m 13 months	£20m 13 months
AA-	£10m 13 months	£20m 13 months	£20m 13 months
A+	£10m 13 months	£20m 13 months	£20m 13 months
A	£10m 13 months	£20m 13 months	£20m 13 months
A-	£10m 6 months	£20m 13 months	£20m 13 months
None	£1m 6 months	n/a	£20m 13 months
Money Market funds	£20m per fund		

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

Operational bank accounts (continued)

Pension Fund: It is requested that the existing additional overnight limit of £10m for the Pension Fund is increased to £20m.

Custodian Accounts

The Derbyshire Pension fund is joining the Local Government Pension Scheme Central pool (LGPS Central) commencing on 01 April 2018.
Northern Trust: This is the custodian for LGPS Central.

BNP Paribas: the existing custodian for the Derbyshire Pension Fund.

In House Account: It is requested that the existing limit of £30m for operational and transactional purposes is maintained until further notice.

Wellington account: It is requested that the existing limit of £20m (US$ equivalent) for operational and transactional is maintained until further notice.

BNY Mellon: It is requested that the existing limit of £1m limit for the former custodian account is maintained until further notice.

* **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. Investment decisions are never solely made based on credit ratings alone, as all other relevant factors including external advice will be taken into account.
  See Appendix B – credit rating definitions (Fitch)
  See Appendix C – UK High St banks/building societies

  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. No unsecured investments with banks rated BBB+ or lower are permitted except for overnight deposits with the Council's main bank account (Lloyds) and contingency bank account (Barclays).

  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+). No unsecured investment with banks rated A- or lower are permitted except for overnight deposits at the Pension Funds custodian banks.

  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 (e.g. a Lloyds Bank covered bond secured by collateral is rated at AAA by Fitch, whilst an unsecured Lloyds bank deposit is rated at A+, 5 notches below).The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

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 (£138m at 31 December 2017). The Authority will distinguish between Upper Tier Authorities (Counties, Unitaries, London Boroughs and Lower Tier Authorities (Boroughs & Districts) in England.

Investments to Scottish, Welsh, Northern Irish, Fire, Police, Transport and Local Authority Pension funds will also be permitted.

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. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility 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.

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 minimum approved investment criteria (BBB+) 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 (A-), 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, treasury bills, 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:

- 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 4a County and 4b Pension Fund below.

Table 4a: Non-Specified Investment Limits (County Fund)

	Cash limit
Total long-term investments	£100m
Total investments rated below A- or unrated (except UK Government and local authorities)	£50m
Total non-specified investments	£150m

Table 4b: Non-Specified Investment Limits (Pension Fund)

	Cash limit
The Pension Fund's Custodian Bank BNP Paribas - In House BNP Paribas – Wellington (US$ equivalent) BNY Mellon – Core & Satelite	 £30m £20m £1m
Total non-specified investments	£51m

Investment Limits (County Fund): The Authority's revenue reserves available to cover investment losses are forecast to be £176m on 31 March 2018. 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 (except for the UK Government or Lloyds Bank as the Council's main bankers) will be £30m (plus accrued interest). 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. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country since the risk is diversified over many countries.

Table 5a: Investment Limits (County Fund)

	Cash limit
UK Central Government	Unlimited
Any single organisation, except the UK Central Government	£30m each
Any group of organisations under the same ownership	£30m per group
Any group of pooled funds under the same management	£30m per manager
Negotiable instruments held in a broker's nominee account	£100m per broker
Foreign countries	£50m in total
Registered Providers	£50m in total
Unsecured investments with Building Societies	£100m in total
Loans to unrated bodies	£100m in total
Money Market Funds	£200m in total

Investment Limits (Pension Fund): The Pension Fund's cash balance is forecast to be £250m at 31 March 2018. In order that no more than approximately 20% of available cash will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (except for the UK Government or Lloyds Bank as the Pension Funds main bankers) will be £20m (plus accrued interest).

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, and foreign countries. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country since the risk is diversified over many countries.

Table 5b: Investment Limits (Pension Fund)

	Cash limit
UK Central Government	Unlimited
Any single organisation, except the UK Central Government	£20m each
Any group of organisations under the same ownership	£20m per group
Any group of pooled funds under the same management	£20m per manager
Negotiable instruments held in a broker's nominee account	£100m per broker
Foreign countries	£50m in total
Unsecured investments with Building Societies	£50m in total
Money Market Funds	£200m 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 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.

Non-Treasury Investments: Although not classed as treasury management activities and therefore not covered by the CIPFA Code or the CLG Guidance, the Authority may also purchase property for investment purposes and may also make loans and investments for service purposes, for example in shared ownership housing, as loans to local businesses and landlords, or as equity investments and loans to the Authority's subsidiaries.
Such loans and investments will be subject to the Authority's normal approval processes for revenue and capital expenditure and need not comply with this treasury management strategy.

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 3 month period, without additional borrowing.

	Target
Total cash available within 91 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	**2018-19**	**2019-20**	**2020-21**
Upper limit on fixed interest rate exposure	100%	100%	100%
Upper limit on variable interest rate exposure	40%	40%	40%

Investments	**2018-19**	**2019-20**	**2020-21**
Upper limit on fixed interest rate exposure	40%	40%	40%
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 at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments 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	20%	0%
12 months and within 24 months	10%	0%
24 months and within 5 years	40%	0%
5 years and within 10 years	40%	5%
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 earliest date on which the lender can demand repayment.

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:

	2018-19	2019-20	2020-21
Limit on principal invested beyond year end	£100m	£80m	£60m

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 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 annually.

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 £674m. The maximum period between borrowing and expenditure is expected to be 2 years, although the Authority is not required to link particular loans with particular items of expenditure.

Financial Implications

The forecast for investment income in 2018-19 is £4.0m, based on an average investment portfolio of £200m at an interest rate of 1.00%. The forecast for debt interest paid in 2018-19 is £14.0m, based on an average debt portfolio of £300m at an average interest rate of 4.69%. 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 & ICT 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 – Arlingclose Economic & Interest Rate Forecast November 2017

Underlying assumptions:

- In a 7-2 vote, the MPC increased Bank Rate in line with market expectations to 0.5%. Dovish accompanying rhetoric prompted investors to lower the expected future path for interest rates. The minutes re-emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

- Further potential movement in Bank Rate is reliant on economic data and the likely outcome of the EU negotiations. Policymakers have downwardly assessed the supply capacity of the UK economy, suggesting inflationary growth is more likely. However, the MPC will be wary of raising rates much further amid low business and household confidence.

- The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. While recent economic data has improved, it has done so from a low base: UK Q3 2017 GDP growth was 0.4%, after a 0.3% expansion in Q2.

- Household consumption growth, the driver of recent UK GDP growth, has softened following a contraction in real wages, despite both saving rates and consumer credit volumes indicating that some households continue to spend in the absence of wage growth. Policymakers have expressed concern about the continued expansion of consumer credit; any action taken will further dampen household spending.

- Some data has held up better than expected, with unemployment continuing to decline and house prices remaining relatively resilient. However, both of these factors can also be seen in a negative light, displaying the structural lack of investment in the UK economy post financial crisis. Weaker long term growth may prompt deterioration in the UK's fiscal position.

- The depreciation in sterling may assist the economy to rebalance away from spending. Export volumes will increase, helped by a stronger Eurozone economic expansion.

- Near-term global growth prospects have continued to improve and broaden, and expectations of inflation are subdued. Central banks are moving to reduce the level of monetary stimulus.

- Geo-political risks remains elevated and helps to anchor safe-haven flows into the UK government bond (gilt) market.

Forecast:

- The MPC has increased Bank Rate, largely to meet expectations they themselves created. Future expectations for higher short term interest rates are subdued. On-going decisions remain data dependant and negotiations on exiting the EU cast a shadow over monetary policy decisions.

- Our central case for Bank Rate is 0.5% over the medium term. The risks to the forecast are broadly balanced on both sides.

- The Arlingclose central case is for gilt yields to remain broadly stable across the medium term. Upward movement will be limited, although the UK government's seemingly deteriorating fiscal stance is an upside risk.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.19
Arlingclose Central Case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk	0.00	0.00	0.00	0.00	0.00	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.15
3-month LIBID rate														
Upside risk	0.10	0.10	0.10	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.22
Arlingclose Central Case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk	-0.10	-0.10	-0.15	-0.15	-0.15	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.20
1-yr LIBID rate														
Upside risk	0.15	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.27
Arlingclose Central Case	0.70	0.70	0.70	0.70	0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.77
Downside risk	-0.15	-0.20	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.15	-0.15	-0.26
5-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.32
Arlingclose Central Case	0.75	0.75	0.80	0.80	0.80	0.85	0.90	0.90	0.95	0.95	1.00	1.05	1.10	0.89
Downside risk	-0.20	-0.20	-0.25	-0.25	-0.25	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.33
10-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.32
Arlingclose Central Case	1.25	1.25	1.25	1.25	1.25	1.30	1.30	1.35	1.40	1.45	1.50	1.55	1.55	1.36
Downside risk	-0.20	-0.25	-0.25	-0.25	-0.25	-0.30	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.33
20-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.32
Arlingclose Central Case	1.85	1.85	1.85	1.85	1.85	1.90	1.90	1.95	1.95	2.00	2.05	2.05	2.05	1.93
Downside risk	-0.20	-0.30	-0.25	-0.25	-0.30	-0.35	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	-0.38
50-yr gilt yield														
Upside risk	0.20	0.25	0.25	0.25	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.32
Arlingclose Central Case	1.70	1.70	1.70	1.70	1.70	1.75	1.80	1.85	1.90	1.95	1.95	1.95	1.95	1.82
Downside risk	-0.30	-0.30	-0.25	-0.25	-0.30	-0.35	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	-0.39

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.

Appendix C

UK High St Banks & Building Societies

Long Term Ratings

a) UK Banks

Bank	Credit Rating Agency			Limit
	Fitch	Moody's	S&P	£m
Barclays	A	A1	A	30
Close Brothers	A	AA3	n/a	30
Goldman Sachs	A	A1	A+	30
HSBC	AA-	AA3	AA-	30
Lloyds (HBOS)	A+	AA3	A	30
RBS/Nat West	BBB+	A3	BBB+	10
Santander UK	A	AA3	A	30

b) UK Building Societies

Building Society	Long term			Limit
	Fitch	Moody's	S&P	£m
Coventry	A	A2	n/a	30
Leeds	A-	A3	n/a	30
Nationwide	A+	AA3	A	30
Yorkshire	A-	A3	n/a	30

c) Foreign Banks

Bank	Credit	Reference	Agency	Limit
	Fitch	Moodys	S&P	£m
Handlesbank	AA	AA2	Aa-	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 & ICT 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.