

The County Council's Treasury Management Strategy 2016/17

1. Introduction and Legislative Framework

Under the Local Government Act 2003, local authorities must have regard to Statutory Proper Practices in their Treasury Management activities. In February 2012 the Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code.) These together require the County Council to set out its strategy in relation to key aspects of its treasury management operations on an annual basis.

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 rate 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 2016/17

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

- economic forecasts – the economic and legislative context
- the level of the approved capital programme which generates the borrowing requirement,
- the current structure of the County Council's investment and debt portfolio
- prospects for interest rates and market liquidity

3.1 Economic Forecast

Economic context

Domestic demand has grown robustly, supported by sustained real income growth and a gradual decline in private sector savings. Low oil and commodity prices contributed to annual CPI inflation falling to 0.1% in October. Wages are growing at 3% a year, and the unemployment rate has dropped to 5.4%. Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 3.5%. These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was an encouraging 2.3% a year in the third quarter of 2015. Although speeches by the Bank of England's Monetary Policy Committee (MPC) members sent signals that some were willing to countenance higher interest rates, the MPC held policy rates at 0.5% for the 81st consecutive month at its meeting in November 2015. Quantitative easing (QE) has been maintained at £375bn since July 2012. Probably need to refer to weaken data towards the end of the year and forecast GDP growth cuts by OBR and others also the recent CIPD reduced wage growth estimates.

In international markets China's growth has slowed and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. US domestic growth has accelerated but the globally sensitive sectors of the US economy have slowed. Strong US labour market data and other economic indicators however suggest recent global turbulence has not knocked the American recovery off course. The Federal Reserve did not raise policy rates at its meetings in October and November, but the statements accompanying the policy decisions point have made a rate hike in December 2015 a real possibility. In contrast, the European Central Bank finally embarked on QE in 2015 to counter the perils of deflation.

The outcome of the 2015 UK general election, which was largely fought over the parties' approach to dealing with the deficit in the public finances, saw some big shifts

in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

The varying fortunes of different parts of the global economy are reflected in market indicators of credit risk. UK Banks operating in the Far East and parts of mainland Europe have seen their perceived risk increase, while those with a more domestic focus continue to show improvement. The sale of most of the government's stake in Lloyds and the first sale of its shares in RBS have generally been seen as credit positive.

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 UK, USA and Germany. The rest of the European Union will follow suit in January 2016, while Australia, Canada and Switzerland are well advanced with their own plans. Meanwhile, changes to the UK Financial Services Compensation Scheme and similar European schemes in July 2015 mean that most private sector investors are now partially or fully exempt from contributing to a bail-in.

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.

	Principal Amount £m	Current Interest Rate %
Call accounts	20.39	0.25
Local Authority Deposits	56.50	1.63
Gilts & Other Core Bonds	366.03	1.74
Floating Rate Notes (short term liquidity)	226.56	0.91
Total Investments	669.48	1.97
Short-term loans	472.90	0.66
Long-term loans (Local Authorities)	167.50	1.53
Shared Investment Scheme*	68.39	0.65
Long-term PWLB loans	338.85	3.07
Long-term market loans (LOBOs)	51.78	5.23
Total Borrowing	1,099.42	1.75
Net Borrowing	469.88	

* Please refer to the Glossary in Appendix C for further information.

3.3 Prospects for Interest Rates and Market Liquidity

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

Arlingclose Ltd projects the first 0.25% increase in UK Bank Rate for the third quarter of 2016, rising by 0.5% a year thereafter, finally settling between 2% and 3% in several years' time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted towards the downside.

A shallow upward path for medium term gilt yields is forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Arlingclose projects the 10 year gilt yield to rise from its current 2.0% level by around 0.3% a year. The uncertainties surrounding the timing of UK and US interest rate rises are likely to prompt short-term volatility in gilt yields.

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
Official Bank Rate													
Upside risk		0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	1.75
Downside risk				-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-1.00	-1.00	-1.25	-1.25
3-month LIBID rate													
Upside risk	0.20	0.30	0.30	0.30	0.35	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40
Arlingclose Central Case	0.55	0.60	0.70	0.80	0.95	1.05	1.15	1.30	1.40	1.55	1.65	1.80	1.85
Downside risk		-0.20	-0.30	-0.45	-0.55	-0.65	-0.80	-0.90	-1.05	-1.10	-1.20	-1.20	-1.20
1-yr LIBID rate													
Upside risk	0.25	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.45
Arlingclose Central Case	1.10	1.20	1.35	1.45	1.55	1.70	1.80	1.95	2.00	2.10	2.15	2.15	2.15
Downside risk	-0.15	-0.25	-0.35	-0.50	-0.60	-0.70	-0.85	-0.95	-1.10	-1.15	-1.25	-1.25	-1.25
5-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	1.50	1.55	1.60	1.70	1.80	1.90	2.00	2.10	2.20	2.25	2.30	2.35	2.35
Downside risk	-0.35	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25
10-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.00	2.05	2.10	2.20	2.30	2.40	2.50	2.60	2.65	2.70	2.75	2.80	2.80
Downside risk	-0.35	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25
20-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.45	2.50	2.55	2.55	2.60	2.65	2.70	2.75	2.80	2.85	2.90	2.95	2.95
Downside risk	-0.30	-0.40	-0.50	-0.55	-0.65	-0.75	-0.85	-0.95	-1.05	-1.10	-1.15	-1.20	-1.20
50-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.45	2.50	2.55	2.60	2.65	2.70	2.75	2.80	2.85	2.90	2.95	3.00	3.00
Downside risk	-0.25	-0.35	-0.45	-0.50	-0.60	-0.70	-0.80	-0.90	-1.00	-1.05	-1.10	-1.15	-1.15

In addition uncertainty surrounding the in/out EU referendum is likely to prove a drag on growth during 2016 with the threat of large market risks involved in any Brexit resulting in slower/negative growth, currency weakness and therefore further rate suppression.

Arlingclose have based this forecast on the following underlying assumptions:

- UK economic growth softened in Q3 2015 but remained reasonably robust; the first estimate for the quarter was 0.5% and year-on-year growth fell slightly to 2.3%. Construction falls were offset by fairly strong services output although survey estimates suggest upwards revisions to construction may be in the pipeline.
- Household spending has been the main driver of GDP growth through 2014 and 2015 and remains key to growth. Consumption will continue to be supported by real wage and disposable income growth.
- Annual average earnings growth was 3.0% in the three months to August. Given low inflation, real earnings and income growth continue to run at relatively strong levels and could feed directly into unit labour costs and households' disposable income. Improving productivity growth should support pay growth in the medium term. The development of wage growth is one of the factors being closely monitored by the MPC.
- Business investment indicators continue to signal strong growth. However the outlook for business investment may be tempered by the looming EU referendum, increasing uncertainties surrounding global growth and recent financial market shocks.
- Inflation is currently very low and, with a further fall in commodity prices, will likely remain so over the next 12 months. The CPI rate is likely to rise towards the end of 2016. If there are no further oil and commodity price declines
- China's growth has slowed and its economy is performing below expectations, which in turn will dampen activity in countries with which it has close economic ties; its slowdown and emerging market weakness will reduce demand for commodities. Other possible currency interventions following China's recent devaluation will keep sterling strong against many global currencies and depress imported inflation.
- Strong US labour market data and other economic indicators suggest recent global turbulence has not knocked the American recovery off course. Although the timing of the first rise in official interest rates remains uncertain, a rate rise by the Federal Reserve seems significantly more likely in December given recent data and rhetoric by committee members. Obviously now known to be Dec but with a very dovish statement and slower than expected upward path
- Longer term rates will be tempered by international uncertainties and weaker global inflation pressure.

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

3.5 Impact of these factors on the Borrowing Strategy

In view of the above assessment of the economic context within which the Council is operating, wherein despite the continuing improvement in the economic outlook, it could be 2017 before there is a rise in official UK interest rates, and the UK's safe haven status and minimal prospect of rate rises are expected to keep gilt yields in check through the near term, there is likely to be no significant change in the County Council's overall borrowing strategy in the current year.

The Council's chief objective when borrowing money is to strike an appropriate balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to continue to borrow short-term whilst taking advantage of the new Municipal Bond Agency facility for some longer term borrowing. By doing so, the council is able to keep net borrowing costs at very low levels, reduce overall treasury risk and still respond to the transformation agenda in reducing the overall size of the balance sheet.

The benefits of short term and internal borrowing are monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose will assist the council with this 'cost of carry' and breakeven analysis. Its output may determine whether the council borrows additional sums at long-term fixed rates in 2016/17 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

Also, if it became apparent that there was a significant risk of a much sharper rise in long and short term rates than that currently forecast, perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the possible action that significant fixed rate funding will be drawn whilst interest rates were still relatively cheap.

Whilst it is expected that the current low rate environment will continue for a further period, the Council have taken steps to ensure that the Council is protected from the impact of rate rises when they do occur. In support of this strategy full council have approved in principle the following actions:

- the establishment of a Lancashire County Council Euro Medium Term Note (EMTN) programme to facilitate access to secure long term debt in readiness for interest rate rises
- Preparations for borrowing through the Municipal Bond Agency to enable access to an alternative economic funding source.

The necessary changes to the Council's Prudential Indicators to facilitate the switch from a programme of rolling short term debt to longer term debt financing.

3.6 Impact of these factors on the Investment Strategy

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

- The Bail-in legislation described above, which ensures that in future large investors including local authorities will rescue failing banks instead of taxpayers. In particular the additional legal protections afforded to private sector investors means that the credit risk associated with making unsecured bank deposits has increased dramatically relative to the risk of other investment options available to the Authority whilst returns from cash deposits remain stubbornly low.
- Given the level of risk involved in dealing with bank counterparties the County Council will continue to diversify its portfolio further away from bank credit while maintaining the highest credit quality of counterparties. Unsecured term deposits or certificates of deposit with banks are no longer an appropriate investment instrument for the County Council.
- The Investment Strategy will also react to the planned use of reserves as outlined in the County Council's revenue budget.

4. Borrowing Strategy

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

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

	2015/16 Revised £m	2016/17 £m	2017/18 £m	2018/19 £m
Capital Programme Expenditure	250.521	103.805	77.024	49.621
<i>Financed by:</i>				
Capital Receipts	21.297	1.036		0.000
Grants and Contributions	143.350	54.540	58.974	39.143
Revenue Contributions	24.869	4.000	4.500	0.000

Borrowing	61.005	44.229	13.550	10.478
<i>Add Maturing Debt to be replaced:</i>				
Long Term PWLB	0.000	0.000	0.000	0.000
Long term fixed Borrowing	0.000	100.000	100.000	100.000
Short Term Market Borrowing	579.950	479.950	479.950	479.950
Less Transferred Debt	1.899	1.687	1.629	1.629
Less Statutory Charge to Revenue	19.967	20.749	20.877	21.537
Total Borrowing Requirement	619.089	601.743	570.994	567.262

At 31st March 2015 the County Council held £1.036bn of short and long-term loans as part of its strategy for funding previous years' capital programmes. The County Council's borrowing requirement as at 31st March 2016 including short term renewals is expected to be £549.11million, and is forecast to rise to £614.24million by March 2017 as capital expenditure is incurred. In addition, the County Council may borrow for short periods of time to cover unexpected cash flow shortages.

The County Council's borrowing position over the coming years includes the need to provide cash flow support for the Preston, South Ribble and Lancashire City Deal to cover the gap between the construction of infrastructure and the payment over of contributions from other organisations including the Government and developers. It is estimated that some £28m of borrowing will be required in 2016/17. This borrowing is temporary.

Therefore the total borrowing requirement in 2016/17 is £647m, largely as a result of needing to refinance maturing short term borrowing. There are a range of options available for the borrowing strategy in 2016/17.

- Variable rate borrowing is expected to be cheaper than fixed rate long term borrowing and will be attractive during the financial year, particularly as variable rates are closely linked to bank rates.
- Under 10 years rates are expected to be substantially lower than long term rates, so this opens up a range of choices that may allow the County Council to spread maturities away from concentration on long dated debt.
- 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.
- Approval is also being considered to add the LGA's Municipal Bond Agency to the County Council's list of approved borrowing counterparties

Against this background, the section 151 officer will, in conjunction with the County Council's advisors, monitor the interest rate situation closely and will adopt a pragmatic approach to delivering the objectives of this strategy within changing economic circumstances. Arlingclose forecast the first rise in official interest rates in Q3 2016 and careful monitoring will ensure that borrowing is taken at the most appropriate time. The table above reflects this forecasted rise and the fixing of £100m of the short term debt in 2016/17.

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

- a) Overall need, whether a borrowing requirement to fund the capital programme or previous capital investment exists;
- b) Timing, when such a borrowing requirement might exist given the overall strategy for financing capital investment, and previous capital spending performance;
- c) Market conditions, to ensure borrowing that does need to be undertaken is achieved at minimum cost, including a comparison between internal and externally financed borrowing.
- d) Scale, to ensure borrowing is undertaken on a scale commensurate with the agreed financing route.

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

The table below is an estimate of the relationship between the borrowing capital financing requirement and total borrowing during the current year and over the next three years. The shared investment scheme is assumed to contribute £120m to the borrowing total. The operation of the scheme is reviewed annually, but this table assumes it will operate for the next three years and shows the position if take-up reaches the limits of the scheme.

	31 Mar 2016 £m	31 Mar 2017 £m	31 Mar 2018 £m	31 Mar 2019 £m
Capital Financing Requirement	1,043	1,061	1,046	1035
Less PFI liability	172	168	164	160
Borrowing CFR	871	893	882	875
Loans Borrowed (31March estimate)	1,039	1,058	1,044	1,031
Borrowing Above CFR	168	165	162	156
<i>Comprising:</i>				
Premiums	48	45	42	36

Shared Investment Scheme	120	120	120	120
Total	168	165	162	156

4.2 Sources of borrowing

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

- Public Works Loan Board
- LGA Municipal Bond Agency (subject to approval of a separate report by cabinet)
- 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
- 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
- capital market bond investors either over the counter or through electronic trading platforms

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 15th July 2014 to invest £250,000 to become a shareholder in the company which should lead to preferential dealing charges and eventually 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 2016. In order to borrow from the MBA the County Council is required to sign a joint and several guarantee contained within a framework agreement.

Signing off the framework agreement and borrowing from the MBA is the subject of a separate report to cabinet.

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.

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

In making any investments of the reserves and other cash items held within its balance sheet the County Council must have regard to the relevant regulations under the Local Government Act 2003, the CLG Guidance on Local Government Investments, and the latest revision of the CIPFA Treasury Management in Public Services Code of Practice (2011) and other relevant publications such as 'Treasury Risk Toolkit for Local Authorities' (2012) and 'Using Financial Instruments to Manage Risk' (2013.)

However it is the opinion of LCC treasury management, along with treasury advisors Arlingclose Ltd, that the CIPFA TM Code of Practice should be revised to properly categorise the risk to local authorities of investing using unsecured term bank deposits and remove the emphasis the code places on them as a low risk specified investment instruments.

The CIPFA TM Panel has requested from CLG consideration of this issue with regard to investment regulation and CLG have agreed to give the issue consideration.

The council's investment priorities are: -

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

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

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

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

The Council requires very high credit ratings for an organisation to be considered a suitable counterparty for investment purposes. Despite a number of downgrades within the financial sector the County Council has not reduced the credit ratings required 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.

The limits for scale and duration of investment in specific categories which form the 2016/17 investment strategy are set out in the table below.

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-.

The table below shows the approved investment Counterparties and Limits

Instrument	Minimum Credit Rating (blended average)	Maximum individual Investment (£m)	Maximum total Investment (£m)	Maximum Period
UK Government Gilts, Treasury Bills & bodies guaranteed by UK Govt	UK Government	500	unlimited	50 yrs
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

Instrument	Minimum Credit Rating (blended average)	Maximum individual Investment (£m)	Maximum total Investment (£m)	Maximum Period
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 AA	500	750	1yr
Repurchase Agreements (Repo/ Reverse Repo)	Other AA+	200	200	1yr
Bond Funds with weighted average maturity maximum 3 yrs	AA Rated weighted average maturity 3yrs	100	250	These investments do not have a defined maturity date.
Bond Funds with weighted average maturity maximum 5 yrs	AAA Rated	100	250	These investments do not have a defined maturity date.
UK Local Authorities (incl Transport for London)	Implied Government support	100	500	50yrs
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

Instrument	Minimum Credit Rating (blended average)	Maximum individual Investment (£m)	Maximum total Investment (£m)	Maximum Period
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.)

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 they are minimised on a daily basis to typically below £1million.

6.1 Types of Investment

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

- denominated in pound sterling,
- due to be repaid within 12 months of the arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
 - the UK Government,
 - a UK local authority, parish council or community council, or
 - a body or investment scheme of "high credit quality".

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

The operational total limit on long-term investments is £600 million. This reflects the portfolio structure adopted by the County Council in order to reduce credit risk 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 day 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 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 will 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:

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 (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. Mention that there is regulation in train to make most derivatives exchange settled.

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:

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:

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.

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 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. Part of that advice was that the County Council should 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. This reflects the proposed changes to the Minimum Revenue Provision calculation which has been reflected in the Medium Term Financial Strategy. The authority is required by statute to make a prudent charge giving consideration to guidance issued by the Government department. Full Council is required to review and approve its MRP policy annually. The proposed changes to the policy are charging debt incurred prior to 2007/8 on a 50 year straight line basis rather than a 4% reducing balance and the use of an annuity calculation for debt incurred later than this date. A revised MRP policy is set out in Appendix C.

	Revenue Budget 2015/16 £m	Revenue Budget 2016/17 £m	Revenue Budget 2017/18 £m	Revenue Budget 2018/19 £m
Minimum Revenue Provision (MRP)	37.085	19.967	20.749	20.877
Interest Paid	22.308	24.036	27.883	29.312
Interest Earned	-12.710	-10.420	-10.524	-10.733
Grants Received	-0.280	-0.260	-0.240	-0.240
Total	46.403	33.323	37.868	39.216

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

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

Annex A

PRUDENTIAL INDICATORS

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

Adoption of CIPFA Treasury Management Code of Practice (2011)

2015/16 2016/17 2017/18 2018/19
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:

2014/15	2015/16	2016/17	2017/18	2018/19
Actual	Estimate	Estimate	Estimate	Estimate
£m	£m	£m	£m	£m
178.016	250.521	103.805	77.024	49.621

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.

2014/15	2015/16	2016/17	2017/18	2018/19
Actual	Estimate	Estimate	Estimate	Estimate
£m	£m	£m	£m	£m
1,022.485	1,043.945	1,068.207	1,061.008	1,050.609

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:

2015/16	2016/17	2017/18	2018/19
Estimate	Estimate	Estimate	Estimate
%	%	%	%
3.22	4.69	5.50	5.76

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

2016/17	2017/18	2018/19
Estimate	Estimate	Estimate
£	£	£
17.12	20.08	6.26

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

	£
2015/16	5.48
2016/17	7.01
2017/18	6.26

External Debt

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

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

	2015/16 Revised	2016/17	2017/18	2018/19
	£m	£m	£m	£m
Borrowing	1,200	1,250	1,250	1,250
Other long term liabilities	200	200	200	200
TOTAL	1,400	1,450	1,450	1,450

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

	2015/16 Revised	2016/17	2017/18	2018/19
	£m	£m	£m	£m
Borrowing	1,120	1,190	1,180	1,160
Other long term liabilities	180	180	180	180
TOTAL	1,300	1,370	1,360	1,340

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:

2015/16	£36.970 m
2016/17	£35.283 m
2017/18	£33.654m
2018/19	£32.080m

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 2016 £m	31 Mar 2017 £m	31 Mar 2018 £m	31 Mar 2019 £m
Borrowing CFR	871	893	882	875
Loans Borrowed (31March estimate)	1,039	1,058	1,044	1,031
Borrowing Above CFR	168	165	162	156
<i>Comprising:</i>				
Premiums	48	45	42	36
Shared Investment Scheme	120	120	120	120
Total	168	165	162	156

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 2015
	£m	£m
Net Interest Payable at Fixed Rates	50.4	6.8
Net Interest Payable at Variable Rates	5.0	3.2
One year impact of a 1% rise in rates	10.0	1.7

Maturity structure of debt

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

	Upper Limit	Dec 2015
	%	
Under 12 months	75	17
12 months and within 2 years	75	38
2 years and within 5 years	75	19
5 years and within 10 years	75	65
10 years and above	100	19

Investments over 364 days

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

Upper Dec 2015

	limit	
	£m	£m
Authorised Limit		
Total invested over 364 days	900	577
Operating Limit		
Total invested over 364 days	600	577

Minimum Average Credit Rating

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

	Benchmark	Dec 2015
Average counterparty credit rating	A+	AA