Treasury Management Strategy 2019/20

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' 2017 edition (the CIPFA Code), and the Ministry of Homes, Communities and Local Government (MHCLG) guidance on local authority investments.

The CIPFA code requires the treasury management strategy to be produced and approved annually. In addition the MHCLG has issued updated statutory guidance on local government investments. This now covers a wider definition of investments and includes those that support local public services by lending to or buying shares in other organisations (service investments), and those made to earn investment income (known as commercial investments where this is the main purpose). Investments held for service purposes or for commercial profit are considered in the non-treasury investment strategy.

In conjunction with the detailed treasury management practices approved by the Director of Finance, 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.

The strategy includes provisions for borrowing, treasury investments, financial derivatives and the indicators that will be used for monitoring purposes throughout the year. It is designed to achieve the following objectives:

- To ensure the security of the principal sums invested which represent the council's various reserves and balances.
- To ensure that the council has access to cash resources as and when required.
- To minimise the cost of the borrowing required to finance the council's capital investment programme, and manage interest and inflation rate risks appropriately.
- To maximise investment returns commensurate with the council's policy of minimising risks to the security of capital and its liquidity position.

In setting the treasury management strategy, the following factors have a strong influence:

- the economic forecast
- the council's current investment and borrowing portfolio
- estimates of future borrowing and investment requirements

Economic forecast

The UK's progress in negotiating its exit from the European Union (EU), together with its future trading arrangements, will continue to be a major influence on the economy and therefore the council's treasury management strategy for 2019/20.

UK Consumer Price Inflation (CPI) for October was up 2.4% over the year, slightly below the consensus forecast. The most recent labour market data for October 2018 showed the unemployment rate edged up slightly to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily. Adjusted for inflation, real wages grew by 1.0%, a level still likely to have little effect on consumer spending.

At 1.5%, annual GDP growth continues to remain below trend. Looking ahead, the Bank of England, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy has been made since. However, the Bank expects that should the economy continue to evolve in line with its November forecast, further increases in Bank Rate will be required to return inflation to the 2% target. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.

Credit outlook: The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ringfencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ringfenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.

Interest rate forecast: Following the increase in Bank Rate to 0.75% in August 2018, the Authority's treasury management adviser Arlingclose is forecasting two more 0.25% hikes during 2019 to take official UK interest rates to 1.25%. The Bank of England's Monetary Policy Committee (MPC) has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. Arlingclose contend that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

The UK economic environment remains relatively soft, despite seemingly strong labour market data. Arlingclose's view is that the economy still faces a challenging outlook as it exits the European Union and Eurozone growth softens. While assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity. As such, the risks to the interest rate forecast are considered firmly to the downside.

Long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on Arlingclose's interest rate projections, due to the strength of the US economy and the ECB's (European Central Bank) forward guidance on higher rates.

Current portfolio

The council's treasury portfolio (excluding transferred debt) as at 30 November 2018 was as follows.

	£m
Call accounts	22.723
Local authority deposits	76.300
Government, local government and supra-national bonds	299.938
Corporate bonds	107.022
Total Investments	505.983

Short term loans	536.500
Shared investment scheme	60.675
Long term loans - local authorities	147.300
Long term loans - PWLB	338.850
Total Borrowing	1,083.325

Net Borrowing	577.342

Estimates of future borrowing and investment requirements

In the medium term the prudential code requires that 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 following table compares the estimated CFR to the borrowing at 30 November 2018. This gives an indication of the borrowing required and the resources available for investment.

The CFR forecast includes the latest approved capital programme. Clearly, this will be subject to change as the capital programme develops.

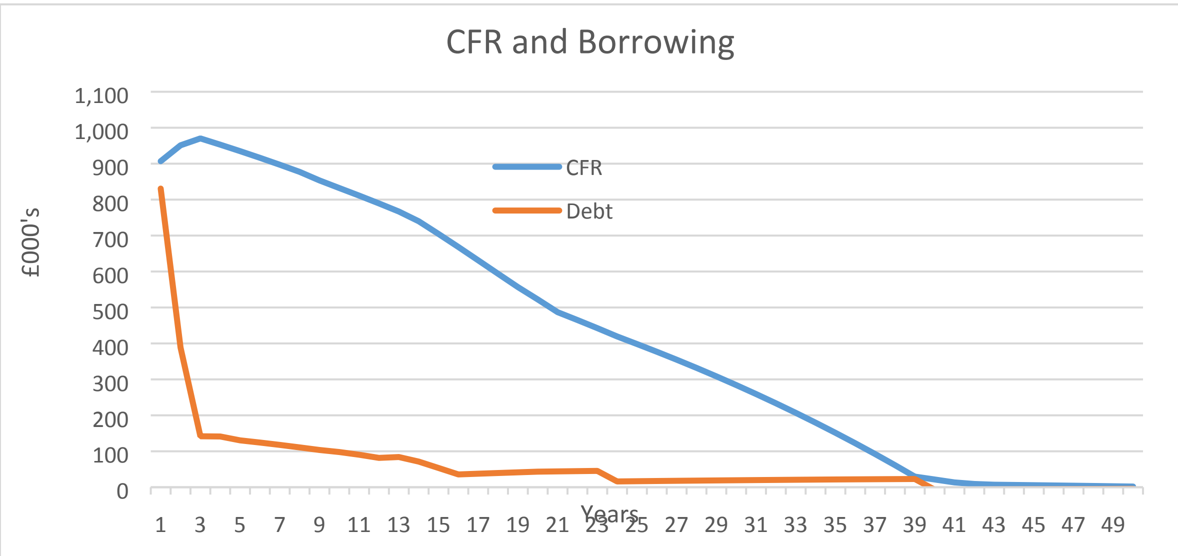
	31/3/2019	31/3/2020	31/3/2021	31/3/2022
	Estimate	Estimate	Estimate	Estimate
	£m	£m	£m	£m
Capital Financing Requirement	1,058.409	1,097.746	1,109.761	1,085.866
Less other long term liabilities	-151.521	-146.602	-139.487	-132.980
Borrowing CFR	906.888	951.144	970.274	952.886
Less external borrowing	-903.150	-456.150	-204.600	-199.600
Borrowing requirement for capital	3.738	494.994	765.674	753.286
Other borrowing requirements*	137.627	132.103	126.890	121.773
Reserves and working capital	-380.094	-337.855	-309.474	-309.000
Borrowing/ -Investment need	-238.729	289.242	583.090	566.059

*shared investment scheme, debt held on behalf other local authorities and premiums

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 and debt for the next 50 years given the capital programme, MRP policy and the debt maturity position at 30 November 2018.



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, debt held on behalf of other local authorities 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 recent past to borrow short-term. Given the economic outlook, significant increases in interest rates are not forecast in the medium term, 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. As a result the council may borrow additional sums at long-term fixed rates in 2019/20 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 2019/20:

- 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.
- Additionally, although it is not felt appropriate at this time, borrowing can be achieved through the issuance of a 'commercial paper (an unsecured, short-term debt instrument issued by a corporation) euro medium term note (EMTN, a debt instrument with fixed payments that are directly issued to the market).

Against this background, the Director of Finance 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, (this 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 benchmark interest rate, such London Interbank Offered Rate (LIBOR) which is the average interest rate at which a large number of banks on the London money market are prepared to lend to one another on unsecured funds or the Sterling Overnight Index Average (SONIA) which is administered by the Bank of England. The balance between fixed and variable rates will be 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 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

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 s151 officer, based on external advice, the achievement of value for money would be prejudiced by delaying borrowing beyond the 2 year horizon.

Having satisfied the criteria above, 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.

Treasury Management Investments 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 MHCLG.

The MHCLG guidance requires treasury management investments to prioritise security, liquidity and yield in that order of importance. 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 council has in recent years pursued a policy to hold as investments a sum as close as possible to the cash value of its reserves and balances. This policy will continue in 2019/20 but it will be regularly reviewed to ensure value for money is achieved.

Business model for holding investments

Under the new IFRS 9 (International Financial Reporting Standard), the accounting for certain investments depends on the council's "business model" for managing them. In general, the authority holds investments to either collect the contractual cash-flows or a mixture of holding for the contractual cash-flows and sale proceeds. Neither of these would result in changes in market value having to be a charge against the Council Tax at year end. However, if investment assets are held for the purpose of trading any changes in the asset value is charged to the accounts. The business model for the main treasury management investments are as follows:

Local authority investments - these are principally investments for a fixed term which are held to maturity. In addition, the authority holds some long term bonds issued by local authorities which are also held to maturity. In both cases interest is received on agreed dates and are held for the contractual cash-flows therefore they will be valued at amortised cost.

Gilts - the holding of Gilts represent a key part of the strategy for holding investments to back up the reserves and balances while maintaining a low credit risk portfolio. They are also a liquid asset and periodic sales will be incurred in reaction to market movements to enhance the overall yield of the holdings but this is not the primary aim of the holding and therefore Gilts will be held at fair value through other comprehensive income (FVOCI) which means that market value changes will not be charged against Council Tax.

Other bonds - the council also holds other high credit quality corporate bonds. These are held primarily for the purposes of liquidity providing a low credit risk holding. These are bought and sold in relation to cash needs and it is proposed these are valued at amortised cost.

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 possible 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.

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, Debt Management Office & bodies guaranteed by UK Government	UK Government	600	600	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
Local authority fixed term deposits	Government	30	450	50 years
Local authority bonds	Government	50	300	50 years

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.

Regarding investments with other local authorities, Arlingclose state that they are comfortable with clients making loans to UK local authorities for periods up to two years, subject to this meeting the approved strategy. For periods longer than two years they recommend that additional due diligence is undertaken prior to a loan being made. On this basis it is proposed that the nominal value of investments to local authorities are limited as follows:

	Maximum individual investment	Maximum total investment	Maximum period
Up to 2 years	£30m	£200m	2 years
Over 2-10years	£25m	£150m	10 years
Over 10 years	£25m	£100m	50 years

In addition to fixed term deposits occasionally local authorities issue bonds. The investment policy allows the county council to purchase such bonds as an investment which are generally held to maturity. The holding of the bonds is considered to be outside the limits expressed above but for the purpose of risk management the total of the bonds plus fixed term deposits with any one authority should not exceed £50m.

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. If there was a failure of National Westminster it is anticipated that they would be subject to bank bail-in rather than made insolvent. This increases the chance of the council maintaining operational continuity but any monies in the bank would be at risk of at least a partial loss.

Long term investments

The Treasury Management code requires where an authority invests, or plans to invest, for periods longer than one year then an upper limit for investments maturing in excess of one year is set. The authority does have fixed term deposits which are for longer than a year and the bonds usually purchased have a maturity date which is in excess of one year and these could be held to maturity.

However, the investments are held in government and supranational securities, which are highly liquid. 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 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.

As a result of the nature of the assets held it is considered appropriate to have high limit which is related to the forecast of reserves and balances held (currently forecast to be £338m at 31 March 20). However, it is anticipated that the reserves will reduce gradually during the year with positive cash-flows requiring a higher level of investments to be held. Therefore the proposed limit for 2019/20 is £475m.

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 Director of Finance 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. 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 Local Authority 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 3-6 months, 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.

It is anticipated that there may be occasions when it is appropriate to undertake transactions which seek to reduce the council's specific exposure to interest rate risk. A standard market technique involves selling Gilts to be paid for at an agreed date in the future rather than the normal next working day. It is proposed that the advance date is restricted to 1 month and the limit on the transaction(s) outstanding is £100m in total.

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.

	Revenue Budget 2018/19 £m	Revenue Budget 2019/20 £m	Revenue Budget 2020/21 £m	Revenue Budget 2021/22 £m
Minimum Revenue Provision	23.432	14.936	16.316	17.389
Interest paid	23.604	24.773	26.192	26.290
Interest earned	-7.777	-10.724	-10.612	-10.074
Grants received	-0.220	-0.200	-0.180	-0.160
Total	39.039	28.785	31.716	33.445

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 in 2020/21.

The position will be closely monitored by the Director of Finance and any changes will be reflected in forecasts presented to Cabinet.

Treasury Management 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 (2017) as setting the framework of principles for its treasury management activities. In accordance with the requirements of these codes the council produces each year prudential indicators which provide either a framework for the prudent management of its treasury management including limits with regard to certain types of activity such as borrowing. The indicators below are a consequence of the activities set out within the treasury management strategy.

Authorised and Operational Limits for debt
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:

	2018/19 Revised	2019/20	2020/21	2021/22
	£m	£m	£m	£m
Borrowing	1,150	1,200	1,250	1,200
Other long term liabilities	175	175	175	175
TOTAL	1,325	1,375	1,425	1,375

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:

	2018/19 Revised	2019/20	2020/21	2021/22
	£m	£m	£m	£m
Borrowing	1,100	1,110	1,120	1,100
Other long term liabilities	155	155	155	155
TOTAL	1,255	1,265	1,275	1,255

The actual external debt at 31 March 2018 was £959.9m.

Gross debt and the capital financing requirement

CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the authority's total debt should be lower than its highest forecast CFR over the next three years. The county councils borrowing is in excess of the CFR however, in making this comparison certain borrowing is included in the total borrowing but does not count against the CFR. These include the shared investment scheme, premiums paid and the transferred debt.

	As at 31 March			
	2019	2020	2021	2022
	£m	£m	£m	£m
Borrowing CFR	906.888	951.144	970.274	952.886
Estimated total borrowing	1,044.515	1,083.247	1,097.164	1,074.659
Borrowing in excess of CFR	137.627	132.103	126.890	121.773
Represented by:				
Premiums	48.672	45.020	41.456	38.008
Shared Investment Scheme	42.750	42.750	42.750	42.570
Borrowing relating to other authorities	46.205	44.333	42.684	41.195

The indicators and limits relating to specific treasury management activities are set out as follows.

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
Upper limit on one-year revenue impact of a 1% rise in interest rates	£30m

Maturity structure of debt

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

	Upper Limit
Under 12 months	75%
12 months and within 2 years	75%
2 years and within 5 years	75%
5 years and within 10 years	75%
10 years and above	75%

Investments over 1 year

Limit on the level of long term investments helps to control liquidity, although the majority of these investments are currently held in securities which are readily saleable. The limit is largely determined by the forecast of reserves and balances held at the year-end (currently forecast to be £338m). The level of investments will be managed to be in line with the estimated reserves and balances and cash flow at 31 March 20 (deemed an operational limit which will be reviewed during the year). However, it is anticipated that the level of reserves will fall gradually during the year and there will be positive cash-flows in year which will require a higher level of investments to be held including bonds held specifically for liquidity purposes. Therefore it is proposed that the limit for maturities in excess of one year is £475m for each of the years.

	Upper limit
Total invested over 1 year	£475m
Operational or forecast limit at 31 March 2020	£375m

Minimum Average Credit Rating

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

	Benchmark
Average counterparty credit rating	A