Audit and Governance Committee
Meeting to be held on Monday, 26 September 2016

Electoral Division affected: (All Divisions);

The County Council's Treasury Management Strategy 2016/17

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Executive Summary

Recent economic uncertainty following the referendum vote to leave the European Union has resulted in the credit agencies downgrading the UK sovereign rating. In view of the recent change and in anticipation of any future reductions the County Council's Treasury Management Policy has been reviewed.

The economic position and low interest rates also requires further consideration for the fixing of long term debt and this report covers the options including the potential use of the Municipal Bond Agency (MBA). This report allows further opportunity to consider the risks associated with the MBA in response to a resolution from County Council.

Recommendation

The Committee is recommended to:

- Approve the changes to the Treasury Management Strategy, as set out in the report, to allow for changes in the UK sovereign credit rating following the referendum vote to leave the European Union; and

- Recommend Full Council to agree that the County Council enters into the UK MBA framework agreement as set out in the report.

Background and Advice

The Council's investment priorities are:

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

To meet the investment priorities the County Council requires very high credit ratings for an organisation to be considered as a suitable counterparty. Although the County Council does not rely solely on the credit ratings in making its investment decisions

they do form an important part of the decision making process and the Strategy approved by the County Council in February included the following:

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:

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 minimum sovereign rating for investment is AA-.

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

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

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

Within the Treasury Management policy is provision for investments to be made with UK local authorities (including Transport for London). The limits are £100m for an individual transaction, £500m for the category as a whole and investment could be for up to 50 years. Currently, the strategy is based on local authorities having the same credit worthiness as the UK government on the assumption that government would provide support for any authority which ran into financial difficulties. Given the current financial uncertainty and potential changes to local government funding with central government grant being phased out this assumption needs to be reviewed. Where local authorities do have individual credit ratings these have recently been reduced. For example on 30 June Standard and Poor issued the following ratings:

Greater London Authority

Long-term rating	Downgraded to AA from AA+
Short-term rating	Affirmed at A-1+
Outlook	Revised to negative from stable

Royal Borough of Kensington & Chelsea

Long-term rating	Downgraded to AA from AAA
Short-term rating	Affirmed at A-1+
Outlook	Remains negative

Transport for London

Long-term rating	Downgraded to AA from AA+
Short-term rating	Affirmed at A-1+
Outlook	Revised to negative from stable

Consideration has been given to reducing the risk associated with the County Council's investment with other local authorities. Arlingclose, the County Council's Treasury Management advisor, state they are "comfortable with clients making loans to UK local authorities for periods up to four years, subject to this meeting their approved strategy. For periods longer than four years we recommend that additional due diligence is undertaken prior to a loan being made." On this basis it is proposed that the investments to local authorities are limited as follows:

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

The County Council will continue to invest in corporate bonds in line with its existing credit policy. These are liquid assets and are covered by corporate bond regulations and therefore are still seen as low risk.

Long Term Debt

The County Council has for the past several years undertaken a policy of taking short term debt to take advantage of the low interest rate environment. Therefore at 31 March 2016 the County Council had debt of some £719m which is due to mature within 5 years and which will need to be renewed to fund the Council's investment programme. Of this £392m is due to mature within 12 months.

Although it is expected that the interest rates will remain low for a further period the rates are at historically very low levels. Therefore to protect the County Council against future rate increases consideration should now be given to fix some of the debt on a long term basis. Traditionally, this would have been via a loan from the PWLB but it is anticipated that this is not the most cost effective method of securing the loan. It is possible that the monies can be raised on the market at a suitable rate but the Treasury Management policy also included approval in principle for:

- Preparations for borrowing through the Municipal Bond Agency
- the establishment of a Lancashire County Council Euro Medium Term Note (EMTN) programme to facilitate access to secure long term debt

These alternatives are re-considered here to determine if they are still appropriate forms of borrowing.

PWLB

The PWLB's function is to lend money from the National Loans Fund to local authorities and it is not anticipated that this function will not remain in the future. However, the PWLB rates are not the cheapest available and once a loan has been taken the early repayment charges can be prohibitive. They are therefore seen by the County Council as a lender of last resort. However, if circumstances are such that they provide the best option, the County Council will use this facility.

Market borrowing

The County Council can borrow from the market. There are sometimes opportunities to borrow from insurance companies or other pension funds. The level of borrowing at rates and timeframes which are considered desirable may however not always be available.

Lancashire County Council Euro Medium Term Note (EMTN)

A potential source of finance is the issuance of bonds. The standard mechanism for accessing public and private debt markets, through bond issuance, is through the creation of a "Euro Medium Term Note" (EMTN) programme. In July 2014 Cabinet approved the establishment and operation of a Lancashire County Council Euro Medium Term Note programme, which included the establishment of a company to

facilitate the funding. A company has been established but to date it has not been seen as appropriate to pursue a bond issuance. To be effective it is estimated that the issuance would need to be a minimum of £250m.

In general to obtain the most advantageous rates a high credit rating is required. Currently the County Council is rated AA2 by Moody's but is on a negative outlook. As discussed above there is a potential for a further reduction in the UK's credit rating which is likely to result in the County Council's rating being reduced. In this instance, and in light of the reported financial position of the County Council the benefits of a bond issuance are uncertain. There could also be significant costs given the administration involved in taking this option forward. The financial markets are likely to take the view that the repayment of the bond would be a first call on future Council funding.

Municipal Bond Agency

The Municipal Bond Agency has been established to give local authorities access to borrowing at cheaper rates than those given by the PWLB. To have access to the borrowing facility the County Council must sign up to a framework agreement issued by the Agency. A report on the Bond Agency was submitted to the County Council on 21 July 2016 County Council resolved that the "Audit and Governance Committee be requested to examine the potential risks of the County Council entering into the Framework Agreement and the possible mitigation of those risks at its meeting on 26 September 2016 and a further report be presented to Full Council on 13 October 2016".

The key area of risk is the guarantees given by any local authority using the Agency. Firstly, all borrowers guarantee to make contribution loans to the Agency if it estimates it will be unable to repay bond investors for any reason. This may be because another local authority has failed to make a scheduled payment of interest or principal on a loan, or because the agency is insolvent, or simply because the agency has poor cash flow management and is unable to borrow elsewhere.

Another key risk is the joint and several nature of the guarantee (JSG) given by local authorities. This guarantee is given by all local authority borrowers directly to the bond investors, guaranteeing to make good any shortfall in payments from the agency to the investors when using the Agency. In effect this means that if the County Council took part in one of the bond issuances it would be guaranteeing the loan of other local authorities and therefore the County Council would potentially be liable if another authority defaulted. This guarantee could potentially extend for 75 years or more. One of the risks faced by the County Council is that over this time period the legislative framework and the role of the PWLB as a lender of last resort may differ from the position now.

Clearly, there is a risk involved with the Framework Agreement. The issue is whether or not the level of risk undertaken in entering the agreement is acceptable. The Bond Agency has taken steps to mitigate the risk and within the agreement it is required:

- to carry out certain processes, e.g. credit check, and not to lend money to local authorities which it believes do not pass the credit assessment;

- to maintain a level of diversification, which ensures that the MBA does not become overly concentrated in lending to a particular authority;

- it sets out the timelines for payment to ensure that the MBA has funds in place on a timely basis for payments of interest and principal;

- it includes requirement for notification in the event that an authority will have difficulty in meeting its payment obligations

The risk of a local authority defaulting on its debts must be considered. To date no local authority has defaulted on a loan. In addition, the major credit agencies consider that local authorities are highly regulated by the DCLG and the risk of lenders to local authorities not getting the principal and interest back is low. This must be caveated that these opinions are based on the current system and cannot predict future changes.

The UK MBA is obliged under the Framework Agreement to pursue any defaulting local authority for full recovery, using whatever means available.

In particular the UK MBA may:

- Declare such local authority's liabilities to the UK MBA to be immediately due and payable;
- Sue for, commence or join any legal or arbitration proceedings against the defaulting local authority;
- Exercise any rights of set off; or
- Apply to the High Court to have a receiver appointed under Section 13(5) of the Local Government Act 2013.

Should a default occur the contribution to cover the default would be in proportion to the non-defaulting loans. Therefore if the County Council agreed to use the MBA it could limit the amount it was to borrow from the MBA thereby potentially reducing its risk. Indeed, the MBA will have its own limits to ensure that proportionately it has not lent too much to a particular authority. This will limit both the risk to the MBA and to other authorities in case of default. Consequently, if it is agreed to enter the Framework Agreement it is not likely that the County Council would be looking to use it as a sole source of financing the debt that is maturing.

It is proposed that the County Council enters into the MBA framework agreement, with the terms of any loan being subject to the approval of the Council's S151 Officer and the Deputy Leader of the County Council, taking into consideration the potential liability being incurred from the guarantees, relative to the other borrowing options available to the Council at the time.

In order to protect the County Council against future interest rate increases, there are a limited number of options to secure the fixing of debt on a longer-term basis as set out in the report. The current economic uncertainty and financial position of the County Council significantly increases the risks around the EMTN. Signing up to the MBA framework agreement would allow the opportunity for this to be considered alongside the other more immediately accessible borrowing options available to the Council.

Consultations

N/A

Implications:

This item has the following implications, as indicated:

Risk management

If the Council does not sign up to the UK MBA framework agreement, the opportunity to secure long term borrowing below the PWLB rate may not be available under desirable terms.

Financial

It is not possible to say with any certainty what rates would be provided when the loans are taken. However, the expectation is that a direct EMTN issuance would be in the region of 0.25% lower than the PWLB rate. It is anticipated that the Bond Agency would also have rates around 0.25% lower than PWLB.

As an illustration, on a £50m loan over a loan period of 30 years, this would mean the saving would be £0.125m per annum and £3.750m in total over the length of the loan period.

Local Government (Access to Information) Act 1985
List of Background Papers

Paper	Date	Contact/Tel
Borrowing from the Municipal Bond Agency	21 July 2016	Khadija Saeed, Head of Corporate Finance, 01772 536195

Reason for inclusion in Part II, if appropriate

N/A