Annual Investment and Treasury Strategy 2015/16

1. Introduction

1.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice for Treasury Management in the Public Services (the Code) requires local authorities to produce a treasury management strategy for the year ahead. The PCC is required to comply with the Code through regulations issued under the Local Government Act 2003 and has adopted specific clauses and policy statements from the Code as part of its Financial Regulations.

1.2 Complementary to the CIPFA Code is the Department for Communities and Local Government's (DCLG's) Investment Guidance, which requires local authorities and PCCs to produce an Annual Investment Strategy. This report combines the reporting requirements of both the CIPFA Code and DCLG's Investment Guidance.

1.3 The primary objectives of the PCC's Investment Strategy are to safeguard the timely repayment of principal and interest, whilst ensuring adequate liquidity for cash flow and the generation of investment yield. A flexible approach to borrowing for capital purposes will be maintained which avoids the 'cost of carrying debt' in the short term. This strategy is prudent while investment returns are low and counterparty risk (the other party involved in a financial transaction, typically a bank or building society) remains relatively high.

2. The Treasury Management Function

2.1 The CIPFA Code defines treasury management activities as "the management of the PCC's cash flows, its banking, money market and capital market transactions; the effective management of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2.2 The PCC is required to operate a balanced budget, which broadly means that cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensures this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties, providing adequate liquidity before considering investment return.

2.3 A further function of the treasury management service is to provide for the borrowing requirement of the PCC, essentially the longer term cash flow planning, typically 30 years plus, to ensure the PCC can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using internal cash balances on a temporary basis. Debt previously borrowed may be restructured to meet PCC risk or cost objectives.

2.4 The PCC has delegated responsibility for treasury management decisions taken within the approved strategy to the PCC CFO. Day to day execution and administration of investment and borrowing decisions is undertaken by Norfolk County Council through contractual arrangements. Day to day cash flow operations are managed by the Constabulary.

2.5 External treasury management services are provided by Capita Asset Services. Capita Asset Services provides a range of services which include:

- Technical support on treasury matters and capital finance issues.
- Economic and interest rate analysis.
- Debt services which includes advice on the timing of long term borrowing.
- Debt rescheduling advice surrounding the existing portfolio.
- Generic investment advice on interest rates, timing and investment instruments.
- Credit ratings/market information service for the three main credit rating agencies (Fitch, Moody's and Standard & Poor's).

2.6 Whilst Capita Asset Services and Norfolk County Council provide support to the treasury function, under market rules and in accordance with the CIPFA Code of Practice, the final decision on treasury matters remains with the PCC.

2.7 Performance will continue to be monitored and reported to the PCC as part of the budget monitoring report.

3. Capita Asset Services Economic Forecast

3.1 Economic Overview

3.1.1 UK GDP growth surged during 2013 and the first half of 2014. Since then it appears to have subsided somewhat but still remains strong by UK standards and is expected to continue likewise into 2015 and 2016. However, there needs to be a significant rebalancing of the economy away from consumer spending to manufacturing, business investment and exporting in order for this recovery to become more firmly established. One drag on the economy is that of wage inflation, which has only recently started to exceed CPI inflation, so enabling disposable income and living standards to start improving.

The plunge in the price of oil brought CPI inflation down to a low of 1.0% in November, the lowest rate since September 2002. Inflation is expected to stay around 1.0% for the best part of a year. This will help improve consumer disposable income and so underpin economic growth during 2015.

The United States, the biggest world economy, has generated stunning growth of 4.6% (annualised) in Q2 2014 and 5.0% in Q3. This is hughly promising for the outlook for strong growth going forward and it very much looks as if the US is now firmly on the path of full recovery from the financial crisis of 2008. Consequently, it is now confidently expected that the US will be the first major weston economy to start on central interest rate increases by mid 2015.

The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

- Greece: the general election on 25th January 2015 is likely to bring a political party to power which is anti EU and anti austerity. However, if this eventually results in Greece leaving the Euro, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect effects of the likely strenthening of anti EU and anti austerity political parties throughout the EU is much more difficult to quantify;

- As for the Eurozone, the downturn in growth and inflation during the second half of 2014, have led to concerns that it could be heading into deflation and prolonged very weak growth. Sovereign debt difficulties have not gone away and major concerns could return in respect of individual countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;

- Investment returns are likely to remain relatively low during 2015/16 and beyond;

- Borrowing interest rates have been volatile during 2014 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. During July to October 2014, a building accumulation of negative news has led to an overall trend of falling rates. 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 monitored to avoid incurring higher borrowing costs in later times, when local 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.

3.1.2 The following table gives Capita Asset Services central view of UK Base Rate and Public Works Loan Board (PWLB) borrowing rates:

Quarter Ending	Base Rate (%)	PWLB Borrowing Rates (%)		
		5 year	25 year	50 year
Mar 2015	0.50	2.20	3.40	3.40
June 2015	0.50	2.20	3.50	3.50
Sept 2015	0.50	2.30	3.70	3.70
Dec 2015	0.75	2.50	3.80	3.80
Mar 2016	0.75	2.60	4.00	4.00
June 2016	1.00	2.80	4.20	4.20
Sept 2016	1.00	2.90	4.30	4.30
Dec 2016	1.25	3.00	4.40	4.40
Mar 2017	1.25	3.20	4.50	4.50
June 2017	1.50	3.30	4.60	4.60
Sep 2017	1.75	3.40	4.70	4.70
Dec 2017	1.75	3.50	4.70	4.70
Mar 2018	2.00	3.60	4.80	4.80
Increase over the 3 year period	+1.50	+1.40	+1.40	+1.40

4. Investment Strategy 2015/16

4.1 Forecasts of short-term interest rates, on which investment decisions are based, suggest that the 0.5% Bank Rate will remain unchanged until the fourth quarter of 2015. There is a risk that if economic growth weakens, increases in the Bank Rate will be pushed back.

4.2 The investment earnings rates which most closely matches our average deposit profile is the 3 month LIBID (London Intra Bank Bid rate for money market trades) forecast. The suggested budgeted interest rates for the following 3 financial years are as follows:

Financial Year	Budgeted Interest Earnings
2015/16	0.60%
2016/17	1.25%
2017/18	1.75%

4.3 There are 3 key considerations to the treasury management investment process. CLG's Investment Guidance ranks these in the following order of importance:

- security of principal invested,
- liquidity for cash flow, and
- investment return (yield).

Each deposit is considered in the context of these 3 factors, in that order.

4.4 CLG's Investment Guidance requires local authorities and PCCs to invest prudently and give priority to security and liquidity before yield, as described above. In order to facilitate this objective, the Guidance requires the PCC to have regard to CIPFA's Code of Practice for Treasury Management in the Public Sector.

4.5 The key requirements of both the Code and the Investment Guidance are to produce an Annual Investment and Treasury Strategy covering the following:

- Guidelines for choosing and placing investments – Counterparty Criteria and identification of the maximum period for which funds can be committed – Counterparty Monetary & Time Limits (Section 5).

- Details of Specified and Non-Specified investment types (Section 6).

5. Investment Strategy 2015/16 - Counterparty Criteria

5.1 Norfolk County Council, on behalf of the PCC, as part of its contractual arrangement, works closely with its external treasury advisors to determine the criteria for high quality institutions.

5.2 The criteria for providing a pool of high quality investment counterparties for inclusion on the PCC's 'Approved Authorised Counterparty List' is provided below.

- **UK Banks** which have as a minimum, the following Fitch, Standard and Poor's and Moody's credit ratings:

UK Banks	Fitch	Standard & Poor's	Moody's
Short Term Ratings	F1	A-1	P-1
Long Term Ratings	A-	A-	A3

- **Non-UK Banks** domiciled in a country which has a minimum sovereign rating of AAA and as a minimum, the following Fitch, Standard and Poor's and Moody's credit ratings:

Non-UK Banks	Fitch	Standard & Poor's	Moody's
Short Term Ratings	F1+	A-1+	P-1
Long Term Ratings	AA-	AA-	Aa3

- **Part Nationalised UK Banks –** Lloyds Banking Group and Royal Bank of Scotland Group. These banks are included while they continue to be part nationalised or they meet the ratings for UK Banks above.

- **The PCC's Corporate Banker –** If the credit ratings of the PCC's corporate banker (currently Barclays Bank plc) fall below the minimum criteria for UK Banks above, then cash balances held with that bank will be for account operation purposes only and balances will be minimised in terms of monetary size and time.

- **Building Societies –** The PCC will use Building Societies which meet the ratings for UK Banks outlined above.

- **Money Market Funds (MMFs) –** which are rated AAA by all three major rating agencies. MMF's are 'pooled funds' investing in high-quality, high-liquidity, short-term securities such as treasury bills, repurchase agreements and certificate of deposit. Funds offer a high degree of counterparty diversification that include both UK and Overseas Banks.

- **UK Government –** including the Debt Management Account Deposit Facility & Sterling Treasury Bills. Sterling Treasury Bills are short-term (up to six months) 'paper' issued by the UK Government. In the same way that the Government issues Gilts to meet long term funding requirements, Treasury Bills are used by Government to meet short term revenue obligations. They have the security of being issued by the UK Government.

- **Local Authorities, Parish Councils etc. –** Includes those in England and Wales (as defined in Section 23 of the Local Government Act 2003) or a similar body in Scotland or Northern Ireland.

5.3 All cash invested by the PCC in 2015/16 will be either Sterling deposits (including certificates of deposit) or Sterling Treasury Bills invested with banks and other institutions in accordance with the Approved Authorised Counterparty List.

5.4 The Code of Practice requires local authorities and PCCs 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 use, additional market information will be used to inform investment decisions. This additional market information includes, for example, Credit Default Swap rates and equity prices in order to compare the relative security of counterparties.

5.5 The current maximum lending limit of £10M for any counterparty will be maintained in 2015/16 to reflect the level of cash balances and to avoid large deposits with the DMO.

5.6 In addition to individual institutional lending limits, “Group Limits” will be used whereby the collective investment exposure of individual banks within the same banking is restricted to a group lending limit of £10M.

5.7 The Strategy permits deposits beyond 365 days (up to a maximum of 2 years) but only with UK banks which have a long term credit rating of AA- (or equivalent). Deposits may also be placed with UK Part Nationalised Banking and Local Authorities for periods of up to 2 years.

6. Investment Strategy 2015/16 – Specified & Non-Specified Investments

6.1 As determined by CLG’s Investment Guidance, Specified Investments offer “high security and high liquidity”. They are Sterling denominated and have a maturity of less than one year. Institutions of “high” credit quality are deemed to be Specified Investments. From the pool of high quality investment counterparties identified in Section 5, the following are deemed to be Specified Investments where the period of deposit is 364 days or less:

- Banks: UK and Non-UK;
- Part Nationalised UK Banks;
- The PCC’s Corporate Banker (Barclays Bank plc)
- Building Societies (which meet the minimum ratings criteria for Banks);
- Money Market Funds;
- UK Government;
- Local Authorities, Parish Councils etc.

6.2 Non-Specified Investments are those investments that do not meet the criteria of Specified Investments. From the pool of counterparties identified in Section 5, they include:

- Any investment greater than 364 days.

6.3 The categorisation of ‘Non-Specified’ does not in any way detract from the credit quality of these institutions, but is merely a requirement of the Government’s guidance.

6.4 The PCC’s proposed Strategy for 2015/16 therefore includes both Specified and Non-Specified Investment institutions.

7. Borrowing Strategy 2015/16

7.1 Capital expenditure can be paid for immediately by applying capital receipts, capital grants or revenue contributions. Capital expenditure in excess of available capital resources or revenue contributions will add to the PCC's borrowing requirement. The PCC's need to borrow is measured by the Capital Financial Requirement, which simply represents the total outstanding capital expenditure, which has not yet been paid for from either capital or revenue resources.

7.2 For the PCC, borrowing principally relates to long term loans (i.e. loans in excess of 364 days). The borrowing strategy includes decisions on the timing of when further monies should be borrowed.

7.3 The main source of long term loans is the Public Works Loan Board (PWLB), which is part of the UK Debt Management Office (DMO). The maximum period for which loans can be advanced by the PWLB is 50 years.

7.4 In accordance with the approved 2014/15 Investment and Treasury Strategy, the PCC has postponed any new borrowing for capital purposes, using cash balances on a temporary basis to avoid the cost of 'carrying' debt in the short term. "Cost of carry" is the difference between interest paid and interest earned on borrowed monies while temporarily held as cash balances until used to fund capital expenditure. Delaying borrowing and running down the level of investment balances also reduces the PCC's exposure to investment counterparty risk. This strategy will be continued in 2015/16.

7.5 Total external borrowing currently stands at £13.161M, with an additional £19.805M financed internally from temporary cash resources. The PCC's overall new borrowing requirement in 2015/16 is estimated at £7.893M. The 2015/16 budget provision for interest payable is around £748K. This covers interest on existing loan debt and the borrowing requirement. It is not envisaged that borrowing will be required during 2015/16 for capital expenditure finance internally since 2009-10. By financing internally there will be an interest saving of around £1.0M.

7.6 The challenging and uncertain economic outlook outlined by Capita Asset Services in Section 3, together with managing the cost of "carrying debt" requires a flexible approach to borrowing. The PCC, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks identified in Capita Asset Services economic overview (Section 3).

7.7 The level of outstanding debt and composition of debt, in terms of individual loans, is kept under review. The PWLB provides a facility to allow the restructure of debt, including premature repayment of loans, and encourages local authorities and PCCs to do so when circumstances permit. This can result in net savings in overall interest charges. The PCC CFO and Capita Asset Services will monitor prevailing rates for any opportunities during the year.

7.8 The PCC has flexibility to borrow funds in the current year for use in future years. For example, the PCC CFO may do so under delegated powers where a sharp rise in interest rates is expected and so borrowing early at fixed interest rates may be economically beneficial or meet budgetary constraints. Whilst the PCC CFO will adopt a cautious approach to any such borrowing, where there is a clear business case for doing so borrowing will be undertaken to fund the approved capital programme. Risks associated with any advance borrowing will be subject to appraisal in advance and subsequent reporting through the established reporting process.

7.9 PWLB borrowing has become less attractive in recent years, due to its policy decision to increase the margin payable over interest rates (Gilts). In response, the Local Government Association is currently in the process of setting up a "Municipal Bond Agency." While it is hoped that the Agency's borrowing rates will be lower than those offered by the PWLB, this is by no means guaranteed. Initially it is unlikely that the Agency will be able to offer the same degree of operational flexibility as the PWLB regarding loan advances and repayments. The PCC will continue to use the most appropriate source of borrowing at the time of making application, including; the PWLB, commercial market loans and the Municipal Bond Agency.

8. Treasury Management Prudential Indicators

8.1 There are four treasury related Prudential Indicators. The purpose of the indicators is to restrict the activity of the treasury function to within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However, if these indicators are 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. It is recommended that the PCC set an upper limit on its variable interest rate exposures for 2015/16, 2016/17 and 2017/18 of 30% of its net outstanding principal sums. This is consistent with policy followed in previous years.

- **Upper Limits on Fixed Interest Rate Exposure** – Similar to the previous indicator, this covers a maximum limit on fixed interest rates. It is recommended that the PCC set an upper limit on its fixed interest rate exposures for 2015/16, 2016-2017 and 2017-2018 of 100% of its net outstanding principal sums.

- **Maturity Structures of Borrowing** – These gross limits are set to reduce the PCC's exposure to large fixed rate sums falling due for refinancing and require upper and lower limits. It is recommended that the PCC sets the following limits for the maturity structures of its borrowing. These limits follow existing treasury management policy and are unchanged from 2014-2015:

	Lower Limit	Upper Limit
Under 12 months	0%	15%
12 months and within 24 months	0%	15%
24 months and within 5 years	0%	45%
5 years and within 10 years	0%	75%
10 years and above	0%	100%

- **Total Principal Funds Invested for Greater than 364 Days –** This limit is set with regard to the PCC's liquidity requirements. It is estimated that in 2015/16, the maximum level of PCC funds invested for periods greater than 364 days will be no more than £10M.