TREASURY MANAGEMENT - INVESTMENT STRATEGY SUPPLEMENTARY REPORT

1 INTRODUCTION

1.1 The Review Committee met on 2 February 2016 to review the Treasury Management Strategy. Post the discussion at this meeting the Committee agreed that the Treasury Management Strategy for 2016/17 be recommended to Council bar the Investment Strategy section, which should be retained as per the 2015/16 Strategy.

1.2 This supplementary report looks to replace/provide additional information raised at the Review Committee to assist Council with its decision making on the Investment Strategy for 2016/17.

2 OVERVIEW

2.1 When the Council has surplus cash balances, these are invested until they are next required. Usually, in line with the current strategy, this means that funds are invested on a short term basis (i.e. up to 364 days), but up to **£500,000** may be invested for periods beyond 364 days.

2.2 The Council must set its investment policy in compliance with CLG's **Guidance on Local Government Investments** and the revised CIPFA **Treasury Management in Public Services Code of Practice** and **Cross Sectoral Guidance Notes**.

2.3 In accordance with regulatory requirements, the primary objectives, when investing the Council's funds, are:

- Firstly to **safeguard** principal sums invested;
- Secondly to ensure adequate **liquidity**; and
- Lastly to consider investment returns or **yield**.

2.4 The Council's funds will primarily be invested according to the Secretary of State's definition of **specified investments** – sterling deposits made for periods of less than one year and offering high security and high liquidity.

2.5 Funds may also be invested according to the Secretary of State's definition of **non-specified investments**. The inclusion of non-specified investments in the strategy is solely to allow funds to be invested for periods of in excess of one year.

2.6 Following consultation with the Treasury Management advisers, the Council would like to consider a more diversified investment portfolio to the traditional cash deposits, as these generally as a rule of thumb provide increased returns and minimise risk by diversifying the Council's interest, but these needs to be considered in line with the risk appetite of the Council and also the recent market volatility.

2.7 In order to diversify an investment portfolio largely invested in cash investments will be placed with a range of approved investment counterparties in order to achieve a diversified portfolio of prudent counterparties, investment periods and rates of return. Maximum investment levels with each counterparty will be set; this is to ensure prudent diversification is achieved and the Council can remain confident that any cash invested will not be required at short notice, or within a short time-span.

2.8 A full list of those items already in the 2015/16 strategy are:

- Term and Call Deposits with banks and building societies
- Term deposits, call deposits and bonds with other UK local authorities
- Certificates of deposit with banks and building societies
- Deposit Facility
- Money Market funds (both Standard and Enhanced)
- Debt Management Agency Deposit Facility (Government Managed)
- Treasury Bills

2.9 The following item will be considered as a new option in the strategy is:

- Investments in property based funds (indirect property investment)

2.10 A full list of those items **not** to be considered are below, based upon the discussion at the Review Committee and the current market volatility:

- Bonds issued by Multilateral Development
- Commercial Paper
- Corporate Bonds
- UK Government Gilts

3 SPECIFIC QUESTIONS RAISED IN REVIEW COMMITTEE

3.1 Of those products / investments outlined previously, are any of these tradeable and if so, how do you propose to deal with the risk?

3.1.1 Answer: The investments / products recommended in this updated strategy paper will not be traded in nature, as in they are not in a market that can be bought and sold at higher or lower prices, so in effect the risk of the principal investment being reduced by direct market pressures is reduced significantly. There is further explanation of the risk involved in the types proposed in section 8.

3.2 Will the Section 151 be in control of the investments that are being made?

3.2.1 Answer: Yes, the Section 151 can act in accordance with the Financial regulations, which specifies the level of investment which the Section 151 officer can make within set investment products and limitations as set out in the Treasury Management strategy and this supplement paper

3.3 What has been the recent 6 month performance of the UK GILT market?

3.3.1 Answer: please see Appendix B to this report

3.4 What control framework is in place?

3.4.1 Answer: please see section 9 of this report

3.5 What Investment Management advisory service will be available?

3.5.1 Answer:

- Capita Asset Services provide the Rochford Section 151 with the Investment Management advisory service, based upon regular reports, email alerts and bi annual calls.

- Rochford now also has on call the expert services of the Chief Accountant of Essex County Council and the Financial Accountancy team that she manages, as part of the Section 151 support provided by Essex County Council. This team are experts in Treasury Management and Investment Strategy managing the County's cash balances effectively

3.6 Can a dummy portfolio be set up with the typical products that are being suggested and an historical view of performance?

3.6.1 Answer: Yes, the options in this paper are the first step on this journey and the dummy portfolio will also include some of the items discounted in paragraph 2.9.

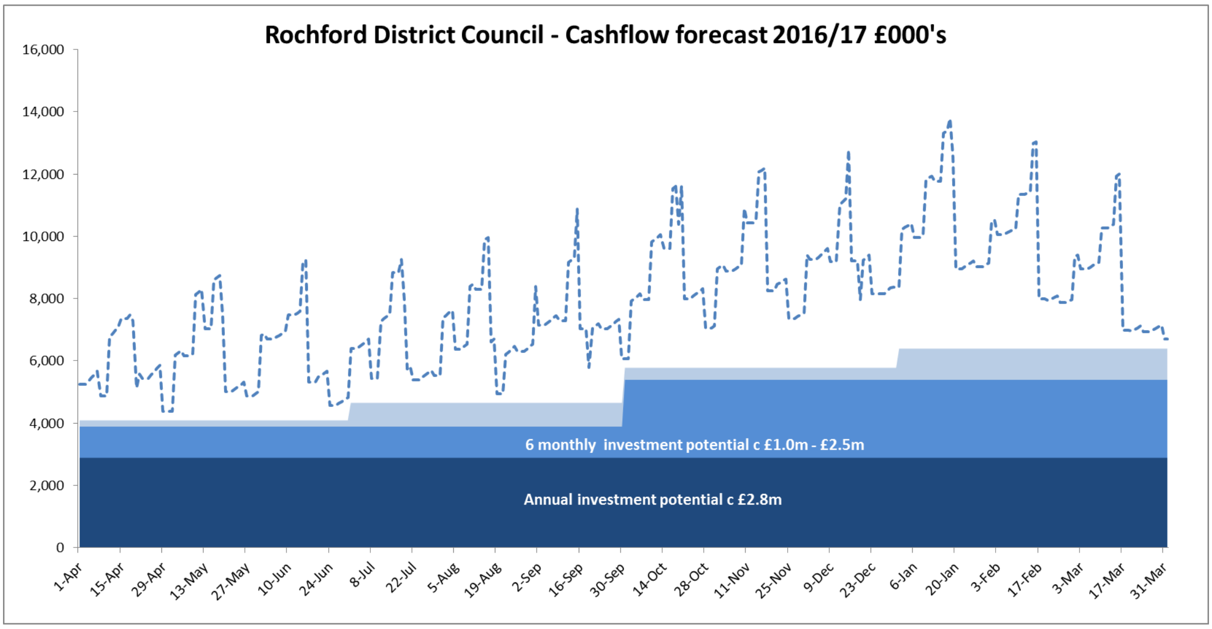
The first report on the performance of this dummy portfolio will be in Q2 of 2016/17, once the EU referendum has occurred so that the position will include a consideration for an extremely volatile period to aid decision making for the potential 2017/18 investment strategy.

4 CASHFLOW FORECAST

4.1 Investment performance is measured against the Local Authority Seven Day Rate (LA7DR) – the aim being to achieve returns that are at least equivalent to this rate.

4.2 Firstly, we must consider the underlying cash flow of the Council, how much is required on a daily and monthly basis to fund the ongoing operations, known as the working capital. Once this is ascertained, a view can be taken of the balance sheet, the capital finance requirements (CFR) and expected reserve movements to ascertain how much cash is available for investing in products between 3-12 months and then over 12 months.

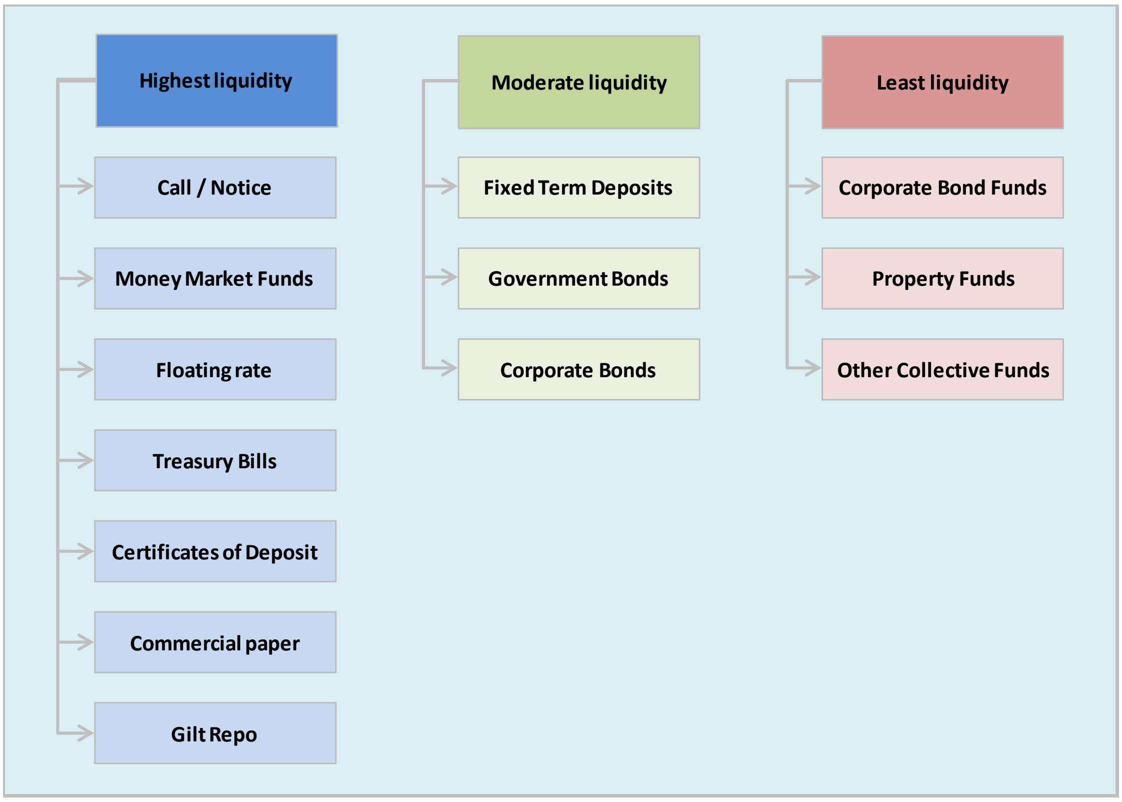
4.3 The graph below shows the movement in the working capital balances and as such it can be ascertained how much **could** be invested in plus one year products, 6 month products, 3 month products and then what remains as a daily cash balance.



4.4 As a guide, the Council's cash flows are expected to fluctuate by an average of **£4.5m** between the peak and trough in its monthly cash flows throughout 2016/17 with the minimum being **£5.8m** in July and maximum being **£10m** in January. With this in mind there are options to invest up to **£2.8m** for over 1 year in 2016/17, between **£1.0m** and **£2.5m** in 6 month term investments, and between **£300k** and **£2.6m** in 3 month term investments. This would always leave at least **£200k** in the bank account at any one time.

5 INVESTMENT OPTIONS

5.1 The following chart lists the types of investment products currently available, categorised according to the liquidity of each product.



5.2 The products offering the highest liquidity will be most suitable for use when investing funds for up to 364 days. Those products offering moderate and the least liquidity will be suitable for use when investing for periods of 1 year +.

5.3 Explanation of the products offering the highest liquidity which are not currently used by the Council:

5.3.1 **Floating rate notes (FRN's)** – bonds on which the rate of interest is established periodically over the life of the deposit with reference to a pre-arranged market rate.

5.3.2 **Treasury bills** – short term debt instruments issued by the UK Government – can be issued with maturities of 1, 3 or 6 months – provide a return to the investor by virtue of being issued at a discount to their final redemption value.

5.3.3 **Certificates of deposit (CD's)** – Tradable deposits with fixed interest – generally issued with a maturity ranging from one month to a year – holder of a CD is able to sell it to a third party before maturity of the CD.

5.3.4 **Commercial paper** – similar to CD's - can be issued by both financial firms and creditworthy corporations – mostly issued for periods from one week to a year.

5.3.5 **Gilt Repo** – one party sells gilts to another and, at the same time, commits to repurchase equivalent gilts on a specified future date, or at call, at a specified price.

5.3.6 Rochford will not consider trading any products unless there was a crisis situation and the funding was required from the general reserve and there were no other sources of cash within RDC. If that was the case, before any consideration of selling the product would occur, a full analysis would be undertaken comparing the potential loss on the sale of said products versus the cost of overdraft fees or the interest on a short term loan, to determine the best value for money.

5.4 Explanation of the products offering the least liquidity which are not currently used by the Council:

5.4.1 **Bonds (Corporate & Government)** – certificate of debt – bond holder is a creditor of the issuer and receives interest at an agreed rate.

5.4.2 **Corporate and other collective Funds** – pooled investments, concentrating in unit trusts, investment trusts or open-ended investment companies, and usually run by professional managers.

6 RISK

6.1 There are risks associated with the use of any combination of these investment products, which may include:

6.1.1 **Liquidity risk** – ability to realise assets in a timely manner, at an appropriate price.

6.1.2 **Security or credit risk** – capital preservation (principal is returned at contractual maturity); payment of interest or principal not being made, or not being made in full.

6.1.3 **Valuation or ‘mark to market’ risk** – paper losses may be reported in year end accounts; liquidating assets prior to maturity could lead to losses being crystalised. Potential issue now becoming apparent with Property funds

6.1.4 **Counterpart risk** – where a portfolio is not diverse enough, and investments made in a single / very small number of institutions now have a single point of failure.

6.2 The use of these investment products therefore need to be weighed against potential rewards of higher returns.

6.3 The counterparties with which the Council will invest funds are largely determined with reference to their credit ratings.

7 CREDIT RATINGS

7.1 The Council uses long-term credit ratings from the three main rating agencies: Fitch Ratings, Moody's Investors Service and Standard & Poor's Financial Services to assess the risk of investment default. The lowest available counterparty credit rating will be used to determine credit quality, unless an investment-specific rating is available. Credit ratings are obtained and monitored by the Council's treasury advisor, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:-

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

7.2 In order to minimise risk and maintain diversity, the Council will have a limit on the amount which can be placed in institution. This limit will also apply to groups. Because the value of investments held at any time can vary by up to **£6m**, depending on cash flow requirements, it is not considered practical to have a percentage limit. The limits will be linked to duration and be as follows:

Capita Colour Coding	Maximum Duration	Maximum Investment
No colour	Not to be used	0
Green	100 days	£6m
Red	6 months 100 days	£3m £6m
Orange	1 year 6 months 100 days	£1m £3m £6m
Blue	1 year	£4m
Purple	2 years 100 days	£3m £6m

Organisation	Maximum Duration	Maximum Investment
Debt Management Office (Government Body)	3 months	£14m
Lloyds Bank current account The Council's main banker	On call (can be withdrawn immediately)	£10m
Money Market Funds – AAA long-term credit rating	On call (can be withdrawn immediately)	£3m per fund

Organisation	Maximum Duration	Maximum Investment
Certificates of Deposit	Will follow the Capita Colour Coding limits as per the above table.	Will follow the Capita Colour Coding limits as per the above table.
Local Authorities	1 year	£3m
Local Capital Finance Company Limited	10 years	£10,000 & 0.6% of borrowing

Country Limits

7.3 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA+ from Fitch Ratings (or equivalent from other agencies if Fitch does not provide).

7.4 Countries other than the UK will be subject to a £3m investment limit for duration of up to one year, subject to Section 151Officer authorisation.

7.5 The Council does not use a fund manager and funds are managed in-house. Investments will accordingly be made with reference to the core balances and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

7.6 **Investment returns expectations.** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 4 of 2016/17. Bank Rate forecasts for financial year ends (March) are:-

- 2016/ 2017 0.75%
- 2017/ 2018 1.25%
- 2018/ 2019 1.75%

7.7 There are upside risks to these forecasts (i.e. start of increases in Bank Rate occur sooner) if economic growth strengthens. However, should the pace of growth fall back there could be downside risk, particularly if Bank of England forecasts for unemployment prove too optimistic.

7.8 The Council will avoid locking into longer term deals while investment rates are down at historically low levels unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile and within the risk parameters set by this Council.

7.9 It is expected that this authority will have sufficient funds to invest that will realise a return on investments c£70,000 - £80,000 for financial year 2016/17

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

8 LIQUIDITY RISK MANAGEMENT

8.1 This Council will ensure it has adequate though not excessive cash resources, borrowing arrangements, overdraft or standby facilities to enable it at all times to have sufficient liquidity in its investments, taking into account known and potential cash-flow requirements and the level of funds available to it which are necessary for the achievement of its business/service objectives.

9 CASH AND CASHFLOW MANAGEMENT

9.1 The optimum amount of cash held by the council will depend on working capital needs. The overall amount of working capital needed can be estimated from forecast activity and the cash conversion cycle.

9.2 The objective should be to keep low interest cash balances at an optimum and maximise temporary investments. There is likely to be a difference between forecast activity and actual activity and therefore working capital will need to be subject to regular review and report to Review Committee/Full Council in the light of changing levels of activity.

9.3 The Council will prepare reports which include cash flow forecasts and actuals on a 12 month rolling basis so as to be able to determine:

- whether minimum acceptable levels of cash balances plus short-term investments might be (or have been) breached
- the adequacy (or otherwise) of standby/overdraft facilities or contingency arrangements. The intention is to never need these, but it must be considered as a contingency plan.
- the optimum arrangements to be made for investing and managing surplus cash.

10 INVESTMENT PORTFOLIO

Investment products	Investment for up to 364 days	Investments for 1-3 years
Call / notice accounts	✓	✗
Fixed term deposits	✓	✓
MMF's	✓	✗
CD's	✓	✓
Property Funds	✗	✓

10.1 Based on the risk appetite of the Council and the potential cash available, the following investment portfolios are options to be considered:

	Portfolio Option 1		Portfolio Option 2		Portfolio Option 3	
	Investment for up to 364 days	Investments for 1-3 years	Investment for up to 364 days	Investments for 1-3 years	Investment for up to 364 days	Investments for 1-3 years
Investment products	£ Invest, % Rate, £ Return	£ Invest, % Rate, £ Return	£ Invest, % Rate, £ Return	£ Invest, % Rate, £ Return	£ Invest, % Rate, £ Return	£ Invest, % Rate, £ Return
Call / notice accounts	£2.8m 0.4% £11k	£ 0.5% £	£2.8m 0.4% £11k	£ 0.5% £	£2.8m 0.4% £11k	£ 0.5% £
Fixed term deposits	£2.2m 0.7% £15k	£m 1.0% £k	£2.5m 0.7% £18k	£m 1.0% £k	£2.5m 0.7% £18k	£m 1.0% £k
MMF's	£1.5m 0.8% £12k	£m 0.9% £k	£1.5m 0.8% £12k	£m 0.9% £k	£m 0.8% £k	£m 0.9% £k
CD's	£m 0.8% £k	£2.8m 1.15% £33k	£m 0.8% £k	£2.0m 1.15% £23k	£1.5m 0.8% £12k	£m 1.15% £k
Property Funds	-	£m 6% £k	-	£0.5m 6% £30k	-	£2.5m 6% £150k
Potential Return	£71k		£94k		£191k	

11 PORTFOLIO OPTIONS

11.1 The options above are a mix of products and investment values in said products over two time periods, up to 1 year and between 1 and 3 years.

11.2 These are potential portfolio's that are available depending on the risk appetite of Rochford based upon the current the market volatility

11.3 The investment level differences represent the mid point available for long term investment based upon the cash flow estimate described earlier. All the options will aim have a minimum of £200k at any time in the bank account on any day throughout the year.

11.4 The investment products in the options above show the range of potential returns at forecast rates for 2016/17 and three of the four can return the target of **£70k to £80k** return per annum.

11.5 The majority of these products are not tradeable, and as such the interest is fixed, however the two products which are tradeable are Certificates of deposit and the Property funds, and both will not be invested into as the intention to trade however, it may be necessary if there is a cash flow crisis, as per 5.3.6.

Property Funds:

11.6 The Property fund considered here is the CCLA, the historic performance of which is outlined in Appendix B, which is proving to be very buoyant in the past few years, but with short term volatility, providing an investment return in the region of 6% p.a.

11.7 The restrictions on the property funds are the liquidity of the investment, often these are investment of 3-10 years, with long lead times to recoup the initial investment (6-9 months in some cases), therefore Rochford needs to be sure it is willing to tie up investments for this long.

11.8 Property funds are now coming under closer scrutiny by local authorities as although they are producing far greater returns than many cash type products, they are soon to be the subject of an accounting change where valuations changes at year end must be recognised, which could mean a significant impact on the each years financial position, and not just the interest gain/loss

11.9 Appendix B shows the historical data of property funds and it can be seen that the funds have suffered significant losses in the past which if the future rules were applied then would have had significant impact on their year end results.

11.10 Many local authorities have invested in these type of products and as such this could pose a risk as any negative movement in property prices could start a run on the fund because there is not enough diversity in the investors, the majority being local authorities, which means our goals are all the same, with similar risk tolerances.

11.11 The referendum due on 23 June 2016 on whether the UK will remain in Europe or not, (BREXIT) will have an impact on the property and investment market, which is not known exactly, but it will unsettle the markets and this uncertainty will have a negative impact on property prices and increased volatility in the markets. The question is how long will this impact be, and will this create a future issue for more complex, market linked products, all which is a further risk to the property fund approach for 2016/17.

Proposal:

11.12 Due to the data set out and the risk/reward available to Rochford, it is recommended that RDC continues with its existing strategy (option 1 above), whilst monitoring the performance of the property funds available, the EU referendum and the implementation of the new accounting rules next year. This gives the reasonable return, estimated at the **£70k** target but with a minimum level of risk based upon these uncertain times.

11.13 The interest rates and cash investment values above will change as the year progresses as the cash flow forecast is updated and with fluctuations in the returns of the products on offer. Therefore, the potential returns are only a guide at this stage.

11.14 Officers will also undertake the dummy portfolio monitoring and report this in Q2 2016/17 to ascertain what the market volatility impact was over this time period on a property fund and a selection of higher risk/higher return products as set out in 2.10.

12 CONTROL

12.1 The Section 151 will have delegated authority to invest cash balances as set out within the limitations of this strategy, as set out in sections **7- 11**

12.2 The portfolio recommendations in this paper are not tradeable and as such will have no need for daily monitoring of the markets, such as a Bloomberg terminal (one of the queries raised at Committee previously), however to clarify Finance staff will still be monitoring the cash balances in the bank account daily and the performance of the products that have been invested in.

12.3 For the proposed products in the current portfolio there will be alerts from Capita Assets Services and Essex County Council if there are any new offers with preferential rates that still fit within the framework as set out in this strategy.

12.4 Rochford is now an online member of Moody's, Fitch and Standard & Poor credit rating agencies and will be monitoring products regularly based upon these providers insight.

13 POLICY ON THE USE OF EXTERNAL SERVICE PROVIDERS

13.1 The Council uses Capita Asset Services as its external treasury management advisers.

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

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

13.4 Through 2016/17 the performance of Capita Asset Services will be monitored closely to guarantee that Rochford District Council is gaining the maximum value for money and being given the best possible treasury/investment management advice. A regular report will be provided to Review Committee along with the investment management advisors performance.

14 SCHEME OF DELEGATION

14.1 Under the Code, the Council is required to specify its Scheme of Delegation for Treasury Management and the responsibilities of the Section 151 Officer, and this is shown below:-

(i) Council

- Receiving and reviewing reports on treasury management policies, practices and activities.
- Approval of annual strategy (including the limits and parameters for investment and borrowing activity).
- Budget consideration and approval.
- Receiving the end of year report on treasury management.

(ii) Review Committee

- Scrutiny of the three main treasury reports, before recommendation to Council or Executive.

(iii) Executive

- Approval of/amendments to the organisation’s adopted clauses, treasury management policy statement and treasury management practices.
- Approval of the division of responsibilities.
- Receiving and reviewing regular monitoring reports and acting on recommendations.

(iv) Audit Committee

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

(v) Section 151 Officer

- Recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance.
- Submitting regular treasury management policy reports.
- Submitting budgets and budget variations.
- Receiving and reviewing management information reports.
- Reviewing the performance of the treasury management function.
- Ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function.
- Ensuring the adequacy of internal audit, and liaising with external audit.

15 RESOURCE IMPLICATIONS

15.1 All interest paid and received is accounted for within the General Fund. The amount of income generated is dependent upon interest rates and level of balances.

16 LEGAL IMPLICATIONS

16.1 This strategy complies with the statutory requirements set out in the Local Government Act 2003 and associated guidance and regulations.

17 RECOMMENDATION

17.1 It is proposed that the Committee **RESOLVES** to build a dummy portfolio including the Property options as per options 2 and 3 on page 6.11 of the report, and also include higher risk / higher return products as set out in paragraph 2.10 to understand the volatility and potential risk/return of this portfolio and to report back to Review Committee in Q2 2016/17 with progress.

Rob Manning

Section 151 Officer

Background Papers:-

None

For further information please contact Rob Manning (Section 151 Officer) on:-

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If you would like this report in large print, Braille or another language please contact 01702 318111.

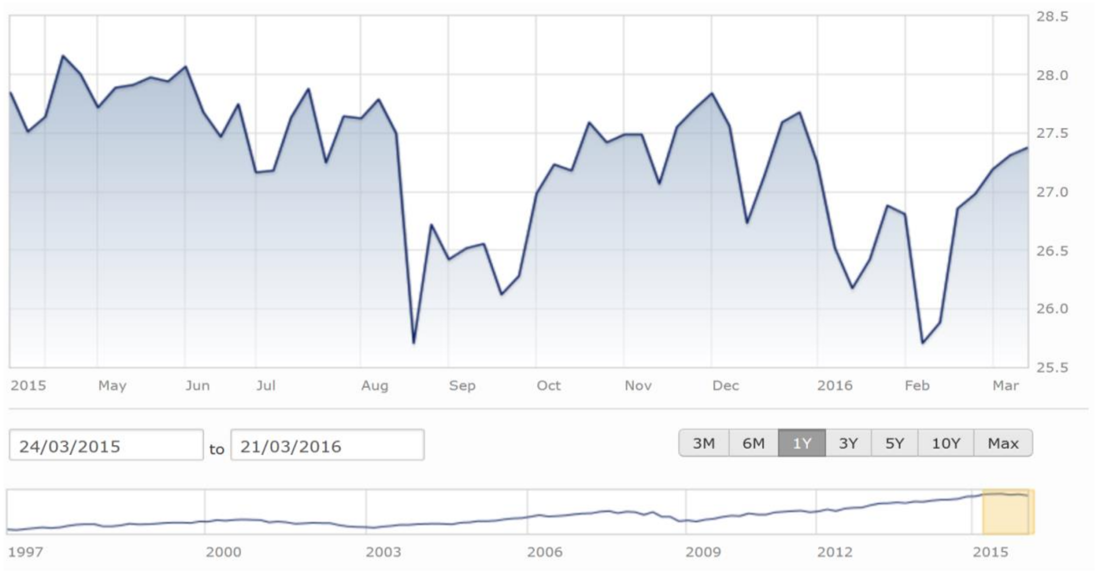
APPENDIX A

Performance of UK GILTS over past 1 year

https://www.trustnet.com/Investments/SectorProfile.aspx?code=U:UGL&univ=U

APPENDIX B

CCLA Property Fund Performance – 1 year past



CCLA Property fund performance – 5 year past

http://www.morningstar.co.uk/uk/funds/snapshot/snapshot.aspx?id=F000002IR1&tab=13