

Appendix 'B'

The County Council's Treasury Management Strategy 2017/18

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 require the County Council to approve a Treasury Management Strategy before the start of the financial year.

In addition, the Department for Communities and Local Government (CLG) issued revised guidance on local authority investments in March 2010 that requires the 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 risk management in 'Treasury Risk Toolkit for Local Authorities' (2012) and the use of derivatives in '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, maintain the security of its cash balances and protect them and ultimately the County Council's operations from credit, liquidity, inflation and interest rate risk.

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 manage interest and inflation rate risks appropriately.

- 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 2017/18

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 current structure of the County Council's investment and debt portfolio
- prospects for interest rates and market liquidity

3.1 Economic Forecast

The major external influence on the Authority's treasury management strategy for 2017/18 will be the UK's progress in negotiating a smooth exit from the European Union. Financial markets, wrong-footed by the referendum outcome, have since been weighed down by uncertainty over whether leaving the Union also means leaving the single market. In January The Prime Minister made a speech indicating that Brexit means an exit from the Single Market and the Customs Union however the government will seek a trade deal with the EU for the greatest possible access with full reciprocity. Negotiations are expected to start once the UK formally triggers exit in early 2017 and last for at least two years. Uncertainty over future economic prospects will therefore remain throughout 2017/18.

The fall and continuing weakness in sterling and the near doubling in the price of oil in 2016 have combined to drive inflation expectations higher. The Bank of England is forecasting that Consumer Price Inflation will breach its 2% target in 2017, the first time since late 2013. However the Bank is expected see this as a temporary impact of the falling currency. Therefore the inflation overshoots during 2017 are unlikely to result in an increase in interest rates so as to avoid derailing the economy.

Initial post-referendum economic data showed that the feared collapse in business and consumer confidence had not immediately led to lower GDP growth. However, the prospect of leaving the single market has dented business confidence and resulted in a delay in new business investment and, unless counteracted by higher public spending or retail sales, will weaken economic growth in 2017/18.

Looking overseas, with the US economy and its labour market showing steady improvement, the market has priced in a high probability of the Federal Reserve increasing interest rates. In December 2016 The Federal Open Market Committee (FOMC) of the US Federal Reserve increased the target range for official interest rates. The range was increased to between 0.5% and 0.75%, from 0.25% and 0.5%. The Eurozone meanwhile has continued to struggle with very low inflation and lack of momentum in growth, and the European Central Bank has left the door open for further quantitative easing.

The impact of political risk on financial markets remains significant over the next year. Challenges such as immigration, the rise of populist, anti-establishment parties seem to exist. During the year French presidential and general elections (April – June 2017) and the German federal elections (August – October 2017) have the potential for upsets.

Credit outlook

Markets have expressed concern over the financial viability of a number of European banks recently. Sluggish economies and continuing fines for pre-crisis behaviour have weighed on bank profits, and any future slowdown will exacerbate concerns in this regard.

Legislative Context

Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the European Union, Switzerland and USA, while Australia and Canada are progressing with their own plans. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority with returns from cash deposits continuing to fall.

Prospects for Interest Rates and Market Liquidity

The Authority's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.25% during 2017/18. The Bank of England has highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further falls in the Bank Rate look less likely. Negative Bank Rate is currently perceived by some policymakers to be counterproductive but, although a low probability, cannot be entirely ruled out in the medium term, particularly if the UK enters recession.

Gilt yields have risen sharply, but remain at low levels. The Arlingclose central case on Gilts is for yields to decline when the government triggers Article 50. Long-term economic fundamentals remain weak, and the quantitative easing (QE) stimulus provided by central banks globally has only delayed the fallout from the build-up of public and private sector debt. The Bank of England has defended QE as a monetary policy tool, and further QE in support of the UK economy in 2017/18 remains a distinct possibility, to keep long-term interest rates low.

3.2 The Current Structure of the Portfolio

The Council's treasury portfolio (net of transferred debt) as at 31st December 2016 was as follows.

Table 1 Treasury Portfolio as at 31 December 2016

	Principal Amount £m	Current Interest Rate %
Call accounts	9.983	0.25
Local Authority Deposits	46.500	1.76
Gilts & Other Core Bonds	312.408	1.40
Senior Secured Bond Fund	30.000	1.67
Floating Rate Notes (short term liquidity)	132.465	1.38
Total Investments	531.356	1.42
Short-term loans	339.500	0.59
Long-term loans (Local Authorities)	203.500	1.32
Shared Investment Scheme	65.382	0.24
Long-term PWLB loans	338.850	2.97
Long-term market loans (LOBOs)	51.783	6.35
Total Borrowing	999.015	1.82
Net Borrowing	467.659	2.27

The average rate for borrowings included in the current Medium Term Financial Strategy of the Council is 2.02% and the average rate for investments is 0.99% in 17-18.

4. Borrowing Strategy

The Borrowing Strategy of the County Council will be determined by the need of the Authority to borrow and the impact of the economic climate outlined above.

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

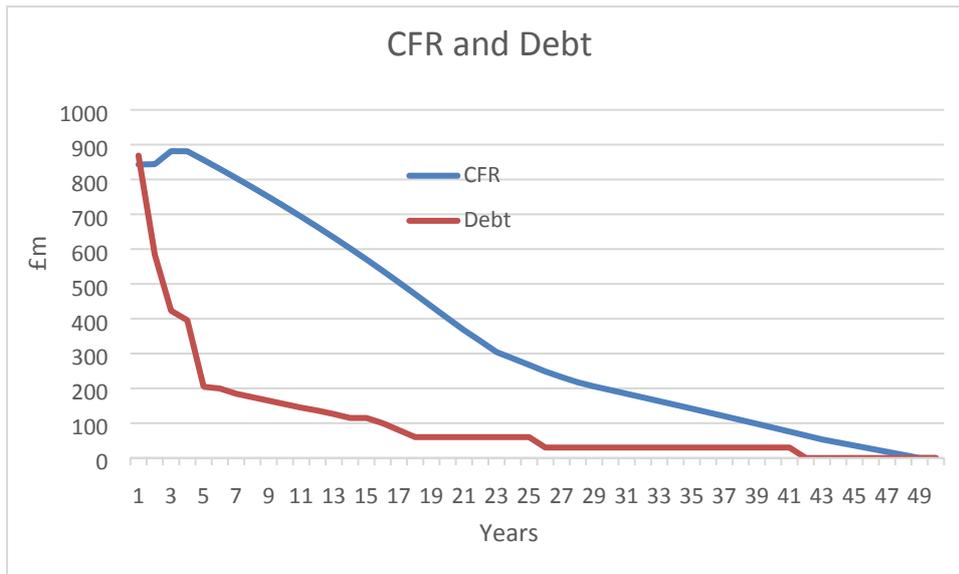
The County Council borrows for capital purposes with the underlying need to borrow for capital purposes being measured by the Capital Financing Requirement (CFR). CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years.

The estimated borrowing requirement in any year will depend upon new borrowing for financing the Capital Programme, replacing existing debt that has matured in the year and the charge made to revenue for the repayment of debt. The position for next three years is as follows:

Table 2: Estimated Borrowing Requirement

	2016/17 Revised £m	2017/18 £m	2018/19 £m	2019/20 £m
Capital Programme Expenditure	151.510	126.184	94.993	26.081
<i>Financed by:</i>				
Capital Receipts	0	1.036	0	0
Grants and Contributions	99.151	101.286	35.87	2.479
Revenue Contributions	0	0.727	0	0
Borrowing	52.359	23.135	59.123	23.602
<i>Add Maturing Debt to be replaced:</i>				
Long Term PWLB	0	0	-7.500	-7.500
Market Borrowing	67.000	284.500	161.000	27.500
Less Transferred Debt	-1.700	-1.642	-1.586	-1.533
Less Statutory Charge to Revenue (MRP)	-20.046	-21.383	-21.828	-23.871
Total Borrowing Requirement	97.613	284.610	189.209	18.198

However, in assessing the need to borrow consideration should be given to the requirement to borrow in the long term. The graph below compares the estimated CFR given the current approved Capital Programme, MRP policy and the debt maturity position at 31 December 2016.



The graph demonstrates that there is a need to borrow over the long term although the amount required reduces over time. There is a large requirement in the early years. This is due to the impact of the approved Capital Programme and the need to replace existing debt as the County Council has followed a policy of taking short term loans to take advantage of existing market conditions. In addition the borrowing for capital there is likely to be borrowing requirements for the shared investment scheme, City Deal and premiums which are outside the CFR.

4.2 Economic position

The County Council's borrowing strategy continues to balance the issues of affordability while ensuring the borrowing needs are met and providing some certainty of cost over the long term.

With short-term interest rates currently lower than long-term rates, it has been more cost effective in the short-term to borrow short-term. Given the economic outlook outlined above increases in interest rates are not forecast in the medium term so this situation is likely to continue. However, there is significant economic uncertainty and rates are at historically low levels. Therefore the benefits of short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates may rise. As a result the County Council may borrow additional sums at long-term fixed rates in 2017/18 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

There are a range of options available for the borrowing strategy in 2017/18.

- 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 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.
- Although it is not felt best pricing can be achieved at the present time through issuance under the County Council's euro medium term note programme (EMTN), a commercial paper issue which has a much shorter maturity, typically 270 days, may be appropriate.
- There is an option to add the LGA's Municipal Bond Agency to the County Council's list of approved borrowing counterparties but this will be subject to approval from the County Council.

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.

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 namely 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;
- 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.

4.2 Sources of borrowing

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

- Public Works Loan Board
- UK Local Authorities
- any institution approved for investments including high quality supranational banks such as the European Central Bank
- UK public and private sector pension funds
- any other financial institution approved by the Prudential Regulation Authority, which is part of the Bank of England and is responsible for the regulation and supervision of around 1,700 banks, building societies, credit unions, insurers and major investment firms
- capital market bond investors either over the counter or through electronic trading platforms

The option remains to add the LGA Municipal Bond Agency and/or Special purpose companies created to enable joint local authority bond issues, using the format of a

euro medium term note programme or a commercial paper programme to the approved sources of borrowing. These will be subject to Member approval.

4.3 UK Municipal Bond Agency PLC

The Municipal Bond Agency was established by the Local Government Association in June 2014 with the primary objective of setting up an alternative capital funding source for the local government sector and reducing UK local authority financing costs by becoming the most efficient and cost effective provider of finance. The Cabinet agreed on 15 July 2014 to invest £250,000 to become a shareholder in the company which should lead to dividends from the MBA when it is in full operation. County Council are one of 56 local authority shareholders, the 57th is the LGA who are the founder shareholder.

It is expected that the MBA will make the first tranche of borrowing available to local authorities in 2017. In order to borrow from the MBA the County Council is required to sign a joint and several guarantee contained within a framework agreement. This agreement has been subject to a report to the Audit and Governance Committee and Full Council.

The County Council on 21 July 2016, referred the proposal to the Audit and Governance Committee for consideration at its meeting on 26 September 2016. The Committee had specifically been requested to consider the potential risks involved and any possible mitigation of those risks.

On 13 October 2016 Full Council noted that, whilst the Committee had recommended Full Council to approve the proposals, further consideration had been given to the proposals and it was resolved that the report be withdrawn until a later date when any outstanding concerns had been resolved.

4.4 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 £100 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*.

4.5 Debt Restructuring

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

4.6 Other borrowing

In addition, the County Council may borrow for short periods of time to cover unexpected cash flow shortages, to take deposits on the shared investment scheme and to provide cash flow support for the Preston, South Ribble and Lancashire City Deal project. This is to cover the gap between the cost of construction of infrastructure and the payment of contributions from other organisations including the Government and developers. This borrowing is temporary but will be reflected in the Prudential Limits outlined in Annex 'A'.

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 any of 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

The County Council holds reserves and other cash items on its balance sheet which are invested. In investing these cash balances the County Council follows guidance issued by CIPFA and DCLG which both require the priorities to be:

- (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.

6.1 Approved Counterparties

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 of 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 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 document.

If the counterparty of an existing investment falls outside the policy due to a change in credit rating, full consideration will be made, taking into account all relevant information, as to whether a premature settlement of the investment should be negotiated.

The minimum sovereign rating for investment is AA- with the exception of the UK as outlined below.

Following the referendum vote to leave the European Union the rating agencies have reviewed the United Kingdom's sovereign ratings. Fitch has downgraded the United Kingdom's sovereign rating by one notch to AA from AA+, and Standard & Poor's has downgraded their corresponding rating by two notches to AA from AAA. The outlook from both agencies is negative. Moody's have also placed the UK on negative outlook.

Although the current ratings still fall within the current strategy it is not impossible as the BREXIT process proceeds or there is an economic downturn that there will be further downgrades which would result in investments in the UK government Gilts, Treasury Bonds and bodies guaranteed by the UK Government falling outside the Treasury Management policy. This is not a desirable, or given the level of investment in Gilts, a sustainable position. Even if there is a further reduction in the credit rating of the UK the UK Government still represents a safe investment. The government has never defaulted on its payments and as an ultimate solution the Government could prevent insolvency by printing money. Therefore it is proposed that the AA- minimum sovereign rating is not applied to the UK. However, given that this is theoretically increasing risk within the portfolio it is proposed that limits on the holdings by maturity is introduced as follows:

	£m
Maximum 1 year to maturity	500
Maximum maturity up to 1-5 years	300
Maximum maturity 5-10 years	250
Over 10 years	250

The table below shows the approved investment Counterparties and Limits

Table 3 Approved Investments

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.

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)	P1/A1/F1 Long term A Government support	100	100	Overnight in line with clearing system guarantee (currently 4 years.)

In addition the County Council can invest with other local authorities. Following the downgrade of the UK, several local authorities saw a reduction in their ratings. Therefore, consideration has been given to reducing the risk associated with the County Council's investment with other local authorities. Arlingclose, the County Council's Treasury Management advisor, state 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". On this basis it is proposed that the investments to local authorities are limited as follows:

Table 4 Local Authority Investments

	Maximum individual investment (£m)	Maximum total investment (£m)	Maximum period
Up to 4 years	20	250	4 years
Over 4 years	20	100	10 years

The County Council's day to day transactional bank National Westminster lies outside the investment credit matrix but emergency overnight deposits may be placed with them from time to time. In practice the balances are considered on a daily basis and kept as near to zero as possible. The balance on any day is typically below £1million.

6.2 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 was £600 million in 2016/17 but with the anticipated reduction in reserves this is to be reduced to £450m in 2017/18. Investment levels can be made above this with the agreement of the section 151 Officer. This revised limit reflects the portfolio structure adopted by the County Council in order to reduce credit risk and ensure liquidity.

Core investments are held in government and supranational securities, which although highly liquid have maturities in excess of 364 days. In addition the County Council holds a secondary liquidity investment book of very high quality covered floating rate notes (FRNs) which are typically issued for a 3 to 5 year term. Because these instruments have their rates re-fixed, at current market rates every 3 months, their price shows a very low sensitivity to changes in market rates, so that although under the current accounting regulations they are classified as long term instruments, in practice they operate as fixed instruments with a maximum of 3 months to maturity and can be liquidated with one or two days' notice. Therefore the 'long term investments' total contains instruments which operate with a short term horizon and which are central to achieving the County Council's security and liquidity objectives.

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 the Use of Financial Derivatives

The County Council will only use financial derivatives (such as swaps, forwards, futures and options) on a standalone 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.

Many embedded derivatives are already used by local authorities across England and Wales including Lancashire County Council, although unlike the government, commercial sector and other public service areas stand-alone derivatives have not generally been used.

A derivative is a financial instrument with three main features:

- The value changes in response to an underlying variable.
- The transaction requires no initial investment, or an initial net investment smaller than would be required for other types of contract with a similar expected response to market changes.
- The contract is settled at a predetermined future date.

The underlying variable represents an existing external risk for which the hedge is required. Examples are a specified interest rate, a commodity price, a credit rating, a foreign exchange rate or any other variable, however as the County Council treasury activity is not directly exposed to all of these risks, for example foreign exchange or commodity prices, the County Council's use of derivatives would be restricted to the management and hedging of interest and inflation rate risk only.

The embedded and standalone derivatives which can be used by the County Council to manage interest rate risk are summarised below:

Table 5: Derivative Options

CLASS	USE	STANDALONE	EMBEDED
Forwards	To fix an interest or inflation rate for a single period in the future.	Forward Rate Agreement (FRA), gilt lock, interest rate or gilt futures	Forward Deal
Swaps	To exchange interest or inflation rate exposures (e.g. fixed to floating)	Interest or inflation rate swap (IRS), Basis swap.	Variable rate deposit, Floating rate note.
Purchased Options	The right but no obligation to fix an interest or inflation rate in exchange for paying a premium.	Caps, floors, collars, swaptions, puts, calls	Callable loan Collared deposit

The Council will not sell interest rate or inflation rate options, (i.e. give another party the right to fix a rate) since these cannot reduce the Council's risk. The only exception is where a sold option is combined with a purchased option of equal or higher premium to create a collar.

There are two methods of engaging in derivative contracts, exchange traded or settled derivatives and over the counter (OTC) derivatives. The former are available in public markets and trade over a physical exchange with a clearing house acting as an intermediary and include futures and options. OTC contracts are privately negotiated and traded between two counterparties and can include swaps and forwards.

In a derivative contract both parties are often required to provide collateral (i.e. pools of valuable and liquid assets set aside specifically to back liabilities arising from the contract) to reduce credit risk. The method of assessing counterparty quality and suitability of collateral within the structure of the contracts is shown below:

Table 6: Derivative counter party

PRODUCT	COUNTERPARTY QUALITY	SECURITY	
Exchange traded or cleared product	Credit rating of exchange	Credit rating of Clearing agent	Margin netting
Bilateral FRAs and swaps assuming netting	Credit rating of counterparty	Full 2-way collateral arrangements	Types of collateral agreed and any haircuts
OTC Options	Credit rating of counterparty	Agreed full 2-way collateral	Types of collateral and haircuts
Intra LA swaps etc	Assumed Credit rating	2-way collateral (cash)	No haircut

The credit quality of the collateral acceptable to the County Council will be determined by the credit rating of the counterparty or exchange, along with credit default swap prices which react much quicker than credit rating agencies and can be used as early indicators of credit or liquidity problems.

The table below defines the appropriate limits for collateral quality:

Table 7: Collateral quality Limits

Counterparty type	Documentation	Collateral types	CDS levels	Rating
Exchange	MIFCA	Cash margins	<75bp	AA
Banks	ISDA/CSA	Cash and Govt bonds	<100bp	A3
Insurers and Pension Funds	ISDA CSA	Cash, Govt Bonds	<100 (Insurers)	A3 (Insurers)
LAs	Contract	Cash, Govt Bonds	England/Wales None	England and Wales None

The County Council will only use derivative contracts to hedge existing risks. This is reflected in the limits below which in future will form a local indicator as part of the Prudential Indicators agreed by the County Council within the annual Treasury Management Strategy. These are shown in the table below, the 100% upper limit means that the County Council has the option to hedge all of, but not more than, its interest rate risk if felt appropriate.

Table 8: Hedge Limits

Exposure Metric	Min Hedge	Max Hedge	Granularity	Tool
Interest rate	0%	100%	0-3 months 3-6months, 6-12m months, 1 to 2 years, 2-5 years and 5 year blocks	FRA, Futures, Options, Swaps Swaption
Inflation rate	0%	100%	1 block	Swap, Swaption, Option

In addition hedge accounting will be used to periodically test the effectiveness of the hedge. It is expected the hedge will work with between 80% and 125% effectiveness in accordance with International Accounting Standards. If the effectiveness is measured as falling outside these parameters, the structure of the hedge will be changed in response.

The calculation method of interest rate risk to be hedged and hedge effectiveness will be set out in the Treasury Management Practices document.

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. However the County Council may need to seek its own legal advice as to the legality of the use of derivatives for risk management purposes.

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 as reflected in the Medium Term Financial Strategy. This is based on the proposed Minimum Revenue Provision policy set out in Appendix 'C'.

Table 9: Treasury Management Medium Term Financial Strategy

	Revenue Budget 2016/17 £m	Revenue Budget 2017/18 £m	Revenue Budget 2018/19 £m	Revenue Budget 2019/20 £m
Minimum Revenue Provision (MRP)	20.046	21.383	21.828	23.871
Interest Paid	24.948	26.774	27.886	27.315
Interest Earned	-11.410	-10.524	-10.733	-10.842
Grants Received	-0.260	-0.240	-0.240	-0.240
Total	33.324	37.393	38.741	40.104

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. Provision has also been made for changing some of the borrowing to a long term fixed rate rather than the existing short term rates.

The position will be closely monitored by the section 151 officer and any changes to the external view will be reflect in a revised Finance Charges forecast and included in any monitoring or MTFS reports presented 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)

2016/17 **2017/18** **2018/19** **2019/20**
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:

2015/16	2016/17	2017/18	2018/19	2019/20
Actual	Estimate	Estimate	Estimate	Estimate
£m	£m	£m	£m	£m
186.077	151.510	126.184	94.993	26.081

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.

2015/16	2016/17	2017/18	2018/19	2019/20
Actual	Estimate	Estimate	Estimate	Estimate
£m	£m	£m	£m	£m
978.363	1,006.001	1,002.377	1,034.997	1,030.053

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:

2016/17	2017/18	2018/19	2019/20
Estimate	Estimate	Estimate	Estimate
%	%	%	%
4.64	5.19	5.33	5.38

The Capital Programme is still being considered by the County Council and is not yet finalised. The indicators have been calculated including the cost of financing the borrowing already included in the Programme. It assumes that any further new starts will be funded and borrowing is not required. It is estimated that the Council Tax impact of the Programme will be:

2017/18	2018/19	2019/20
Estimate	Estimate	Estimate
£	£	£
5.94	5.42	10.69

Any programmed financing from revenue is included in the figures however 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:

	£
2017/18	3.88
2018/19	5.42
2019/20	10.69

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 proposed that this is an overall limit but the section 151 Officer can approve a switch between borrowing and other long term liabilities.

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:

	2016/17 Revised	2017/18	2018/19	2019/20
	£m	£m	£m	£m
Borrowing	1,100	1,100	1,150	1,150
Other long term liabilities	200	200	200	200
TOTAL	1,300	1,300	1,350	1,350

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 are:

	2016/17 Revised	2017/18	2018/19	2019/20
	£m	£m	£m	£m
Borrowing	1,050	1,075	1,100	1,090
Other long term liabilities	170	170	170	170
TOTAL	1,220	1,245	1,270	1,260

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:

£m

2016/17	35.650
2017/18	34.008
2018/19	32.421
2019/20	30.889

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:

	31 Mar 2017	31 Mar 2018	31 Mar 2019	31 Mar 2020
	£m	£m	£m	£m
Borrowing CFR	842.931	843.982	881.277	881.008
Loans Borrowed (31 March estimate)	1,007.207	1,003.316	1,035.724	1,029.623
Borrowing Above CFR	164.276	159.334	154.447	148.615
<i>Comprising:</i>				
Premiums	45.000	42.000	39.000	36.000

Shared Investment Scheme	85.000	85.000	85.000	85.000
Transferred Debt	35.650	34.008	32.421	30.889
Total	165.650	161.008	156.421	151.889

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	Dec 2016
	£m	£m
Net Interest Payable at Fixed Rates	50.4	9.7
Net Interest Payable at Variable Rates	5.0	3.2
One year impact of a 1% rise in rates	10.0	1.6

Maturity structure of debt

Limits on the maturity structure of fixed debt help control refinancing risk

	Upper Limit %	Dec 2016
Under 12 months	75%	9%
12 months and within 2 years	75%	37%
2 years and within 5 years	75%	27%
5 years and within 10 years	75%	7%
10 years and above	50%	20%

Investments over 364 days

Limit on the level of long term investments helps to control liquidity, although the majority of these investments are held in available for sale securities. The limit is an

operational one and if required can be exceeded with the approval of the Chief Financial Officer. The proposed operational limit is

	Upper limit
	£m
Operating Limit Total invested over 364 days	450

Minimum Average Credit Rating

To control credit risk the County Council requires a very high credit rating from its treasury counterparties

	Benchmark	Dec 2016
Average counterparty credit rating	A+	AA+