Recommendations to the Council

(a) Treasury Management, Annual Investment and Minimum Revenue Provision Strategies 2016/17

1. The management of the County Council's cash flows and borrowing have a significant impact on the budget.

The Cabinet, at their meeting on 20 January 2016, approved the proposed strategies for the 2016/17 financial year.

Adoption of the Annual Investment Strategy (AIS) and the adoption of the Minimum Revenue Provision policy are however matters that are reserved for the Full Council to determine.

2. **Recommend** – That, in accordance with the regulations:

(a) The Annual Investment Strategy (AIS) 2016/17 as described in paragraphs 24 to 67 and as detailed in Appendices 2 and 4 of the report considered by the Cabinet (attached) be adopted.

(b) That the Minimum Revenue Provision (MRP) policy 2016/17 as summarised in paragraphs 101 to 103 and as set out in full at Appendix 8 to the report considered by the Cabinet (attached), be adopted.

(b) Members' Allowances Scheme - Independent Remuneration Panel Report

3. The County Council is required to establish and maintain an Independent Remuneration Panel to provide advice and recommendations to the Council on its Members' Allowances Scheme. Any decisions on the nature and level of allowances are a matter for the full Council, but the Council must have regard to any recommendations submitted by the Independent Remuneration Panel before establishing or amending the Members' Allowances Scheme. The Panel meets each year to consider the recommendations to be made to the Council in respect of the level and nature of the forthcoming year's allowances.

The Independent Remuneration Panel's report of March 2016, including recommendations on the Members' Allowances Scheme for 2016/17 has been emailed to all members of the County Council and copies have been placed in the Resource Room in County Buildings; alternatively a copy is available at this link

The Council's views on the recommendations of the Independent Remuneration Panel are requested.

Members will also be aware that the Council's Medium Term Financial Strategy proposals for 2016/17, which were approved by the County Council at its meeting on 11 February 2016, included the discontinuation of the provision for Members to be reimbursed the cost of their telephone/broadband line rental. In view of this, it is necessary to amend the Council's Constitution by removing paragraph 12 of Appendix 3 to section 3 [Members' Allowance Scheme - Reimbursement of Telephone and Broadband line rental].

4**. Recommend** – (a) The Council’s views on the recommendations of the Independent Remuneration Panel are requested.

(b) The period of office for Ray Betteridge, Jane Landick and Michelle Martin, members of the Independent Remuneration Panel be extended for a further period of 12 months to 31 March 2017.

(c) That the Council’s Constitution be amended by the deletion of paragraph 12 of Appendix 3 to section 3 [Members’ Allowance Scheme - Reimbursement of Telephone and Broadband line rental].

APPENDIX

Annual Investment Strategy (AIS) 2016/17

24. The County Council manages a significant investment portfolio that can reach over £200m each year. Since the financial crisis in 2008, the County Council has taken a low risk approach and the AIS continues in this vein.

Investment options

25. The main characteristics which determine an investment strategy are related to;
- the credit risk of the counterparties that you invest with
- the length of the investment
- the type of financial instrument that is used.

26. These issues have to be considered in the light of the regulatory framework provided by the Government.

27. Key parts of this framework are the Government Guidance on Local Government Investments, issued in March 2010 and the CIPFA Code of Practice for Treasury Management in the Public Services. These state that the two prime risk issues are;
- the security of capital
- the liquidity of investments.

28. In addition, government regulations specify the type of financial instruments you can invest in and divide them into what they term ‘specified’ investments and ‘non-specified’ investments.

Specified investments

29. Specified investments are investments made in sterling for a period of less than a year that are not counted as capital expenditure and are invested with;
- the UK Government
- a local authority
- a parish or community council
- a body, or in an investment instrument, **that has ‘high credit quality’.**

30. The first three named investments will be used by the County Council by virtue of their inclusion within the guidance (referred to as regulation investments subsequently in this report). The assessment of the fourth aspect is dealt with in the paragraphs that follow.

31. Whilst it is difficult to define ‘high credit quality’, credit ratings are published by credit rating agencies (for example, Fitch, Standard and Poors, Moodys); this information is provided by the County Council’s treasury adviser, Arlingclose, where available.

Money Market Funds (MMF's)

32. Money Market Funds are pooled investment vehicles consisting of money market deposits and similar instruments. Arlingclose recommend the use of MMF's by their local authority clients, and these have been used for some time by the County Council.

33. In the background there is the possibility of European Commission (EC) regulations that may affect how MMF's operate and in the light of these, it is MMF's that meet the criteria listed below which will be considered to have high credit quality and will be included on the lending list:

- Recommended to clients by the County Council's treasury adviser, Arlingclose.
- Diversified – MMF's are diversified across many different investments, far more than the County Council could hope to achieve on its own account.
- Same day liquidity – this means that funds can be accessed on a daily basis.
- Ring-fenced assets – the investments are owned by the investors and not the fund management company.
- Custodian – the investments are also managed by an independent bank known as a custodian, who operates at arms-length from the fund management company.

34. All treasury activity carries an element of risk and MMF's are no different. In the event of a further financial crisis, the failure of one or more of an MMF's investments could lead to a run on the MMF as investors rush to redeem their investment. This could then spread to other MMF's as investors take flight from this asset class.

35. The very low interest rate environment also threatens the ongoing continuity of MMF's. Each MMF charges a fee and this could mean that interest earned becomes negative after its deduction. If this problem arises then it would be a matter of moving funds to an alternative class of investment.

36. All of these issues point towards the fundamental need for diversification across MMF's and also investment categories where possible. This issue is dealt with later in this report (**paragraph 52** onwards).

The credit management strategy for 2016/17

37. Government guidance requires an explanation of how credit quality is monitored, what happens when it changes and what additional sources of information are used to assess credit quality.

38. The assessment of what "high credit quality" is for banks or building societies is set out in this section of the report.

39. Arlingclose are the County Council's treasury advisor and an important aspect of this service is credit advice. This is where the advisor provides information to the County Council about suitable investments in the context of the current economic risk environment and incorporates the views of credit rating agencies. What follows is an overview of how this operates, it is important to

understand that the County Council is responsible for the decisions it takes with its investments.

40. Credit ratings provided by the three main credit rating agencies form an important, but not the only, aspect of how creditworthiness is assessed by Arlingclose. For 2016/17 minimum credit-rating thresholds are set at a long-term rating of “BBB" where available. Counterparties that are rated below this level are excluded.

41. In addition the following are also considered:
- Statements of potential government support.
- Credit Default Swap prices (CDS) (i.e. the cost of insuring against counterparty default).
- Share prices.
- Gross Domestic Product (GDP) in the country of incorporation.
- Macro-economic factors.
- Information in the press.
- A subjective overlay, i.e. a judgement being made about whether the counterparty should be recommended or not.

42. In practical terms all of this information is considered by Arlingclose when they determine their recommendations. Any change in these criteria can result in a counterparty being removed from the lending list, not solely a change in credit rating.

43. In the recent past, the economic environment has been very volatile, so the advice provided by Arlingclose results in counterparties with high quality credit characteristics that are intended to insulate the County Council against further volatility. Of course, the future cannot be foreseen and in some situations changes may need to be made quickly, but this is considered a cautious approach.

44. The County Council remains responsible for its investment decisions. The Treasury Management Panel, chaired by the Director of Finance and Resources, meets monthly and a review of the lending list and any changes made by Arlingclose will take place at these meetings. In between meetings the treasury team will implement any recommendations made by Arlingclose. On the rare occasion that Arlingclose do not make a firm recommendation then this will be referred to the Panel for their review.

45. Under stressed market conditions, additional Panel meetings may take place at very short notice after which the Panel may decide to adjust the County Council’s investment risk profile. The end result may involve moving investments to lower risk counterparties or instruments.

46. The proposed AIS would be based on the following definition of high credit quality:
- Regulation investments as set out (**paragraph 29 and 30**)
- Diversified sterling Money Market Funds meeting the criteria set out (**Paragraph 33**).
- A bank or building society that is recommended by Arlingclose for inclusion on the lending list.

Monitoring

47. As required, an overview of the monitoring process is outlined below:
    - Rating changes and significant changes in risk indicators will be communicated to the treasury team by Arlingclose together with any revisions to their recommendations.
    - Changes are sent by e-mail and in urgent situations followed up by a phone call.

The County Council's banker

48. The County Council recently completed the implementation of its new banking provider, Lloyds Bank. Under the new arrangements funds are retained with Lloyds Bank each night earning interest at a market rate; the amount retained will be set in line with the diversification policy set out at **paragraph 52** onwards.

49. Should the Lloyds credit rating fall below the minimum specified in this report, then small balances may be retained with the bank for operational efficiency. This will be determined by the Treasury Management Panel chaired by the Director of Finance and Resources.

Investment duration for specified investments

50. In considering the financial instruments that meet the definition of a specified investment, there is the scope to consider the length of the investment period.

51. One of the important lessons of the banking crisis has been to exercise caution in the duration of investments with banks and building societies. This recognises that the factors that led to the investment being considered sound can change adversely over time. As such it is judged reasonable to limit unsecured fixed-term deposits with banks or building societies to a maximum duration of 12 months, even if Arlingclose recommend a longer duration.

Investment diversification

52. Having determined the lending list of highly rated counterparties and the duration of investments, the last piece of the process is to overlay the methodology for ensuring diversification. This is achieved by setting a maximum amount to be invested with each counterparty to limit risk and to spread investments.

53. Ensuring diversification has never been more important; it protects the security of the investments by limiting the County Council's loss in the event of a counterparty default. However, diversification does not protect the County Council from a systemic failure of the banking sector, although the risk of this has diminished as a result of new the bail-in banking regulations introduced.

54. Investment balances rise and fall during the year, so diversification needs to take account of this. The limits shown are based upon percentages of investments and the treasury team will review and reset these limits at least once a month with reference to forecast future balances. This action will then be ratified by the Treasury Panel at their next meeting. The interval between

each review is very much a matter of balance between ensuring diversification and efficient processing as investment balances cannot practically be moved each day to accommodate shifting limits. It is judged that a monthly review strikes this balance.

55. Investment diversification is proposed at two levels; firstly at investment category level:

Investment category	Maximum % of total investments
Regulation Investments*	100%
MMF's	50%
Banks and Building Societies	50%

**no limit is proposed (in certain circumstances these may be utilised for all of the County Council's investments)*

56. Secondly, diversification will also take place at investment category level:

Banks and Building Societies Lower of:	
£m	Maximum investment as a proportion of the total forecast balances
30	5% (unsecured) 10% (secured)

MMF Lower of:	
Maximum investment as a proportion of total MMF size	Maximum investment as a proportion of the total forecast balances
0.50%	10%

57. There is an exception to these rules, that where balances are low then the amount invested in MMFs may be as high as 100%. This recognises the fact that there may simply be no other available investment for small amounts where liquidity is needed.

58. Arlingclose amended their advice during 2015/16 to take account of the new bail-in regulations, previously discussed in this report. Before they recommended a maximum of 10% of balances be invested per bank or building society, now they recommend 10% but only if investments are secured (e.g. covered bonds). The limit for investments which are unsecured (e.g. fixed term deposits) was reduced to 5%.

59. It is proposed that both the application and amendment of the investment diversification policy are delegated to the Treasury Management Panel chaired by the Director of Finance and Resources, with the results reported to Cabinet in the regular treasury management reports.

<u>Non-specified investments</u>

60. The Government regulations define non-specified investments as all other types of investment that do not meet the definition of specified investments. In contrast to specified investments, government guidance indicates that the AIS should;
- set out procedures for determining which categories of non-specified investments should be prudently used
- identify such investments
- state an upper limit for each category of non specified investment
- state upper limits for the total amount to be held in such investments.

61. The non-specified investments proposed for use within the AIS are listed below. None of these present any additional security risk to the investments within specified investments and each is explained below.

- <u>Covered Bonds</u> – These are issued by banks and building societies and guaranteed by a group company that holds the bank or building societies mortgage assets. Covered bonds are exempt from bail-in and the structure enables investors to have effective security over the mortgage assets, which means they could be sold if needed. Covered bonds could be classified as a specified investment but only if the maturity was under 12 months with a bank or building society recommended by Arlingclose.
- <u>Repos (a Repurchase Agreement)</u> – The purchase of securities with the agreement to sell them at a higher price in the future. Repos involve investments being exchanged for assets, such as government bonds which can be sold in the case of a loss.
- <u>Certificates of Deposit (CD's)</u> – Identical to a fixed term deposit and not exempt from bail-in. A certificate is issued for the specified length of time and rate of interest which could be sold in the secondary market if needed. CD's could be classified as a specified investment but only if the maturity was under 12 months with a bank or building society recommended by Arlingclose.
- <u>Government gilts</u> – equivalent to the Debt Management Account Deposit Facility (DMADF) account and Treasury Bills, simply a longer term investment with the UK Government that can be sold.
- <u>Multilateral development bank bonds</u> – "AAA" rated, these are institutions created and backed by a group of countries which can be sold as needed.
- <u>Collective schemes</u> - There are many types of collective schemes, from enhanced MMF's (which have 3-5 day liquidity as they invest further along the yield curve) to property and equity funds. These all have varying risk and return profiles. The category is included here for possible use, subject to a decision by the Treasury Management Panel.

62. Where investments are subject to market risk (this is the risk that the value of the investment can go down as well as up), the inclusion of these investment instruments is proposed only on the basis that if purchased they would be held until maturity under normal circumstances. At maturity the investment and

expected interest would be paid in full. In the case of Certificates of Deposit then these would only be sold early on the basis that there were concerns over the borrower defaulting.

63. Investments that involve the considerations referred to above, the decision to invest will only be taken after due consideration by the Treasury Management Panel chaired by the Director of Finance and Resources.

64. For the purpose of setting investment amount and duration limits, it is planned to split non-specified investments into two categories (see **Appendix 2**).

- For long-term local authority loans and UK Government Gilts it is proposed to have a combined investment limit of £45m (up to 40 years duration) due to their similar high credit quality. The County Council has held £30m of long term local authority investments since 2013.
- For other non-specified investments, it is proposed to cap the individual investment amount per asset class at £20m (up to 5 years duration) with an overall cap of £50m for this group.

This means a total of £95m can be invested in non-specified investments in 2016/17 and is reflected in **Appendix 5,** prudential indicators (point 5).

65. **Appendix 2** sets out the investment categories authorised for use in 2016/17 and **Appendix 4** lists the County Council's lending List, as recommended by Arlingclose, at the time of writing this report.

Risk assessment

66. Although guidance sets out security and liquidity as being the main treasury risks, they are not the only risks in investing faced by the County Council. **Appendix 3** sets out a high-level risk assessment of six of the key risks which are summarised in the following table:

Risk	**Assessment**
Security	Low
Liquidity	Low
Interest rate	Low to Medium
Market	Low
Refinancing	Low to Medium
Regulatory and Legal	Low

67. The proposed AIS has been assessed against these risks and the judgement is that the most important risks have been reduced as far as possible. This is not to say that all risk has been eliminated, which is not possible in treasury terms.

Appendix 2

Cabinet – 20 January 2016 - Investment categories authorised for use 2016/17

<table>
<tr><th>Investment</th><th>Specified*</th><th>Non-Specified</th><th>Comments</th></tr>
<tr><td>UK Government - Debt Management Account Deposit Facility (DMADF) (regulation investment)</td><td>unlimited</td><td>n/a</td><td>6 months maximum available</td></tr>
<tr><td>UK Government - Treasury Bills (T-Bills) (regulation investment)</td><td>unlimited</td><td>n/a</td><td>6 months maximum available</td></tr>
<tr><td>UK local authorities term deposits (regulation investment)</td><td>unlimited</td><td rowspan="2">£45m across these categories</td><td rowspan="2">Up to 40 years in duration (non-specified)</td></tr>
<tr><td>UK Government – Gilts</td><td>unlimited</td></tr>
<tr><td>Money Market Funds</td><td>✓</td><td>n/a</td><td>50% of total investments in this category.
Lower of 0.50% of MMF size or 10% of all investments per MMF</td></tr>
<tr><td>Term deposits with banks and building societies</td><td>✓</td><td>✗</td><td>50% of total investments in this category.
Lower of 5% (unsecured) or 10% (secured) of total investments or £30m per counterparty</td></tr>
<tr><td>Certificates of deposit (banks / building societies)</td><td>✓</td><td rowspan="5">Maximum £20m per investment category and £50m in total across all categories</td><td rowspan="5">Up to 5 years in duration (non-specified)</td></tr>
<tr><td>Bonds issued by Multilateral Development Banks</td><td>✓</td></tr>
<tr><td>Collective Investment Schemes</td><td>✗</td></tr>
<tr><td>Covered Bonds</td><td>✓</td></tr>
<tr><td>Repos (repurchase agreement)</td><td>✗</td></tr>
</table>

** Up to 12 months*

Appendix 4

Cabinet - 20 January 2016

County Council lending list – December 2015	
	Time Limit
Regulation investments	
DMADF account	6 months
UK Government T-bills	6 months
UK local authority	12 months
Banks and building societies	
Barclays	100 days
HSBC	6 months
Lloyds / Bank of Scotland	100 days
Nationwide	100 days
Santander	100 days
MMF	
Black Rock	same day
Insight	same day
Federated	same day
Standard Life	same day
State Street (SSGA)	same day

MRP Strategy 2016/17

101. The County Council are also legally obliged to have regard to government guidance issued in February 2008 concerning the Minimum Revenue Provision (MRP) policy. MRP is where the County Council must make an annual revenue provision for the repayment of debt (also referred to as the Capital Financing Requirement or CFR). The MRP policy must be submitted to the full Council for approval prior to the start of the financial year to which the provision will relate. The policy for 2016/17 is summarised below and shown in full at **Appendix 8**.

102. Following guidance issued in 2007/08 regarding the Minimum Revenue Provision (MRP), it is proposed to continue the agreed policy as follows:

- The major proportion of the MRP for 2016/17 will relate to the more historic debt liability that will continue to be charged at the rate of 4%, in accordance with the recommendations and intent of Option 1 of the guidance.
- Further amounts of new capital expenditure may continue to be charged at the rate of 4%, and added to the above mentioned base CFR amount, up to an amount equivalent to the County Council's annual Supported Capital Expenditure (Revenue) allocation.
- Certain expenditures reflected within the debt liability at 31 March 2016 will under delegated powers be subject to MRP under Option 3.
- With regards to loans granted by the County Council no MRP will be charged on them. The MRP will be equated to the principal repayment of the individual loans.

103. In practical terms, this approach means that capital expenditure funded from supported borrowing (that is, supported by government grant) will be repaid at 4%. However, expenditure funded from unsupported borrowing will be repaid at a rate which matches the useful lives of those assets funded. This will result in a saving for the authority as the debt can be spread over a longer period of time, for example 60 years where a building has been funded from unsupported borrowing (that is, supported by the County Council). The MRP Policy statement for 2016/17 is shown at **Appendix 8**.

Appendix 8

Cabinet – 20 January 2016

Minimum Revenue Provision (MRP) Policy Statement

Introduction

Capital expenditure is expenditure on assets which have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. It would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred therefore such expenditure is spread over several years in order to try to match the years over which such assets benefit the local community through their useful life.

The manner of spreading these costs is through an annual Minimum Revenue Provision (MRP), which was previously determined under Regulation, and will in future be determined under Guidance.

The Government issued guidance which came into force on 31 March 2008 which requires that a Statement on the County Council's policy for its annual MRP should be submitted to the full Council for approval before the start of the financial year to which the provision will relate.

The guidance offers four main options under which MRP could be made (for information these are detailed over the page), with an overriding recommendation that the County Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits.

MRP Policy Statement 2016/17

The County Council implemented the new MRP guidance in 2009/10, and will assess their MRP for 2016/17 in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

The major proportion of the MRP for 2016/17 will relate to the more historic debt liability that will continue to be charged at the rate of 4%, in accordance with the recommendations and intent of Option 1 of the Guidance.

Further amounts of new capital expenditure may continue to be charged at the rate of 4%, and added to the above mentioned base Capital Financing Requirement (CFR) amount, up to an amount equivalent to the County Council's annual Supported Capital Expenditure (Revenue) allocation.

Certain expenditures reflected within the debt liability at 31 March 2016 will under delegated powers be subject to MRP under Option 3.

Estimated life periods will be determined under delegated powers. To the extent that expenditure is not on the creation of an asset and is of a type that is subject to estimated life periods that are referred to in the guidance, these periods will generally be adopted by the County Council. However, the County Council reserves the right to determine useful life periods and prudent MRP in exceptional circumstances where the recommendations of the guidance would not be appropriate.

Asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also, whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure.

With regards to loans granted by the County Council no MRP will be charged on them. The MRP will be equated to the principal repayment of the individual loans.

Option 1: Regulatory Method

Under the previous MRP regulations, MRP was set at a uniform rate of 4% of the adjusted CFR (i.e. adjusted for “Adjustment A”) on a reducing balance method (which in effect meant that MRP charges would stretch into infinity). This historic approach must continue for all capital expenditure incurred in years before the start of this new approach. It may also be used for new capital expenditure up to the amount which is deemed to be supported through the SCE annual allocation.

Option 2: Capital Financing Requirement Method

This is a variation on option 1 which is based upon a charge of 4% of the aggregate CFR without any adjustment for Adjustment A, or certain other factors which were brought into account under the previous statutory MRP calculation. The CFR is the measure of an authority’s outstanding debt liability as depicted by their balance sheet.

Option 3: Asset Life Method.

This method may be applied to most new capital expenditure, including where desired that which may alternatively continue to be treated under options 1 or 2.

Under this option, it is intended that MRP should be spread over the estimated useful life of either an asset created, or other purpose of the expenditure. There are two useful advantages of this option: -

- Longer life assets e.g. freehold land can be charged over a longer period than would arise under options 1 and 2.
- No MRP charges need to be made until the financial year after that in which an item of capital expenditure is fully incurred and, in the case of a new asset, comes into service use (this is often referred to as being an ‘MRP holiday’). This is not available under options 1 and 2.

There are two methods of calculating charges under option 3:

a. equal instalment method – equal annual instalments,
b. annuity method – annual payments gradually increase during the life of the asset.

Option 4: Depreciation Method

Under this option, MRP charges are to be linked to the useful life of each type of asset using the standard accounting rules for depreciation (but with some exceptions) i.e. this is a more complex approach than option 3.

The same conditions apply regarding the date of completion of the new expenditure as apply under option 3.