

Review of Treasury Management Investment Policy

Introduction

The Treasury Management Investment Policy is developed to be in line with the forecast cash-flows for current and future years. In particular, the ability to hold long term investments has been determined by the estimated level of long term assets, principally reserves, held on the balance sheet. The latest Medium Term Financial Strategy (MTFS) of the County Council shows that reserve levels are due to reduce significantly over the next three years. The planned level, and actual holding, of long term investments has already been reduced in response to this. However, it is necessary to review the current policy to see whether the type of investments currently held, and the allocation to investment categories, is still appropriate for the anticipated level of resource available for investment in future and the economic context.

Economic Context

Interest rates are at historically low levels with the Bank of England base rate being at 0.25%. Recent months has seen continued economic growth in the UK and an increase in inflation which has risen above the Bank of England target of 2%. This has led to some demands for an increase in interest rates. At the March meeting of the Bank of England Monetary Policy Committee (MPC) which sets the base rate one member voted for an increase in interest rates while the other 8 members voted for it to remain unchanged. There is significant uncertainty in the UK economy. Real term income is falling which will result in reduced spending and the Brexit negotiations will have an unknown impact on both business investment and consumer spending plans. The last quarters' economic growth was 0.3% which was the lowest for the year and below the Bank of England expectations. Therefore, the movement in interest rates is uncertain. The current forecast of Arlingclose, the County Council's treasury management advisers, is that the base rate will remain unchanged until at least June 2020. Even if rates do increase it is anticipated that the increases will be gradual therefore the anticipation is that the low interest rate environment will continue.

In addition, the MPC has aimed to stimulate the economy by 'Quantitative easing'. In effect this has meant that the Bank has been buying both government and corporate bonds. This will increase the demand for the bonds and will impact on the price. Although there has been no recent change in the policy, a change in response to changing economic conditions is a possibility.

Current Policy

In developing the current policy the County Council has adhered to guidance issued by CIPFA and DCLG, both of which require the priorities to be:

- (a) The security of capital, and
- (b) The liquidity of investments

The County Council also aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. In order to give priority to

security, the counterparty credit rating is a fundamental part of the Investment Policy with the table below showing the current approvals.

Instrument	Minimum Credit Rating (blended average)	Maximum individual Investment (£m)	Maximum total Investment (£m)	Maximum Period
UK Government Gilts, Treasury Bills & bodies guaranteed by UK Govt	UK Government	500	1,300	50 yrs
Sterling Supranational Bonds & Sterling Sovereign Bonds	AA-	150	500	50 yrs
Corporate Bonds (Short Term less than 1yr to maturity)	P1/A1/F1	40	200	1yr
Corporate Bonds (Medium term up to 5 years)	AA- P1/A1/F1	100	500	5yrs
Corporate Bonds (Long term)	AA P1/A1+/F1+	50	250	50yrs
Government Bond Repurchase Agreements (Repo/ Reverse Repo)	UK Government	500	500	1yr
Repurchase Agreements (Repo/ Reverse Repo)	Other AA-	200	200	1yr
Bond Funds with weighted average maturity maximum 3 years	AA Rated weighted average maturity 3yrs	100	250	These investments do not have a defined maturity date.
Bond Funds with weighted average maturity maximum 5 years	AAA Rated	100	250	These investments do not have a defined maturity date.
Collateralised lending agreements backed by higher quality government or local government and supra national sterling securities.	AA- with cash or AA- for any collateral	250	500	25yrs
Call accounts with UK and Overseas Banks (domiciled in UK)	P1/A1/F1 Long term A Government support	100	100	Overnight in line with clearing system guarantee (currently 4 years.)

At 31 March 2017 the investment holding was:

Investments	£m
Fixed rate deposits with other local authorities	78.0
Local Authority Bonds	35.9
Supra-national bond	0.6
Gilts	173.2
Corporate Bonds	170.8
Call Account	26.0
Bond Fund	30.0
Reverse REPO	60.0
TOTAL	574.5

In recent years the County Council has focused its long term investments in Gilts and covered bonds. This has proved to be a successful strategy. It has provided a portfolio with a high level of security and it has enabled the County Council to take advantage of major volatility in the markets to sell the investments at a surplus. However, there is no guarantee that a surplus can be made as the potential is highly dependent upon market movements and as bond yields are close to record lows the scope for making such gains may be reduced. The position over the years has been:

	Year Ended 31/03/12 £m	Year Ended 31/03/13 £m	Year Ended 31/03/14 £m	Year Ended 31/03/15 £m	Year Ended 31/03/16 £m	Year Ended 31/03/17 £m
Gilts	-48.741	-8.514	-2.309	-62.793	-16.408	-19.580
LA Bonds	0	-0.429	0	0	0	0
Other bonds	-4.892	-2.730	2.586	-9.126	0.292	-5.090
Total Gain(-)/Loss	-53.633	-11.673	0.277	-71.919	-16.116	-24.670

However, over this time the County Council has had a very positive cash-flow and therefore it has been able to hold sufficient investments which are not subject to major price volatility to cover its liquidity needs. Therefore it has not been in a position whereby it has had to sell the Gilts for liquidity purposes with sales and purchases then being in response to market factors. If this had not been the case significant losses could have been incurred. For example at 31 March 2017 the market value of the Gilt portfolio was £17.4m less than it was purchased for.

This market risk has always been a significant factor in considering the holding of Gilts. With the reducing level of reserves and balances it is becoming a more significant risk. It is with this position in mind that the S151 Officer received advice to sell all or a significant proportion of the Gilts, even though this would incur a loss, as it was

anticipated that the losses in the future could be greater if liquidity needs led to a forced sale.

Clearly then in assessing the suitability of holding Gilts or any other alternative investment the forecast of cash-flows is essential.

Cash Flow Forecast

The recent policy has been based on having resources to back long term investments of £600m which within the Council's Prudential Indicators has been reduced to £450m for 2017/18. There is an expectation that this will be reduced further in subsequent years. The current forecast of the balance sheet is as follows:

	Actual	Provisional Actual	Forecast	Forecast	Forecast
	31/03/2016	31/03/2017	31/03/2018	31/03/2019	31/03/2020
	£m	£m	£m	£m	£m
County Fund	36.000	36.000	36.000	36.000	36.000
Revenue reserves	278.647	223.556	114.939	17.020	17.025
School Reserves	86.022	79.200	76.962	73.062	73.062
Capital receipts	17.696	22.700	15.000	10.000	10.000
Capital grant unapplied	70.740	62.500	40.000	40.000	40.000
Provisions	31.239	28.600	30.000	30.000	30.000
Receipts in advance	10.641	8.300	10.000	10.000	10.000
TOTAL	530.985	460.856	322.901	216.082	216.087
Shared Investments	75.000	60.815	60.000	60.000	50.000
TOTAL	605.985	521.671	382.901	276.082	266.087

From the table above it would seem that the County Council will be able to support a long term investment pool of c£260m. However, the key risks in this forecast are:

- School balances will fall faster than anticipated, especially if there is an increase in the number of schools converting to academies
- Authorities leave the shared investment scheme
- Capital expenditure is such that no resources are carried forward at the end of any given year

Taking a more pessimistic view of these movements would lead to a forecast balance sheet by 31 March 2020 of some £125m. However, in addition to cash-flows generated by balance sheet items the County Council usually has the ability to make short term investments with income generally being received in advance of expenditure.

As such, a long term investment portfolio of £200m seems reasonable.

Investment Options

In reviewing the investment alternatives the key concepts to consider are the levels of credit risk and market risk. The credit risk is the likelihood of the investment being lost. The market risk is the possibility that a loss will be incurred if it needs to be realised for liquidity purposes. The sections below give an indication of the relative risks of the different types of investments.

Gilts

A Gilt is a UK Government bond denominated in sterling, issued by HM Treasury and listed on the London Stock Exchange. The term "Gilt" or "gilt-edged security" is a reference to the primary characteristic of Gilts as an investment: namely their high security. This is a reflection of the fact that the British Government has never failed to make interest or principal payments on Gilts as they fall due. As the Gilts are traded the price of them can fluctuate significantly even over short periods of time. Therefore if the Gilt needs to be sold before its maturity date a loss could potentially be incurred. For example at 31 March 2017 the market value of the County Council's holding was less than it was purchased for and if sold would have resulted in a loss of £17.4m.

In constructing an overall Treasury Management Investment portfolio consideration should be given to whether Gilts are being held with the expectation that there will be a degree of trading or whether they are being held for a long time and potentially to maturity.

As referred to above the main benefit of the Gilts is the very low credit risk. However, if the intention is to obtain Gilts and hold them to maturity the yield is expected to be low. Although the yield will vary between different Gilts current expectations of a Gilt with 10 years to maturity would be a yield of around 1.2%. The gains that have been made in the past have mainly been derived from the opportunity to sell Gilts in response to changes in the market. Although this presents a liquidity risk, it could be mitigated by creating a volatility reserve.

Investment in other local authorities

Lending to other local authorities on the basis of a fixed term deposit are a low credit risk given the current anticipated level of government support. However, the market may be limited and there is no guarantee of future government support. In the past year some authorities which have a separate credit rating have seen these reduced. Therefore, Arlingclose, the County Council's Treasury Management advisers, state that they are "comfortable with clients making loans to UK local authorities for periods up to four years, subject to this meeting their approved strategy. For periods longer than four years we recommend that additional due diligence is undertaken prior to a loan being made." These do form part of the current investment policy but the opportunities for long term investments giving a suitable yield are limited. Currently it would be anticipated that a yearlong investment would yield around 0.6%. However, this category is and is likely to continue to be an important source for short term investments.

Non-Government Bonds

There are a variety of options with respect to bonds which have varying degrees of risk and potential returns. Some of these already form part of the current investment policy. The County Council only invests in high credit worthy instruments. Some of the types of bonds that the Council invests in are:

Covered Bonds- these are long-term secured investments with a bank. They are secured on the bank's residential mortgages and are tradeable. Bonds are over collateralised and therefore usually have an AAA credit rating.

Supranational bonds- with multi- national institutions. These are very highly rated and therefore have a low credit risk.

Corporate bonds- bonds issued by private companies, including major multi-national companies. The bonds need to have a credit rating of at least AA for the County Council to hold them. There are many bonds available on the market with a lower rating.

Under the current policy the credit risk of holding these bonds is low but there is a market risk. However, due to the type of bonds held, the volatility in the price is generally not as high as Gilts. Current yields are expected to be around 0.5%.

The policy on the level of credit risk could be changed to encourage additional returns but this would likely involve reducing the credit ratings allowable of bonds held. Unless this was very carefully constructed it could be seen as not meeting the key criteria of ensuring security of the investment.

The County Council has invested in a bond fund which holds a range of bonds. A wide variety of bond funds exist with different duration and credit risk. If the County Council was to make greater use of these for long term investments a re-assessment of the credit risk may be required.

Reverse repurchase agreements (REPO)

A reverse REPO is when the authority buys bonds, usually from a bank, on one date and agrees to sell them at an agreed price on an agreed date. These are a very low credit risk investments as the County Council actually takes ownership of the bonds and therefore has an asset should the bank default. Typically this is used for short term investments and the current yield is around 0.2%. It is anticipated that this investment option will continue to be used to ensure short term cash is invested securely.

Other potential areas of investment which are not currently within the approved Treasury Management Strategy are:

Fixed Term Deposits in banks and building societies

For many local authorities, deposits with banks and building societies represent the majority, if not all, of their investment holding. According to DCLG statistics at 31 March

2016 some 42% of local authority investments are deposits with banks or building societies. However, with the exception of a call account at Svenska Handelsbanken and the ability to keep a small sum with the County Council's bank, investment in banks and building societies do not form part of the Council's investment policy.

Although the yields achievable are probably marginally higher than from other local authorities they represent a credit risk. Legislation, referred to as the 'bail-in', means that local authority deposits with banks are some of the least secured if an institution looks as if it is becoming insolvent. In this instance the authority would lose some, if not all, of its capital. The maximum duration of an investment recommended by Arlingclose is 13 months for the strongest banks and significantly less for other banks and building societies.

Property

Some authorities have been undertaking direct investment in property. These are often retail opportunities and have the potential to make good returns, although the actual return will vary significantly from property to property. However, there needs to be careful consideration in entering into property as an investment class namely:

- If the property is in Lancashire, is it purely an investment or is there an economic regeneration factor behind the transaction? Although both are valid reasons for an authority to invest in a property, if a factor in making the purchase is to promote economic development then the transaction may not be the most beneficial investment.
- There are many uncertainties, including: Will the rental income always be available, what happens in a recession, or if a key tenant pulls out? Some of these risks could potentially be mitigated by holding a range of properties.
- The asset is relatively illiquid. If cash is required the authority may need to take a substantial loss on any sale depending upon the property market at the time.
- All property expenditure would be categorised as capital expenditure. This will mean capital resources would need to be applied to meet the investment or funding needed from the minimum revenue provision. This will involve an annual charge to the revenue account.

Given the number of authorities moving into direct property investment there have been a number comments made in the national press. There has been concern of the risk being taken by local authorities and in November 2016 the public accounts committee of the House of Commons produced a report expressing concern over local authorities understanding the risks involved and the oversight from DCLG.

Pooled Funds

In addition to direct investment and the bond funds referred to above, there are opportunities to invest in other types of pooled funds. The main types of fund available are:

- **Property Funds**

An alternative to holding direct property is to buy a share in a property fund. This has the advantage of having access to specialist professionals and having a share in a wide range of properties. Over the last few years these funds have made high returns. However, performance will be linked to the overall economy and property market and therefore there will be times when returns are low. It would also have to be viewed as an illiquid asset. Although the funds do allow for the investors to withdraw money it can be subject to their ability to sell a property and potential losses could be made. With the exception of the CCLA fund, property funds are also classified as capital expenditure.

- **Equity Funds**

If a local authority was to purchase shares in a company these would be treated as capital expenditure. However, shares in an equity fund are classed as investment. Like other types of fund this does also give the advantage of access to specialist investment managers but the value of any fund will be subject to stock market fluctuations. Traditionally over a long period of time returns have been good however, there is the potential for low returns in the short term and again if the authority needed to redeem its holding then a loss could be incurred.

- **Multi asset Fund**

Some investment managers offer multi asset funds. These are formed by a mix of equities, bonds and cash. The mix and ability to switch between categories will differ from fund to fund. The availability and suitability of these for a local authority would need to be carefully examined.

The yield from any pooled funds (equity, property, bond or multi asset) would be very dependent upon the make-up and management of the individual fund and probably even more importantly the overall performance of the economy.

Reduce borrowing

The County Council has tended to borrow externally to meet the borrowing needs arising from its capital investment. It has undertaken this approach on the understanding that the return on investments was likely to exceed the cost of borrowing. An alternative approach would be to use internal cash to fund the capital programme thereby reducing the available cash for investment. As the County Council has a significant holding of short term borrowing the potential is available to not renew these. To replace the borrowing would involve taking on new loans which are currently at low rates (0.5% or less for short term borrowing) therefore there would not be a significant saving.

Treasury Management Adviser's Comments

The County Council has sought advice from Arlingclose and LPPI in respect of the options. Arlingclose have reviewed the cash flow forecasts and see an investment portfolio of some £200m as reasonable. They view that the current portfolio is highly exposed to market risk and the potential impact of increases in interest rates. They

recommend moving a proportion of the Gilt portfolio into property and equity funds to provide a more diversified fund and minimise the fall in investment income. Although not a guaranteed relationship the advisers note that property and equity market movement is generally in the opposite direction to the movement in Gilts. They also suggest reducing the borrowing.

LPPI as the Council's treasury management advisers have suggested that any investment is aligned with the Council's risk tolerance and that given the market environment the risks within the long duration Gilt market are material.

Conclusion

The Investment Policy followed by the County Council has worked well and has been effective in both keeping credit risk very low and enabling a good rate of return to be achieved. It would seem reasonable to maintain the Gilt and corporate bond holdings as a key part of the Policy to help maintain the low credit risk. However, there is a potential for increases in interest rates and change in quantitative easing which would lead to an increase in the market risk of holding Gilts and corporate bonds. This allied to the reduced level of reserves and balances would suggest that some diversification of the portfolio would be beneficial. Therefore, it is proposed that the Treasury Management Strategy is modified to allow investment in property and equity funds of up to £50m in each category.

The intention would be to move towards a long term investment portfolio which limits the investment to:

	£m
Gilts/long duration bond funds	100
Equity pooled funds	50
Property pooled funds	50

It will be important to consider the potential pools carefully before entering into any agreement. It is not anticipated that the whole allocation will necessarily be included in one pool but could be spread over three or four pools. Therefore there does need to be some flexibility in implementation both in terms of the timing of taking on new investments and reacting to the speed at which reserves are reduced.

It is proposed that the portfolio should be managed so that the sum of the Gilts/long duration bond funds, property funds and equity funds does not exceed £200m unless agreed by the S151 officer. Pooled funds do not tend to have credit ratings, since they do not promise to repay the sum invested and therefore cannot default. Individual funds will need to be assessed based on a number of factors including their investment strategy (e.g. UK or Global), the perceived risk appetite of the fund as measured by volatility and past performance. Before entering into any fund, advice will be sought from the Council's treasury management advisers.

Investment requirements in excess of this, which are likely to be of a relatively short term, can be met from the high credit rated corporate bonds, short dated bond funds, reverse repo, investments with other local authorities and call accounts.