Essential Reference Paper B

East Herts District Council

Treasury Management Strategy Statement

Minimum Revenue Provision Policy Statement and Annual Investment Strategy

2016/17 to 2018/19

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1 INTRODUCTION

1.1 Background

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

CIPFA defines treasury management as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.2 Reporting requirements

The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals.

Prudential and treasury indicators and treasury strategy (this report) - The first, and most important report covers:

- the capital plans (including prudential indicators);
- a minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
- the treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

A mid year treasury management report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision.

An annual treasury report – This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

Scrutiny
The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Audit Committee and Joint Meeting of Scrutiny Committees.

1.3 Treasury Management Strategy for 2016/17

The strategy for 2016/17 covers two main areas:

Capital issues

- the capital plans and the prudential indicators;
- the minimum revenue provision (MRP) policy.

Treasury management issues

- the current treasury position;
- treasury indicators which limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- debt rescheduling;
- the investment strategy;
- creditworthiness policy; and
- policy on use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, CLG MRP Guidance, the CIPFA Treasury Management Code and CLG Investment Guidance.

1.4 Training

The CIPFA Code requires the S151 officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsibe for scrutiny. Treasury Management training has been undertaken by members of the audit committee on 25th November 2015 and further training will be arranged as required.

The training needs of treasury management officers are periodically reviewed.

1.5 Treasury management consultants

The Council uses Capita Asset Services, Treasury solutions as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

2 THE CAPITAL PRUDENTIAL INDICATORS 2016/17 – 2018/19

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

2.1 Capital expenditure

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the capital expenditure forecasts:

Capital expenditure	2014/15 Actual £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000
Total	**1,859**	**23,365**	**5,160**	**2,258**	**1,992**	**2,000**

Other long term liabilities. The above financing need excludes other long term liabilities, such as leasing arrangements which already include borrowing instruments.

The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

Capital expenditure	2014/15 Actual £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000
Total	**1,859**	**23,365**	**5,160**	**2,258**	**1,992**	**2,000**
Financed by:						
Capital receipts	1,132	2,387	1,640	1,270	800	500
Capital grants	459	293	293	293	293	293
Capital reserves	243	238	14	360	-	-
Revenue	25	981	25	25	25	25
Net financing need for the year	**0**	**19,466**	**3,188**	**310**	**874**	**1,182**

2.2 The Council's borrowing need (the Capital Financing Requirement)

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each assets life.

The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £888k of such schemes within the CFR.

The Council is asked to approve the CFR projections below:

£m	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2018/19 Estimate
Capital Financing Requirement						
Total CFR	**(43,082)**	**(23,904)**	**(21,012)**	**(21,008)**	**(20,134)**	**(18,952)**
Movement in CFR	**(280)**	**19,178**	**2,892**	**4**	**874**	**1,182**
Movement in CFR represented by						
Net financing need for the year (above)	0	19,466	3,188	310	874	1182
Less MRP/VRP and other financing movements	(280)	(288)	(296)	(306)	0	0
Movement in CFR	**(280)**	**19,178**	**2,892**	**4**	**874**	**1,182**

2.3 Minimum revenue provision (MRP) policy statement

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the minimum revenue provision - MRP), although it is also allowed to undertake additional voluntary payments if required (voluntary revenue provision - VRP).

Following the disposal of the Council's Housing Stock and the retention of outstanding debt, the Council has a negative CFR. MRP has therefore been set as nil.

CLG regulations have been issued which require the full Council to approve **an MRP Statement** in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement

For authorities which participate in LAMS, LAPP or CSB using the cash backed option, the mortgage lenders require a 5 year cash advance from the local authority to match the 5 year life of the indemnity. The cash advance placed with the mortgage lender provides an integral part of the mortgage lending, and should therefore be treated as capital expenditure and a loan to a third party. The Capital Financing Requirement (CFR) will increase by the amount of the total indemnity. The cash advance is due to be returned in full at maturity, with interest paid annually. Once the cash advance matures and funds are returned to the local authority, the returned funds are classed as a capital receipt, and the CFR will reduce accordingly. As this is a temporary (5 year) arrangement and the funds will be returned in full, there is no need to set aside prudent provision to repay the debt liability in the interim period, so there is no MRP application. The position should be reviewed on an annual basis.

2.4 Core funds and expected investment balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end balances for each resource and anticipated day to day cash flow balances.

Year End Resources £m	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Fund balances / reserves	18,986	15,545	14,362	14,148	14,138	14,080
Capital receipts	1,275	0	0	0	0	0
Provisions	2,675	2,675	2,675	2,675	2,675	2,675
Other	(2,969)	(3,142)	(3,142)	(3,142)	(3,342)	(3,342)
Total core funds	**19,967**	**15,078**	**13,895**	**13,681**	**13,471**	**13,413**
Working capital*	(703)	(703)	(703)	(703)	(703)	(703)
Under/over borrowing	50,582	31,404	28,512	28,008	27,364	26,452
Expected investments	**69,846**	**45,779**	**41,704**	**40,986**	**40,132**	**39,162**

* Working capital balances shown are estimated year end; these may be higher mid-year

2.5 Affordability prudential indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

2.6 Ratio of financing costs to net revenue stream

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

%	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Ratio	4.54	4.70	4.81	4.68	4.47	4.32

The estimates of financing costs include current commitments and the proposals in this budget report.

2.7 Incremental impact of capital investment decisions on council tax

This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in this budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

Incremental impact of capital investment decisions on the band D council tax

£	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Council tax - band D	12.51	30.39	12.36	12.13	11.85	11.73

3 BORROWING

The capital expenditure plans set out in Section 2 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

3.1 Current portfolio position

The Council's treasury portfolio position at 31 March 2015, with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

£m	**2014/15 Actual £'000**	**2015/16 Estimate £'000**	**2016/17 Estimate £'000**	**2017/18 Estimate £'000**	**2018/19 Estimate £'000**	**2019/20 Estimate £'000**
External Debt						
Debt at 1 April	7.5	7.5	7.5	7.5	7.5	7.5
Expected change in Debt	0	0	0	0	0	0
Other long-term liabilities (OLTL)	0.9	0.6	0.3	0	0	0
Expected change in OLTL	0	0	0	0	0	0
Actual gross debt at 31 March	**8.4**	**8.1**	**7.8**	**7.5**	**7.5**	**7.5**
The Capital Financing Requirement	**(43,082)**	**(23,904)**	**(21,012)**	**(21,008)**	**(20,134)**	**(18,952)**
(Under) / over borrowing	**(43,073.6)**	**(23,895.9)**	**(21,004.2)**	**(21,000.5)**	**(20126.5)**	**(18,944.5)**

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2016/17 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The S151 Officer reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

3.2 Treasury Indicators: limits to borrowing activity

The operational boundary. This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

Operational boundary	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Debt	9	9	9	9
Other long term liabilities	1	1	1	1
Total	10	10	10	10

The authorised limit for external debt. A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

1. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

2. The Council is asked to approve the following authorised limit:

Authorised limit £m	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Debt	12	12	12	12
Other long term liabilities	1	1	1	1
Total	13	13	13	13

3.3 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 their central view.

Capita Asset Services Interest Rate View													
	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Capita Asset Services View	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%	2.00%	2.00%
5yr PWLB Rate	2.30%	2.40%	2.60%	2.70%	2.80%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%
10yr PWLB View	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%
25yr PWLB View	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.30%	4.30%	4.40%	4.40%	4.40%	4.50%
50yr PWLB Rate	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.00%	4.10%	4.20%	4.20%	4.30%	4.30%	4.30%	4.40%

UK: UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, probably being second to the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y) before weakening again to +0.5% (2.3% y/y) in quarter 3. The November Bank of England

Inflation Report included a forecast for growth to remain around 2.5 – 2.7% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero since February 2015 this year. Investment expenditure is also expected to support growth. However, since the August Inflation report was issued, worldwide economic statistics have distinctly weakened and the November Inflation Report flagged up particular concerns for the potential impact on the UK.

The Inflation Report was notably subdued in respect of the forecasts for inflation; this was expected to barely get back up to the 2% target within the 2-3 year time horizon. However, once the falls in oil, gas and food prices over recent months fall out of the 12 month calculation of CPI, there will be a sharp tick up from the current zero rate to around 1 percent in the second half of 2016. The increase in the forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon was the biggest since February 2013. There is considerable uncertainty around how quickly inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate.

USA: The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015, but then weakened again to 2.1% in quarter 3. The downbeat news in late August and in September about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision at its September meeting to pull back from a first rate increase. However, the nonfarm payrolls figure for growth in employment in October was very strong and, together with a likely perception by the Fed. that concerns on the international scene have subsided, has now firmly opened up the possibility of a first rate rise in December.

EZ: In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and +0.3% in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

Greece: During July, Greece finally capitulated to EU demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.

- Investment returns are likely to remain relatively low during 2016/17 and beyond;
- Borrowing interest rates have been highly volatile during 2015 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. Gilt yields have continued to remain at historically phenominally low levels during 2015. The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt;
- There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

3.4 Borrowing strategy

The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), 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 relatively high.

Against this background and the risks within the economic forecast, caution will be adopted with the 2016/17 treasury operations. The S151 Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- *if it was felt that there was a significant risk of a sharp FALL in long and short term rates* (e.g. due to a marked increase of risks around 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.
- *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 an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an 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 lower than they will be in the next few years.

Any decisions will be reported to Executive/Council at the next available opportunity.

Treasury management limits on activity

There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs / improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments;
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

The Council is asked to approve the following treasury indicators and limits:

£m	2016/17	2017/18	2018/19
Interest rate exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	50%	50%	50%
Maturity structure of fixed interest rate borrowing 2016/17			
Under 12 months			0%
12 months to 2 years			0%
2 years to 5 years			80%
5 years to 10 years			0%
10 years to 20 years			0%
20 years to 30 years			0%
30 years to 40 years			20%
40 years to 50 years			0%
Maturity structure of variable interest rate borrowing 2016/17			
Under 12 months			0%
12 months to 2 years			0%
2 years to 5 years			0%
5 years to 10 years			0%
10 years to 20 years			0%
20 years to 30 years			0%
30 years to 40 years			0%
40 years to 50 years			0%

3.5 Policy on borrowing in advance of need

The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

3.6 Debt rescheduling

As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

All rescheduling will be reported to the Council, at the earliest meeting following its action.

3.7 Municipal Bond Agency

It is likely that the Municipal Bond Agency, currently in the process of being set up, will be offering loans to local authorities in the near future. It is also hoped that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). This Authority intends to make use of this new source of borrowing as and when appropriate.

4 ANNUAL INVESTMENT STRATEGY

Introduction: changes to credit rating methodology

The main rating agencies (Fitch, Moody's and Standard & Poor's) 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.

4.1 Investment policy

The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then return.

In accordance with the above 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.

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.

Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

Investment instruments identified for use in the financial year are listed in **Appendix 5.1** under the 'specified' and 'non-specified' investments categories. Counterparty limits will be as set through the Council's treasury management practices – schedules.

4.2 Creditworthiness policy

This Council applies the creditworthiness service provided by Capita Asset Services. 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 credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- 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 *
- **Dark pink:** 5 years for Enhanced money market funds (EMMFs) with a credit score of 1.25
- **Light pink:** 5 years for Enhanced money market funds (EMMFs) with a credit score of 1.5

- **Purple:** 2 years
- **Blue:** 1 year (only applies to nationalised or semi nationalised UK Banks)
- **Orange:** 1 year
- **Red:** 6 months
- **Green:** 100 days
- **No colour:** not to be used

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour

4.2 Creditworthiness policy

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 that:

- 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; and
- 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.

The Director of Finance will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

Credit rating information is supplied by Capita Asset Services, our treasury consultants, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating Watches (notification of a likely change), rating Outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance, a negative rating Watch applying to a counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions.

The criteria for providing a pool of high quality investment counterparties (both specified and non-specified investments) is:

- Banks 1 - good credit quality – the Council will only use banks which:
  i. are UK banks; or
  ii. are non-UK and domiciled in a country which has a minimum sovereign Long Term rating of AAA

and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):

i. Short Term – F1

ii. Long Term – A-

- Banks 2 – Part nationalised UK bank – Royal Bank of Scotland. This bank can be included provided it continues to be part nationalised or it meets the ratings in Banks 1 above.
- Banks 3 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- Bank subsidiary and treasury operation - The Council will use these where the parent bank has provided an appropriate guarantee or has the necessary ratings outlined above.
- Building societies - The Council will *use* all societies which meet the ratings for banks outlined above;
- Money market funds (MMFs) – AAA
- Enhanced money market funds (EMMFs) - AAA
- UK Government (including gilts, Treasury Bills and the DMADF)
- Bonds issued by a financial institution which is guaranteed by the UK government.
- Sovereign bond issues (i.e. other than the UK Government)
- Local authorities, parish councils etc.
- Supranational institutions
- Local Authority Mortgage Scheme (LAMS), Local Authority Partnership Purchase Scheme (LAPP) and Custom Build and Self Build Scheme (CSB). These are classified as being policy investments, rather than a treasury management investment, and are therefore outside of the specified / non specified categories.
- Corporate Bonds
- Floating Rate Notes
- Property Funds

A limit of 60% will be applied to the use of non-specified investments.

Use of additional information other than credit ratings. Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating Watches/Outlooks) will be applied to compare the relative security of differing investment counterparties.

Time and monetary limits applying to investments. The time and monetary limits for institutions on the Council's counterparty list are as follows (these will cover both specified and non-specified investments):

	Fitch Long term Rating (or equivalent)	Money and/or % Limit	Time Limit
Banks 1 higher quality	***AAA***	**£10m / 80%**	**5yrs**
Banks 1 medium quality	***AA-***	**£10m / 75%**	**1yr**
Banks 1 lower quality	***A-***	**£10m / 70%**	**100 Days**
Banks 2 – part nationalised	**N/A**	**£20m / 75%**	**1yr**
Limit 3 category – Council's banker (not meeting Banks 1)	**N/A**	**N/A**	**1 day**
Other institutions limit	**-**	**£10m / 70%**	**1yr**
DMADF	**AAA**	**unlimited**	**6 months**
Local authorities	**N/A**	**unlimited / 60%**	**5yrs**
	Fund rating	**Money and/or % Limit**	**Time Limit**
Money market funds	**AAA**	**unlimited**	**liquid**
Enhanced money market funds	**AAA**	**unlimited**	**liquid**
Property Funds	**Based on external credit assessment by the Council's Treasury Management Advisors. UK asset investment.**	**£20 million at fund entry. Maximum of two Funds at any one time for viability.**	**Long Term investment**

The proposed criteria for specified and non-specified investments are shown in **Appendix 5.1** for approval.

4.3 Country and sector limits

Due care will be taken to consider the country, group and sector exposure of the Council's investments.

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA+ from Fitch (or equivalent). The list of countries that qualify using this credit criteria as at the date of this report are shown in **Appendix 5.2**. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

In addition:

- no more than 20% will be placed with any non-UK country at any time;
- limits in place above will apply to a group of companies;
- sector limits will be monitored regularly for appropriateness.

4.4 Investment strategy

In-house funds. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

Investment returns expectations. Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2016. Bank Rate forecasts for financial year ends (March) are:

- 2016/17: 1.00%
- 2017/18: 1.75%
- 2018/19: 2.00%

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next eight years are as follows:

- 2016/17: 0.90%
- 2017/18: 1.50%
- 2018/19: 2.00%
- 2019/20: 2.25%
- 2020/21: 2.50%
- 2021/22: 3.00%
- 2022/23: 3.00%
- Later years: 3.00%

The overall balance of risks to these forecasts is currently to the downside (i.e. start of increases in Bank Rate occurs later). However, should the pace of growth quicken and / or forecasts for increases in inflation rise, there could be an upside risk.

Investment treasury indicator and limit - total principal funds invested for greater than 364 days. 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.

The Council is asked to approve the treasury indicator and limit: -

Maximum principal sums invested > 364 days			
£m	**2016/17**	**2017/18**	**2018/19**
Principal sums invested > 364 days	£30m	£30m	£30m

For its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to100 days) in order to benefit from the compounding of interest.

4.5 Investment risk benchmarking

This Council will use an investment benchmark to assess the investment performance of its investment portfolio of 7 day, 1, 3, 6 or 12 month LIBID uncompounded.

4.7 End of year investment report

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

5 APPENDICES

5.1 APPENDIX: Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

SPECIFIED INVESTMENTS: All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' quality criteria where applicable.

NON-SPECIFIED INVESTMENTS: These are any investments which do not meet the specified investment criteria. A maximum of 75% will be held in aggregate in non-specified investment

A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories.

The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

	Minimum credit criteria / colour band	** Max % of total investments/ £ limit per institution	Max. maturity period
Debt Management Account Deposit facility – UK Government	N/A	100%	6 months
UK Government gilts	UK sovereign rating	80%	12 months
UK Government Treasury bills	UK sovereign rating	80%	12 months
Fixed Bonds – Corporate, Financial, Supranational or Covered.	AAA	40%	12 months
Money market funds	AAA	100%	Liquid
Enhanced money market funds with a credit score of 1.25	AAA	100%	Liquid
Enhanced money market funds with a credit score of 1.5	AAA	100%	Liquid
Local authorities	N/A	100%	12 months
Term deposits with banks and building societies	Blue Orange Red Green No Colour	80%	12 months 12 months 6 months 100 days Not for use

CDs or corporate bonds with banks and building societies	Blue Orange Red Green No Colour	50%	12 months 12 months 6 months 100 days Not for use
Gilt funds	UK sovereign rating	100%	

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

NON-SPECIFIED INVESTMENTS: A maximum of 75% will be held in aggregate in non-specified investment

1. Maturities of ANY period

	Minimum Credit Criteria / Colour band	Use	Max % of total investments	Max. maturity period
Fixed term deposits with variable rate and variable maturities: -Structured deposits	Blue Orange Red Green No Colour	In-house	80%	12 months 12 months 6 months 100 days Not for use
Certificates of deposit issued by banks and building societies	Blue Orange Red Green No Colour	In-house and Fund Managers	80%	12 months 12 months 6 months 100 days Not for use
Fixed Bonds – Corporate, Financial, Supranational or Covered.	AAA	In-house and Fund Managers	10%	5 years
Floating rate notes	AAA	In house and Fund Managers	10%	5 years
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs)				
Corporate bond fund	AAA	In house and Fund Managers	10%	5 years
Property fund	Based on external credit assessment from the Council's Treasury Management Advisors. UK asset investment.	In house and Fund Managers	£20m at fund entry. Maximum of two Funds at any one time for viability.	Long Term

2. Maturities in excess of 1 year

	Minimum Credit Criteria / Colour Band	Use	Max % of total investments	Max. maturity period
Term deposits – local authorities	N/A	In-house and Fund Managers	60%	5 Years
Term deposits – banks and building societies	Blue Orange Red Green No Colour	In-house and Fund Managers	80%	12 months 12 months 6 months 100 days Not for use
Certificates of deposit issued by banks and building societies	Blue Orange Red Green No Colour	In-house and Fund Managers	80%	12 months 12 months 6 months 100 days Not for use
UK Government Gilts	UK sovereign rating	In-house and Fund Managers	80%	10 years
Fixed Bonds – Corporate, Financial, Supranational or Covered.	AAA	In-house and Fund Managers	10%	5 years
Sovereign bond issues (other than the UK govt)	AAA	Fund Managers	50%	10 years
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs)				
Property fund	Based on external credit assessment from the Council's Treasury Management Advisors. UK asset investment.	In house and Fund Managers	£20m at fund entry. Maximum of two Funds at any one time for viability.	Long Term

5.2 APPENDIX: Approved countries for investments

This list is based on those countries which have sovereign ratings of AA+ or higher and also have banks operating in sterling markets which have credit ratings of green or above in the Capita Asset Services credit worthiness service.

AAA

- Australia
- Canada
- Denmark
- Germany
- Singapore
- Sweden
- Switzerland

AA+

- Finland
- Netherlands
- U.K.
- U.S.A.

Note: This list is correct as at 11 November 2015

5.3 APPENDIX: Treasury management scheme of delegation

(i) Full board / Council

- receiving and reviewing reports on treasury management policies, practices and activities;
- approval of annual strategy.

(ii) Boards/committees/council/responsible body

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- budget consideration and approval;
- approval of the division of responsibilities;
- receiving and reviewing regular monitoring reports and acting on recommendations;
- approving the selection of external service providers and agreeing terms of appointment.

(iii) Body/person(s) with responsibility for scrutiny

- reviewing the treasury management policy and procedures and making recommendations to the responsible body.

5.4 APPENDIX: The treasury management role of the Section 151 Officer

The S151 (responsible) Officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.