Appendix 'B'

Treasury Management Strategy 2018/19

Under the Local Government Act 2003, local authorities must have regard to statutory proper practices in their treasury management activities. In effect this means the council must adhere to the Chartered Institute of Public Finance and Accountancy's 'Treasury Management in the Public Services: Code of Practice' 2011 edition (the CIPFA Code), and the Department for Communities and Local Government (DCLG) guidance on local authority investments.

The CIPFA code requires the county council to approve a Treasury Management Strategy and the DCLG guidance requires an investment strategy to be approved before the start of each financial year.

Both regulations are potentially subject to change and at the time of writing a revised version of both codes has been published.

The strategy also has regard to other CIPFA treasury management publications such as in relation to risk management in the 'Treasury Risk Toolkit for Local Authorities' (2012), and the use of derivatives in 'Using Financial Instruments to Manage Risk' (2013.) The council is also required to publish a policy on its Minimum Revenue Provision (MRP). This does not need to form part of the Treasury Management Strategy, but as it impacts on treasury management activity it is published as part of this report.

As such, in line with these various requirements, this strategy includes:

- Borrowing Strategy
- Policy on Borrowing in Advance of Need
- Investment Strategy
- Policy on Use of Financial Derivatives
- Prudential Indicators (Annex A)
- MRP statement (Annex B)

In conjunction with the detailed treasury management practices approved by the section 151 officer, the strategy provides the policy framework for the engagement of the council with financial markets in order to fund its capital investment programme, to maintain the security of its cash balances and protect them from credit, liquidity, inflation and interest rate risk.

Strategic Objectives of the Treasury Management Strategy

The 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.

Setting the Treasury Management Strategy for 2018/19

In setting the treasury management strategy, the council must consider the following factors which will have a strong influence over the appropriateness of treasury management plans:

- economic forecasts;
- prospects for interest rates;
- the current structure of the council's investment and debt portfolio;
- estimates of future borrowing and investment requirements.

Economic Forecast

The forecast economic conditions include an expectation that growth in the next few years will be low. Negotiations on the UK exit from the European Union and future trade relations is causing uncertainty. The progress and final outcome of these negotiations may impact on economic growth not only in 2018/19 but also in future years. In his budget in November 2017, the Chancellor of the Exchequer announced forecasts of growth which were significantly less than those given in the budget of spring 2017. The forecast was as follows:

	November 2017 Budget	Spring Budget
2017/18	1.5%	1.8%
2018/19	1.4%	1.6%
2019/20	1.3%	1.8%
2020/21	1.5%	1.9%
2021/22	1.5%	2.0%

Inflation increased during 2017 with the Consumer Price Index (CPI) rising to 3.0% in September. This was largely as a result of the impact of the fall in the value of sterling following the Brexit decision but it is anticipated that inflation will fall from this position. The forecast CPI in the Chancellor's budget was as follows:

2017/18	3.0%
2018/19	2.2%
2019/20	1.8%
2020/21	2.0%
2021/22	2.0%

With inflation increasing and unemployment remaining low during 2017/18 the Bank of England believed that the extent of spare capacity in the economy seemed limited and the pace at which the economy could grow without generating inflationary pressure had fallen over recent years. Therefore the Monetary Policy Committee of the Bank of England concluded that a rise in interest rates was appropriate. In

November 2017 they raised the base rate for the first time in a decade with the base rate increasing from 0.25% to 0.50%

Looking forward, the forecast from the Council's treasury advisers, Arlingclose, is for UK Bank Rate to remain at 0.50% during 2018/19. The Monetary Policy Committee emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

Future expectations for higher, short term, interest rates are subdued with on-going decisions remaining data-dependant and negotiations on exiting the EU casting a shadow over monetary policy decisions. The risks to the Arlingclose forecast are broadly balanced on both sides.

The Current Structure of the Portfolio

The council's treasury portfolio (net of transferred debt) as at 30th November 2017 was as follows.

	£m	Interest Rate
Call accounts	25.030	0.15%
Local authority deposits	82.800	1.23%
Government, local government and supra-national bonds	170.140	1.41%
Corporate bonds	194.130	0.80%
Total Investments	472.100	
Short term loans	462.000	0.68%
Shared investment scheme	79.130	0.25%
Long term loans - local authorities	97.500	1.61%
Long term loans - PWLB	338.850	3.07%
Long term loans – LOBO	50.000	6.16%
Total Borrowing	1,027.480	
Net Borrowing	555.380	

The average rate for borrowing in 2018/19 included in the current Medium Term Financial Strategy (MTFS) of the council is 1.84% and the average rate of return on investments is 1.15%.

Forecast Position

In the medium term the council borrows for capital purposes only. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The table below compares the estimated CFR to the debt which exists at 30 November, adjusted for transferred debt. This gives an indication of the borrowing required. It also shows the estimated resources available for investment. An option is to use these balances to finance the expenditure rather than investing, often referred to as internal borrowing, so the table gives an indication of the minimum borrowing requirement through this method.

	31/3/2018	31/3/2019	31/3/2020	31/3/2021
	£m	£m	£m	£m
Capital Financing Requirement	1,060.298	1,104.375	1,111.017	1,080.851
Less other long term liabilities	157.300	151.200	145.100	139.000
Borrowing CFR	902.998	953.175	965.917	941.851
Less external borrowing	787.936	383.775	343.062	146.162
Borrowing requirement	115.062	569.400	622.855	795.689
Reserves and working capital	(398.984)	(293.532)	(250.867)	(247.367)
Borrowing/(investment) need	(283.922)	275.868	371.988	548.322

The CFR forecast in the table above includes the latest forecast of the funding of the approved Capital Programme. The programme assumes expenditure funded by borrowing of:

2017/18 £84.718m
2018/19 £73.609m
2019/20 £38.644m
2020/21 £ 3.455m

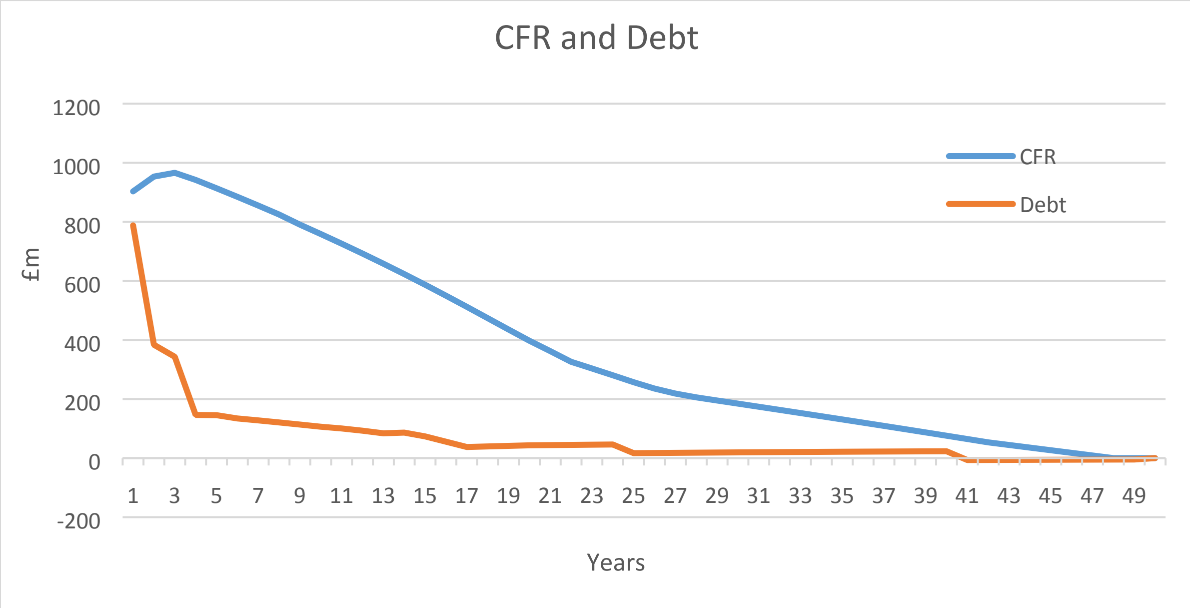
Clearly, these will be subject to change as the capital programme develops.

The table shows that from 2018/19 onwards the council has a borrowing requirement even if it followed a policy of internal borrowing. However, the council has in recent years pursued a policy to hold as investments a sum as close as possible to the cash value of its balance sheet. Consideration is also given to matching the duration of the cash balance anticipated. This policy will continue in 2018/19 but it will be regularly reviewed to ensure value for money is achieved.

Borrowing Strategy

The borrowing strategy will be determined by the need for the council to borrow and the impact of the economic climate on the prevailing cost and availability of borrowing**.**

The 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 council's total debt should be lower than its highest forecast CFR over the next three years. The council has a borrowing requirement over the next three years, however in assessing the need to borrow consideration is given to the requirement to borrow for the longer term. The graph below compares the estimated CFR given the capital programme, MRP policy and the debt maturity position at 30 November 2017.



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 new capital schemes in the programme and the need to replace existing debt as the council has followed a policy of taking short term loans to take advantage of existing market conditions. In addition to 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.

The 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, significant 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 council may borrow additional sums at long-term fixed rates in 2018/19 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

There are a range of options available for borrowing in 2018/19:

- 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 council to spread maturities away from a concentration on long dated debt.

- Additionally, although it is not felt appropriate at this time, borrowing can be achieved through the issuance of a 'commercial paper', euro medium term note (EMTN).
- There is also the option to add the LGA's Municipal Bond Agency to the council's list of approved borrowing counterparties but this would be subject to further approval from a meeting of Full Council.

Against this background, the section 151 officer will, in conjunction with the council's advisers, 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.

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

Borrowing Instruments

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

- Bank overdrafts.
- Fixed term loans.
- Callable loans or revolving credit facilities where the 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 £150m in total.
- Lender's option borrower's option (LOBO) loans, but subject to a maximum of £100m 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 in this Treasury Management Strategy.

Debt Restructuring

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

Other borrowing

The county council may borrow for short periods of time to cover unexpected cash flow shortages and to take deposits on the shared investment scheme. Also 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 within the Prudential Limits at Annex 'A'.

Policy on Borrowing in Advance of Need

The 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 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 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 with the value for money of the proposal 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.

Investment Strategy

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

The 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 council is low in order to give priority to security of its investments.

Approved Counterparties

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

However, the 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. In this way ensuring the council transacts with only the highest quality counterparties.

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 council has not reduced the credit ratings required from its counterparties, but has maintained the existing very high ratings required for short, medium and long term investments. These are set out as follows:

For short term lending of up to 1 year, the short term ratings from the ratings agencies be used and that a counterparty 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 (1 to 5 years, 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-,
Short term	P1/F1+/A1+

For longer term investments (5 years 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. The UK's latest rating was issued by Moody's in September 2017 when they reduced the long term rating to Aa2.

Although the rating still falls within the current strategy it is not impossible as the Brexit process proceeds or if there is an economic downturn that there will be further downgrades. This could result in investments in UK government gilts, treasury bonds and bodies guaranteed by the UK government falling outside the Treasury Management strategy. However, even if there is a further reduction in the UK credit rating, the UK government is still deemed a safe investment. The government has never defaulted on its payments and as an ultimate solution it 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 the limits on the holdings by maturity are as follows:

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

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 Government	UK Government	500	500	No limit
Sterling Supranational Bonds & Sterling Sovereign Bonds	AA-	150	300	No limit
Corporate Bonds (Short Term less than 1yr to maturity)	P1/A1/F1	50	200	1 year
Corporate Bonds (Medium term up to 5 years)	AA- P1/A1/F1	100	300	5 years
Corporate Bonds (Long term)	AA P1/A1+/F1+	50	200	No limit
Government Bond Repurchase Agreements (Repo/ Reverse Repo)	UK Government	300	300	3 years
Repurchase Agreements (Repo/ Reverse Repo)	Other AA-	200	200	1 year
Bond Funds with weighted average maturity maximum 3 years	AA Rated weighted average maturity 3yrs	50	100	These investments do not have a defined maturity date
Bond Funds with weighted average maturity maximum 5 years	AAA Rated	50	100	These investments do not have a defined maturity date
Collateralised lending agreements backed by higher quality government or local government and supra national sterling securities.	AA- with cash or AA- for any collateral	300	300	25 years
Call accounts with UK and Overseas Banks (domiciled in UK)	P1/A1/F1 Long term A Government support	100	200	Overnight in line with clearing system guarantee (currently 4 years)
Unsecured deposits/CDs to Banks and Building Societies	AA	10	50	1 year
Equity, property, multi asset or credit Pooled Funds	Ratings are not produced for such Funds	50	100	These investments do not have a defined maturity date

Other than call account and operational bank accounts the council does not currently make unsecured investments with banks. This is as a result of the risk following the implementation of 'bail-in' legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future. However the option to undertake small scale lending, widely spread, may have some value and is therefore included in the policy.

The council has previously approved the use of property and equity pooled funds if they are deemed appropriate for the overall treasury management portfolio. In addition, multi asset and credit funds exist. It is proposed that investment can also be made in these funds but that overall no more than £100m is invested in pooled funds.

In addition the council can invest with other local authorities. Following the downgrade of the UK, some local authorities saw a reduction in their ratings. Therefore, consideration has been given to reducing the risk associated with the council's investment with other local authorities. Arlingclose state that they are comfortable with clients making loans to UK local authorities for periods up to four years, subject to this meeting their approved strategy. For periods longer than four years they 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:

	Maximum individual investment	Maximum total investment	Maximum period
Up to 4 years	£20m	£200m	4 years
Over 4 years	£20m	£100m	10 years

The 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 £1m.

Although not treated as an investment any monies would be subject to bank bail-in if there was a bank failure. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the council maintaining operational continuity.

Types of Investment

The DCLG 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):

  a) the UK Government,
  b) a UK local authority, parish council or community council, or
  c) 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 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 £450m in 2017/18 but with the anticipated reduction in the council's reserves this is to be reduced to £300m in 2018/19. Investment levels can be made above this with the agreement of the section 151 officer.

Investments are held in government and supranational securities, which although are highly liquid have maturities in excess of 364 days. In addition the 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 council's security and liquidity objectives.

In recent times, a wider range of investment instruments within the area of sterling deposits have 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 council’s external advisers, consider the benefits and drawbacks of these instruments and whether any of them are appropriate for the 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 treasury management objectives.

Policy on the Use of Financial Derivatives

The council will only use financial derivatives (such as swaps, forwards, futures and options) on a standalone basis, where it can clearly be 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 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, 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 council's treasury activity is not directly exposed to all of these risks, for example foreign exchange or commodity prices, the 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 council to manage interest rate risk are summarised as follows:

Class	**Use**	**Standalone**	**Embedded**
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 (eg. 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 as follows:

Product	**Counterparty Quality**	**Security**	**Method**
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	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 following table defines the appropriate limits for collateral quality:

Counterparty type	**Documentation**	**Collateral types**	**CDS levels**	**Rating**
Exchange	MIFCA	Cash margins	<75bp	AA
Bank	ISDA/CSA	Cash and Government bonds	<100bp	A3
Insurer and Pension Fund	ISDA CSA	Cash and Government bonds	<100 (Insurers)	A3 (Insurers)
Local Authority	Contract	Cash and Government bonds	England/Wales None	England and Wales None

The council will only use derivative contracts to hedge existing risks. This is reflected in the limits below. The 100% upper limit means that the council has the option to hedge all of, but not more than, its interest rate risk if felt appropriate.

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 to 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 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 council may need to seek its own legal advice.

Impact on the County Council's Revenue Budget

With base rates at exceptionally low levels, investment returns are likely to continue to be far lower than has previously been the case. 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.

The following table 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 Minimum Revenue Provision policy set out at Annex 'B'.

	Revenue Budget 2017/18 £m	Revenue Budget 2018/19 £m	Revenue Budget 2019/20 £m	Revenue Budget 2020/21 £m
Minimum Revenue Provision	21.337	23.432	25.902	27.521
Interest paid	23.533	23.143	22.214	21.918
Interest earned	-7.912	-7.316	-6.854	-6.676
Grants received	-0.240	-0.220	-0.200	-0.180
Total	36.718	39.039	41.062	42.583

The revenue budget above reflects a position which takes account of the views of both internal and external advisers, 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 will be reflected in a revised forecast and included in budget monitoring or MTFS reports presented to Cabinet.

DCLG Consultation on Local Government Investments

DCLG have issued a consultation paper on investments which proposes an effective date of 1 April 2018. This includes a new definition of investments, providing that investments "covers all the financial assets of the organisation, as well as other non-financial assets which the organisation holds primarily for financial returns, such as investment property portfolios. This may therefore include investments which are not managed as part of normal treasury management or under treasury management delegations. All investments require an appropriate investment management and risk management framework under this Code."

In practice, this means that any loans given or investment in assets wholly for income generation purposes are covered by the Code. Under the proposed Code, loans for economic development purposes can be made even if they do not meet the strict criteria for security and liquidity. However, the Code will expect the loans to be proportionate to the overall portfolio and limits to be set on the maximum that can be loaned.

Similarly, councils can hold non-financial investments, which will normally involve a physical asset that can be realised to recoup the capital invested. The Code requires details on the assessment of risk and the action to be taken if the value of the asset no longer covers the investment.

If there are any required actions, including the setting of limits, they will be undertaken once the outcomes of the consultation paper are finalised.

Currently, the council does not make direct investments in property for income generation purposes.

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 (2011) as setting the framework of principles for its treasury management activities. In accordance with the requirements of these codes the council produces each year a set of prudential indicators which assist in the process of monitoring the degree of prudence with which the council undertakes its capital expenditure and treasury management activities. Specific indicators also provide limits with regard to certain types of activity such as borrowing. These indicators are a consequence of the activities set out within the Treasury Management Strategy.

Capital Expenditure and Financing

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

Actual	Estimate			
2016/17	2017/18	2018/19	2019/20	2020/21
£144.653m	£155.271m	£161.392m	£59.928m	£4.797m

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.

Actual	Estimate			
2016/17	2017/18	2018/19	2019/20	2020/21
£1,002.017m	£1,060.298m	£1,104.375m	£1,111.017m	£1,080.851m

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 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 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:

2017/18	2018/19	2019/20	2020/21
4.79%	5.22%	5.46%	5.77%

The capital programme is being considered by the council and is not currently 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 by grants or contributions and therefore borrowing is not required. It is estimated that the incremental council tax impact of the programme on taxpayers will be:

2018/19	2019/20	2020/21
£7.58	£8.36	£3.68

External Debt

The 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. Taking into account the capital plans and estimates of cash flow and its risks, the authorised limits for external debt are as follows:

	2017/18 Revised	2018/19	2019/20	2020/21
	£m	£m	£m	£m
Borrowing	1,150	1,220	1,220	1,200
Other long term liabilities	185	185	185	185
TOTAL	1,335	1,405	1,405	1,385

The 'operational limit' 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 council's current plans. As required under the Code, this limit will be carefully monitored during the year. The proposed operational limits for external debt are:

	2017/18 Revised	2018/19	2019/20	2020/21
	£m	£m	£m	£m
Borrowing	1,070	1,115	1,125	1,095
Other long term liabilities	160	160	160	160
TOTAL	1,235	1,275	1,285	1,255

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

2017/18	£15.942m
2018/19	£15.079m
2019/20	£14.239m
2020/21	£13.661m

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 following table shows the comparison for the council:

	As at 31 March			
	2018	2019	2020	2021
	£m	£m	£m	£m
Borrowing CFR	902.998	953.175	965.917	941.851
Estimated total borrowing	1,050.510	1,095.576	1,103.192	1,074.311

Borrowing above CFR Comprising:

Premiums	38.458	35.204	31.951	28.785
Shared Investment Scheme	60.815	60.815	60.815	60.815
Borrowing relating to other authorities	48.239	46.382	44.509	42.860

The gross debt is higher than the capital financing requirement. This is because certain borrowing is included in the total borrowing but does not count against the CFR. These include the shared investment scheme and the transferred debt.

Treasury Management Indicators

The indicators and limits relating to specific treasury management activities are set out as follows, with the 2017 information provided for reference.

Interest rate exposure

In order to control interest rate risk the council measures its exposure to interest rate movements. These indicators place limits on the overall amount of risk the 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	2017
Net Interest Payable at Fixed Rates	£50.400m	£9.300m
Net Interest Payable at Variable Rates	£5.000m	£4.300m
One year impact of a 1% rise in rates	£10.000m	£1.800m

Maturity structure of debt

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

	Upper Limit	2017
Under 12 months	75%	47%
12 months and within 2 years	75%	5%
2 years and within 5 years	75%	26%
5 years and within 10 years	75%	6%
10 years and above	50%	16%

Investments over 364 days

Limit on the level of long term investments helps to control liquidity, although the majority of these investments are currently held in available for sale securities. The limit is an operational one and if required can be exceeded with the approval of the Director of Finance. The proposed operational limit is:

	Upper limit
Total invested over 364 days	£300m

Minimum Average Credit Rating

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

	Benchmark	2017
Average counterparty credit rating	A+	AA+

Annex B

Minimum Revenue Provision Statement 2018/19

This requirement for this annual statement to be approved by the county council arises from statutory guidance initially issued by the Department of Communities and Local Government (DCLG) in 2008 and updated in 2010. DCLG have recently issued a consultation paper including this subject area and this has been taken into consideration in producing this policy statement.

Local authorities are required to make a prudent charge to the revenue account in respect of the provision to repay debt and other credit liabilities (mainly finance leases or PFI contracts). This is referred to as the Minimum Revenue Provision (MRP).

Guidance issued by DCLG provides four options which can be used for the purpose of calculating the MRP. However the legal requirement is to set a prudent charge and therefore authorities are free to move away from the guidance if they feel it is appropriate.

The Four Options Explained

1. Regulatory method

Before the Prudential Code system of capital finance was introduced in 2004 the MRP was calculated at 4% of the credit ceiling. On the introduction of the Prudential Code this was changed to a charge of 4% of the Capital Financing Requirement, which is derived from the balance sheet and broadly represents the outstanding debt used to finance fixed assets. However, to avoid changes in the charge to revenue in 2004/5 an adjustment figure was calculated which would then remain constant overtime. For technical accounting reasons this methodology would have led to an increase in the MRP and would therefore have had an impact upon the council's budget, so this method has not been used and is not recommended for future use.

2. Capital Financing Requirement (CFR) method

This option allows for the MRP to be calculated as 4% of the Capital Financing Requirement. The CFR is derived from the balance sheet and represent the value of the fixed assets for which financing provision has not already been made. This method of calculation has been used at the council since the introduction of the MRP in 2004.

3. Asset Life Method

Guidelines for this method allow for an MRP to be calculated based on the estimated life of the asset. The actual calculation can be made in two ways as follows:

- A calculation to set an equal charge to revenue over the estimated life of the asset. This charge will not be varied by the state of the asset or,
- An annuity method. This provides for greater charges in the later years of the assets life and should only be used if it can be demonstrated that benefits are likely to increase in the later years.

The DCLG consultation paper proposes maximum asset lives to be used. These are 50 years for freehold land and 40 years for other assets. Although these have to be confirmed. The council has generally used asset lives within these limits. Therefore it is proposed that for 2018/19 the asset lives used in calculating the MRP will be kept within these limits.

4. Depreciation method

This requires a charge to be made for depreciation in line with normal accounting purposes. This could include the impact of any revaluations, and would be calculated until the debt has been repaid.

The first two options, the Regulatory and Capital Financing Requirement methods, can be applied to borrowing which is supported by government via Revenue Support Grants.

For capital expenditure financed by unsupported borrowing, as allowed under the Prudential Code, the guidelines identify the Asset Life method or the Depreciation method as possible alternatives.

Finance Leases and PFI

Assets held under a PFI contract form part of the balance sheet. This increases the CFR and on a 4% basis the charge to the revenue account. To prevent the increase the guidance permits a prudent MRP to equate to the amount charged to revenue under the contract to repay the liability. In terms of the existing PFI schemes this charge forms part of the payment due to the PFI contractor.

The Council's Policy

From 2008/09 to 2014/15 the CFR method has been applied to all supported borrowing incurred before 1 April 2007. This charge is based on 4% of the outstanding capital financing. As the charge is based on a 4% reducing balance, it never effectively repays the debt. Also, it is considered that the 4% charge over-estimates the level of support within the revenue support grant. From 2015/16 the charge was made with reference to the CFR but based upon a 50 year life rather than a reducing balance. It is assumed that there is an equal charge over each of the 50 years. It is proposed to continue this policy in 2018/19.

For 2008/09 to 2014/15 the Asset Life method (Equal Charge approach) has generally been applied to capital expenditure financed by unsupported borrowing. PFI payments will be made in line with the amounts due to repay the liability under the contract. An alternative approach to the equal charge is the annuity method which is the cheapest MRP option in the early years, and maintains a constant impact on the revenue account over the useful life of the asset being financed, once interest costs are taken into account. The basis of the charge will remain as the asset life for 2018/19 and the annuity basis will be used to calculate the MRP.

For new assets MRP will not be charged until the financial year after which the project is deemed to be complete.

MRP will not be made for assets constructed as part of the Preston, South Ribble and Lancashire City Deal where the borrowing will be repaid from other capital financing sources within the life of the City Deal. As this is temporary borrowing that will be repaid from sources such as Community Infrastructure Levy and funding from the Homes and Communities Agency when the development of the assets has taken place. Thus it is deemed that an alternative prudent plan for repayment is in place. However, this position will be reviewed each year in the light of progress on the City Deal programme.