PUBLIC

Agenda Item No. 4 (i)

DERBYSHIRE COUNTY COUNCIL

PENSIONS and INVESTMENTS COMMITTEE

8 May 2019

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 2019/20.

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 6 February 2019. 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, it does not invest in Pooled Funds (other than Money Market Funds) for treasury management purposes.

The Fund's current benchmark allocation to cash is 2% (about £100m 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 2019 was 7.9%, equating to £389.6m. Future commitments at 31 March 2019 totaled some £450m, of which £85m was drawn-down immediately following the period end.

The recommended Treasury Management Strategy for 2019/20 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 2b on page 4 of the Treasury Management Strategy;
- Investments should be limited by type in accordance with Table 3b on page 8 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, 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

Appendix 1

Treasury Management Strategy Report 2019-20

1) Introduction

Treasury Management is the management of the Council's cash flows, borrowing and investments and the associated risks. The Council 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 financial risk is therefore central to the Council's prudent financial management.

Treasury Risk Management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's "*Treasury Management in the Public Services: Code of Practice 2017 Edition"* (the CIPFA Code) which requires the Council to approve a Treasury Management Strategy before the start of each financial year. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

Investments held for service purposes or for commercial profit are considered in the Investment Strategy.

2) External Context

Economic background: The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Council's Treasury Management Strategy for 2019-20.

Following a weak reading in the first quarter of 2018, attributed to weather-related factors, UK GDP growth rebounded in the second quarter to 0.4% and 0.6% in the third quarter. An annual rate of 1.50% is forecast, as the likelihood of a relatively smooth Brexit diminishes. As economic growth had evolved broadly in line with its November Inflation Report forecast, the Bank of England's Monetary Policy Committee (MPC) voted unanimously for a rate rise of 0.25% in August, taking the Bank Rate to 0.75%. The MPC reiterated that any increases would be at a gradual pace and limited in extent.

The headline rate of inflation (CPIH) was to 2.2% year on year in November 2018, higher than the Bank of England's target of 2%. Labour market data is positive. The ILO unemployment rate was 4.1%. The 3-month average annual growth rate for pay, excluding bonuses, remained at 3.3% in October. Real wages were only up by 1.1% and only likely to have a moderate impact on household spending.

As the US economy has continued to perform well, the Federal Reserve maintained its monetary tightening stance and pushed up its target range for the Fed Funds Rate in December 2018 by 0.25%, to 2.25%-2.50%. The Federal Reserve may be more cautious, with further rises being data dependent in 2019. The fallout from the US-China trade war continues, which combined with tighter monetary policy, risks contributing to a slowdown in global economic activity in 2019.

Despite slower growth in the region, the European Central Bank confirmed the end of its quantitative easing programme, although the timing of the first interest rate increase, is not expected before late 2019.

Credit outlook: The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ringfencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ringfenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks, with the ringfenced banks generally being better rated than their non-ringfenced counterparts.

Interest rate forecast: Following the increase in Bank Rate to 0.75% in August 2018, the Council's Treasury Management Adviser, Arlingclose, is forecasting two more 0.25% increases during 2019, to take official UK interest rates to 1.25%. The Bank of England's MPC has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems and that a higher Bank Rate will be a more effective policy weapon, should downside Brexit risks crystallise when rate cuts will be required.

The UK economic environment remains relatively soft, despite a seemingly strong labour market data. Arlingclose's view is that the economy still faces a challenging outlook as it exits the European Union and Eurozone growth softens. Whilst assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity. As such, the risks to the interest rate forecast are considered firmly to the downside.

Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected, based on Arlingclose's interest rate projections, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.5%-1.7% and 2.0%-2.2% respectively over the interest rate forecast horizon, however volatility arising from both

economic and political events is likely to continue to offer borrowing opportunities.

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%.

3) Local Context

[Wording Removed – not relevant to Pension Fund]

[Table Removed – not relevant to Pension Fund]

4) Borrowing Strategy

[Wording Removed – not relevant to Pension Fund]

5) Investment Strategy

[Wording Removed – not relevant to Pension Fund]

Objectives: The CIPFA Code requires the Council 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 Council'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 Council 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 2019-20, there is a small chance that the Bank of England could set its Bank 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: [Wording Removed – not relevant to Pension Fund]

Business models: Under the new IFRS 9 standard, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Approved counterparties: The Council may invest its surplus funds with any of the counterparty types in Tables 2a and 2b below, subject to the cash limits (per counterparty) and the time limits shown.

Table 2a: Approved investment counterparties and limits (County Fund)

[Table Removed]

Table 2b: Approved investment counterparties and limits (Pension Fund)

Credit rating	Banks unsecured	Banks secured	Government
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 (MMF)	£30m per fund		

Operational bank accounts: The Council 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. 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 Council maintaining operational continuity. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept below:

County Fund: [Wording Removed – not relevant to Pension Fund]

D2N2: [Wording Removed – not relevant to Pension Fund]

Derbyshire Developments Ltd: [Wording Removed – not relevant to Pension Fund]

Pension Fund: It is requested the existing additional overnight limit of £20m is maintained.

Pension Fund Currency Accounts US$/€: Any receipts are cleared to Nil by the following working day.

Pension Fund Custodian Accounts:

BNP Paribas (In House Account): It is requested the existing limit of £30m is maintained.

BNP Paribas (Wellington): It is requested the existing limit of £20m (US$ equivalent) is amended to 5% of assets under management (approximately £25m).

BNY Mellon: It is requested the existing limit of £1m for the former custodian is maintained.

LGPS Central:

The Derbyshire Pension Fund joined the Local Government Pension Scheme (LGPS) Central Pool from 1 April 2018.

DCC Pension Fund re LGPS Central Trading Account: It is requested that a cash limit of 5% of assets under management (approximately £50m) is approved.

DCC Pension Fund re LGPS Central Dividend Account: Dividends received are held in this account until transferred to Lloyds on a monthly basis. It is recommended that a limit of £10m is approved.

Credit rating: Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

Banks unsecured: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

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 higher 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.

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 generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

Corporates: [Wording Removed – not relevant to Pension Fund]

Registered providers: [Wording Removed – not relevant to Pension Fund]

Pooled funds: [Wording Removed – not relevant to Pension Fund]

Real Estate Investment Trusts (REITs): [Wording Removed – not relevant to Pension Fund]

Risk assessment and credit ratings: Credit ratings are obtained and monitored by the Council'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 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 minimum approved rating criteria, 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 Council 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, reports in the quality financial press and analysis and advice from the Council's Treasury Management Adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above 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 Council 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 Council'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.

Investment limits (County Fund): [Wording Removed – not relevant to Pension Fund]

Investment limits (Pension Fund): The Pension Fund's cash balance is forecast to be £184.000m at 31 March 2019. In order to minimise risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government, BNY Paribas (custodian) or Lloyds Bank operational bank accounts as previously detailed) will be £30m and capitalised 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.

Liquidity management: The Council uses purpose-built cash flow forecasting software and Excel spreadsheets 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 Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

Table 3a: Investment limits (County Fund)

[Table Removed – not relevant to Pension Fund]

Table 3b: Investment limits (Pension Fund)

	Cash limit
Any single organisation or group of organisations under the same ownership, except the UK Central Government	£30m each
UK Central Government	Unlimited
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
Unsecured investments with building societies	£50m in total
Money market funds	£200m in total

6) Treasury Management Indicators

The Council measures and manages its exposures to Treasury Management risks using the following indicators.

Security: The Council 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. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	**Target**
Portfolio average credit rating:	
County Fund [Removed]	
Pension Fund	A

Liquidity (Option 1): – The Council 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 three month period, without additional borrowing.

Liquidity risk indicator	**Target**
County Fund:	
Total cash available within 3 months	£30m
Pension Fund:	
Total cash available within 1 month	£60m

Liquidity (Option 2) –:

[Wording Removed – not relevant to Pension Fund]

Maturity structure of borrowing: [Wording Removed – not relevant to Pension Fund]

Principal sums invested for periods longer than a year: [Wording Removed – not relevant to Pension Fund]

Related Matters

The CIPFA Code requires the Council to include the following in its Treasury Management Strategy.

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 Council 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 Council 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.

Markets in Financial Instruments Directive: The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's Treasury Management activities, the Director of Finance & ICT believes this to be the most appropriate status.

Financial Implications

[Wording Removed – not relevant to Pension Fund]

Other Options Considered

The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Finance & ICT, having consulted the Cabinet Member for Council Services, 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 may 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 may 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 may 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 may 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 may be less certain

Appendix A

[Appendix Removed – not relevant to Pension Fund]

Appendix B

[Appendix Removed – not relevant to Pension Fund]