Treasury Management Strategy 2017/18

1.0 Introduction

1.1 Treasury Management is an important part of the overall financial management of the Council's affairs. Its importance has increased as a result of the freedoms provided by the Prudential Code. The 12 prudential indicators in Appendix 1 cover the affordability and impact of capital expenditure decisions and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992. There are 5 specific statutory treasury management prudential indicators and 8 local indicators.

1.2 The treasury management service performs the borrowing and investment activities of the Council and effectively manages the associated risks. Its activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management - Revised November 2009). The adoption of the Code is one of the 17 statutory Prudential Indicators. This Council adopted the Code of Practice on Treasury Management on 2nd March 2010. As a result of adopting the Code, the Council also adopted a Treasury Management Policy Statement on 2nd March 2010.

1.3 The policy requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming year and includes prudential indicators relating specifically to Treasury Management for the next three years. Further reports are produced; a mid-year monitoring report and a year-end report on actual activity for the year (Annual Treasury Management Stewardship Report). In addition, Treasury Management Practice (TMPs) documents are also maintained by the Chief Finance Officer. The TMPs do not require Council approval but are available for viewing. The TMPs will be reviewed and updated annually following approval of the Treasury Management Strategy to reflect any changes in the Treasury Management Strategy agreed by Council.

1.4 A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. This strategy covers:

- The Council's debt and investment projections;
- The expected movement in interest rates;
- The Council's borrowing strategy;
- The Council's investment strategy;
- Treasury Management prudential indicators and limits on activity;
- Local Treasury issues

2.0 Debt and Investment Projections 2016/17 – 2019/20

2.1 The borrowing requirement comprises the expected movement in the Capital Financing Requirement (CFR) and any maturing debt that will need to be re-financed. The table below shows the anticipated effect on the treasury position over the current and next three years based on the current capital programme. The expected maximum debt position during each year represents the Operational Boundary prudential indicator (for borrowing only) and so may be different from the year-end position. It also highlights the expected change in investment balances.

	2016/17 Revised £'000	2017/18 Estimated £'000	2018/19 Estimated £'000	2019/20 Estimated £'000
External Debt				
Debt at 1 April	76,643	83,334	91,473	91,032
Expected change in debt	6,691	8,139	(441)	(237)
Debt at 31 March	83,334	91,473	91,032	90,795
Operational Boundary (debt only)	93,700	102,300	101,100	100,100
Investments				
Total Investments at 31 March	23,900	21,100	12,900	11,900
Investment change	(4,900)	(2,800)	(8,200)	(1,000)

The expected change in debt includes the projected General Fund borrowing for the new Lincoln Transport Hub scheme, which will be partially funded through borrowing, and for the purchase of Broadgate Carpark which will be entirely funded through borrowing. For the Lincoln Transport Hub scheme funding some temporary/internal borrowing will be taken and then repaid with grant received from partners, who are jointly funding the scheme, in future years. Expected borrowing has been profiled to take out loans before current low borrowing interest rates are forecast to rise significantly.

2.2 The related impact of the above movements on the revenue budgets are:

	2016/17 Revised £'000	2017/18 Estimated £'000	2018/19 Estimated £'000	2019/20 Estimated £'000
Revenue Budgets				
Total interest payable on borrowing	3,221	3,236	3,335	3,511
Related HRA charge	2,352	2,352	2,352	2,352
Net General Fund interest payable	869	884	983	1,159
Total investment income	161	96	59	76
Related HRA income share	73	33	15	16
Related to other commitments	19	18	18	18
Net General Fund income	69	45	26	42

3.0 Prospects for Interest Rates

The Council has appointed Capita Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates.

The following table gives the Capita central view and paragraphs 3.1 to 3.6 give Capita's view on economic prospects.

Annual Average %	Bank Rate	Money Rates		PWLB Rates*		
		3 month	1 year	5 year	25 year	50 year
March 2017	0.25	0.30	0.70	1.60	2.90	2.70
March 2018	0.25	0.30	0.70	1.70	3.00	2.80
March 2019	0.25	0.50	1.00	1.80	3.20	3.00
March 2020	0.75	0.90	1.40	2.00	3.40	3.20

* Borrowing Rates

3.1 **Economic Growth (Capita's view)**

UK. **GDP growth rates** in 2013, 2014 and 2015 of 2.2%, 2.9% and 1.8% were some of the strongest rates among the G7 countries. Growth is expected to have strengthened in 2016. The latest Bank of England forecast for growth in 2016 as a whole is +2.2%.

The June 2016 **referendum vote for Brexit** delivered an immediate shock fall in confidence at the beginning of August, which was reflected in the Bank of England's August Inflation Report as pointing to an impending sharp slowdown in the economy. However, the following month of September showed an equally sharp recovery. So it is generally expected that the economy will post reasonably strong growth numbers through the second half of 2016 and also in 2017, but at a slower pace than in the first half of 2016.

The **Monetary Policy Committee, (MPC), meeting of 4th August** took action to counter the expected sharp slowdown i.e. a cut in Bank Rate from 0.50% to 0.25%, a renewal of quantitative easing, with £70bn made available for purchases of gilts and corporate bonds, and a £100bn tranche of cheap borrowing being made available for banks to use to lend to businesses and individuals.

The **MPC meetings of 3 November and 15 December** left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unchanged. This was in line with market expectations.

The latest MPC decision included a forward view that **Bank Rate** could go either up or down depending on how economic data evolves in the coming months. Our central view remains that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in quarter 2 2019. However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely. We would also point out that forecasting as far ahead as mid 2019 is highly fraught as there are so many economic and political uncertainties globally on the horizon at the moment.

Bank of England GDP forecasts in the November quarterly Inflation Reports were as follows, (August forecasts in brackets) - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.

The Chancellor has said he will do 'whatever is needed' to **promote growth**; there are two main options he can follow – fiscal policy e.g. cut taxes, increase investment allowances for businesses, and/or increase government expenditure on infrastructure, housing etc. This will mean that the PSBR deficit elimination timetable will slip further into the future as promoting growth will be a more urgent priority. The newly appointed Chancellor, Phillip Hammond, announced, after the referendum result and the formation of a new Conservative cabinet, that the target of achieving a budget surplus in 2020 would be eased in the Autumn Statement on 23 November. This was confirmed in the Statement and included some increases in infrastructure spending.

The other key factor in forecasts for Bank Rate is **inflation** where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017. This increase was largely due to the sharp fall in the value of sterling since the referendum. This depreciation will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to look through the acceleration in inflation caused by external influences. However it has warned that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise Bank Rate.

What is clear is that **consumer disposable income** will come under pressure, as the latest employers' survey is forecasting median pay rises for the year ahead of only 1.1% at a time when inflation will be rising significantly higher than this. The CPI figure has been on an upward trend in 2016 and reached 1.2% in November. However, prices paid by factories for inputs rose to 13.2% though producer output prices were still lagging behind at 2.3% and core inflation was 1.4%, confirming the likely future upwards path.

Gilt yields, and consequently PWLB rates. There has been huge volatility during 2016 as a whole with a sharp rise since hitting a low point in mid-August. The year started with 10 year gilt yields at 1.88%, fell to a low point of 0.53% in August, and hit a new peak of 1.55% in November. The rebound reflects the initial combination of the yield-depressing effect of the MPC's new round of quantitative easing in August, together with the pessimistic Bank of England Inflation Report forecast. However GDP growth in quarter 3 at +0.5% q/q, confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

Employment has grown steadily during 2016 but October saw the first fall in over a year. November's employment data was distinctly weak with an increase in unemployment benefits claimants of 2,400. **House prices** have risen at a modest pace in 2016, but the pace of increase has slowed since the referendum; a downturn in prices could dampen consumer confidence and expenditure.

<u>USA.</u> The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. Expectation was that there would be four more increases to come in 2016. Since then, more downbeat news on the international scene, and then the Brexit vote, have caused a delay in the second increase of 0.25% which came, as expected, in December 2016. Overall, despite some data setbacks, the US is still, probably, the best positioned of the major world economies to make solid progress towards a combination of strong growth, full employment and rising inflation: this is going to require the central bank to take action to raise rates. The Fed. has indicated that it may make three further increases of 0.25% in 2017 to deal with rising inflationary pressures.

The result of the **presidential election** in November is expected to lead to a strengthening of US growth if Trump's election promise of a major increase in expenditure on infrastructure is implemented. This is also likely to strengthen inflation pressures as the economy is already working at near full capacity.

Trump's election has had a profound effect on the **bond market and bond yields** rose sharply in the week after his election. Time will tell if this is a reasonable assessment of his election promises to cut taxes at the same time as boosting expenditure. This could lead to a sharp rise in total debt issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the 1920s, there is by no means any certainty that the politicians and advisers he has been appointing and both houses, will implement the more extreme policies that Trump outlined during his election campaign. Trump may even rein back on some of those policies himself.

In the first week since the US election, there was a major shift in **investor sentiment** away from bonds to equities, especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election result which could be reversed. Other commentators take the view that this could well be the start of the long expected eventual unwinding of bond prices that have been at unrealistically high levels, (and conversely bond yields down), by the artificial and temporary power of quantitative easing.

<u>EZ.</u> In the Eurozone, **the ECB** commenced, in March 2015, its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month. This was programmed to run to March 2017 at its December 2015 meeting. The measures taken, including at its March 2016 meeting increasing its monthly asset purchases to €80bn, have had little impact in boosting economic growth, nor in increasing inflation to reach the target of 2%. Consequently, at its December 2016 meeting it extended its asset purchases at the current monthly pace of €80 billion until the end of March 2017, but then continuing at €60 billion per month until the end of December 2017, or beyond, if necessary, until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. It also stated that if the outlook were to become less favourable or a sustained adjustment of the path of inflation didn't materialise, the Governing Council will increase the programme in terms of size and/or duration.

EZ GDP growth in 2016 has been moderate and indications are that it is likely to continue at moderate levels. This has fuelled comments from many forecasters that central banks in countries around the world which are currently struggling to combat low growth, are running out of ways to stimulate growth and to boost inflation. Central banks have also been stressing that national governments will need to do more e.g. structural reforms, fiscal measures and direct investment expenditure to support demand and economic growth in their economies.

There are also significant specific political and other risks within the EZ: -

- **Greece** continues to cause major stress in the EU due to its tardiness and reluctance in implementing the EU's required key reforms to make it more efficient and to make significant progress towards it being able to pay its way – and before the EU is prepared to agree to release further bail out funds.
- **Spain** has had two inconclusive general elections in 2015 and 2016, with neither producing a workable government with a majority. At the eleventh hour on 31 October, before having to call a third general election, the party with the biggest bloc of seats was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the

need to deal with an EU demand to implement a highly unpopular package of austerity cuts.

- The under capitalisation of **Italian banks** poses a major risk. Some **German banks** are also undercapitalised, especially Deutsche Bank, which is under threat of major financial penalties from regulatory authorities (further weakening its capitalisation). EU rules prevent national governments rom providing state aid to bail out banks that are at risk, while, at the same time, the banks are unable realistically to borrow additional capital in financial markets due to their vulnerable financial state. However, they are also 'too big, and too important to their national economies, to be allowed to fail'.
- **4 December Italian constitutional referendum** on reforming the Senate and reducing its powers; this was also a confidence vote on Prime Minister Renzi who has resigned on losing the referendum. However, there has been remarkably little fall out from this result which probably indicates that the financial markets had already fully priced it in. A rejection of these proposals is likely to inhibit significant progress in the near future to fundamental political and economic reform which is urgently needed to deal with Italy's core problems, especially low growth and a very high debt to GDP ratio of 135%..
- **Dutch general election 15.3.17**; a far right party is currently polling neck and neck with the incumbent ruling party. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.

<u>Asia.</u> Economic growth in **China** has been slowing down which in turn, has been denting economic growth in emerging market countries dependent on exporting raw materials to China. Medium term risks have been increasing in China e.g. a dangerous build up in the level of credit compared to the size of GDP, plus there is a need to address a major oversupply of housing and surplus industrial capacity, which both need to be eliminated. This needs to be combined with a rebalancing of the economy from investment expenditure to consumer spending. However, the central bank has a track record of supporting growth through various monetary policy measures, though these further stimulate the growth of credit risks and so increase existing major imbalances within the economy.

Economic growth in **Japan** is still patchy, at best, and skirting with deflation, despite successive rounds of huge monetary stimulus and massive fiscal action to promote consumer spending. The government is also making little progress on fundamental reforms of the economy.

<u>Emerging countries.</u> There have been major concerns around the vulnerability of some emerging countries exposed to the downturn in demand for commodities from China or to competition from the increase in supply of American shale oil and gas reaching world markets. The ending of sanctions on Iran has also brought a further significant increase in oil supplies into the world markets. While these concerns have subsided during 2016, if interest rates in the USA do rise substantially over the next few years, (possible also accompanied by a rise in the value of the dollar in exchange markets), this could cause significant problems for those emerging countries with large amounts of debt denominated in dollars. The Bank of International Settlements has recently released a report that $340bn of emerging market corporate debt will fall due for repayment in the final two months of 2016 and in 2017 – a 40% increase on the figure for the last three years.

Financial markets could also be vulnerable to risks from those emerging countries with major sovereign wealth funds, that are highly exposed to the falls in commodity prices from the levels prevailing before 2015, especially oil, and which, therefore, may have to liquidate substantial amounts of investments in order to cover national budget deficits over the next few years if the price of oil does not return to pre-2015 levels.

4.0 The Council's Borrowing and Debt Strategy 2017/18

4.1 The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the CFR), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is high and will be maintained for the borrowing, excluding the Lincoln Transport Hub and the purchase of Broadgate Carpark.

4.2 Against this background and the risks within the economic forecast, caution will be adopted with the 2017/18 treasury operations. The Chief Finance Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances as follows.

4.3 If it was felt that there was a significant risk of a sharp fall in long term rates e.g. due to a marked increase of risks around a relapse into recession or of risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

4.4 If it was felt 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 likely action that fixed rate funding will be drawn whilst interest rates are still relatively cheap.

4.5 The Council's overall core borrowing objectives will remain uniform and follow a similar pattern to previous years as follows:

- To reduce the revenue costs of debt in line with the targets set for the Chief Finance officer (see local indicators).
- To manage the Council's debt maturity profile, leaving no one future year with a high level of repayments that might cause problems in re-borrowing.
- To effect funding at the cheapest cost commensurate with future risk.
- To forecast average future interest rates and borrow accordingly i.e. short term/variable when rates are 'high', long term/fixed when rates are 'low'.
- To monitor and review the level of variable rate loans in order to take greater advantage of interest rate movements.
- To proactively reschedule debt in order to take advantage of potential savings as interest rates change. Each rescheduling exercise will be considered in terms of the effect of premiums and discounts on the General Fund and the Housing Revenue Account.

- To manage the day-to-day cash flow of the Council in order to, where possible, negate the need for short-term borrowing. However, short-term borrowing will be incurred, if it is deemed prudent to take advantage of good investment rates.

4.7 There is unsupported borrowing in the General Fund Investment Programme (GIP) as detailed in the MTFS. The Council expects to take out loans for the General Fund to fund the Transport Hub scheme and the purchase of Broadgate Carpark before current low borrowing interest rates are forecast to rise significantly, and it will continue to use internal balances whilst interest rates on investments remain low. Officers are continually evaluating the cost effectiveness of borrowing as opposed to selling capital assets. Proposals are presented to Members when borrowing becomes more cost effective.

4.8 There are currently no plans to borrow for the HRA planned new build programme during the next MTFS period, starting in 2017/18. It is planned to fund the programme using alternative sources of funding.

4.9 The strategy allows for additional borrowing in line with the expected movement in the Capital Financing Requirement (CFR), should it become necessary for cash flow requirements. The Council will consider PWLB loans, Market loans, the Municipal Bond Agency and other financial institutions, if attractive rates are offered. In addition, should schemes be identified that benefit the Council's strategic aims and be deemed cost effective, i.e. Invest to Save schemes where the income streams more than pay for the borrowing costs, unsupported borrowing will be considered.

5.0 The Council's Investment Strategy 2017/18

5.1 The Council's investment strategy's primary objectives are safeguarding the repayment of the principal and interest of its investments on time, ensuring adequate liquidity, with the investment return being the final objective.

The intention of the strategy is to provide security of investment and minimisation of risk.

The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk.

In line with this aim, the Council will ensure:

- It maintains a policy covering the types of specified and unspecified investments it will invest in, criteria for choosing investment counterparties with adequate security and monitoring their security. This is set out in the paragraphs below.

  - **Specified Investments** – these are high security investments (i.e. high credit quality) and high liquidity investments in sterling with a maturity of no more than one year.
  - **Non-specified Investments** – investments that do not fall into the category of Specified Investments, representing a potential greater risk (e.g. over one year).

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

5.2 **Risk benchmarking**

Yield benchmarks are widely used to assess investment performance. Discrete security and liquidity benchmarks are also requirements to Treasury Management reporting, although the application of these is more subjective in nature. Additional background in the approach taken is shown at the end of this appendix.

5.3 These benchmarks are simple guides to maximum risk and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

5.4 **Security**

The Council's expected security risk benchmark for the current portfolio, when compared to these historic default tables, is:

- 0.008% historic risk of default when compared to the whole portfolio.

5.5 **Liquidity**

In respect of this area the Council seeks to maintain:

- Bank overdraft - £nil.
- Liquid short term deposits of at least £3 million available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.19 years.

5.6 **Yield**

Local measure of yield benchmark employed is:

- Investments – return above the 7 day LIBID rate

5.7 **Investment Counterparty Selection Criteria**

The primary principle governing the Council's investment criteria is the security of its investments although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.

It has sufficient liquidity in its investments. For the purpose it will set out procedures for determining the maximum periods for which funds may be prudently committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

5.8 The Chief Finance Officer will maintain a counterparty list in compliance with the criteria set out in the table contained within this appendix and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which chooses Specified and Non-Specified investments as they provide an overall pool of counterparties considered high quality which the Council may use rather than defining what its investments are.

5.9 Following the Comprehensive Spending Review on the Council's grant funding settlement and the ongoing financial pressures, the identification of savings and income generation are critical to the delivery of the Medium Term Financial Strategy. Treasury Management is an important area for further income generation and therefore, the main theme of the Council's investment strategy must continue to be to maximise interest from investments, after ensuring adequate security and liquidity. The Investment Strategy 2017-18 seeks to achieve this objective by establishing a pool of counterparties available for investment whilst still containing overall risk within acceptable levels.

5.10 The Council uses Capita Asset Services' creditworthiness service. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies – Fitch, Moody's and Standard and Poor's.

The 3 rating agencies have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. Commencing in 2015, in response to the evolving regulatory regime, all three agencies have begun removing these "uplifts" with the timing of the process determined by regulatory progress at the national level. The process has been part of a wider reassessment of methodologies by each of the rating agencies. In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A consequence of these new methodologies is that they have also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

In keeping with the agencies' new methodologies, the rating element of our own credit assessment process now focuses solely on the Short and Long Term ratings of an institution. While this is the same process that has always been used for Standard & Poor's, this has been a change in the use of Fitch and Moody's ratings. It is important to stress that the other key elements to our process, namely the assessment of Rating Watch and Outlook information as well as the Credit Default Swap (CDS) overlay have not been changed.

The evolving regulatory environment, in tandem with the rating agencies' new methodologies also means that sovereign ratings are now of lesser importance in the assessment process. Where through the crisis, clients typically assigned the highest sovereign rating to their criteria, the new regulatory environment is attempting to break the link between sovereign support and domestic financial institutions. While this authority understands the changes that have taken place, it will continue to specify a minimum sovereign rating of AA. This is in relation to the fact that the underlying domestic and where appropriate, international, economic and wider political and social background will still have an influence on the ratings of a financial institution.

It is important to stress that these rating agency changes do not reflect any changes in the underlying status or credit quality of the institution. They are merely reflective of a reassessment of rating agency methodologies in light of enacted and future expected changes to the regulatory environment in which financial institutions operate. While some banks have received lower credit ratings as a result of these changes, this does not mean that they are suddenly less credit worthy than they were formerly. Rather, in the majority of cases, this mainly reflects the fact that implied sovereign government support has effectively been withdrawn from banks. They are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In fact, in many cases, the balance sheets of banks are now much more robust than they were before the 2008 financial crisis when they had higher ratings than now. However, this is not universally applicable, leaving some entities with modestly lower ratings than they had through much of the “support” phase of the financial crisis.

In accordance with the guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

As with previous practice, ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as “credit default swaps” and overlay that information on top of the credit ratings. This is fully integrated into the creditworthiness methodology provided by Capita Asset Services. The result is a colour coding system, which shows the varying degrees of suggested creditworthiness.

Alongside the credit ratings other information sources are used and include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process with regard to the suitability of potential investment counterparties.

The credit ratings of counterparties are supplemented with the following overlays:

- Credit watches and credit outlooks from credit rating agencies;
- Credit Default Swaps (CDS) spreads to give early warning of likely changes in credit ratings;
- Sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands:

Yellow	5 years
Purple	2 years
Blue	1 year (only applies to part-government owned UK banks)
Orange	1 year
Red	6 months
Green	100 days
No colour	Not to be used

The Capita Asset Services creditworthiness service uses a wider array of information than primary ratings alone and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

5.11 Typically, the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1 and a Long Term rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances, consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

The credit ratings specified above are defined as follows:-

F1 (short term rating) – Highest credit quality

A- (long term rating) – High credit quality, denoting a very strong bank

5.12 All credit ratings will be monitored regularly. The Council is alerted to changes to ratings of all three agencies through its use of Capita's creditworthiness service.

- If a downgrade results in the counterparty no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- In addition to the use of credit ratings the Council will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's counterparty list.

Sole reliance will not be placed on the use of this external service. In addition the Council will also use market data and market information, information on sovereign support for banks and the credit ratings of that supporting government.

5.13 **Country and sector considerations**

Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part the country selection will be chosen by the credit rating of the Sovereign state. In addition:

- No more than 50% will be placed with any non-UK country at any time (see below).

- Group limits have been set to ensure that the Council is not exposed to excessive risk due to concentration of investments within any one institution or group. These are detailed in the Investment Counterparty Limits table contained within this appendix.

Although the strategy sets a limit for investment in non-UK countries at no more than 50%, the Council has been operating a tighter operational strategy in the light of the Eurozone difficulties and has not been investing outside the UK. This operational restriction will continue until the problems in the Eurozone economy have been sufficiently resolved.

5.14 In the normal course of the Council's cash flow operations it is expected that both Specified and Non-specified investments will be used for the control of liquidity as both categories allow for short-term investments. The Chief Finance Officer will strive to keep investments within the Non-specified category to a prudent level (having regard to security and liquidity before yield). To these ends the Council will maintain a maximum of 75% of investments in Non-specified investments.

5.15 The use of longer-term instruments (greater than one year from inception to repayment) will fall in the Non-specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. The investment in longer-term instruments is also limited by the prudential indicator 16 shown in paragraph 6.3, which gives the maximum amount to be invested over 1 year, as well as the limits on the amounts that can be placed with the categories within the non-specified range of investments (see above paragraph 5.14).

5.16 Expectations on shorter-term interest rates, on which investment decisions are based, reflect the fact that an increase in the current 0.25% Bank Rate is unlikely until June 2019. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts.

5.17 There is a clear operational difficulty arising from the ongoing economic conditions. Ideally investments would be invested longer to secure better returns, however uncertainty over counterparty creditworthiness suggests shorter dated investments would provide better security

5.18 The criteria for choosing counterparties set out above provide a sound approach to investment in the current difficult market circumstances.

5.19 Sensitivity to Interest Rate Movements

The Council's Statement of Accounts is required to disclose the impact of risks on the Council's treasury management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 0.5% increase/decrease in the average interest rates for investments for next year. That element of the debt and investment portfolios, which are of a longer term, fixed interest rate nature, will not be affected by interest rate changes. There will be no effect on borrowing costs as all the Council's existing debt is fixed rate and the additional borrowing planned will also be fixed rate and has been included within the budget figures in this report at the forecast rate for 2017/18.

£000	2017/18 Estimated + 0.5%	2017/18 Estimated - 0.5%*
Revenue Budgets		
Investment income	104,613	0
Related HRA Income	61,276	0
Net General Fund Income	43,337	0

*The average interest rates on investment are less than 0.5% so if interest rates fell by this amount they would be zero which would result in no interest being earned

6.0 Treasury Management Limits on Activity

6.1 There are four further treasury activity limits, which were previously prudential indicators. The purpose of these is to contain the activity of the treasury function within certain limits, thereby managing the risk and reducing the impact of an adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunity to reduce costs. The indicators are:

- **Upper limit on variable rate exposure** – this identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- **Upper limit on fixed rate exposure** – Similar to the previous indicator this covers a maximum limit on fixed interest rates.
- **Maturity structures of borrowing** – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing at the same time and are required for upper and lower limits.
- **Total principal sums invested for periods longer than 1 year** – These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

6.2 In addition the Chief Finance Officer has set eight additional local indicators. The aim of these indicators is to increase the understanding of the treasury management indicators.

6.3 The 4 treasury limits above together with the adoption of the Code of Practice indicator are shown below:

Indicator 13	2016/17 Upper £m	2017/18 Upper £m	2018/19 Upper £m
Upper Limit on variable interest rate exposure	33.0	37.2	37.2

Indicator 14	2016/17 Upper £m	2017/18 Upper £m	2018/19 Upper £m
Upper Limit on fixed interest rate exposure	76.6	87.6	89.7

Indicator 15	2016/17		2017/18		2018/19	
Maturity Structure of fixed borrowing	**Lower**	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	40%	0%	40%	0%	40%
12 months to 2 years	0%	40%	0%	40%	0%	40%
2 years to 5 years	0%	60%	0%	60%	0%	60%
5 years to 10 years	0%	80%	0%	80%	0%	80%
10 years and above	10%	100%	10%	100%	10%	100%

Indicator 16	2016/17 £m	2017/18 £m	2018/19 £m
Maximum principal sums invested for longer than 1 year	5	5	5

Although this indicator has been set at £5m, the Council has approved a service investment in the Local Authority Mortgage Scheme (LAMS) of up to a maximum of £2m, which must be included in this maximum limit. This means that at any one time, the total of amounts invested in treasury deposits for longer than one year plus the LAMS service deposit must not exceed the above limit i.e. £5m. However the investment the Council has in this scheme will be repaid in 2017/18 so this will no longer apply.

Indicator 17
CIPFA Code of Practice for Treasury Management in the Public Services (Revised November 2009) adopted by Council on 2nd March 2010.

6.4 The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury management function over the year. The Chief Finance Officer has therefore set 8 local indicators, which are believed to add value and assist the understanding of the main prudential indicators. These indicators are:

- Debt – Borrowing rate achieved against average 7 day LIBOR.
- Investments – Investment rate achieved against average 7 day LIBID.
- Average rate of interest paid on the Councils Debt – this will evaluate performance in managing the debt portfolio to release revenue savings.
- Amount of interest on debt as a percentage of gross revenue expenditure.
- Limit on fixed interest rate investments
- Limit on fixed interest rate debt
- Limit on variable rate investments
- Limit on variable rate debt

6.5 The 8 indicators are shown below:

	2016/17 Target	2017/18 Target	2018/19 Target
Debt - Borrowing rate achieved i.e. temporary borrowing (loans of less than 1 year)	Less than 7 day LIBOR	Less than 7 day LIBOR	Less than 7 day LIBOR

	2016/17 Target	2017/18 Target	2018/19 Target
Investment rate achieved	Greater than 7 day LIBID	Greater than 7 day LIBID	Greater than 7 day LIBID

	2016/17 Target	2017/18 Target	2018/19 Target
Average rate of Interest Paid on Council Debt (%)	4.25%	4.25%	4.25%

	2016/17 Target	2017/18 Target	2018/19 Target
Interest on Debt as a % of Gross Revenue Expenditure	3.1%	3.4%	3.6%

	2016/17 Target	2017/18 Target	2018/19 Target
Upper Limit on fixed interest rate Investments	100%	100%	100%

	2016/17 Target	2017/18 Target	2018/19 Target
Upper Limit on fixed interest rate debt	100%	100%	100%

	2016/17 Target	2017/18 Target	2018/19 Target
Upper Limit on variable interest rate investments	75%	75%	75%

	2016/17 Target	2017/18 Target	2018/19 Target
Upper Limit on variable interest rate debt	40%	40%	40%

6.6 Treasury Management Advisers

The Council uses Capita Asset Services as its treasury management consultants. The company provides a range of services which include:

- Technical support on treasury matters, capital finance issues and the drafting of Member reports;
- Economic and interest rate analysis;
- Debt rescheduling advice surrounding the existing portfolio;
- Credit ratings/market information service comprising the three main credit rating agencies.

Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the Council. This service is subject to regular review.

6.7 **Member and Officer Training**

The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers.

This Council has addressed this important issue by:

- Member Training – Our treasury management advisers provided training to the Audit Committee and Budget Review Scrutiny Group prior to the consideration of this year's strategy and review of the Draft MTFS 2017-22. They also provided training to the Performance Scrutiny Committee to support their consideration of the mid-year report. The training needs will be regularly reviewed and updated as necessary in 2017/18.
- Staff Training – training needs for staff engaged in treasury management are addressed through the appraisal process. Training is provided both by the Council's treasury management advisers, other external providers and internally. In addition, the Council encourages staff engaged in treasury to undertake a professional accountancy qualification and ensures that the day-to-day trading is overseen by a professionally qualified accountant following the CIPFA Code of Practice.

7.0 Breakdown of Investment Categories with Maximum Amounts and Periods

The Chief Finance Officer, in accordance with TMP 1 (1) within the Council's Code of Practice, is authorised to invest funds surplus to immediate requirements with the following types of institutions subject to the minimum ratings produced by the three credit rating agencies Fitch, Moody's and Standard & Poor's. The Capita Asset Services creditworthiness service is applied to determine a list of suitable counterparties available for investment. The minimum ratings applied by Capita Asset Services in compiling their recommended counterparty list are set out in section 5.11 of the investment strategy.

All counterparty ratings are updated on a regular basis on the advice of the Council's Treasury Consultants. Notifications of rating changes are received as they happen.

<u>Investment Counterparty Limits</u>

Institution	Minimum credit criteria/colour band	Maximum limit per group or institution £ million	Maximum maturity period
SPECIFIED INVESTMENTS			
UK Bank [*1]	Orange/Blue Red Green	£5 million	1 year 6 months 100 days
Non-UK Banks[*1] Sovereign rating AA	Orange Red Green	£5 million	1 year 6 months 100 days
Building Society[*2]	Orange Red Green	£5 million	1 year 6 months 100 days
Money Market Fund[*3]	Yellow	£5 million	Liquid

UK Government[*4]	Yellow	unlimited	6 months
UK Local Authority[*4]	Yellow	£2 million	1 year
NON-SPECIFIED INVESTMENTS			
UK Bank[*1]	Purple	£5 million	2 years
Non-UK Banks[*1] Sovereign rating AA	Purple	£3 million	2 years
Building Society[*2]	Purple Yellow	£2 million	2 years 5 years
UK Local Authority[*4]	Yellow	£2 million	5 years
Lincoln Credit Union	N/A	£10K	N/A
Council's own bank[*5] (operational cash limit in addition to the investment group limit)	N/A	£500K	Overnight
Local Authority Mortgage Scheme. Under this scheme, the Council is authorised to place funds of up to £2 million, with the approved mortgage providers for a period of 5 years. This is classed as being a service investment, rather than a treasury management investment, and is therefore outside of the specified/non-specified categories. It must, however, be included within the group limit total for the relevant institution.			

***1**Where the term 'Bank' is used, this denotes a UK or European Bank authorised to accept deposits through a bank account incorporated within the UK banking sector. The maximum amount indicated is the 'Group total' and covers the total amount that can be invested when spread over any number of subsidiaries within that group.

***2** Where the term Building Society is used, this denotes a UK Building Society.

***3** Money market funds are mutual funds that invest in short-term high quality debt instruments. The assets are actively managed within very specific guidelines to offer safety of principal, liquidity and competitive returns. Although money funds are regarded as short-term investments the rating agencies use a classification system based on long-term debt ratings.

***4** The UK Government (i.e. HM Treasury and its Executive Agency, the Debt Management Office) and Local Authorities, although not rated as such, are classified as having the equivalent of the highest possible credit rating.

***5**This limit covers normal treasury management activities but excludes any deposits received after money market trading has closed. It allows up to £500K of operational cash to be held in the Council's main bank account in addition to the group investment limit for the bank, if the bank is included on the Council's counterparty list.

Approved Investment Instruments

In addition to determining the rating and limits of authorised counterparties TMP 4 "Approved instruments, methods and techniques" within the Council's Code of Practice requires the Council to define the instruments that the Authority will use in undertaking its Treasury Management activities. In accordance with this, and the investment regime issued as part of the prudential capital finance system, the Instruments that the Chief Finance Officer will consider investing surplus funds in are shown below:

Instruments of Specified Investments *1

1. Gilt-edged securities issued by the United Kingdom Debt Management Office (UK DMO), an Executive Agency of HM Treasury.
2. Treasury Bills issued by the UK DMO.
3. Deposits with the Debt Management Office Debt Management Account Deposit Facility (DMADF).
4. Deposits with a Local Authority, Parish Council or Community Council.
5. Deposits with Banks and Building Societies (Including opening Business Accounts).
6. Certificates of deposit issued by Banks and Building societies.
7. Pooled investment vehicles (e.g. money market funds)

***1** To be defined as a Specified Investment the above instruments will have these features common to all:

- Be denominated in Sterling,
- Of not more than 1 year maturity,
- Of longer than 1 year maturity but the Council has the right to be repaid within 12 months,
- For instruments numbered 5 to 7 these must be with institutions of high credit quality.

Instruments of Non-Specified Investments *2

1. Deposits with Banks, Building Societies and their subsidiaries.
2. The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.
3. Certificates of deposit issued by Banks and Building Societies.

***2** To be defined as a Non-Specified Investment the above instruments will have these features common to all:

- Denominated in Sterling,
- Of more than 1 year maturity,
- Of less than 1 year maturity with an institution that does not meet the basic security requirements under Specified Investments e.g. a deposit with a non-credit rated Bank or Building Society.

Security, Liquidity and Yield benchmarking

Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service

A requirement for Treasury Management reporting is the consideration and approval of security and liquidity benchmarks.

These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury Report.

Yield – These benchmarks are widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Benchmarks for the cash type investments are set out below and these will form the basis of reporting in this area. In other investment categories appropriate benchmarks will be used where available.

Liquidity – This is defined as "having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

- Bank overdraft - nil
- Liquid short term deposits of at least £3m available with a week's notice.

The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – a shorter WAL would generally embody less risk. In this respect the proposed benchmark to be used is:

- WAL benchmark is expected to be 0.19 years.
- Security of the investments – In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard and Poor's). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy.

The Council's expected security risk benchmark from its budgeted investment strategy is:

- 0.008% historic risk of default when compared to the whole portfolio which equates to a potential loss of £1,909 on an investment portfolio of £23.867m. In addition that the security benchmark for each individual year is:

	1 year	2 year	3 year	4 year	5 year

Maximum	0.30%	0.30%	0.30%	0.30%	0.30%

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Investment Annual Report. As this data is collated, trends and analysis will be collected and reported