APPENDIX 1

# FLINTSHIRE COUNTY COUNCIL

**REPORT TO:** **CABINET**

**DATE:** **TUESDAY, 17 FEBRUARY 2015**

**REPORT BY:** **CORPORATE FINANCE MANAGER**

**SUBJECT:** **TREASURY MANAGEMENT STRATEGY 2015/16**

## 1.00 PURPOSE OF REPORT

1.01 To present to Members the draft Treasury Management Strategy for 2015/16 for recommendation to Council.

## 2.00 BACKGROUND

2.01 The Local Government Act 2003 requires all local authorities to have due regard to both the Chartered Institute of Public Finance and Accountancy's Treasury Management in Public Services: Code of Practice (The CIPFA Code of Practice) and Welsh Government guidance on Local Authority Investments.

2.02 The Council has adopted The CIPFA Code of Practice which requires:-

- The Council to create and maintain a Treasury Management Policy Statement which states the Council's policies, objectives and approach to risk management of its treasury management activities.

- The Council to create and maintain suitable Treasury Management Practices (TMPs) and accompanying schedules, stating how those policies and objectives will be achieved and prescribing how those activities will be managed and controlled.

- The Council to receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMPs.

- Responsibility for Treasury Management to be clearly defined. The Council delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Cabinet, and for the execution and administration of treasury management decisions to the Corporate Finance Manager, who will act in accordance with the organisation's policy statement and TMPs and, CIPFA's *Standard of Professional Practice on Treasury Management*.

- A body to be responsible for the scrutiny of Treasury Management Policy, Strategy and Practices. The Council has nominated the Audit Committee to be responsible for ensuring effective scrutiny of the treasury management function. The Audit Committee has previously agreed to include treasury management as a standing item on each quarterly agenda to receive an update.

2.03 A training session open to all Members on treasury management was run by Arlingclose, the Council's Treasury Management advisors on the morning of 21st January. The aim of the workshop was to aid Members' understanding of the Treasury Management Strategy.

## 3.00 CONSIDERATIONS

3.01 The 2015/16 Treasury Management Strategy is attached in Appendix 1 for review and discussion. The Strategy is updated and reported annually to Members in accordance with the CIPFA Code of Practice and the Welsh Government guidance.

3.02 The Treasury Management Strategy details the approach that the Council will take for investing and borrowing over the next year, including the budgetary implications of the planned investment and borrowing strategy and a number of treasury management indicators that the CIPFA Code requires.

3.03 The contents and layout of the 2015/16 Strategy have not materially changed from that of the 2014/15 Strategy.

Changes made and matters needing to be brought to Members attention are summarised below along with the supporting rationale:-

3.04
- Section 4 – Local context.

  This section summarises the anticipated treasury position in 2015/16. A new graph called the liability benchmark has been included (Table 4) which shows the net requirement for borrowing after considering resources available from reserves and working capital over the next 50 years. Treasury Management activity in 2015/16 will change and will focus more on borrowing and less on investments than in recent years.

3.05
- Section 5 – Housing Revenue Account; Subsidy Reform and introduction of self financing.

  Preparations continue to be made for the abolition of the Housing Revenue Account Subsidy (HRAS) system in Wales and the introduction of 'Self Financing' for the Housing Revenue

Account on 31st March 2015. The treasury impact will be to increase the Council's debt position. Section 5 of the report provides further information.

3.06 • Section 6 – Investment Strategy.

Changes have been made to the format of the Investment criteria and limits detailed in table 5. The changes are necessary to ensure that the Council's exposure to credit risk is minimised. This is as a consequence of the recently introduced legislation (commonly referred to as 'bail-in') to reform procedures should financial institutions fail in the future. The reforms end potential support available from the government and require investors / creditors classed as unsecured bondholders (such as Councils) to be bailed-in to secure the future financial stability in the event of a default.

3.07 • Section 7 – Borrowing Strategy.

Changes have been made to the planned borrowing strategy in 2015/16 from that of 2014/15 which can be seen in Section 7 – Borrowing Strategy. In 2014/15 the strategy was to create short term revenue savings by not undertaking any new borrowing. In 2015/16 the Council will need to borrow to fund the capital programme.

3.08 At a meeting of the Audit Committee on 28th January 2015 Members reviewed the draft Treasury Management Strategy for 2015/16.

3.09 Investments and borrowing requirements were discussed at length during the meeting, with no amendments made to the draft report.

3.10 On 1st March 2013 the Council approved the current Treasury Management Policy and Treasury Management Practices with both documents covering 3 financial years, 2013 to 2016. It was agreed that these documents would not require annual approval by Members, unless any significant changes was required. No changes need to be made to the Policy, and only minor changes need to be made to the Practices simply to bring them in line with changes approved to the Strategy.

## 4.00 RECOMMENDATION

4.01 That the Cabinet approves and recommends to the Council the Treasury Management Strategy 2015/16.

## 5.00 FINANCIAL IMPLICATIONS

5.01 As set out in the report.

**6.00 ANTI POVERTY IMPACT**

6.01 None directly as a result of this report.

**7.00 ENVIRONMENTAL IMPACT**

7.01 None directly as a result of this report.

**8.00 EQUALITIES IMPACT**

8.01 None directly as a result of this report.

**9.00 PERSONNEL IMPLICATIONS**

9.01 None directly as a result of this report.

**10.00 CONSULTATION REQUIRED**

10.01 Arlingclose Ltd as Treasury Management Advisers.

**11.00 CONSULTATION UNDERTAKEN**

11.01 Arlingclose Ltd as Treasury Management Advisers.

**12.00 APPENDICES**

12.01 Appendix 1 – Draft Treasury Management Strategy 2015/16

**LOCAL GOVERNMENT (ACCESS TO INFORMATION ACT) 1985 BACKGROUND DOCUMENTS**

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**APPENDIX 1**

# FLINTSHIRE COUNTY COUNCIL

# TREASURY MANAGEMENT STRATEGY

# 2015/16

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**Treasury Management Strategy Report 2015/16**

**The Council is recommended to:**

- **approve the Treasury Management Strategy for 2015/16**
- **approve the Treasury Management Indicators for 2015/16**

## 1.0 Introduction

In April 2012 the Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year.

In addition, the Welsh Government (WG) issued revised guidance on local authority investments in March 2010 that requires the Council to approve an investment strategy before the start of each financial year.

This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the WG Guidance.

The successful identification, monitoring and control of risk are central to the Council's treasury management strategy as the Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates.

## 2.0 Economic Context (including Interest Rate Forecast – as provided by Arlingclose Ltd, November 2014).

**Economic background:** There is momentum in the UK economy, with a continued period of growth through domestically-driven activity and strong household consumption. There are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP. However, inflationary pressure is benign and is likely to remain low in the short-term. There have been large falls in unemployment but levels of part-time working, self-employment and underemployment are significant and nominal earnings growth remains weak and below inflation.

The MPC's focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee. Despite two MPC members having voted for a 0.25% increase in rates at each of the meetings August 2014 onwards, some Committee members have become more concerned that the economic outlook is less optimistic than at the time of the August Inflation Report.

**Credit outlook:** The transposition of two European Union directives into UK legislation in the coming months will place the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors. The *Bank Recovery and Resolution Directive* promotes the interests of individual and small businesses covered by the Financial Services Compensation Scheme and similar European schemes, while the recast *Deposit Guarantee Schemes Directive* includes large companies into these schemes. The combined effect of these two changes is to leave public authorities and financial organisations (including pension funds) as the only senior creditors likely to incur losses in a failing bank after July 2015.

The continued global economic recovery has led to a general improvement in credit conditions since last year. This is evidenced by a fall in the credit default swap spreads of banks and companies around the world. However, due to the above legislative changes, the credit risk associated with making unsecured bank deposits will increase relative to the risk of other investment options available to the Authority.

**Interest rate forecast:** The Authority's treasury management advisor Arlingclose forecasts the first rise in official interest rates in August 2015 and a gradual pace of increases thereafter, with the average for 2015/16 being around 0.75%. Arlingclose believes the normalised level of the Bank Rate post-crisis to range between 2.5% and 3.5%. The risk to the upside (i.e. interest rates being higher) is weighted more towards the end of the forecast horizon. On the downside, Eurozone weakness and the threat of deflation have increased the risks to the durability of UK growth. If the negative indicators from the Eurozone become more entrenched, the Bank of England will likely defer rate rises to later in the year. Arlingclose projects gilt yields on an upward path in the medium term, taking the forecast average 20 year PWLB loan rate for 2015/16 to 2.8%.

Table 1: Interest rate forecast

| | Bank Rate | 3 month LIBID | 12 month LIBID | 20 year PWLB rate | 50 year PWLB rate |
|---|---|---|---|---|---|
| Q1 2015 | 0.50 | 0.60 | 1.00 | 2.55 | 2.65 |
| Q2 2015 | 0.50 | 0.75 | 1.05 | 2.65 | 2.70 |
| Q3 2015 | 0.75 | 0.90 | 1.20 | 2.75 | 2.80 |
| Q4 2015 | 0.75 | 1.05 | 1.35 | 2.85 | 2.90 |
| Q1 2016 | 1.00 | 1.20 | 1.50 | 2.95 | 3.00 |
| Q2 2016 | 1.00 | 1.35 | 1.65 | 3.00 | 3.05 |
| Q3 2016 | 1.25 | 1.50 | 1.80 | 3.05 | 3.10 |
| Q4 2016 | 1.25 | 1.60 | 1.95 | 3.10 | 3.15 |
| Q1 2017 | 1.50 | 1.70 | 2.10 | 3.15 | 3.20 |
| Q2 2017 | 1.50 | 1.80 | 2.20 | 3.20 | 3.25 |
| Q3 2017 | 1.75 | 1.90 | 2.30 | 3.25 | 3.30 |
| Q4 2017 | 1.75 | 2.00 | 2.40 | 3.30 | 3.55 |

For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.65%, and that new long-term loans will be borrowed at a weighted average rate of 3.15%.

## 3.0 Current Treasury Portfolio

The Council's treasury portfolio as at 31st December 2014 was as follows:

Table 2: Current Treasury Portfolio

| | Principal £m | Interest rate % |
|---|---|---|
| **Investments:** | | |
| Call accounts | 5.0 | 0.35 |
| Money market funds | 15.6 | 0.44 |
| Short-term deposits | 31.8 | 0.62 |
| Long-term deposits | - | - |
| **Total Investments** | **52.40** | **0.55** |
| | | |
| **Borrowing:** | | |
| Short-term loans | - | - |
| Long-term PWLB loans (fixed) | 143.16 | 5.86 |
| Long-term PWLB loans (variable) | 10.00 | 0.55 |
| Long-term market loans (LOBOs) | 18.95 | 4.53 |
| **Total Borrowing** | **172.11** | **5.42** |
| | | |
| **Net Borrowing** | **119.71** | |

## 4.0 Local Context

Forecast changes in the sums in section 3 are shown in the balance sheet analysis in the table below.

Table 3: Balance Sheet Summary and Forecast

| | 31.3.14 Actual £m | 31.3.15 Estimate £m | 31.3.16 Estimate £m | 31.3.17 Estimate £m | 31.3.18 Estimate £m |
|---|---|---|---|---|---|
| Council Fund Capital Financing Requirement (Borrowing only) | 154 | 164 | 186 | 190 | 188 |
| Housing Revenue Account Capital Financing Requirement (Borrowing only) | 25 | 24 | 122 | 130 | 140 |
| **Capital Financing Requirement (Borrowing only)** | **179** | **188** | **308** | **320** | **328** |
| Less: Current borrowing | -172 | -172 | -172 | -172 | -172 |
| **Funding Required** | **7** | **16** | 136 | 148 | 156 |
| Less: Usable reserves | -60 | -43 | -25 | -21 | -19 |
| Less: Working capital | 4 | 4 | 5 | 5 | 5 |
| **Investments / New borrowing (called the Liability Benchmark)** | **49** | **23** | **-116** | **-132** | **-142** |

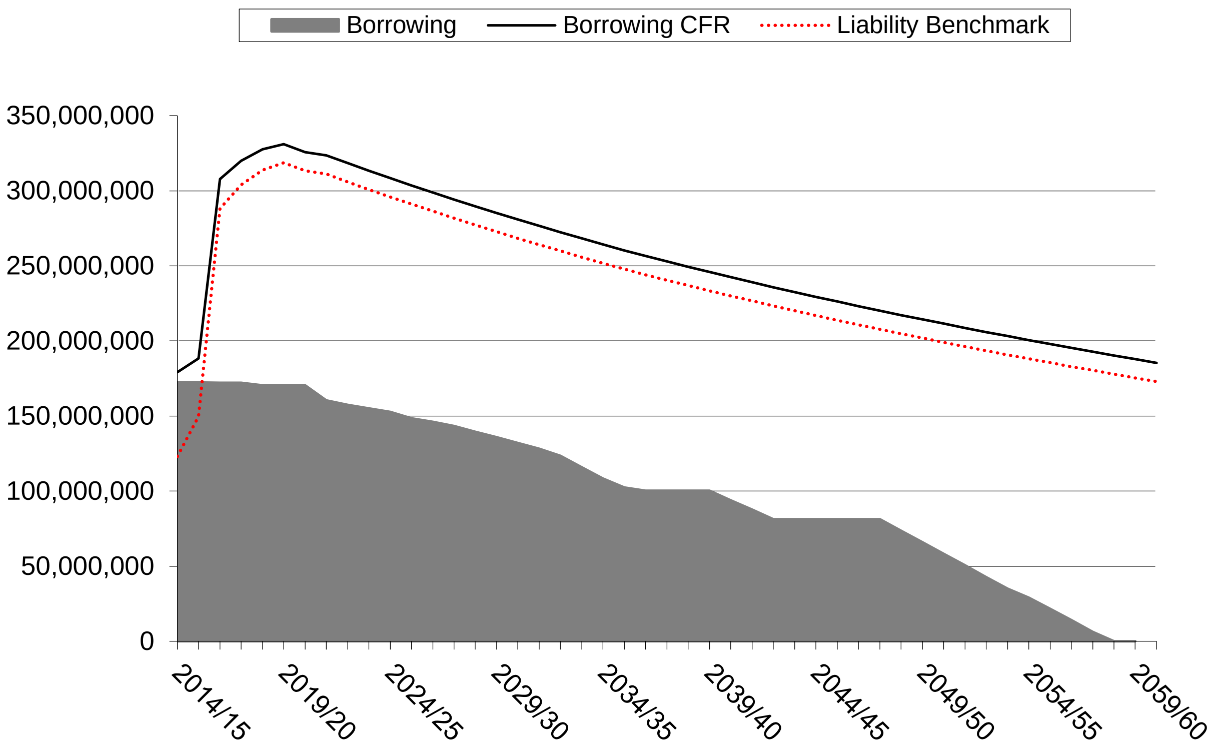
The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Authority's current strategy is to maintain borrowing below their underlying levels, sometimes known as internal borrowing.

Table 3 shows the Authority's CFR increasing steadily until 2015/16, this is linked with the capital programme which increases sharply in 2015/16 due to the 21st century schools building programme and the payment required to exit the Housing Revenue Account Subsidy system (described in more detail in section 5). The level of reserves the Authority has is expected to fall in 2014/15 following the implementation of the Single Status Agreement. The combination of the increase in capital expenditure and a reduction in reserves, results in:

- an expected reduction in investments in 2014/15 and 2015/16,
- a significant projected new borrowing requirement in 2015/16 and further new borrowing required in 2016/17 and 2017/18.

The graph in table 4 shows the Council's anticipated liability benchmark over the next 50 years, being the net requirement for borrowing after considering resources available from reserves and working capital. The steep rise in the liability benchmark in 2015/16 corresponds with the need to borrow to fund the increase in capital expenditure described above. The strategy in 2015/16 and over the medium term is to ensure that any new borrowing undertaken does not exceed the liability benchmark and cause the council to borrow more than it needs.

Table 4: Liability Benchmark - Flintshire County Council (January 2015)




The impact of the above will result in the focus of treasury management activity changing in 2015/16. In recent years attention will have been concentrated on investments, which will now switch to borrowing.

Budget implications

The budget for investment income in 2015/16 is £130k, based on an average investment portfolio of £20m at an average interest rate of 0.65%. The total budget for loan interest paid in 2015/16 is £12.6m, based on an average debt portfolio of £276.5m at a weighted average interest rate of 4.53%. If levels of investments, borrowing and interest rates differ from those forecast, performance against budget will be correspondingly different.

## 5.0 Housing Revenue Account (HRA) – Introduction of Self Financing and Subsidy Reform

Agreement has been reached between the UK Government and the Welsh Government to change the financing arrangements for council housing in Wales from April 2015. Currently a negative subsidy system is in operation which requires Flintshire to make annual payments of c£6m in negative subsidy to Welsh Government and on to UK Treasury, along with the other 11 stock retaining authorities in Wales.

The agreement is expected to generate revenue savings allowing the Council to increase its investment in existing stock, and support the delivery of additional supply of housing. It will also provide more local accountability to tenants.

Introduction of self financing will end the negative subsidy system and annual payments. The subsidy payments will be replaced with interest payments on PWLB loans that the Council must borrow to exit the subsidy system. The PWLB loans, called the settlement payment (a one-off lump sum payment), will be paid to Welsh Government (WG) and on to UK Treasury.

WG have established an officer Steering Group and a number of work streams to undertake the considerable amount of work involved to exit the subsidy system by the 31st March 2015, which Flintshire has been contributing to. Good progress has been made to date, but the work continues.

The settlement payment will be set with reference to PWLB interest rates on 31st March 2015 and therefore cannot be confirmed at this point in time. The current projection for Flintshire is £92m, based on the latest interest rate forecast. At this value the estimated annual revenue savings are £0.5m. These figures will change up until 31st March and will be monitored and revised as necessary.

The sharp increase in the HRA capital financing requirement from 2015/16 onwards in table 3 above, is due to the estimated £92m settlement payment and an estimated planned programme of £28.3m capital expenditure over 3 years to improve existing stock and to start building new council houses.

## 6.0 Investment Strategy

The Council holds surplus funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £45.2 and £80.9 million.

Both the CIPFA Code and the WG Guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Strategy

Given the increasing risk and continued low returns from short-term unsecured bank investments, the Authority aims to further diversify into more secure asset classes during 2015/16. This is especially the case for any longer-term investment made. The majority of the Authorities surplus cash is currently invested in short-term unsecured bank deposits and money market funds. This diversification will therefore represent a change in strategy over the coming year.

Investment criteria and limits

The Council may invest its surplus funds with any of the counterparties in the following table, subject to the monetary and time limits shown.

Table 5: Investment criteria and limits

*(This table should be read in conjunction with the notes that follow it)*

<table>
<tr><th>Minimum Credit Rating</th><th>Banks Unsecured</th><th>Banks Secured</th><th>Government</th><th>Corporates</th><th>Registered Providers</th></tr>
<tr><td>UK Government</td><td colspan="2"></td><td>£ Unlimited<br>50 years</td><td colspan="2"></td></tr>
<tr><td colspan="6"></td></tr>
<tr><td>AAA</td><td rowspan="2">£4m<br>5 years</td><td rowspan="2">£7m<br>5 years</td><td rowspan="2">£7m<br>25 years</td><td rowspan="2">£4m<br>5 years</td><td rowspan="4">£4m<br>10 years</td></tr>
<tr><td>AA+</td></tr>
<tr><td>AA</td><td>£4m<br>4 years</td><td>£7m<br>4 years</td><td>£7m<br>15 years</td><td>£4m<br>4 years</td></tr>
<tr><td>AA-</td><td>£4m<br>3 years</td><td>£7m<br>3 years</td><td>£7m<br>10 years</td><td>£4m<br>3 years</td></tr>
<tr><td>A+</td><td>£4m<br>2 years</td><td>£7m<br>2 years</td><td rowspan="3">£7m<br>5 years</td><td>£4m<br>2 years</td><td rowspan="3">£4m<br>5 years</td></tr>
<tr><td>A</td><td>£4m<br>1 year</td><td>£7m<br>1 year</td><td>£4m<br>1 year</td></tr>
<tr><td>A-</td><td>£4m<br>6 months</td><td>£7m<br>6 months</td><td>£4m<br>6 months</td></tr>
<tr><td colspan="6"></td></tr>
<tr><td>Pooled Funds</td><td colspan="5">£7m per fund</td></tr>
<tr><td colspan="6"></td></tr>
<tr><td>BBB-</td><td colspan="5">The Council is restricted to overnight deposits at its' own current account bank with a limit of £5m where the banks lowest credit rating is BBB+, BBB or BBB- (or equivalent)</td></tr>
<tr><td colspan="6"></td></tr>
<tr><td>Unrated Local Authorities</td><td colspan="2"></td><td>£4m<br>2 years</td><td colspan="2"></td></tr>
<tr><td colspan="6"></td></tr>
<tr><td>Unrated Other</td><td colspan="5">The Council may invest in any other unrated organisation, subject to:<br>• an external credit assessment and specific advice from the Authority's treasury management adviser (£1m each / 1 year limit)<br>• a further policy framework for investing with any other organisations being developed(£100k each / 5 year limit)</td></tr>
</table>

<u>Credit Rating</u>

Investment decisions are made by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

<u>Banks Unsecured</u>

Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. Unsecured investment with banks rated BBB+, BBB or BBB- are restricted to overnight deposits at the Authority's current account bank.

Banks Secured

Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

Government

Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

Corporates

Loans, bonds and commercial papers issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made as part of a diversified pool in order to spread the risk widely.

Registered Providers

Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations. These bodies are tightly regulated by the Welsh Government or Homes and Communities Agency and, as providers of public services, they retain a high likelihood of receiving government support if needed. The Council will consider investing with unrated Registered Providers with adequate credit safeguards, subject to receiving independent advice.

Pooled Funds

Shares in diversified investment vehicles consisting of any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Money Market Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives will be monitored regularly.

Other Organisations

The Authority may also invest cash with other organisations, for example by making loans to small businesses. Because of the higher perceived risk of unrated businesses, such investments may provide considerably higher rates of return. They will however only be made following a favourable external credit assessment and on the specific advice of the Authority's treasury management adviser.

Foreign countries

Investments in foreign countries will be limited to those that hold an AAA or AA+ / Aa1 sovereign credit rating from all three major credit rating agencies, and to a maximum of £10 million per foreign country. Investments in countries whose lowest sovereign rating is not AAA will be limited to one year's duration. No country limit will apply to investments in the UK, irrespective of the sovereign credit rating.

Risk assessment and credit ratings

The Council uses long-term credit ratings from the three main rating agencies Fitch Ratings Ltd, Moody's Investors Service Inc and Standard & Poor's Financial Services LLC to assess the risk of investment default. The lowest available credit rating will be used to determine credit quality.

Long-term ratings are expressed on a scale from AAA (the highest quality) through to D (indicating default). Ratings of BBB- and above are described as investment grade, while ratings of BB+ and below are described as speculative grade. The Council's credit rating criteria are set to ensure that it is unlikely that the Council will hold speculative grade investments, despite the possibility of repeated downgrades.

Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it is likely to fall below the above criteria, then no further investments will be made in that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks.

Other information on the security of investments

The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the above criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of "high credit quality" are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

Specified investments

The WG Guidance defines specified investments as those:

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

The Council defines 'high credit quality' organisations as those having a credit rating of A- or higher that are, domiciled in the UK, or a foreign country with a sovereign rating of AA+ or higher. For money market funds and other pooled funds "high credit quality" is defined as those having a credit rating of [A-] or higher.

Non-Specified Investments

Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any investments in foreign currencies. Non- specified investments will therefore be limited to long term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement; those that are defined as capital expenditure, such as money market funds and other pooled funds; and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in the table below.

Table 6: Non-Specified Investment Limits

| | Cash Limit |
|---|---|
| Total long-term investments | £10m |
| Total shares in pooled funds | £30m |
| Total investments without credit ratings or rated below A- (not including pooled funds) | £10m |
| Total non-specified investments | £50m |

<u>Liquidity management</u>

The Council uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a pessimistic basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast.

<u>Planned investment strategy for 2015/16</u>

The UK implemented the *'bail-in'* provisions on 1st January 2015 ending government support potentially available should a bank fail in the future. Investors / creditors classed as senior unsecured bondholders will be bailed-in to secure the future financial stability of a bank in the event of a default.

There is a risk that following the withdrawal of potential government support, the credit rating agencies will downgrade the credit ratings of some institutions on Flintshire's counterparty list to BBB+, below A- which is the minimum rating required by the Treasury Management Strategy.

To mitigate this risk, the Council will:

- Not invest in any financial institution rated below A-, with the exception of overnight deposits with the Council's current account.
- Reduce the amount of unsecured investments made.
- Seek to invest in alternative, secure financial instruments such as UK Government Treasury Bills and investments secured on a bank or building societies assets, such as covered bonds, that are exempt from bail-in in the unlikely event of insolvency.
- Continue to diversify the portfolio of investments, subject to cash flow requirements as outlined in the following paragraphs

Treasury management staff will continue to seek out investments that meet the criteria detailed within this strategy whilst having full regard for the Council's cash flow requirements, in particular the expectancy to meet outstanding single status and equal pay obligations during the 2015/16 financial year.

The cash flow forecast will be used to divide surplus funds into three categories:

- Short-term – cash required to meet known cash outflows in the next month, plus a contingency to cover unexpected cash flows over the same period.
- Medium-term – cash required to manage the annual seasonal cash flow cycle, including amounts to cover forecast shortages, planned uses of reserves, and a longer-term contingency.
- Long-term – cash not required to meet cash flows, and used primarily to generate investment income.

Short-term funds are required to meet cash flows occurring in the next month or so, and the preservation of capital and liquidity is therefore of paramount importance. Generating investment returns is of limited concern here, although it should not be ignored. Instant access money market funds and bank deposit accounts will be the main methods used to manage short-term cash.

Medium-term funds which may be required in the next one to twelve months will be managed concentrating on security, with less importance attached to liquidity but a slightly higher emphasis on yield. The majority of investments in this period will be in the form of fixed term deposits with banks and building societies. A wide spread of counterparties and maturity dates will be maintained to maximise the diversification of credit and interest rate risks.

Cash that is not required to meet any liquidity need can be invested for the longer term with a greater emphasis on achieving returns that will support spending on local authority services. Security remains important, as any losses from defaults will impact on the total return, but fluctuations in price and even occasional losses can be managed over the long term within a diversified portfolio. Liquidity is of lesser concern, although it should still be possible to sell investments, with due notice, if large spending commitments arise unexpectedly. A wider range of instruments, including structured deposits, certificates of deposit, gilts and corporate bonds will be used to diversify the portfolio.

## 7.0 Borrowing Strategy

The Council currently holds £172.11m of long-term loans, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in section 4 shows that the Council will need to undertake significant new long term borrowing during 2015/16.

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

The Council's capital expenditure plans will be monitored throughout 2015/16 to inform and confirm the Council's long term borrowing need (figures in section 4 are an estimate). This is to ensure that the Council does not commit to long term borrowing too early and borrow unnecessarily which will be costly. The use of short-term borrowing will assist with such. This will be balanced against securing low long term interest rates currently being forecast.

Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term instead. By doing so, the Council is able to reduce net borrowing costs (despite forgone investment income) and reduce overall treasury risk. Credit risk as a result of the bail-in legislation has increased as referred to in section 6 the planned borrowing strategy helps to mitigate the increased risk.

Whilst such a strategy is most likely to be beneficial over the next 2-3 years as official interest rates remain low, it is unlikely to be sustained in the medium-term. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing costs are forecast to rise. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis.

In addition, the Council may borrow for short periods of time (normally for up to one month) to cover unexpected cash flow shortages.

<u>Sources of borrowing</u>

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

- Public Works Loan Board (PWLB)
- UK local authorities
- any institution approved for investments above
- any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds (except the Clwyd Pension Fund)
- capital market bond investors
- Local Capital Finance Company and other special purpose companies created to enable joint local authority bond issues.

In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

<u>LGA Bond Agency (Municipal Bond Agency)</u>

The LGA Bond Agency is a Local Capital Finance Company established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities.

This will be a more complicated source of finance than the PWLB for three reasons: borrowing authorities may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans; there will be a lead time of several months between committing to borrow and knowing the interest rate payable; and up to 5% of the loan proceeds will be withheld from the Authority and used to bolster the Agency's capital strength instead. Any decision to borrow from the Agency will therefore be the subject of a separate report to Cabinet.

LOBOs

The Authority holds £18.95m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. All of these LOBOS have options during 2015/16, and although the Authority understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Authority will take the option to repay LOBO loans at no cost if it has the opportunity to do so.

Short-term and Variable Rate loans

These loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators in section 9.

Debt Rescheduling

The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Authority may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

Planned borrowing strategy for 2015/16

The Corporate Finance Manager will:

- Manage the Council's debt maturity profile, i.e. to leave no one future year with a high level of repayments that could cause problems in re-borrowing with the limits stated in this Strategy Statement. Appendix A analyses the debt portfolio of the Council, as at 31st December, 2014.

- Effect any borrowing that maybe required in 2015/16 at the cheapest cost commensurate with future risk based on interest rate forecasts.

- Monitor and review the level of variable interest rate loans in order to take greater advantage of interest rate movements, within the limits stated in this Strategy.

- Continue to monitor options for debt-restructuring and debt re-payment.

The Corporate Finance Manager will monitor the interest rate market and adopt a pragmatic approach to any changing circumstances, reporting any decisions and actions taken under delegated powers to Cabinet via the Audit Committee.

The Council has previously raised the majority of its long-term borrowing from the Public Works Loan Board, but it continues to investigate other sources of finance, such as bond issues and bank loans, that may be available at more favourable rates.

Loans that present additional risk to the authority, such as lender's option borrower's option (LOBO) loans and variable rate loans will be restricted to the limit on the net exposure to variable interest rates in the treasury management indicators in section 9.

## 8.0 Policy on Use of Financial Derivatives

In the absence of any legislative power, the Council's policy is not to enter into standalone financial derivatives transactions such as swaps, forwards, futures and options. Derivatives embedded into loans and investments may be used, and the risks that they present will be managed in line with the overall treasury risk management strategy.

## 9.0 Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators. The Council is asked to approve the following indicators:

Interest rate exposures

This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as an amount of net principal borrowed will be:

| | 2015/16 | 2016/17 | 2017/18 |
|---|---|---|---|
| Upper limit on fixed interest rate exposures | £330m | £350m | £360m |
| Upper limit on variable interest rate exposures | £60m | £70m | £80m |

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity structure of borrowing

This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

| | Lower | Upper |
|---|---|---|
| Under 12 months | 0% | 10% |
| 12 months and within 24 months | 0% | 10% |
| 24 months and within five years | 0% | 30% |
| Five years and within 10 years | 0% | 50% |
| 10 years and above | 0% | 100% |

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal sums invested for periods longer than 364 days

The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

| | 2015/16 | 2016/17 | 2017/18 |
|---|---|---|---|
| Limit on total principal invested beyond year end | £10m | £10m | £10m |

Any long term investments carried forward from previous years will be included in each years limit.

Borrowing limits

The Council is being asked to approve these Prudential Indicators as part of the Capital Programme report. However they are repeated here for completeness.

| | 2015/16 | 2016/17 | 2017/18 |
|---|---|---|---|
| Operational boundary – borrowing | £304.1m | £321.1m | £333.1m |
| Operational boundary – other long-term liabilities | £10.1m | £10.1m | £10.1m |
| Operational boundary – TOTAL | £314.2m | £331.2m | £343.2m |
| Authorised limit – borrowing | £324.1m | £341.1m | £353.1m |
| Authorised limit – other long-term liabilities | £20.1m | £20.1m | £20.1m |
| Authorised limit – TOTAL | £344.2m | £361.2m | £373.2m |

## 10.0 Other Matters

The WG Investment Guidance requires the Council to note the following three matters each year as part of the investment strategy:

Treasury Management Advisers

The Council's treasury management adviser, Arlingclose continues to provide advice and information on the Council's investment and borrowing activities, although responsibility for final decision making remains with the Council and its officers. The services received include:

- advice and guidance on relevant policies, strategies and reports,
- advice on investment decisions,
- notification of credit ratings and changes,
- other information on credit quality,
- advice on debt management decisions,
- accounting advice,
- reports on treasury performance,
- forecasts of interest rates, and
- training courses.

The quality of this service is controlled by Financial Procedure Rules

Investment training

The needs of the Council's treasury management staff for training in investment management are assessed as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA and other appropriate organisations.

Investment of Money Borrowed in Advance of Need

The Authority may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Authority is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Authority's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £344.2 million. The maximum period between borrowing and expenditure is expected to be two years, although the Authority is not required to link particular loans with particular items of expenditure.

## Other Options Considered

The WG Investment Guidance and the CIPFA Code of Practice do not prescribe any particular treasury management strategy for local authorities to adopt. The Corporate Finance Manager, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed in the following table.

| Alternative | Impact on income and expenditure | Impact on risk management |
|---|---|---|
| Invest in a narrower range of counterparties and/or for shorter periods. | Interest income will be lower | Reduced risk of losses from credit related defaults |
| Invest in a wider range of counterparties and/or for longer periods. | Interest income will be higher | Increased risk of losses from credit related defaults |
| Borrow additional sums at long-term fixed interest rates | Debt interest costs will rise; this is unlikely to be offset by higher investment income | Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs will be more certain |
| Borrow short-term or variable loans instead of long-term fixed rates | Debt interest costs will initially be lower | Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long term costs will be less certain |
| Reduce level of borrowing if debt rescheduling costs weren't prohibitive | Saving on debt interest is likely to exceed lost investment income | Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs will be less certain |

## APPENDIX A – DEBT MATURITY PROFILE