**Appendix B**

## The County Council's Treasury Management Strategy 2015/16

## 1. Introduction and Legislative Framework

Under the Local Government Act 2003, local authorities must have regard to Statutory Proper Practices in their Treasury Management activities. In February 2012 the Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code.)

These together require the county council on an annual basis to set out its strategy in relation to key aspects of its treasury management operations over the coming year.

In addition, the Department for Communities and Local Government (CLG) issued revised guidance on local authority investments in March 2010 that requires the county council to approve an investment strategy before the start of each financial year. The strategy also has regard to other CIPFA treasury management publications such as 'Treasury Management Toolkit for Local Authorities' (2012) and 'Using Financial Instruments to Manage Risk' (2013)

In line with these various requirements this strategy includes:

- The Annual Borrowing Strategy
- The Council's Policy on Borrowing in Advance of Need
- The Annual Investment Strategy
- Policy on Use of Financial Derivatives
- The Prudential Indicators (Annex A to this Appendix)
- The Annual MRP statement (Appendix C to this report.)

In conjunction with the Treasury Management Policy Statement and the detailed Treasury Management Practices approved by the section 151 officer, these provide the policy framework for the engagement of the county council with the financial markets in order to fund its capital investment programme and maintain the security of its cash balances.

## 2. Strategic Objectives of the Treasury Management Strategy

The county council's Treasury Management Strategy is designed to achieve the following objectives:

a) To ensure the security of the principal sums invested which represent the county council's various reserves and balances
b) To ensure that the county council has access to cash resources as and when required
c) To minimise the cost of the borrowing required to finance the county council's Capital Investment programme, and

d) To maximise investment returns commensurate with the county council's policy of minimising risks to the security of capital and its liquidity position.

In the context of these objectives it will be the county council's policy to hold as investments a sum as close to the cash value of its balance sheet as possible, matching both value and duration as closely as possible.

## 3. Setting the Treasury Management Strategy for 2015/16

In setting the treasury management strategy, the county council must have regard to the following factors which will have a strong influence over the strategy adopted:

- economic forecasts – the economic and legislative context
- the level of the approved Capital Programme which generates the borrowing requirement,
- the current structure of the county council's investment and debt portfolio
- prospects for interest rates and market liquidity

3.1 Economic Forecast

*Economic context*

There is momentum in the UK economy, with a continued period of growth through domestically-driven activity and strong household consumption. There are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP. However, there are no signs of inflationary pressure and this is likely to remain the case at least for the short-term. There have been large falls in unemployment but levels of part-time working, self-employment and underemployment are significant and nominal earnings growth remains weak and below inflation.

The Bank of England's Monetary Policy Committee's (MPC) focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate in the Committee. Despite two MPC members having voted for a 0.25% increase in rates at each of the meetings from August 2014 onwards, some Committee members have become more concerned that the economic outlook is less optimistic than at the time of the August Inflation Report.

The MPC's guidance on the expected path for the Bank Rate continues to apply. When the Bank Rate does begin to rise, the pace of rate increases is expected to be gradual, with rates probably remaining below average historical levels for some time.

*Legislative Context*

In the past governments had only two options to resolve failing banks: insolvency, that is ceasing essential services immediately with a strong possibility of financial instability, or alternatively to conduct a taxpayer funded bail-out, either by buying new shares in the bank, or by subsidising a takeover. However recent banking reform legislation introduces a third option, which allows customers to retain access to their bank accounts, but passes the banks losses onto its investors instead of taxpayers. This is known as a "bail in".

The first piece of legislation concerned with the concept of 'bail-in' was the Financial Service (Banking Reform) Act 2013. This introduced bail-in as a tool for banking regulators to recapitalise failing banks by applying a percentage reduction in the amount to be paid to investors.

A bail-in can be conducted before a bank becomes insolvent, and importantly, 7 day interbank loans, covered bonds, repurchase agreements and derivatives are exempt from bail-in. Insured deposits are classed as a preferred creditor, ranking above others in the event of insolvency.

The Financial Service (Banking Reform) Act 2013 was followed by the Bank Recovery and Resolution Directive 2014/59/EU which in addition to the above added that large deposits (over £85,000 or €100,000) from depositors (individuals and SMEs) are to rank above other uninsured deposits in both insolvency and bail-in situations. This was incorporated into UK law with effect from 1st January 2015.

Finally the Deposit Guarantee Schemes Directive 2014/49/EU will be implemented in the UK by 3rd July 2015, whereby deposit insurance schemes (e.g. Financial Services Compensation Scheme) are to be extended to include large companies and charities, so that by July 2015 all non-financial private sector organisations will be eligible for compensation, however public sector and financial organisations, including pension funds and money market funds, will remain ineligible for compensation, the rationale being that:

— “Public authorities have much better access to credit than citizens, so should not be eligible for protection.”

Although these changes will probably not increase the risk of any bank defaulting, they will definitely increase the loss given default. Losses from either a bail-in or an insolvency process will be larger than they would otherwise have been, since there will be fewer creditors among which to share the losses.

The impact of a bail-in depends on, the size of loss incurred by the bank, the amount of equity capital and junior bonds that can absorb losses first, and the proportion of insured deposits, covered bonds and other liabilities that are exempt from bail-in.

Taking these factors into account, the chart below produced by the Council's treasury management advisers, Arlingclose Ltd., shows how the bail in would be financed for various levels of loss incurred under a theoretical bank default.

IMPACT OF A % LOSS OF RISK-WEIGHTED ASSETS ON UNSECURED UNINSURED CREDITORS AFTER JULY 2015

| LOSS | Barclays | Close Bros | Clydesdale | Co-op Bank | HSBC Bank | Lloyds ex TSB | RBS Group | Santander UK | Stan Chart | Svenska Hand | TSB | Virgin Money | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1% | E | E | E | E | E | E | E | E | E | E | E | E | |
| 2% | E | E | E | E | E | E | E | E | E | E | E | E | |
| 3% | E | E | E | E | E | E | E | E | E | E | E | E | |
| 4% | E | E | E | E | J | E | E | E | E | E | E | E | |
| 5% | J | E | E | E | J | E | J | E | E | E | E | E | |
| 6% | J | E | E | 56% | H | J | J | J | J | E | E | E | RBS 2008 |
| 7% | 2% | E | E | 80% | H | J | J | J | J | E | E | E | |
| 8% | 5% | E | E | 100% | H | J | J | J | J | E | E | E | |
| 9% | 8% | H | J | 100% | H | J | J | 3% | J | E | E | E | |
| 10% | 11% | H | J | 100% | 2% | J | J | 6% | J | E | E | 100% | |
| 11% | 15% | 4% | 1% | 100% | 6% | J | 7% | 10% | H | E | E | 100% | Co-op 2013 |
| 12% | 18% | 9% | 11% | 100% | 11% | J | 15% | 14% | H | 0% | E | 100% | |
| 13% | 21% | 13% | 22% | 100% | 15% | J | 23% | 18% | H | 1% | E | 100% | |
| 14% | 24% | 18% | 32% | 100% | 20% | 4% | 32% | 21% | H | 2% | E | 100% | |
| 15% | 27% | 23% | 42% | 100% | 24% | 10% | 40% | 25% | H | 4% | E | 100% | |
| 16% | 30% | 23% | 53% | 100% | 29% | 15% | 48% | 29% | 0% | 5% | E | 100% | |
| 17% | 33% | 23% | 63% | 100% | 33% | 21% | 57% | 33% | 6% | 6% | E | 100% | |
| 18% | 36% | 23% | 74% | 100% | 38% | 27% | 63% | 36% | 6% | 7% | E | 100% | Anglo Irish 2008/9 |
| 19% | 39% | 23% | 84% | 100% | 42% | 32% | 63% | 40% | 6% | 8% | J | 100% | |
| 20% | 41% | 23% | 86% | 100% | 47% | 38% | 63% | 44% | 6% | 9% | J | 100% | |

E - Loss is covered by equity

J - Loss is covered by a bail-in of junior debt

H - Loss is covered by a bail-in of holding company senior debt or conversion of loan from parent

% - Loss to be covered by a bail-in of senior unsecured debt and uninsured deposits

Balance sheet data as at June 2014 except Close Bros (July), Clydesdale (March), Svenska (September) and Virgin (December 2013)

Shown alongside the table are the level of recent bank losses for RBS, Co-op and Anglo Irish Bank. From this can be seen the level of bail in that would have been required had the legislation been in place at the time, and it therefore indicates the possible level of bail in that may be required in the future.

In addition given that bail-in exempt assets are clearly defined within the banking reform directives, this picture is likely to deteriorate further from the perspective of the potential impact on the Council, as there is an incentive for banks to issue instruments held in exempt categories so increasing the proportionate bail in risk for uninsurable deposits.

The continued global economic recovery has led to a general improvement in credit conditions since last year. This is evidenced by a fall in the credit default swap spreads of banks and companies around the world. However, due to the above legislative changes, the credit risk associated with making unsecured bank deposits will increase relative to the risk of other investment options available to the Council.

3.3 The Current Structure of the Portfolio

The Council's treasury portfolio (net of transferred debt) as at 31st December 2014 was as follows.

| | Principal Amount £m | Current Interest Rate % |
|---|---|---|
| Call accounts | 43.66 | 0.49 |
| Short-term deposits | 74.00 | 2.94 |
| Long-term deposits | 56.50 | 1.63 |
| Bond Portfolio | 514.47 | 2.54 |
| **Total Investments** | **688.64** | **2.38** |
| | | |
| Short-term loans* | 531.52 | 0.61 |
| Long-term loans (Local Authorities) | 116.50 | 1.46 |
| Shared Investment Scheme** | 78.12 | 0.67 |
| Long-term PWLB loans | 338.85 | 3.06 |
| Long-term market loans (LOBOs) | 51.89 | 4.75 |
| **Total Borrowing** | **1,116.88** | **1.64** |
| | | |
| **Net Borrowing** | **428.24** | |

*Short terms loans includes £284 million in relation to the waste PFI agreement between the county council and Global renewables Lancashire Limited being brought to an end. Previously the liability for the waste PFI was included in other long term liabilities.

** Please refer to the Glossary for further information.

*3.4 Prospects for Interest Rates and Market Liquidity*

In planning the treasury management strategy, the Council will consider the prevailing and forecast interest rate situation. Regular forecasts of interest rates are provided by Arlingclose Ltd, treasury management advisers to the county council. The Chief Investment Officer for the Council also provides a view on interest rate forecasts based on current and future market data.

Arlingclose's first rise in official interest rates is forecast for September 2015 with a gradual pace of increases thereafter, the average rate for 2015/16 being around 0.75%. They believe the normalised level of the Bank Rate post-crisis to range between 2.5% and 3.5%. The risk to the upside (i.e. interest rates being higher) is weighted more towards the end of the forecast horizon. On the downside, Eurozone weakness and the threat of deflation have increased the risks to the durability of UK growth. If the negative indicators from the Eurozone become more entrenched, the Bank of England will likely defer rate rises to later in the year. In the near term gilt yields (long term interest rates) are not expected to move very much from current levels, however, Arlingclose projects gilt yields on an upward path in the medium term, taking the forecast average 10 year PWLB loan rate for 2015/16 to 3.40%.

| | Mar-15 | Jun-15 | Sep-15 | Dec-15 | Mar-16 | Jun-16 | Sep-16 | Dec-16 | Mar-17 | Jun-17 | Sep-17 | Dec-17 | Mar-18 | Average |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Official Bank Rate | | | | | | | | | | | | | | |
| Upside risk | | | | 0.25 | 0.25 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | |
| Arlingclose Central Case | 0.50 | 0.50 | 0.75 | 0.75 | 1.00 | 1.00 | 1.25 | 1.25 | 1.50 | 1.50 | 1.75 | 1.75 | 1.75 | 1.17 |
| Downside risk | | | 0.25 | 0.25 | 0.50 | 0.50 | 0.75 | 0.75 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | |
| 3-month LIBID rate | | | | | | | | | | | | | | |
| Upside risk | 0.35 | 0.40 | 0.45 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | |
| Arlingclose Central Case | 0.60 | 0.75 | 0.90 | 1.05 | 1.20 | 1.35 | 1.50 | 1.60 | 1.70 | 1.80 | 1.90 | 2.00 | 2.10 | 1.42 |
| Downside risk | 0.15 | 0.20 | 0.30 | 0.40 | 0.55 | 0.65 | 0.75 | 0.85 | -0.95 | -0.95 | -0.95 | -0.95 | -1.00 | |
| 1-yr LIBID rate | | | | | | | | | | | | | | |
| Upside risk | 0.35 | 0.40 | 0.45 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | |
| Arlingclose Central Case | 1.00 | 1.05 | 1.20 | 1.35 | 1.50 | 1.65 | 1.80 | 1.95 | 2.10 | 2.20 | 2.30 | 2.40 | 2.50 | 1.77 |
| Downside risk | -0.15 | -0.20 | -0.30 | -0.50 | -0.55 | -0.60 | -0.65 | -0.70 | -0.75 | -0.80 | -0.80 | -0.80 | -0.80 | |
| 5-yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.35 | 0.40 | 0.45 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.55 | 0.55 | 0.55 | 0.55 | |
| Arlingclose Central Case | 1.45 | 1.60 | 1.75 | 1.90 | 2.00 | 2.15 | 2.25 | 2.35 | 2.45 | 2.50 | 2.55 | 2.60 | 2.60 | 2.17 |
| Downside risk | -0.35 | -0.35 | -0.35 | -0.40 | -0.45 | -0.50 | -0.55 | -0.60 | -0.65 | -0.70 | -0.70 | -0.70 | -0.70 | |
| 10-yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.35 | 0.40 | 0.45 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.55 | 0.55 | 0.55 | 0.55 | |
| Arlingclose Central Case | 2.00 | 2.10 | 2.20 | 2.30 | 2.40 | 2.50 | 2.60 | 2.70 | 2.75 | 2.80 | 2.85 | 2.90 | 2.95 | 2.54 |
| Downside risk | -0.35 | -0.35 | -0.35 | -0.40 | -0.45 | -0.50 | -0.55 | -0.55 | -0.55 | -0.60 | -0.60 | -0.60 | -0.60 | |
| 20-yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.35 | 0.40 | 0.45 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.55 | 0.55 | 0.55 | 0.55 | |
| Arlingclose Central Case | 2.55 | 2.65 | 2.75 | 2.85 | 2.95 | 3.00 | 3.05 | 3.10 | 3.15 | 3.20 | 3.25 | 3.30 | 3.30 | 3.01 |
| Downside risk | -0.35 | -0.35 | -0.35 | -0.40 | -0.45 | -0.50 | -0.50 | -0.55 | -0.55 | -0.60 | -0.60 | -0.60 | -0.60 | |
| 50-yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.35 | 0.40 | 0.45 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.55 | 0.55 | 0.55 | 0.55 | |
| Arlingclose Central Case | 2.65 | 2.70 | 2.80 | 2.90 | 3.00 | 3.05 | 3.10 | 3.15 | 3.20 | 3.25 | 3.30 | 3.55 | 3.60 | 3.10 |
| Downside risk | -0.35 | -0.35 | -0.35 | -0.40 | -0.45 | -0.50 | -0.55 | -0.55 | -0.55 | -0.60 | -0.60 | -0.60 | -0.60 | |

Arlingclose have based this forecast on the following underlying assumptions:

- The UK economic recovery has continued. Household consumption remains a significant driver, but there are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP in 2015.
- Arlingclose expect consumption growth to slow, given softening housing market activity, the muted outlook for wage growth and slower employment growth. The subdued global environment suggests there is little prospect of significant contribution from external demand.
- Inflationary pressure is currently low (annual CPI is currently 1.3%) and is likely to remain so in the short-term. Despite a correction in the appreciation of sterling against the US dollar, imported inflation remains limited. We expect commodity prices will remain subdued given the weak outlook for global growth.
- The MPC's focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee.
- Nominal earnings growth remains weak and below inflation, despite large falls in unemployment. This is likely to be because the levels of part-time, self-

employment and underemployment are significant and indicate capacity within the employed workforce, in addition to the still large unemployed pool. Productivity growth can therefore remain weak in the short term without creating undue inflationary pressure.

- Employment growth is expected to slow as economic growth decelerates. This is likely to boost productivity, which will bear down on unit labour costs and inflationary pressure .In addition policymakers are evidently concerned about the bleak prospects for the Eurozone, and the generally subdued global environment suggests there is little prospect of significant contribution from external demand

These factors will maintain the current direction of the MPC in the medium term.

*3.5 Impact of these factors on the Borrowing Strategy*

- In view of the above assessment of the economic context within which the Council is operating in, where despite the gradually improving economic outlook, the UK still remains in a relatively low growth situation, with a continuing tight fiscal and loose monetary policy approach; it could be 2016 before there is a rise in official UK interest rates and the UK's safe haven status and minimal prospect of rate rises are expected to keep gilt yields in check through the near term. However, If it became apparent that there was a significant risk of a much sharper rise in long and short term rates than that currently forecast, perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

The council’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 Council’s long-term plans change is a secondary objective.

Given the significant cuts to public expenditure and in particular to local government funding, the council’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 instead.  By doing so, the council is able to reduce net borrowing costs and reduce overall treasury risk.

The benefits of internal borrowing are monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose will assist the council with this ‘cost of carry’ and breakeven analysis. Its output may determine whether the council borrows additional sums at long-term fixed rates in 2015/16 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

Whilst it is expected that the current low rate environment will continue for a further period, it is prudent for the council to prepare for a further change in capital financing strategy to ensure that the council is protected from the impact of rate rises when they occur; in support of this strategy full council have approved in principle the following options:-

- the establishment of a Lancashire County Council Euro Medium Term Note (EMTN) programme to facilitate access to secure long term debt in readiness for interest rate rises, as this option provides the best prices for the county council and

- An equity investment in the proposed Local Government Bond Agency to cement the county council's founder member status, and to enable access to an alternative economic funding source

- The necessary changes to the Council's Prudential Indicators to facilitate the switch from a programme of rolling short term debt to longer term debt financing in 2014/15

In addition, the council may borrow short-term (normally for up to one month) to cover unexpected cash flow shortages.

*3.6 Impact of these factors on the Investment Strategy*

In view of the above assessment of the economic context within which the Council is operating in the county council's investment strategy will be based upon the following information:

- The continuing concerns in the financial markets over sovereign debt, particularly in the Eurozone are impacting negatively on the credit quality of bank counterparties, and the county council will therefore continue to reduce the duration of its exposure to those bank counterparties which continue to meet tightened credit quality criteria.

- Given the level of risk involved in dealing with bank counterparties the county council will continue to diversify its portfolio further away from such counterparties while maintaining the highest credit quality of counterparties. Banking legislation reforms effective from 1st January 2015 rule out unsecured term deposits with banks as an appropriate investment vehicle for the county council.

## 4. Borrowing Strategy

*4.1 The Level of the Approved Capital Programme – the Borrowing Requirement*

The county council's estimated borrowing requirement for financing the capital programme in the current and the next three years is as follows:

| | 2014/15 Revised £m | 2015/16 £m | 2016/17 £m | 2017/18 £m |
|---|---|---|---|---|
| **Capital Programme Expenditure** | **205.903** | **217.919** | **172.647** | **79.206** |
| *Financed by:* | | | | |
| Capital Receipts | 8.171 | 29.531 | 9.132 | 2.232 |
| Grants and Contributions | 187.450 | 117.633 | 97.343 | 76.974 |
| Revenue Contributions | 8.999 | 12.806 | 0.284 | 0.000 |
| **Borrowing** | **1.283** | **57.949** | **65.888** | **0.000** |
| *Add Maturing Debt to be replaced*: | | | | |
| Long Term PWLB | 0.000 | 0.000 | 0.000 | 0.000 |
| Long term fixed Borrowing | 0.000 | 250.000 | 250.000 | 250.000 |
| Short Term Market Borrowing | 579.950 | 329.950 | 329.950 | 329.950 |
| Less Transferred Debt | 1.967 | 1.899 | 1.687 | 1.629 |
| Less Statutory Charge to Revenue | 30.157 | 28.873 | 29.907 | 31.216 |
| **Total Borrowing Requirement** | **549.109** | **607.127** | **614.244** | **547.105** |

At 31st March 2014 the county council held £814.8million of short and long-term loans as part of its strategy for funding previous years' capital programmes. The county council's borrowing requirement as at 31st March 2015 is expected to be £549.11million, and is forecast to rise to £614.24million by March 2017 as capital expenditure is incurred. In addition, the county council may borrow for short periods of time to cover unexpected cash flow shortages.

The county council's borrowing position over the coming years is affected by a number of specific factors:

- The need to provide cash flow support for the Preston, South Ribble and Lancashire City Deal to cover the gap between the construction of infrastructure and the payment over of contributions from other organisations including the Government and developers. This borrowing is temporary.

- There is likely to be a similar need to provide even shorter term financial support in relation to the construction of the Heysham – M6 Link Road which is largely funded by government grant payable in arrears.

- An increase in underlying borrowing as the result of the refinancing of the long term liabilities associated with the Waste PFI project

It can be seen from the above table that the borrowing requirement for 2015/16 is £607.13million, largely as a result of needing to refinance maturing short term borrowing. There are a range of options available for the borrowing strategy in 2015/16.

- Variable rate borrowing is expected to be cheaper than fixed rate long term borrowing and will be attractive during the financial year, particularly as variable rates are closely linked to bank rates.
- Under 10 years rates are expected to be substantially lower than long term rates, so this opens up a range of choices that may allow the county council to spread maturities away from concentration on long dated debt.
- The establishment of a Lancashire County council Euro Medium Term Note Programme (EMTN); and also participation in the Local Government Bond Agency led by the LGA's Municipal Bond Agency are both prudent approaches which will afford the council some protection from future interest rate increases.

Against this background, the section 151 officer will, in conjunction with the county council's advisors, monitor the interest rate situation closely and will adopt a pragmatic approach to delivering the objectives of this strategy within changing economic circumstances, Arlingclose forecast the first rise in official interest rates in Q4 2015 carefully monitoring will ensure that borrowing is taken at the most appropriate time. The table above reflects this forecasted rise and the fixing of £250m of the short term debt in 2015/16.

Given the increased cost of PWLB borrowing relative to other market services the county council is likely to undertake future borrowing activity within the financial markets, taking advantage of the benefits of its AA+ credit rating.

All decisions on whether to undertake new or replacement borrowing to support previous or future capital investment will be subject to evaluation against the following criteria:

a) Overall need, whether a borrowing requirement to fund the capital programme or previous capital investment exists;
b) Timing, when such a borrowing requirement might exist given the overall strategy for financing capital investment, and previous capital spending performance;

c) Market conditions, to ensure borrowing that does need to be undertaken is achieved at minimum cost, including a comparison between internal and externally financed borrowing.
d) Scale, to ensure borrowing is undertaken on a scale commensurate with the agreed financing route.

All long term decisions will be documented reflecting the assessment of these criteria.

The table below is an estimate of the relationship between the borrowing capital financing requirement and total borrowing during the current year and over the next three years. The shared investment scheme is assumed to contribute £150m to the borrowing total. The operation of the scheme is reviewed annually, but this table assumes it will operate for the next three years and shows the position if take-up reaches the limits of the scheme.

| | **31 Mar 2015 £m** | **31 Mar 2016 £m** | **31 Mar 2017 £m** | **31 Mar 2018 £m** |
|---|---|---|---|---|
| Capital Financing Requirement | 1,007 | 1,033 | 1,066 | 1031 |
| Less PFI liability | 177 | 172 | 168 | 164 |
| **Borrowing CFR** | **830** | **861** | **898** | **867** |
| Loans Borrowed (31March estimate) | 1,010 | 1,041 | 1,078 | 1,047 |
| **Borrowing Above CFR** | **180** | **180** | **180** | **180** |
| *Comprising:* | | | | |
| Liquidity Buffer | 30 | 30 | 30 | 30 |
| Shared Investment Scheme | 150 | 150 | 150 | 150 |
| **Total** | **180** | **170** | **170** | **170** |

*4.2 Sources of borrowing*

The approved sources of long-term and short-term borrowing will be:

- Public Works Loan Board
- LGA Municipal Bond Agency
- Special purpose companies created to enable joint local authority bond issues, using the format of a Euro Medium Term Note programme

- UK Local Authorities
- any institution approved for investments
- any other bank or building society authorised by the Prudential Regulation Authority to operate in the UK
- UK public and private sector pension funds
- capital market bond investors

*4.3 Borrowing Instruments*

The county council may only borrow money by use of the following instruments:

- bank overdrafts
- fixed term loans
- callable loans or revolving credit facilities where the county council may repay at any time (with or without notice)
- callable loans where the lender may repay at any time, but subject to a maximum of £150 million in total
- lender’s option borrower’s option (LOBO) loans, but subject to a maximum of £50 million in total
- bonds, notes, bills, commercial paper and other marketable instruments
- sale and repurchase (repo) agreements

Loans may be borrowed at either a fixed rate of interest, or at a variable rate linked to a market interest rate, such as LIBOR, subject to the limits on interest rate risk approved each year in the *Treasury Management Strategy*.

*4.4 Debt Restructuring*

The county council continuously monitors both its debt portfolio and market conditions to evaluate potential savings from debt restructuring.

## 5. Policy on Borrowing in Advance of Need

The county council will not borrow more than or in advance of need with the objective of profiting from the investment of the additional sums borrowed.

However, borrowing in advance of need is appropriate in the following circumstances:

a) Where there is a defined need to finance future capital investment that will materialise in a defined timescale of 2 years or less; and

b) Where the most advantageous method of raising capital finance requires the county council to raise funds in a quantity greater than would be required in any one year, or

c) Where in the view of the section 151 officer, based on external advice, the achievement of value for money would be prejudiced by delaying borrowing beyond the 2 year horizon.

Having satisfied these criteria any proposal to borrow in advance of need would also need to be reviewed against the following factors:

a) Whether the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered and reflected in those plans and budgets, and the value for money of the proposal has been fully evaluated.

b) The merits and demerits of alternative forms of funding.

c) The alternative interest rate bases available, the most appropriate periods over which to fund and repayment profiles to use.

All decisions will be documented reflecting the assessment of these circumstances and criteria.

## 6. Investment Strategy

In making any investments of the reserves and other cash items held within its balance sheet the county council must have regard to the relevant regulations under the Local Government Act 2003, the CLG Guidance on Local Government Investments, any revisions to that guidance, the Audit Commission's report on Icelandic investments and the latest revision of the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes. The council's investment priorities are: -

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

The county council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the county council is low in order to give priority to security of its investments.

The counterparty credit matrix is at the heart of Lancashire County Council's Treasury Management Policy and Strategy and has always been conservatively constructed to protect the county council against credit risk whilst allowing for efficient and prudent investment activity.

However, the county council does not rely solely on credit ratings in assessing counterparties. Other market information is also monitored such as information from the credit default swap (CDS) market and any press releases in general, thus ensuring the council transacts with only the highest quality counter-parties.

The council requires very high credit ratings for an organisation to be considered a suitable counterparty for investment purposes. Despite a number of downgrades within the financial sector the county council has not reduced the credit ratings required by its counterparties, but has maintained the existing very high ratings required for short, medium and long term investments. These are set out below:

- **For short term lending of up to 1 year** that the short term ratings from the ratings agencies be used and that a counter-party must have a minimum of the following:

  Moody's. P1
  S&P A1
  Fitch. F1

  Short term ratings were specifically created by the agencies for money market investors placing deposits for up to one year as they reflect specifically the liquidity positions of the institutions concerned.

- **For medium term investments** in the form of tradeable bonds or certificates of deposit (1yr to 5yrs, where immediate liquidation can be demonstrated), a blended average of the ratings will be taken (averaging across all available ratings) , with a minimum of:

  - Long term AA3/AA-, and
  - Short term P1/F1+/A1+

- **For longer term investments (5yrs and above)** in the form of tradeable bonds where immediate liquidation can be demonstrated, a blended average of the ratings will be taken, with a minimum of:

  - Long term AA2/AA
  - Short term P1/A1+/F1+

The detailed calculation methodology of the blended average will be agreed with the council's advisers and set out in the Treasury Management Practices.

The limits for scale and duration of investment in specific categories which form the 2014/15 investment strategy are set out in the table below.

Should an existing investment, due to a change in credit rating after a fixed deposit has been made, fall outside the policy, full consideration will be made, taking into account all relevant information, as to whether a premature settlement of the investment should be negotiated in order to protect the county council.

The minimum sovereign rating for investment is AA-.

The table below shows the approved investment Counterparties and Limits

| 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 | unlimited | 50 yrs |

| Instrument | Minimum Credit Rating (blended average) | Maximum individual Investment (£m) | Maximum total Investment (£m) | Maximum Period |
|---|---|---|---|---|
| Sterling Supranational Bonds & Sterling Sovereign Bonds | AA- | 150 | 500 | 50 yrs |
| Term Deposits with UK and Overseas Banks (domiciled in UK) and Building Societies, Certificates of Deposit up to 1yr | P1/A1/F1 | 40 | 100 | 1yr |
| Corporate Bonds (Medium term) | AA-<br>P1/A1/F1 | 100 | 500 | 5yrs |
| Corporate Bonds (Long term) | AA<br>P1/A1+/F1+ | 50 | 250 | 50yrs |
| Government Bond Repurchase Agreements (Repo/ Reverse Repo) | UK Government AA | 500 | 750 | 1yr |
| Repurchase Agreements (Repo/ Reverse Repo) | Other AA+ | 200 | 200 | 1yr |
| Bond Funds with weighted average maturity maximum 3 yrs | 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 yrs | AAA Rated | 100 | 250 | These investments do not have a defined maturity date. |
| UK Local Authorities (incl Transport for London) | Implied Government support | 100 | 500 | 50yrs |

| Instrument | Minimum Credit Rating (blended average) | Maximum individual Investment (£m) | Maximum total Investment (£m) | Maximum Period |
|---|---|---|---|---|
| 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) and Nationalised UK Banks | P1/A1/F1 Long term A Government support | 100 | 100 | Overnight in line with clearing system guarantee (currently 4 years.) |

Emergency overnight deposits may be placed with the county council's bank, National Westminster. These will not count against the above individual limits but in practice are minimised on a daily basis to typically around £1million.

*6.1 Types of Investment*

The CLG Guidance defines two types of investment, firstly specified investments which are those:

- denominated in pound sterling,
- due to be repaid within 12 months of the 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".

Any investment not meeting the definition of a specified investment is classed as non-specified. The county council will not make any investments with low credit quality bodies, nor any that are defined as capital expenditure by legislation, such as company shares.

The operational total limit on long-term investments is £600 million. This reflects the portfolio structure adopted by the county council in order to reduce credit risk by holding a proportion of the portfolio in government and supranational securities, which although highly liquid have maturities in excess of 364 days. In practice they can be liquidated at one day's notice and are therefore central to achieving the county council's liquidity objective.

In recent times, a wider range of investment instruments within the area of sterling deposits has been developed by financial institutions. All of these afford similar security of capital to basic sterling deposits but they also offer the possibility, although never of course the certainty, of increased returns. The section 151 officer will, in liaison with the county council's external advisers, consider the benefits and drawbacks of these instruments and whether any of them are appropriate for the County council. Because of their relative complexity compared to straightforward term deposits, most of them would fall within the definition of non-specified investments. Decisions on whether to utilise such instruments will be taken after an assessment of whether their use achieves the Council's objectives in terms of reduction in overall risk exposure as part of a balanced portfolio.

## 7. Policy on Use of Financial Derivatives

The county council will only use financial derivatives (such as swaps, forwards, futures and options) either on a standalone, or embedded basis, where it can be clearly demonstrated that as part of the prudent management of the council's financial affairs the use of financial derivatives will have the effect of reducing the level of financial risks that the county 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.

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.

At all times the county council will comply with CIPFA advice and guidance on the use of financial derivatives and have regard to CIPFA publications on risk management.

## 8. Performance Measurement

With base rates at exceptionally low levels, investment returns are likely to continue to be far lower than has been the case in recent years. However, in the knowledge that a portion of cash invested will not be required in the short term; and to protect against continued low investment rates; investments may be made for longer time periods, depending on cash flow considerations and the prevailing market conditions.

The performance target on investments is a return above the average rate for 7 day notice money.

## 9. Impact on the County Council's Revenue Budget

The table below outlines the budget for the financing charges element of the Council's revenue budget.

| | Revenue Budget 2014/15 £m | Revenue Budget 2015/16 £m | Revenue Budget 2016/17 £m | Revenue Budget 2017/18 £m |
|---|---|---|---|---|
| Minimum Revenue Provision (MRP)* | 34.29 | 37.09 | 36.79 | 36.33 |
| Interest Paid | 22.48 | 28.03 | 33.50 | 35.22 |
| Interest Earned | -18.63 | -18.43 | -18.25 | -18.79 |
| Grants Received | -0.30 | -0.28 | -0.26 | -0.24 |
| Total | 37.84 | 46.40 | 51.78 | 52.52 |

*The MRP has since been revised in-line with the capital programme requirements. Please refer to section 4 of the borrowing strategy.

The revenue budget above reflects a position which takes account of the views of both internal and external advisors, particularly in relation to interest rate movements and the potential timing to move from short term variable rates to fixed rates.

The position will be closely monitored by the S151 officer and any changes to the external view will be reflect in a revised Finance Charges forecast and taken to Cabinet.

**Annex A**

**PRUDENTIAL INDICATORS**

In line with the relevant legislation the county council has adopted the Prudential Code for Capital Finance in Local Authorities and the CIPFA Treasury Management in the Public Services Code of Practice as setting the framework of principles for its Treasury Management activities. In accordance with the requirements of these codes the County council produces each year a set of prudential indicators which assist in the process of monitoring the degree of prudence with which the county council undertakes its Capital Expenditure and Treasury Management activities. Certain of these indicators also provide specific limits with regard to certain types of activity such as borrowing. These indicators are a consequence of the borrowing requirements and actions set out within the body of the Treasury Management Strategy.

**Adoption of CIPFA Treasury Management Code of Practice (2011)**

| **2014/15** | **2015/16** | **2016/17** | **2017/18** |
|---|---|---|---|
| Adopted for all years | | | |

## Indicators on Capital Expenditure and Financing

The total capital expenditure in each year, irrespective of the method of financing estimated to be incurred by the County council is as follows:

| 2013/14<br>Actual<br>£m | 2014/15<br>Estimate<br>£m | 2015/16<br>Estimate<br>£m | 2016/17<br>Estimate<br>£m | 2017/18<br>Estimate<br>£m |
|---|---|---|---|---|
| 154.600 | 205.903 | 217.919 | 172.647 | 79.206 |

The estimated capital expenditure stated above will be financed by a mixture of borrowing, capital receipts, revenue contributions, grants and other contributions. A key control of the prudential system is the underlying need to borrow for capital purposes, which is represented by the cumulative effect of past borrowing decisions and future plans. This is shown as the capital financing requirement. This is not the same as the actual borrowing on any one day, as day to day borrowing requirements incorporate the effect of cash flow movements relating to both capital and revenue expenditure and income. The estimate of the capital financing requirement for each year is as follows, and includes the impact of PFI obligations.

| 2013/14<br>Actual<br>£m | 2014/15<br>Estimate<br>£m | 2015/16<br>Estimate<br>£m | 2016/17<br>Estimate<br>£m | 2017/18<br>Estimate<br>£m |
|---|---|---|---|---|
| 1,039.230 | 1,007.119 | 1,032.958 | 1,065.702 | 1,031.249 |

## Prudence and Affordability

CIPFA's Prudential Code for Capital Finance in Local Authorities states the following as a key indicator of prudence:

"In order to ensure that, over the medium term, net borrowing will only be used for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of capital financing requirement in the preceding year, plus the estimates of any additional capital financing requirement for the current and next two financial years."

The county council's financial plans are prepared on this basis and, indeed the policy on borrowing in advance of need explicitly references this statement as part of the decision making criteria.

It is important to ensure that the plans for capital expenditure and borrowing are affordable in the long term. To this purpose the code requires an indicator which estimates the ratio of financing costs to the net revenue stream.

The financing costs are the interest payable on borrowing, finance lease or other long term liabilities and the amount defined by statute which needs to be charged to revenue to reflect the repayment of the principal element of the county council's borrowing. Any additional payments in excess of the statutory amount or the cost of early repayment or rescheduling of debt would be included within the financing cost. Financing costs are expressed net of investment income.

The net revenue stream is defined as the amount required to be funded from Government Grants and local taxpayers, in effect the budget requirement.

Estimates of the ratio of financing costs to net revenue (or budget requirement) are as follows:

| 2014/15 | 2015/16 | 2016/17 | 2017/18 |
|---|---|---|---|
| **Estimate** | **Estimate** | **Estimate** | **Estimate** |
| **%** | **%** | **%** | **%** |
| 4.87 | 5.81 | 6.90 | 7.88 |

The Capital Programme is still being considered by the County Council and is not yet finalised. The indicators have been calculated on the assumption that any new starts will be funded from either grants or revenue resources. Including the cost of financing the borrowing already included in the Programme to meet current commitments it is estimated that the Council Tax impact of the whole Programme will be:

| 2014/15 | 2015/16 | 2016/17 | 2017/18 |
|---|---|---|---|
| **Estimate** | **Estimate** | **Estimate** | **Estimate** |
| **£** | **£** | **£** | **£** |
| 26.78 | 41.05 | 16.33 | 21.20 |

It is important to note that the figures do not represent annual increases in Council Tax. Both the 2014/15 and 2015/16 figures will include the full year effects of decisions taken in 2013/14. Similarly, all three years include the effect of financing capital expenditure from revenue or internal loans. Provision for these already exists within the revenue budget. The Prudential Code requires the estimated revenue impact of capital investment decisions in Band D Council Tax terms to be calculated. The estimated effect in Band D Council Tax terms of the net cost of the borrowing is:

| | **£** |
|---|---|
| 2015/16 | 2.94 |
| 2016/17 | 15.48 |
| 2017/18 | 21.20 |

External Debt

The county council is required to approve an “authorised limit” and an “operational boundary” for external debt. The limits proposed are consistent with the proposals for capital investment and with the approved treasury management policy statement and practices. The limits also include provision for the £150m cap on the shared investment scheme. The indicators are split between borrowing and other long term liabilities, such as PFI projects. It is, therefore, proposed to set a limit for the section 151 to work within.

The authorised limit is a prudent estimate of external debt, but allows sufficient headroom for unusual cash flow movements. After taking into account the capital plans and estimates of cash flow and its risks, the proposed authorised limits for external debt are:

| | **2014/15 Revised** | **2015/16** | **2016/17** | **2017/18** |
|---|---|---|---|---|
| | **£m** | **£m** | **£m** | **£m** |
| Borrowing | 1,590.000 | 1,300.000 | 1,335.000 | 1,304.000 |
| Other long term liabilities | 250.000 | 250.000 | 250.000 | 250.000 |
| TOTAL | 1,840.000 | 1,550.000 | 1,585.000 | 1,554.000 |

The authorised limit boundary for external debt will be raised by £300m for a 12 month period. This allows time for our exiting variable debt to be replaced by the debt raised by the bond issue and any bridging finance constructed to be unwound efficiently.

The proposed operational boundary for external debt is based on the same estimates as the authorised limit. However, although it reflects a prudent estimate of debt, there is no provision for unusual cash flow movements. In effect, it represents the estimated maximum external debt arising as a consequence of the county council's current plans. As required under the Code, this limit will be carefully monitored during the year. The proposed operational boundary for external debt is:

| | 2014/15 Revised | 2015/16 | 2016/17 | 2017/18 |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Borrowing | 1,240.000 | 1,250.000 | 1,285.000 | 1,254.000 |
| Other long term liabilities | 200.000 | 200.000 | 200.000 | 200.000 |
| TOTAL | 1,440.000 | 1,450.000 | 1,485.000 | 1,454.000 |

The debt figures include transferred debt which is managed by the county council on behalf of other authorities. The transferred debt included within the debt indicators is estimated at the end of each year to be:

| | |
|---|---|
| 2014/15 | £39.106 m |
| 2015/16 | £37.207 m |
| 2016/17 | £35.520m |
| 2017/18 | £33.891m |

## Gross Debt and Capital Financing Requirement

As a measure of prudence and to ensure that over the medium term debt is only used for a capital purpose, the prudential code requires a comparison of gross debt and the capital financing requirement. The comparison for the county council is shown below:

| | 2014/15 | 2015/16 | 2016/17 | 2017/18 |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Capital Financing Requirement | 830 | 861 | 898 | 867 |
| Maximum Gross Debt | 1,010 | 1,041 | 1,078 | 1,047 |
| Debt to CFR | 122% | 121% | 120% | 121% |

The ratio of gross debt to capital financing requirement shows that gross debt is higher than the capital financing requirement. This is because the shared investment scheme and the replacement overdraft facility are currently accounted for as borrowing but not counted against the capital financing requirement.

**Treasury Management Indicators**

**Interest rate exposure**

In order to control interest rate risk the county council measures its exposure to interest rate movements. These indicators place limits on the overall amount of risk the county council is exposed to. The one year impact indicator calculates the theoretical impact on the revenue account of an immediate 1% rise in all interest rates over the course of one financial year.

| | Upper Limit £m | Dec2014 £m |
|---|---|---|
| Net Interest Payable at Fixed Rates | 50.4 | 5.5 |
| Net Interest Payable at Variable Rates | 5.0 | 0.5 |
| One year impact of a 1% rise in rates | 10.0 | 2.4 |

**Maturity structure of debt**

Limits on the maturity structure of debt help control refinancing risk

| | Lower Limit % | Upper Limit % | Dec 2014 |
|---|---|---|---|
| Under 12 months | | 75 | 19 |
| 12 months and within 2 years | | 75 | 47 |
| 2 years and within 5 years | | 75 | 8 |
| 5 years and within 10 years | | 75 | 5 |
| 10 years and above | 25 | 100 | 21 |

**Investments over 364 days**

Limits on the level of long term investments helps to control liquidity, although the majority of these investments are held in available for sale securities.

| | **Upper limit £m** | **Dec 2014 £m** |
|---|---|---|
| **Authorised Limit** | | |
| Total invested over 364 days | 900 | 550 |
| **Operating Limit** | | |
| Total invested over 364 days | 600 | 550 |

The "Investments over 364 days" indicator now includes an Authorised Limit and an Operating Limit.

The Authorised Limit for investments over 364 days includes £300m for a 12 month period; to accommodate the Treasury Management Strategy regarding the county councils EMTN programme and the county councils participation in the LGA led Municipal Bond Agency.

**Minimum Average Credit Rating**

To control credit risk the county council requires a very high credit rating from its treasury counterparties

| | Benchmark | Dec 2014 |
|---|---|---|
| Average counterparty credit rating | A+ | AA |