

**Report to the Ethics, Transparency and Audit Panel (ETAP)
7 February 2019**

TREASURY MANAGEMENT STRATEGY 2019/20

Report of the Director of Finance, Assets and Resources

1. Background

- 1.1 The Staffordshire Commissioner became responsible for the governance of Staffordshire Fire and Rescue Service from 1 August 2018, in addition to his existing role overseeing Staffordshire Police. However, both remain separate legal entities, with separate budgets, staff and governance processes.
- 1.2 This report will detail the treasury management strategy for the **Staffordshire Fire and Rescue Service** only; with a separate report produced for Staffordshire Police. Therefore, reference is made only to Staffordshire Commissioner Fire and Rescue Authority ('the Authority') as part of this report.

2. Introduction

- 2.1 To outline the Treasury Management Strategy for the 2019/20 financial year.
- 2.2 Treasury management comprises the management of the Authority's cash flows, borrowings and investments, and their associated risks. The Authority is exposed to financial risks, including the effects on revenue from changing interest rates on borrowings and investments, and the risks of a potential loss of invested funds. Therefore it is essential that the Authority successfully identifies, monitors and controls financial risk as part of prudent financial management.
- 2.3 The Authority conducts its treasury risk management within the framework of the Chartered Institute of Public Finance and Accountancy's (CIPFA) revised *Treasury Management in the Public Services Code of Practice* (the CIPFA Code), published in December 2017. The CIPFA Code requires that the Authority approves a treasury management strategy before the start of each financial year. In addition, this report fulfils the legal obligation to have regard to the CIPFA Code under the Local Government Act 2003.
- 2.4 The Annual Investment Strategy (AIS) for 2019/20 meets the requirements of the statutory guidance issued by the Ministry of Housing, Communities and Local Government's (MHCLG) in its revised *Guidance on Local Government Investments* published in February 2018.
- 2.5 CIPFA's revised Prudential Code for Capital Finance in Local Authorities introduced the requirement for a new capital strategy report; this is a separate report and will give a high level overview of how capital expenditure, capital financing and treasury management contribute to the provision of services, with an overview of how risk is managed and implications for future financial sustainability.

- 2.6 This strategy has been prepared in conjunction with the Treasury team at Staffordshire County Council (SCC), and after consultation with the Director of Finance, Assets and Resources at the Authority.

3. Recommendations

- 3.1 That the Panel note the proposed borrowing strategy for the 2019/20 financial year comprising:
- a) a borrowing strategy to operate within the prudential limits set out in **Appendix 1**;
 - b) a borrowing strategy, to use cash as far as is practical with the option to borrow up to £3m long-term where the Director of Finance, Assets and Resources (the Director) considers this appropriate in 2019/20;
 - c) a forward borrowing strategy that will not be used in 2019/20; and
 - d) a loan restructuring strategy that is potentially unlimited where this rebalances risk.
- 3.2 That, in accordance with the MHCLG's Guidance on Local Authority Investments, the Panel note, as recommended for approval by Fire SGB, the adoption of the Annual Investment Strategy (AIS) 2019/20 as set out in **paragraph 8.0 to 8.50** of this report and **Appendix 3**, and note the policies on:
- a) reviewing the strategy (page 13);
 - b) the use of external advisors (page 13); and
 - c) training (see page 14).

4. Economic Background

- 4.1 The UK's progress in negotiating an exit from the European Union (EU), together with any future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2019/20. The Office for Budget Responsibility (OBR), the government's independent official forecaster, warned of the risks of the UK economy going into recession if a Brexit deal is not negotiated with the EU.
- 4.2 However, the OBR's UK growth forecasts are based on achieving an orderly withdrawal process; in October 2018, it predicted that the UK economy will grow by 1.6% in 2019, an improvement on the 1.3% it had projected in March 2019. The improved forecasts coincided with October's autumn budget statement that saw Chancellor Philip Hammond announce a fiscal giveaway of close to £15 billion for 2019.
- 4.3 In August 2018, expectations for inflation caused the Bank of England's Monetary Policy Committee (MPC) to vote unanimously for a rate rise of 0.25%, taking Bank Rate to 0.75%. UK Consumer Price Inflation did fall back to 2.4% in September 2018 from 2.7% in August, although higher import and energy prices continued to hold inflation above the BoE target of 2%. The November Inflation Report showed that further interest rate increases may be required to bring inflation down to the 2% target over the forecast horizon.
- 4.4 The US economy has continued to perform well, and the Federal Reserve has maintained its monetary tightening stance and pushed up its target range for the Fed Funds Rate in December 2018 by 0.25% to 2.25% - 2.5%. It is expected that there will be a further two rises in 2019. However, there is a risk that the US-

China trade war, combined with a continued tightening of monetary policy, may contribute to a slowdown in global economic activity in 2019.

- 4.5 Although Europe experienced slower growth in 2018, the European Central Bank (ECB) has started conditioning markets for the end of quantitative easing as well as the timing of the first interest rate hike. This is currently expected in 2019, with the timing and magnitude of further rate increases thereafter.
- 4.6 Due to the risks of financial market volatility, the treasury strategy retains the low risk approach adopted in recent years, based on prioritising security, liquidity and then yield.

5. Interest Rates

- 5.1 In terms of treasury management, the Bank Rate is fundamental to the income received and it may also affect expenditure on loan interest where new loans are taken out or variable rate loans are held.
- 5.2 The Authority has been informed that Staffordshire County Council has forecast two more Bank Rate hikes of 0.25% during 2019, to take official UK interest rates to 1.25%. The Bank of England's MPC continues to have a bias towards tighter monetary policy although it is has maintained further rate rises would be gradual and to a limited extent. Some commentators believe that MPC members consider cutting Bank Rate from a higher level would be a more effective policy if some of the Brexit risks transpire.
- 5.3 The UK economic environment remains uncertain, primarily because the economy faces a challenging outlook as it exits the EU. At the time of writing, Prime Minister May had reached an agreement with the EU on transition and on future relations, that had been backed by her Cabinet. However, the deal still required approval by UK Parliament with the possibility of a "no deal" Brexit still hanging over economic activity. As such, the risks to the interest rate forecast are considered firmly to the downside.
- 5.4 Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on the interest rate projections, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.5% and 2% respectively over the interest rate forecast horizon, however volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.
- 5.5 Interest rates in the medium term are still not expected to reach pre-crisis levels and this is important for the strategies that follow. This is because variable rate investment income will not cancel out fixed loan interest expenditure (known as the cost of carrying loans).

6. Credit outlook

- 6.1 The Bank Recovery and Resolution Directive (BRRD) from 2015 introduced a significant risk for local authorities. Under these rules, a failing bank will need to be 'bailed-in' by current investors instead of a 'bail out' by government. The risk of loss for local authorities in a bail-in situation is much greater, as any unsecured fixed-term deposits would be ranked near the bottom of the capital structure and would be one of the first to suffer losses.

- 6.2 Ring-fencing legislation adopted by UK financial regulators required the larger UK banks to separate their core retail banking activity from the rest of their business i.e. investment banking. The aim is to protect retail banking activity from unrelated risks elsewhere in the banking group, as occurred during the global financial crisis. The big four UK banking groups - Barclays, HSBC, Lloyds and NatWest/Royal Bank of Scotland - have now divided their retail and investment banking divisions into separate legal entities. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.
- 6.3 In November 2018, the Bank of England released the results of its latest stress tests on seven of the UK's largest banks and building societies. The Bank believe that the tests showed that the UK banking system is resilient to deep recessions that are more severe than the global financial crisis. The Bank did not require any bank to raise additional capital.
- 6.4 European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading there. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be high if ever needed. The uncertainty caused by the protracted negotiations between the UK and EU is weighing on the creditworthiness for UK and European banks with substantial operations in both jurisdictions.
- 6.5 The Authority will work with the Treasury and Pensions team at Staffordshire County Council to monitor developments on bank credit risk.
- 6.6 The Authority's full creditworthiness approach is detailed in the Annual Investment Strategy (AIS) outlined in **Section 8**. This also sets out where cash will be invested.

7. Borrowing Strategy

- 7.1 At 31 March 2019, it is anticipated that the Authority's long-term loan debt will be around 70% funded, i.e. covered by fixed interest rate long-term loans of £18.1m. The gap of around £7.8m which is forecast to be needed to complete the borrowing reflects the Authority's strategy of using cash in lieu of borrowing over recent years.
- 7.2 The Authority has three main options in its borrowing strategy:
- to use cash (i.e. do not borrow);
 - to bring borrowing up to the amount needed to fully fund the capital programme at any point in time; or
 - to forward borrow up to two years in advance.
- 7.3 The following table shows an estimate for the levels of debt and loans at 31 March 2019 and a forecast for the next three years if the first option, i.e. using cash in lieu of borrowing, was continued.

	Estimated 2018/19 £m	Forecast 2019/20 £m	Forecast 2020/21 £m	Forecast 2021/22 £m
Forecast Gross Debt	25.9	26.6	26.4	26.4
Forecast Loans Position	18.1	17.6	17.1	16.6
Gap Funded from Cash	7.8	9.0	9.3	9.8

- 7.4 The increase in the use of cash in 2019/20 can be attributed to a combination of new borrowing and loans maturing over this period. As some of the new borrowing is due to be financed from reserves, it is possible that the levels of cash reserves in future years may not be sufficient to cover the gap funded from cash. In this scenario, the Authority would need to consider external borrowing.
- 7.5 The loans position includes a £1m LOBO (Lender Option Borrower Option) loan held with Dexia Bank where the maturity date is not certain. The bank has an option to amend (i.e. increase) the loan interest rate on pre-determined dates in 2019/20; if this option is exercised then the Authority as a matter of policy will repay the loan.
- 7.6 In recent years, some banks owning LOBO loans, such as Commerzbank, have been removing these non-core assets from their balance sheet, ahead of changes to accounting standards and capital adequacy regulations, that may prove costly to them. Consequently they have contacted relevant local authorities and have given them the option to repay their LOBO loans with a reduced premium. Although Dexia Bank are not currently offering such favourable repayment terms for their LOBO loans, it is conceivable to think they may do so in the future.
- 7.7 Aside from a potential restructure, it is judged unlikely in the current interest rate environment that LOBO loans options will be exercised. However a repayment of the LOBO loan would further increase the “gap” funded from cash; alternatively the Authority could take up a shorter-term and cheaper loan, say with the Public Works Loan Board (PWLB), or its successor body. A decision would be taken at the time.
- 7.8 Despite the availability of external loans, the economic environment continues to favour using cash:
- There is a normal yield curve so it is cheaper to use cash than to borrow.
 - Due to bail-in legislation it is important to minimise investment risk as using cash reduces investment balances.
 - Using cash within practical cash management limits would meet key parts of the regulatory framework provided by the government.
 - Investments are still yielding a low return.
 - The interest rate forecast at **paragraph 5.2** shows the Bank rate is at a very low level and it is expected to remain well below the average debt rate for the next year and beyond. Continuing to use cash would meet the objective of bringing down the average rate of interest for borrowing and provide an opportunity to fund the capital programme at low cost.
- 7.9 An important aspect of using cash is its risk reduction effects:
- Using cash reduces security risk as investment balances are lower; the Government emphasises the importance of minimising this risk above all others in regulations discussed later in this report.

- The Authority will be less exposed to variable interest rate changes; this exposure arises when a fixed term loan is taken out with corresponding variable rate investments. This is avoided when cash is used.

7.10 Looking at risk in a wider sense, the CIPFA Code of Practice on Treasury Management sets out a number of risks to be considered. This assessment is shown at **Appendix 2** for the six main risks considered relevant and summarised below.

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

7.11 Overall the use of cash in lieu of borrowing is considered a relatively low risk strategy although it is impossible to eliminate all treasury risk. The consequences of using cash are the possibility of extra costs in the future if interest rates rise; although this must be balanced with the extra cost now if loans were taken (the cost of carry).

External borrowing requirement

7.12 Although the current economic environment favours the use of cash, this strategy is only possible where cash is available to fund borrowing. As referred to in **paragraph 7.4**, it is conceivable that forecasted levels of reserves may not be sufficient to cover the gap funded from cash. In this instance it may be necessary to raise external loans.

7.13 The Authority also needs to recognise the possibility of further unexpected reductions in cash balances from those forecast. This could be due to:

- increases in the capital programme;
- budget pressures;
- changes in the Authority's cash funding as a result of structural changes; or
- LOBO loan call options being called.

7.14 Where additional liquidity is needed, the Authority can call upon short-term temporary loans raised from the money markets, including from other local authorities with surplus cash to invest. The Authority can also obtain long term loans of over one year, for example through the PWLB.

7.15 It is important to understand that when raising loans, all of the funding gap need not be closed with the new loans. A gap should be retained that continues to use available cash for the reasons outlined at **paragraph 7.8**. The proposed strategy aims to strike a balance between the liquidity needs of day to day cash management with the low risk approach that is maintained by using cash.

Sources of borrowing

7.16 The approved sources of long-term and short-term borrowing are:

- Public Works Loans Board (PWLB) and any successor body

- UK Municipal Bonds Agency Plc and any other special purpose companies created to enable local authority bond issues
- Other UK public sector bodies
- UK public pension funds
- Approved banks or building societies authorised to operate in the UK
- Any institutions approved for investments.

Short-term loans

- 7.17 Short-term loans raised from money markets are typically under 6 months duration. These are low cost and the Authority can respond flexibly to liquidity pressures by raising these when needed. The disadvantage of short-term loans is one of availability and it can be difficult to raise quickly from banks and building societies.
- 7.18 The local authority lending market has progressed considerably in recent years and funds are generally available in the short to medium term. However future availability cannot be predicted as loans raised depend upon other local authorities still having cash balances and being prepared to lend it to the Authority.

Long-term loans

- 7.19 Long-term loans are those for a duration of more than 12 months. The Authority has previously raised the majority of its long term borrowing from the PWLB, a statutory body that issues loans to local authorities. Government consent is not required hence the PWLB continues to be seen as the 'lender of first resort' because of the flexibility and ease of access. However local authorities are required by law to have regard to the Prudential Code and only borrow within relevant legislation and its borrowing powers.
- 7.20 The traditional source of long term loans has been the PWLB, effectively the UK Government. These loans are relatively more expensive now than in the past as the Government increased the margin over Gilts several years ago (this is now 0.80% under the "certainty rate" regime). However, loans can be raised and cash received within 3 working days so the PWLB provides a strong contingency against liquidity shortfalls.
- 7.21 In November 2016 the Government announced plans to transfer the powers of the PWLB to the Treasury. It is important to note that the reforms have had no real effect on the Authority's existing PWLB loans or on local authority lending policy from Central Government.
- 7.22 The exact type of loan to be raised by the Authority and its duration would have to be considered at the time; but with current interest rates and the maturity profile of the existing loan portfolio, loans towards the shorter end of the yield curve offer better value for money.
- 7.23 The optimum timing for borrowing cannot be foreseen and decisions often need to be taken at short notice. Because of this, it is proposed to delegate the decision to borrow long-term loans to the Director of Finance, Assets and Resources at the Authority, and reported retrospectively to the Strategic Governance Board. The maximum amount has been set at £3m; this is deemed sufficient to meet the forecasted borrowing needs. There is no limit where short term loans are taken.

- 7.24 The Board will be kept informed of any loans raised via the outturn and half-year reports.

Loan restructuring

- 7.25 Movements in interest rates over time may provide opportunities to restructure the loan portfolio in one of two ways:
- Replace existing loans with new loans at a lower rate (known as loan rescheduling).
 - Repay loans early without replacing the loans. However this would increase the use of cash which may not be possible under current forecasts for reserves.
- 7.26 Currently loan restructuring would be very expensive and unattractive for the Authority. This is because:
- Gilt yields are still historically low. This would lead to large penalties to compensate the PWLB or its successor body if loans were repaid early; and
 - new loans are much more expensive than in the past even though gilt yields are so low. Since 2010 the Government has increased the margin on top of gilts at which it onward lends to local government via the PWLB (originally 1.00%, subsequently dropped to 0.80%).
- 7.27 Market conditions and regulations do change so the outcome cannot be foreseen. It is therefore proposed to allow unlimited loan restructuring with the decision being delegated to the Director of Finance, Assets and Resources and reported retrospectively to the Strategic Governance Board.

Policy on Borrowing in Advance of Need

- 7.28 As the borrowing strategy proposed for 2019/20 involves maximising the use of cash until borrowing is required, the policy is not to borrow in advance this year. This will be revisited annually as part of the overall borrowing strategy.

8. Annual Investment Strategy (AIS) 2019/20

- 8.1 Following the introduction of the second Markets in Financial Instruments Directive (MiFID II) regulations from January 2018, local authorities will automatically be treated as retail clients by financial services firms, unless they 'opt up' to be professional clients. As a retail client, the Authority would receive enhanced protections but this would also mean it may face increased costs and restricted access to certain products including money market funds, pooled funds, treasury bills and treasury advice.
- 8.2 The Authority, however, continues to meet the criteria set out under MiFID II and will carry-on being treated as a professional client by regulated financial services firms in 2019/20.

Investment options

- 8.3 The Authority manages a portfolio of cash that can reach over £23m at certain times in the year; the average balance to date has been £17m in 2018/19. Since the financial crisis the Authority has taken a low risk approach to investment and the AIS continues in this vein.

- 8.4 The CIPFA Code requires the Authority 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 Authority'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.
- 8.5 If the UK enters into a recession in 2019/20, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.
- 8.6 The main investment options to consider are related to:
- the credit risk of counterparties that are used for investment
 - the length of the investment; and
 - the type of financial instrument that are used.
- 8.7 The type of financial instruments that can be used can be divided into 'specified' investments and 'non-specified' investments.

Specified Investments

- 8.8 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 UK local authority, parish council or community council; or
 - a body or investment instrument, that has 'high credit quality'.
- 8.9 The first two named investments are not subject to 'bail-in' risk as mentioned in **paragraph 6.1** in this report. The assessment of the third aspect of high credit quality is dealt with in the paragraphs that follow.

The Credit Management Strategy for 2019/20

- 8.10 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.
- 8.11 In the past a broad list of banks and building societies were utilised; however, over time the number of approved banks and building societies has fallen away because of poor returns relative to the risk of investing. The anticipated position for 2019/20 is that only one bank will be used, Lloyds Bank Plc, and this will be in the context of their banking relationship with the Authority.
- 8.12 As with any bank, the credit environment will be monitored to make a subjective judgement on the creditworthiness of Lloyds, this includes:
- credit ratings from the three main credit rating agencies;
 - Credit Default Swaps (CDS) (i.e. the cost of insuring against counterparty default);
 - share price and bond yields;
 - balance sheet structure;
 - macro-economic factors; and
 - potential government support.

- 8.13 The Authority remains responsible for all its investment decisions. Meetings with colleagues from the Treasury team at Staffordshire County Council take place on a quarterly basis where a review of the Lending List will take place.
- 8.14 Under stressed market conditions, additional meetings with Staffordshire County Council's Treasury team may take place at very short notice. A decision may be made to adjust the Authority's investment risk profile; the end result may involve moving investments to lower risk counterparties or instruments.

Money Market Funds

- 8.15 Money Market Funds (MMF's) are pooled investment vehicles consisting of money market deposits and similar instruments. MMF's are used by the Authority currently and more widely by other public and private sector bodies.
- 8.16 Existing MMFs are expected to be compliant to new EU regulations by January 2019. As part of the reforms, most short term MMF's will convert from a Constant Net Asset Value (CNAV) to a Low Volatility Net Asset Value (LVNAV) structure.
- 8.17 The assets of LVNAV MMFs are marked to market, meaning the dealing NAV (unit price) may fluctuate. However MMFs will be allowed to maintain a constant dealing NAV provided they meet strict new criteria and minimum liquidity requirements. Public debt CNAV MMFs will still be available where 99.5% of assets are invested in government debt instruments.
- 8.18 MMF's proposed for use by the Authority would be 'AAA' rated, the highest possible credit rating and they would have the following attributes:
- Diversified – MMF's are diversified across many different investments, far more than the Authority could achieve on its own account.
 - Same day liquidity – 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 managed by an independent bank known as a custodian, who operates at arms-length from the fund management company.
- 8.19 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. The new MMF regulations look to limit some of these risks.
- 8.20 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 arose then it would be a matter of moving funds to an alternative class of investment. However this threat has receded with the recent rise in Bank Rate.
- 8.21 All of these issues point towards the fundamental need for diversification across investment categories. This issue is dealt with later in this report (see from **paragraph 8.27**).

Banking

- 8.22 The Authority's banking provider is Lloyds Bank. Cash is 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 8.29**.
- 8.23 In respect of the Bank ring-fencing legislation referred to in **paragraph 6.2**, Lloyds Bank has a relatively small investment banking operation meaning that 97% of the bank's assets remained within the 'retail' ring-fence. The Authority's business with Lloyds Bank will take place within the 'retail' ring-fence (Lloyds Bank Plc) and not form part of their investment banking operations (Lloyds Bank Corporate Markets).
- 8.24 Long term credit rating issued by the three major agencies indicate there have been upgrades for some ringfenced 'retail' banks and downgrades for some non-ringfenced 'investment' banks. Lloyds Bank Plc has seen a credit ratings upgrade; should the Lloyds credit rating fall, then small balances may be retained with the bank for operational efficiency. The Authority will continue to seek information on any developments from the Treasury team at Staffordshire County Council, with a course of action to be determined by the Director of Finance, Assets and Resources.

Investment duration

- 8.25 The specified investments set out in this report are of short duration; funds invested with banks (either through a MMF) or the Authority's banker are liquid and available at same day notice. Other regulation investments may be invested for up to 12 months.
- 8.26 The Authority's lending list is shown at **Appendix 3**. The maximum recommended investment duration for 2019/20 is to not invest for more than a year.

Investment diversification

- 8.27 Having determined the list of highly rated counterparties and the duration of investments, the last piece of the process is to overlay the methodology for ensuring diversification. Ensuring diversification is important as it protects the security of the investments by limiting loss in the event of a counterparty default. However, diversification does not provide protection from a systemic failure of the banking sector, although the risk of this has diminished as a result of bail-in banking regulations.
- 8.28 Diversification is achieved by setting a maximum amount to be invested with each counterparty; this helps to limit risk and ensure a spread of investments. For regulation investments (the least risk of all) there is no limit so all investments could be placed here.
- 8.29 For Lloyds Bank a limit is set of the lower of 10% of total balances or £1.0m (subject to a minimum upper level of £500k); this amount will minimise processing costs and provide additional liquidity for the Authority. The Treasury team at Staffordshire County Council will review and reset this limit once a month with reference to forecast future balances.

MMF Limits

- 8.30 Cash balances at the Authority can be relatively high, especially from the point the pensions top up grant is received in July. Once MMF limits are reached, it can be difficult to invest the higher cash balances when there is insufficient demand for local authority borrowing and with returns from DMADF deposits being relatively low.
- 8.31 Current forecasts indicate cash balances may be higher for a while longer so it is proposed that the Authority continues with a hard MMF limit of £2.5m with a soft limit of £1.5m. This will allow the Authority to have the flexibility to exceed the soft limit when investment diversification is restricted due to limitations in the market. The Authority would continue to maintain assurance on the security of investments as MMFs have a 'AAA' credit rating.
- 8.32 When cash balances do fall low this may mean that all investments are placed with the MMF's and Lloyds bank. However, balances will be within the limits stated above.
- 8.33 Both the application and amendment of this policy is delegated to the Director of Finance, Assets and Resources with the outcome reported in the regular treasury management reports.

Non-Specified Investments

- 8.34 Non-Specified investments are defined as all other types of investment that do not meet the definition of specified investments. Non-Specified investments are typically used less frequently and may require further approval from the Director of Finance, Assets and Resources.
- 8.35 Collective Investment Schemes are Non-Specified investments that range from enhanced MMF's to property and equity funds. These all have varying risk and return profiles. The Strategy and Resources Committee approved a decision to use this category of investment in 2016/17 by committing to the Royal London Fund, a AAA rated enhanced Cash Plus MMF with a 3 day liquidity notice period.
- 8.36 The Royal London Cash Plus Fund allows the Authority to earn an increased yield in a low interest rate environment, and where the Authority has high cash balances. Security is maintained as it invests in highly sought after covered (secured) bonds, which are exempt from bail-in. These enhanced duration MMF's have the same characteristics as same day liquidity MMF's, but typically have a 3-5 day notice period and a recommended investment duration of at least 6 months, due to their longer investment horizon.
- 8.37 The financial limit for the Royal London Cash Plus MMF has been set at £1.5m.

Non-treasury investments

- 8.38 Under the revised CIPFA Codes and MHCLG Guidance, local authorities may invest in other financial assets and property for financial return, and also make loans and investments for service purposes.
- 8.39 The revised CIPFA Code and MHCLG Guidance require such non-treasury investments to be assessed as part of the new capital strategy and investment strategy. They should set out the specific policies and arrangements for non-

treasury investments and ensure the same robust procedures for the consideration of risk and return are applied to these, as for treasury investments.

- 8.40 Under the new CIPFA Codes, the Authority should also maintain a schedule setting out a summary of its non-treasury investments. The Authority does not currently hold any non-treasury investments.

Risk

- 8.41 Although guidance sets out security and liquidity as being the main treasury risks, they are not the only investment risks faced by the Authority. **Appendix 4** sets out a high-level risk assessment for 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

- 8.42 Within the Authority's AIS there is a balance to be struck between the security of investments and liquidity; the safest investments are not the most liquid and so a pragmatic approach must be taken.
- 8.43 The proposed AIS has been evaluated against these risks and the judgement is that the most significant 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.

Review of strategy

- 8.44 Regulations require that the circumstances under which a revised strategy would be prepared should be stated. These circumstances would be a change in:
- the economic environment;
 - the financial risk environment;
 - the budgetary position; or
 - the regulatory environment.
- 8.45 The responsibility for assessing these circumstances and proposing changes to the strategy is allocated to the Director of Finance, Assets and Resources.

Policy on the use of external service providers

- 8.46 Regulations require that the policy on the use of external providers is disclosed. Currently the Authority has no contracted external treasury adviser and this is considered appropriate with the simple arrangements set out.
- 8.47 The treasury service to the Authority is provided by the Treasury team at Staffordshire County Council, who use Arlingclose as their external treasury management adviser. The County Council's contract with Arlingclose was renewed in 2017 following a tender process. The Authority could use Arlingclose to provide consultancy advice on an ad-hoc basis should this be considered necessary.

Investment management training

- 8.48 Regulations require disclosure of the processes for ensuring officers are well trained in investment management. Treasury management is a specialised area requiring high quality and well trained staff with an up to date knowledge of current issues, legislation and treasury risk management techniques.
- 8.49 Officers at Staffordshire County Council who provide the treasury service are experienced and attend regular CIPFA and treasury consultant training seminars throughout the year.
- 8.50 Training needs for officers at the Authority who attend quarterly meetings with County Council treasury officers are assessed on an ongoing basis by local managers.

Service Level Agreement

- 8.51 Staffordshire County Council provides treasury management, banking and VAT services as part of a Service Level Agreement (SLA) with the Authority. The SLA does not constitute a contract but is a document of good practice; it outlines the range of services offered by the Council and the degree of co-operation required from the Authority in order for the Council to fulfil its role.
- 8.52 The current SLA was updated by the Treasury team at the County Council in 2018/19 and approved by the Director of Finance, Assets & Resources.

9 Financial Implications

All financial implications are covered in the body of this report.

10 Legal Implications

Approval of Prudential Indicators and an AIS are necessary in order to meet the requirements of the Local Government Act 2003.

11 Equality & Diversity Implications

There are no equality and diversity implications.

12 Risk Implications

Risk is inherent in treasury management operations and is dealt with throughout this report. **Appendices 2 and 4** show a risk assessment for borrowing and investment activities.

13 Consultation and Engagement Undertaken

Staffordshire County Council's Treasury and Pension Fund Team have provided the economic background and forecasts for this report.

14 Procurement and Social Value Implications

The daily treasury management function is carried out on behalf of the Authority by Staffordshire County Council, under a Service Level Agreement (SLA).

15 **Protective Security Considerations**

Data protection and protective security policies are implemented within Staffordshire County Council and all departments within the Council. Treasury management activities are undertaken in line with these policies and the agreed SLA.

David Greensmith
Director of Finance, Assets and Resources

Contact at Staffordshire Council

Johirul Alam
Investment Accountant

Background Documents:

1. Treasury Management in the Public Services: Code of Practice (CIPFA) (2017)
2. The Prudential Code for Capital Finance in Local Authorities (CIPFA) (2017)
3. The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
4. Statutory Guidance on Local Government Investments – Issued under Section 15(1) (a) of the Local Government Act 2003 (2018)
5. Statutory Guidance on Minimum Revenue Provision – Issued under section 21 (1A) of the Local Government Act 2003 (2018)

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Treasury Management Indicators

Indicator	Estimate 2019/20	Estimate 2020/21	Estimate 2021/22
1. External Debt	£m	£m	£m
Authorised Limit	34.1	31.6	31.6
Authorised Limit for other liabilities	84.5	82.0	79.5
TOTAL	118.6	113.6	111.1
Operational Boundary	30.0	29.6	29.4
Operational Boundary for other liabilities	84.5	82.0	79.5
TOTAL	114.5	111.6	108.9
External Loans	17.6	17.1	16.6
<p><i>The Authorised Limit is the maximum level of external borrowing which should not be exceeded. It is linked to the estimated level of borrowing assumed in the Capital Programme.</i></p> <p><i>The Operational Boundary represents the Director's estimate of the day to day limit for Treasury Management activity based on the most likely i.e. prudent but not worst case scenario</i></p> <p><i>Other liabilities relate to PFI schemes on the balance sheet.</i></p>			
2. Interest Rate Exposures			
a. Upper Limit (Fixed)	26.6	26.4	26.4
b. Upper Limit (Variable)	(25)	(25)	(25)
<p><i>Upper limits of fixed and variable borrowing and investments are required to be set. This limits the Authority's exposure to both fixed and variable interest rate movements as part of the overall risk management strategy for treasury management activities. Negative figures are shown in brackets; these relate to investments at a variable rate which are not offset by variable borrowings.</i></p>			
3. Maturity Structure of Borrowing	Upper Limit	Lower Limit	
Under 12 months	10%	0%	2.8%
12 months and with 24 months	10%	0%	2.8%
24 months and within 5 years	30%	0%	1.9%
5 years and with 10 years	50%	0%	6.6%
10 years and above	100%	25%	85.9%
<p><i>This indicator identifies the amount of loans maturing in specified periods. The overarching principle is that steps should be taken from a risk management point of view to limit exposure to significant refinancing risk in any short period of time.</i></p> <p><i>The Authority currently applies the prudent practice of ensuring that no more than 10% of its total gross fixed rate loans mature in any one financial year.</i></p>			
4. Total principal sums invested for periods longer than a year	£	£	£
<i>Any investments made for longer than a year will be in accordance with the limits on non-specified investments.</i>	nil	nil	nil

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Risk assessment – Borrowing strategy

Risk heading	Risk description	Relevance to borrowing	Key control	Assessment	Borrowing strategy
Security	A third party fails to meet its contractual obligations (i.e. counterparty risk).	Unlikely that there is a failure between the agreement to borrow and sums being received a few days later. However, if we borrow in advance we must invest until this is needed and this increases exposure to investment risk.	Usually borrow from the Government (PWLB or its successor body) with funds received within 3 working days from the date of agreement to borrow.	LOW	Use of cash to fund borrowing reduces this risk further i.e. less money is held with banks and third parties as a result.
Liquidity	Cash is not readily available when it is needed.	Only borrow for capital – usually borrow from Government (PWLB or its successor body) with a maximum limit of £3m for long-term borrowing set in 2019/18.	Prudential rules on borrowing and consideration of whether Government is secure.	LOW	Use of cash to fund borrowing increases this risk as liquidity is reduced when borrowing is avoided. However, the Authority is able to borrow money temporarily using the money markets should it need to, so the overall risk remains low.
Interest rate	Unexpected <u>reduction</u> in short term Interest rates.	Depends on the mix between fixed rate borrowing and variable rate borrowing. Higher exposure to variable rate borrowing helps the budget.	The control is set out below.	LOW to MEDIUM	Pursuing a strategy of using cash reduces the overall net exposure to sudden interest rate falls.
Interest rate	Unexpected <u>increase</u> in short term interest rates.	Mix of variable and fixed rates – Lower exposure to variable rate borrowing helps the budget.	Limit variable rate borrowing to a relatively small proportion (e.g. 20%).	LOW to MEDIUM	20% limit provides a suitable risk control.

Appendix 2 (continued)

Risk heading	Risk description	Relevance to borrowing	Key control	Assessment	Borrowing strategy
Market	The market value of loans changes substantially (i.e. how much is the borrowing strategy exposed to long term interest rate change).	How much risk is built into the maturity profile of the loans structure. LOBO's (5% of all loans) are the only 'market' instrument in borrowing terms currently used.	This is inversely linked to refinancing risk below.	MEDIUM	Use of cash will shorten the duration of the loan portfolio and reduces this risk. Without the use of cash this risk assessment would probably be high.
Refinancing risk	Maturing transactions cannot be renewed on similar terms.	Need to avoid a high level of borrowing over a short period where you are exposed to high interest rates.	The Authority has a policy of limiting maturing loans to 10% of the loans portfolio.	MEDIUM	Using cash to fund borrowing potentially increases the refinancing risk. Without the use of cash this risk assessment would probably be low.
Regulatory and legal risk	Rules governing local government borrowing are changed or amended without notice, which has happened in the recent past.	Local government is heavily reliant upon PWLB (or its successor body); cost and ability to reschedule / manage loans are determined by the Government The Government could close the PWLB (or its successor body) and force local authorities to use market loans for all new borrowing.	Market loans will be evaluated and taken if these are good overall value and dilute reliance on the PWLB (or its successor body). The newly set up UK Municipal Bonds Agency may provide an alternative in the future.	MEDIUM	One LOBO loan is held. Use of cash means that PWLB (or its successor body) loans are not being taken. If the PWLB (or its successor body) was closed to new business then market loans would be the only option.

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Lending List – January 2019	
	Time Limit
Regulation Investments	
UK Government DMADF account	6 months
UK Local Authority	12 months
Banks	
Lloyds Group (£1.0m max)	call only
MMF	
Federated (£2.5m max)	call only
Morgan Stanley (£2.5m max)	call only
Aberdeen Standard (£2.5m max)	call only
Enhanced MMF	
Royal London Cash Plus (£1.5m max)	3 day notice

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Risk assessment - Investments

Risk heading	Risk description	Relevance to investment	Key control	Assessment	Approved Investment Strategy (AIS)
Security	A third party fails to meet its contractual obligations (i.e. counterparty risk).	Crucial that money invested is returned (principal and interest).	Relies on credit management policy including; credit risk, diversification, duration and amount of investment, and an ongoing review of the credit environment. Prudential limit on investment over 1 year.	LOW	Use of the counterparties identified within the AIS reduces this risk to a low level. The borrowing strategy identified will reduce cash balances and the resulting security risk. With the exception of regulation investments, counterparties have a financial limit to ensure funds are spread amongst them. Overall this remains a low risk strategy.
Liquidity	Cash is not readily available when it is needed.	Need to plan investment to match cash requirements.	Managed through detailed cash flow forecast and investment in highly liquid funds – can also borrow temporarily (Local Authorities are a good credit risk if lent money).	LOW	Same day access accounts are currently held with: <ul style="list-style-type: none"> • Federated MMF • Morgan Stanley MMF • Aberdeen Standard MMF • Lloyds Banking Group (as banker) Cash flow plans are completed annually and regularly updated. Overall the risk is low.

Appendix 4 (continued)

Risk heading	Risk description	Relevance to investment	Key control	Assessment	Approved Investment Strategy (AIS)
Interest rate	Unexpected <u>reduction</u> in Interest rate.	Reduces the return on investment and reduces the level of reserves.	Can reduce risk by; A) netting off investment against borrowing to reduce net exposure B) investing for longer periods.	LOW	Investments will be short term, this does not protect against an interest rate reduction. The current interest rate environment has interest rates at historically low levels.
Interest rate	Unexpected <u>increase</u> in interest rates.	In order to take advantage of the unexpected return, would need to keep investment short term and increase the amount of cash invested (e.g. by not using cash in lieu of borrowing).	Controlled through the overall strategy.	MEDIUM	Current policy allows upturns to be taken advantage of as investments are not fixed for long periods. Using cash to fund borrowing (the proposed borrowing strategy) reduces this risk as the overall exposure to short term interest rates is less.
Market	Unexpected need to liquidate market instrument quickly and accept 'price on the day'.	Only relevant if invest in market instruments (e.g. CD's, Gilts).	Limit investment in market instruments or alternatively have capacity to borrow to avoid need to liquidate. Controlled by limits on Non-Specified Investments.	LOW	Market instruments are not in use by the Authority.
Refinancing risk	Maturing transactions cannot be renewed on similar terms.	Reflected in the term (duration) of investments. If everything invested shorter term there is a higher refinancing risk.	Proportion of investments maturing in the short term.	LOW/ MEDIUM	The current policy is to invest in the relatively short term. There is an increased risk with this strategy due to frequent 'refinancing' but this is expected to be advantageous in a rising interest rate environment. Using cash to fund borrowing (the proposed borrowing strategy) reduces this risk as the overall exposure to short term interest rates is less.

Appendix 4 (continued)

Risk heading	Risk description	Relevance to investment	Key control	Assessment	Approved Investment Strategy (AIS)
Regulatory and legal risk	Rules governing local government investment powers are changed or amended without notice.	Investment powers are granted through statute and guidance.	None.	LOW	<p>The current policy of using cash in lieu of borrowing reduces the Authority's dependency on interest receipts.</p> <p>The AIS is low risk and uses liquid and conservative investment instruments.</p>