POLICE AND CRIME COMMISSIONER FOR AVON AND SOMERSET

POLICE & CRIME BOARD – 12th April 2017

TREASURY MANAGEMENT STRATEGY STATEMENT 2017-18

REPORT OF THE PCC's CHIEF FINANCE OFFICER

PURPOSE

1. The CIPFA 'Treasury Management in the Public Services' Code of Practice (Revised) 2011 (CIPFA TM Code) requires that each Local Authority prepare a report outlining the proposed Treasury Management policies, strategy, and activities for the coming financial year.
2. The Local Government Act 2003 (LGA 2003) requires that an Annual Investment Strategy Statement be submitted, outlining the proposed investment strategy. This can be combined with the Treasury Management Statement, but must state explicitly where it is dealing with the guidance by the Secretary of State. The CLG Guidance was revised and updated, with changes effective from 1st April 2010.
3. Under Section 3 of the LGA 2003 (duty to determine affordable borrowing limit), a Local Authority must have regard to the CIPFA Prudential Code for Capital Finance in Local Authorities Revised 2011 Edition (CIPFA Prudential Code). This code requires the setting of a number of Prudential Indicators, benchmarks within which Treasury and Investment Management, and Capital Financing are managed.
4. The setting of Prudential Indicators requires Authorities to recognise key implications of their borrowing and investment strategies. These relate to the affordability of overall borrowing limits and the risk of exposure to interest rate changes, the maturity structure of borrowing, credit risk, and longer-term investments.
5. This report brings together the requirements of the LGA 2003, and the CIPFA TM, and Prudential Codes. In presenting the Treasury Management and Investment Strategies, and the Prudential Indicators, account is taken of the current treasury position and the outlook for interest rates.

BACKGROUND

6. The debt portfolio at 31st December 2016 stood at just over £36.2m. During 2016-17, the differential between investment earnings and debt costs remains negative. The cost of carry associated with long term borrowing compared to temporary investment returns, as well as the added counterparty risk by having more funds to invest, meant that a passive borrowing strategy, borrowing funds as they are required has remained appropriate. Capital expenditure to date during financial year 2016-17 has been paid for from cash balances and reserves. It is anticipated that further borrowing of up to £5m may be required before the end of the current year to meet capital funding requirements and manage reserve levels.
7. As at 31st December there were investments of approximately £50m, with a peak of nearly £92m, and an average daily balance of nearly £66m for the year-to-date. These factors represent significant cash management and cash flows, and

it is important that the Police & Crime Commissioner ("PCC") and team – Office of Police & Crime Commissioner ("OPCC") have strategies and policies in place to manage such balances and turnover effectively.

8. The PCC is responsible for its treasury decisions and activity. No treasury management activity is without risk. The successful identification, monitoring and control of risks are the prime criteria by which the effectiveness of the PCC's treasury management activities will be measured. The main risks to the PCC's treasury activities are: -
   - Credit and counterparty risk (security of investments);
   - Liquidity risk (inadequate cash resources);
   - Market or interest rate risk (fluctuations in interest rate levels);
   - Refinancing risk (impact of debt maturing in future years);
   - Legal & regulatory risk.

9. The PCC currently manages its treasury management activities via contractual agreement with Somerset County Council (SCC).

10. The PCC will appraise its Treasury Management and Investment Strategies from time to time to ensure that they continue to be fit for purpose, and if necessary, to realign them with evolving market conditions and expectations for future interest rates. Any revisions or changes would need to be passed by the appropriate body.

TREASURY MANAGEMENT POLICY STATEMENT

Introduction and Background

11. This PCC adopts the key recommendations of CIPFA's Treasury Management in the Public Services: Code of Practice (the code), as described in Section 5 of the Code.
    1. Accordingly, the PCC will create and maintain, as the cornerstones for effective treasury management: -
       - A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities.
       - Suitable treasury management practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.
    2. This PCC will receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review, and an annual report after its close, in the form prescribed in its TMPs;
    3. This PCC delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to the **PCC's Police & Crime Board,** and for the execution and administration of treasury management decisions to the Chief Finance Officer, who will act in accordance with the organisation's policy statement and TMPs and, if he/she is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management;

4. This PCC nominates the **Joint Audit Committee ("JAC")** to be responsible for ensuring effective scrutiny of the governance of treasury management strategy and policies.

Policies and Objectives of Treasury Management Activities

12. The PCC defines its treasury management activities as: -

    "The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

13. The PCC regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the PCC, and any financial instruments entered into to manage these risks.

14. The PCC acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

15. The PCC's borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk and refinancing risk. The source from which the borrowing is taken and the type of borrowing should allow the PCC transparency and control over its debt.

16. The PCC's primary objective in relation to investments remains the security of capital. The liquidity or accessibility of the PCC's investments followed by the yield earned on investments remain important, but are secondary considerations.

TREASURY MANAGEMENT STRATEGY

Short-Term Borrowing

17. The PCC has not needed to obtain short-term funds from the money market during 2016-17 to date. This is due to the use of Call Accounts and Money Market Funds (MMFs), which offer better security and liquidity (instant access in most cases), with the added benefit of better rates than for most short-term deposits of up to 3-months. This is expected to continue into 2017-18.

18. The use of Call Accounts and MMFs, as covered in the Investment Strategy will continue where advantageous to rates and/or cash flow, and will provide optimal liquidity of funds. If this is not deemed advantageous, or there is an unforeseen shortfall, short-term funds may be obtained from the London Money Market using the services of money market brokers.

Long-Term Borrowing

19. The PCC's need to borrow for capital purposes is determined by the Capital Programme. **Within the Medium Term Financial Plan (MTFP) there is an updated report on the Capital Programme.** The PCC and OPCC are aware of the major projects identified for the financial years 2017 to 2021. **In addition to the possible £5m of borrowing needed during 2016-17, there is a potential**

further requirement of £10m for 2017-18, and a further £10m for 2018-19 to support the capital programme a set out in the MTFP papers approved by the PCC and Chief in January 2017 at the Police & Crime Board. There is £926,000 of PWLB debt scheduled to be repaid during 2017-18.

20. A prudent and pragmatic approach to borrowing will be maintained to minimise borrowing costs without compromising the longer-term stability of the portfolio, consistent with the PCC's Prudential Indicators. The PCC will keep under review the options it has in borrowing from the PWLB, the market and other sources identified in the TMPs, up to the available capacity within its Authorised Limit.

21. The overriding objective for new borrowing is that it will be carried out in line with the CIPFA TM Code, i.e. that performance measurement should consider risk as well as cost (borrowing rate). Priority will be given to risk management, and secondly the pursuit of minimising rate. There are many circumstances that may force borrowing at rates higher than the lowest achievable rate, but may be directly attributable to good risk management or differing risk tolerances. These may include: -

    - Taking loans of a stated maturity regardless of rate to ensure the desired maturity profile and thereby reduce refinancing risk;
    - Taking Lender's Options Borrower's Option (LOBO) loans with greater regard to the structure rather than the cheapest rate where optionality exposes the PCC to refinancing, liquidity, and interest rate risk;
    - Taking LOBO loans that dovetail with existing LOBO optionality;
    - It may not be policy to borrow in advance of need even though it may be generally accepted that rates will go higher in the near future.
    - It may be prudent to wait until capital expenditure has been incurred before loans are taken, even though rates may increase in the interim.

22. There are simple performance measures available, i.e. debt rate achieved in relation to average PWLB rates for the year, for any given maturity and type of loan. However, it is suggested that each loan be looked at individually to develop an appreciation of the factors influencing performance, with a view to improving the future processes of treasury decision-making.

23. **To support the Capital Programme as set out in the MTFP papers approved by the PCC and Chief in January 2017, (always subject to detailed business case approval) covering 2017-2021 new borrowing of £10m in 2017-18 and £10m in 2018-19 are forecast as required.** This is subject to actual levels and timing of capital receipts and expenditure.

24. The differential between investment earnings and debt costs remains negative and this is expected to continue during 2017-18. The cost of carry associated with long term borrowing compared to temporary investment returns, as well as the added counterparty risk by having more funds to invest, means that a passive borrowing strategy, borrowing funds internally, may again remain appropriate for the majority of the year. As a borrowing need has been identified, the benefits of this strategy will be monitored and weighed against the risk of shorter-term rates rising more quickly than expected.

25. The PWLB remains an attractive source of borrowing, given the transparency and control that its facilities continue to provide. At the time of writing, PWLB variable rates remain at approximately 1.05% to 1.15%, and are expected to remain low as Base Rate is kept at current low levels to help to sustain the recovery and the

uncertainty caused by Brexit. Variable rate loans currently mitigate the cost of carry. Shorter-dated EIP loans are cheaper than loans repaid on maturity and are repaid systematically in equal instalments over their life. Both will be actively considered where necessary.

26. A possible alternative to the PWLB is borrowing for between 1 to 3 years from other Local Authorities. If this source of borrowing is available, then duration, rates, and maturity dates will be factors when considering these loans as part of the portfolio.

27. LOBO loans generally offer lower rates than PWLB, but present a potential risk that once the initial period has ended the lender can exercise its option to ask an enhanced rate of interest (This rate of interest would then be fixed until the end of the loan, subject to further lender options to raise). The primary factor when considering a new market loan would be the structure of the loan (the length of time before the first option, and the period between options). Proposed new loans would need to dovetail with the existing LOBO loans' structures.

28. The PCC has £11.775m of LOBO loans of which one, for £2.5m will have an option during 2017-18. A LOBO is called when the Lender exercises its right to amend the interest rate on the loan at which point the Borrower can accept the revised terms or reject them and repay the loan without penalty. LOBO loans present a potential refinancing risk to the PCC since the decision to call a LOBO is entirely at the lender's discretion. In June 2016, Barclays Bank announced that they had waived all their rights to the options on the LOBO loans that they made. This included the £6.5m loan held by the PCC. This loan is now effectively a long-term fixed loan.

29. In the event that the lender exercises the option to change the rate or terms of the loans, the PCC's policy is to repay the loans without penalty rather than accept a higher rate. The PCC would replace the loans by borrowing from the PWLB or Local Authorities, or may consider utilising cash resources for repayment.

30. Prudential Indicators are set as part of a framework for Treasury Management in relation to the overall borrowing limit, the level of exposure to changes in interest rates, and the maturity structure of borrowing. Allowances have been made accordingly to accommodate this strategy.

Debt Rescheduling

31. The PCC will maintain a flexible policy for debt rescheduling. Current market volatility and the possible steepening of the yield curve may provide opportunities during the year, but it seems very unlikely.

32. Any restructuring undertaken would be with the objective of reducing interest costs, or to alter the maturity profile of the loans portfolio to reduce inherent refinancing risks.

33. Options will be appraised taking into account relevant accounting regulations, and decisions will comply with stated regulations.

ANNUAL INVESTMENT STRATEGY (AIS)

Introduction

34. The Office of the Deputy Prime Minister, (now Communities and Local

Government) issues guidance on Local Government Investments under section 15(1) of the LGA 2003. Changes to this guidance came into effect from 1st April 2010.

35. The overriding aim of the guidance is to encourage authorities to invest prudently, without burdening them with detailed prescriptive regulation. The priority given to security and liquidity, rather than yield is re-emphasised in the revised guidance. It states: - *"Provided that proper levels of security and liquidity are achieved, it may then (but only then) be reasonable to seek the highest yield consistent with those priorities"*. With this in mind, the PCC has set an objective of achieving a gross return of 0.5% above 7-day LIBID, over a rolling 3-year period.

36. Under the guidance there are two types of investment, 'Specified' and 'Non-Specified'. Specified investments are those that offer high security and high liquidity, are made in Sterling, and with a maturity of no more than one year. Investments with the UK Government, other Local Authorities, or bodies with 'high credit quality' will count as specified investments. Non-Specified investments are all other investments that fall outside of this description, and must be dealt with in more detail than those classified as Specified.

37. Proposals state that the AIS can be replaced by a revised strategy, if circumstances change during the year, subject to PCC approval. As stated in point 10, the PCC will from time to time appraise its Investment Strategy, including counterparty criteria, to ensure that it continues to be fit for purpose, and if necessary, to realign it with evolving market conditions and expectations for future interest rates

38. Since April 2010 the PCC's investments and cash flows have been managed on a segregated basis, in the name of the PCC.

Investment Strategy

39. The PCC's cash flows, and thereby investments can be divided into three main areas.

- Monthly working capital (Approximately £25m) - This is regular monthly grant and precept income received and used to pay monthly outgoings such as creditors and payroll. This is lent very short term to help smooth cash flows.
- Funds which have been identified as not being immediately required (Approximately £25m) – This pot is core balances / reserves, and can be lent for longer periods, providing sufficient liquidity is maintained via a rolling portfolio of loans.
- Annual Pensions top-up (£45m for 2016-17). This rump of cash is generally spent evenly throughout the year, and can be invested accordingly, i.e. investments with maturities spread evenly throughout the year.

40. Short-term, mainly revenue cash will be lent for short periods where appropriate, with authorised counterparties, either by direct contact or via brokers. Call Accounts and Money Market Funds (MMFs) will also be used to provide instant access to funds. AAA rated MMFs offer a high security, high liquidity investment into an extremely diversified portfolio. Many Call Accounts and MMFs offer more competitive rates than short-term time deposits, with the extra benefit of instant access. Proposed regulatory changes to MMFs may result in the Funds changing to VNAV and/or not being credit-rated in the future.

41. The pool of funds identified as not immediately needed, i.e. earmarked reserves and core balances (circa £25m) will be invested for longer periods when investment conditions are deemed favourable, to protect against a prolonged period of low interest rates. Given the increasing risk and falling returns from short-term unsecured bank investments, it may be appropriate to diversify into more secure and/or higher yielding asset classes during 2017-18. The pensions top-up will be invested via both short-term call facilities and the use of time deposits up to 1 year.

42. The Chief Finance Officer, under delegated powers, will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. He in turn commissions treasury management services including implementing policy to Treasury Management Officers at SCC. Details of deposits and investments taken by SCC Officers are reported monthly to the Chief Finance Officer and discussed at quarterly meetings.

43. Under current market conditions the PCC will primarily focus its investment activity to that considered during 2016-17, namely: -

- Business Reserve Accounts and term deposits, including authorised overseas banks;
- Deposits with other Local Authorities or PCCs;
- AAA-rated Money Market Funds with a Constant Net Asset Value;
- VNAV Funds
- The Government Debt Management Office
- Certificates of Deposit with Banks and Building Societies
- Commercial Paper

44. Due to the implementation of the UK Banking Reform Act 2014, and the broadly similar European Union Bank Recovery and Resolution Directive, and the perceived lack of government support for, and potential bail-in risk at banks and building societies, it would seem prudent to allow for greater diversification of investment instruments and counterparties. The list of further potential investment activities below was included last year, and they will continue to be monitored and assessed as alternatives to mitigate bail-in risk and falling, potentially negative returns.

- Use of any public or private sector organisation or issue that meets the creditworthiness criteria rather than just banks and building societies.
- Building Societies – Including unrated Societies with better creditworthiness than their credit rated peers.
- Corporate Bonds – Can offer access to high credit rated counterparties, such as utility, supermarket, and infrastructure companies.
- Covered Bonds and Reverse Repurchase Agreements (Repos) present an opportunity to invest short-term with banks on a secured basis and hence be exempt from bail-in.
- Gilts or other sterling denominated sovereign or supra-national bonds.
- Pooled funds. These funds allow the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. Their values change with market prices, so will be

considered for longer investment periods. It would be the Authority's intention to be invested in longer-dated bond funds or equity funds for at least 3 years, and for property funds for 5 years plus.

As is current procedure, the use of a new instrument or counterparty would be proposed and specifically authorised on a case-by case basis by the Chief Finance Officer.

45. These proposals would mean that most PCC investments would remain within the 'Specified Investments' category, i.e. offering high security and high liquidity. However, the changes to investment strategy would mean that the following would fall into the 'Non-Specified' category.

- The continued use of the PCC's current bankers, Nat West should they have their ratings downgraded below the minimum criteria. (In this case the instant access Call Account facility would still be used for short-term liquidity requirements and business continuity arrangements).
- Deposits and marketable instruments with a maturity over 364 days and up to 5 years. **There will be a limit of £25m for investments outstanding over 1-year at any given time, as per the Prudential Indicators.**
- Unrated Building Societies. Many unrated Building Societies are of equal or better creditworthiness than their credit rated peers. Consideration will be given to Societies after analysis of suitable creditworthiness indicators (Funding and Capital ratios, % of non-performing loans). Deposits will be limited to £1m per Society for a maximum of 1 year.
- CNAV and VNAV Funds. CNAV Funds will become 'Non-Specified' should they all no longer be rated. The merits of individual VNAV and other pooled Funds will be discussed with Fund Managers to ensure their philosophy and risk parameters are aligned with those of the PCC. Any Fund is to be approved by the Chief Finance Officer prior to use. VNAV Funds will be considered on an individual basis, taking into account the risk/reward characteristics including volatility, expected income return and potential for capital growth. No more than £30m of total investments outstanding are to be held in VNAV Funds.
- Other Pooled Funds. These have no defined maturity date, but are available for withdrawal after a notice period. The fact that their market value changes (and may at times go below the original investment) means that they need to be viewed as a longer-term investment. With this in mind, the CFO will determine the level of prudent investment, with reference to the level of core balances and reserves, and the potential volatility of any proposed investment.

46. A new requirement of revised guidance is that the strategy should report on procedures for ensuring that treasury management staff have the right kind of training in investment management. As part of the contracting-out exercise, the PCC satisfies itself that the personnel proposed by the contractor are sufficiently qualified and experienced to manage the PCC's investments.

Counterparties for Lending

47. The financial crisis has refocused attention on the treasury management priority of security of capital monies invested. The PCC has constructed and will maintain a counterparty list based on the criteria set out in appendix A. As per recommendation, minimum credit quality is proposed to be set at BBB+ or equivalent. BBB+ counterparties used will be on a duration far shorter than the ratings outlook period of 13-months. The creditworthiness of institutions (and issues if used) will be monitored and updated on a regular basis. This assessment will include credit ratings and other alternative assessments of credit strength as outlined below.

48. The PCC will continuously monitor counterparties. All three credit rating agencies' websites will be visited frequently, and all ratings of proposed counterparties will be subject to verification on the day of investment. All ratings will be reported in the monthly treasury management report, and quarterly at meetings with the Chief Finance Officer, where proposals for any new eligible counterparties will be discussed, agreed, and minuted before they are used. Any changes to ratings that put the counterparty below the rating criteria whilst they hold a deposit will be brought to the attention of the Chief Finance Officer immediately, and an appropriate response decided on a case-by-case basis. Sovereign credit ratings will be monitored and acted on as for financial institution ratings.

49. Current conditions in the financial sector continue to improve, but the uncertainty caused by Brexit has seen greater volatility in financial markets, and an expectation that economic conditions may deteriorate in the future. Given the increasing risk and falling returns from short-term unsecured bank investments, it may be appropriate to diversify a proportion of funds into more secure and/or higher yielding asset classes during 2017-18.

50. With approximately £45m of Pensions top-up in July expected, it would seem prudent to maintain current exposures to individual counterparties whilst seeking greater diversification where possible. This will always be subject to identifying counterparties that will continue to provide acceptable levels of counterparty risk.

51. The sovereign states whose banks and other organisations are to be considered are Australia, Canada, Denmark, Finland, France, Germany, Netherlands, Singapore, Sweden, Switzerland, and the USA.

Maximum investment levels with counterparties and by type of investment are included in the criteria to ensure prudent diversification is achieved.

52. The PCC will use a range of indicators to assess counterparties, not just credit ratings. Among other indicators to be taken into account will be:-

- Credit Default Swaps and Government Bond Spreads;
- GDP, and Net Debt as a Percentage of GDP for sovereign countries;
- Likelihood and strength of Parental Support;
- Banking resolution mechanisms for the restructure of failing financial institutions, i.e. bail-in;
- Share Price;
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.
- Underlying security or collateral for 'covered instruments'.
- Other macroeconomic factors

Such indicators of creditworthiness are considered in relative rather than

absolute terms, and this is how short-term ratings are also considered.

It remains the PCC's policy to suspend or remove institutions that still meet criteria, but where any of the factors above give rise to concern. Also, when it is deemed prudent, the duration of deposits placed is shortened or lengthened, depending on counterparty specific metrics, or general investment factors.

53. The revised CIPFA TM code requires that the PCC must explicitly state whether it plans to use derivative instruments to manage risks. Currently, Local Authorities' legal power to use derivative instruments remains unclear. The General Power of Competence enshrined in the Localism Bill is not sufficiently explicit. Consequently, the PCC does not intend to use derivatives. Should this position change, the PCC may seek to develop a detailed and robust risk management framework governing the use of derivatives, but this change in strategy will require PCC approval.

PRUDENTIAL INDICATORS

54. The first Prudential Indicator considered by treasury management is that the PCC has adopted the CIPFA TM Code. ***The PCC adopts the content and the spirit of the Revised 2011 code (confirmed at Police & Crime Board)***

55. The PCC is required to set an ***authorised limit*** for total external debt, gross of investments, separately identifying borrowing from other long-term liabilities. The PCC is also required to set an operational limit separately identifying borrowing from other long-term liabilities. This prudential indicator is referred to as the ***operational boundary***, and is based on the PCC's estimate of the most likely, i.e. prudent, but not worst-case scenario. They are both set for the forthcoming, and the following two years.

56. Both the authorised limit and the operational boundary are consistent with the PCC's plans for capital expenditure and financing; and with the treasury management statement. As the capital programme and capital receipts are both subject to complex change programmes and collaboration programmes, and changing CT requirements, sufficient contingency will be allowed for borrowing to fill this shortfall. As it is not envisaged that borrowing in advance of need will be taken, these limits do not incorporate flexibilities to take capital in advance, as per point 24.

57. The PCC has set upper limits to the fixed and variable rate exposures to the effects of changes in interest rates. Prudential Code guidance point 227 acknowledges that there may be circumstances where a PCC's actual or projected exposures, when subjected to calculations set out in the code, will deliver extreme values. This is the case with projected PCC exposures and is due to two main factors.

    1) The fact that due to cash flows during the year, debt held will change from a position of being greater than investments to a position where it will be less than investments, means that the net difference between the two (the divisor for calculation purposes) becomes very small. This has the effect of giving greater variance of percentages for smaller movements between fixed/variable scenarios.
    2) Current market conditions, and the adoption of the principal that all deposits of less than one year are treated as variable rate, means that the PCC will be investing the majority of funds in variable rate

deposits.

58. The calculations deliver extreme exposure values, in some scenarios more than 2,000%. These figures, under current conditions are deemed meaningless, so it is considered more effective to view debt and investment portfolios on a segregated basis. Variable rate deposits are part of the strategy for 2017-18, as point 40, and now that all deposits of less than one year are treated as variable rate, a limit of 100% has been set to accommodate this. Where fixed rate loans are held (£15m maximum as point 45), they may form a larger percentage at year-end when funds are low (£32m has been the lowest point in 2016-17 to date, and may be lower over the MTFP period as reserves are utilised for capital and change). Therefore a limit of 45% has been set and will be kept under review.

59. The PCC has set for the forthcoming year, both the upper and lower limits with respect to the maturity structure of its borrowing. These indicators are referred to as the ***upper*** and ***lower limits*** respectively ***for the maturity structure of its fixed rate borrowing***. The calculation is the amount of projected borrowing that is fixed rate maturing in each period, expressed as a percentage of the total projected borrowing that is fixed rate. Revised guidance recommends breaking maturity profile into more significant periods where there are maturities greater than 10 years. The periods to be used going forward, are: -

- Under 12 months
- >12 months and within 24 months
- >24 months and within 5 years
- >5 years and within 10 years
- >10 years and within 20 years
- >20 years and within 30 years
- >30 years and within 40 years
- >40 years and within 50 years
- >50 years

60. The 2011 Revised CIPFA Code guidance for the ‘maturity structure’ indicator has been revised to specifically state that the maturity of LOBO loans should be treated as if their next option date is the maturity date. They had previously been treated as running to maturity, so the percentage of earlier maturities has risen. The ‘maturity structure of borrowing’ indicators have been set with regard to this change, and having given due consideration to proposed new borrowing, current interest rate expectations, and the possibility of rescheduling loans outlined in the borrowing strategy.

61. The next treasury management prudential indicator is referred to as the ***total principal sum invested for a period longer than 364 days***. The purpose of this indicator is to help the PCC to contain its exposure to the possibility of loss that might arise as a result of having to seek early repayment or redemption of principal sums invested. The PCC’s investment strategy includes the possibility to lend for a maximum of five years. Whilst the proposed investment strategy would point to a minimal prudential indicator for investments over 364 days, practice is that once an investment is over 364 days (and therefore ‘Non-Specified’), it remains that until maturity. This means that if investment conditions were to improve during the year, the PCC might well invest more on a rolling one-year basis. Furthermore, should the PCC wish to diversify into pooled funds, it would be the Authority’s intention to be invested in these for periods of 3-5 years

plus. **A prudential indicator of £25m is deemed necessary.**

62. In order that the preceding Treasury and Investment Management Strategies are carried out, the following Prudential Indicators are recommended to the PCC: -

	2017-18 £000	**2018-19 £000**	**2019-20 £000**
Authorised limit (borrowing only)	**75,000**	**75,000**	**75,000**
Operational boundary	**70,000**	**70,000**	**70,000**
Debt - Upper limit on 1) fixed, 2) variable interest rate exposure	1) 100%	2) 20%	
Investments - Upper limit on 1) fixed, 2) variable interest rate exposure	1) 45%	2) 100%	

Maturity structure of borrowing

	Upper Limit	Lower Limit
Under 12 months	30%	0%
> 12 months and < 24 months	30%	0%
> 24 months and < 5 years	35%	10%
> 5 years and < 10 years	25%	0%
> 10 years and < 20 years	30%	0%
> 20 years and < 30 years	15%	0%
> 30 years and < 40 years	20%	10%
> 40 years and < 50 years	35%	15%
> 50 years	0%	0%

	2017-18 £m	**2018-19 £m**	**2019-20 £m**
Prudential Limit for principal sums invested for periods longer than 364 days	**25.0**	**25.0**	**25.0**

63. The 2011 Revision suggested that Authorities may wish to create an indicator that considers Credit Risk. At this stage there has been no guidance on how this is to be measured or reported. The PCC considers security, liquidity and yield, in that order, when making investment decisions. Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the PCC's assessment of counterparty credit risk. The only indicators with prescriptive values are credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms. Counterparty Creditworthiness criteria and other indicators are stated in appendix A.

64. CIPFA introduced a new indicator for 2013-14, **‘Gross debt and the Capital Financing Requirement’**. The objective of the indicator is to ensure that borrowing only takes place for capital purposes over the medium to long-term. Where the gross debt is greater than the CFR, the reasons should be clearly stated in the Treasury Management Strategy. The gross debt is less than the current CFR for the PCC.

REPORTING ARRANGEMENTS

65. The Chief Finance Officer will report to the PCC on its treasury activities in the form of an Annual Treasury Management Report, and to the Finance Committee on an interim basis as required.

66. As required by the revised CIPFA TM Code, a mid-year review will be prepared for the full PCC, in the form described in the TMPs.

67. Appropriate analysis of the outstanding debt position as required by the Prudential Code will be included in the Annual Statement of Accounts.

68. Officers from the SCC Treasury Management team report debt and investment positions and performance via monthly papers, and at quarterly meetings with the PCC Chief Finance Officer.

MEMBER TRAINING

69. CIPFA’s revised TM Code states that – *“All public service organisations should be aware of the growing complexity of treasury management in general, and its application to the public services in particular. Modern treasury management demands appropriate skills…..”.*

    It goes on, *“Public service organisations have a responsibility to ensure that those charged with governance have access to the skills and knowledge they require to carry out this role effectively. The organisation should ensure that this also applies to treasury management”.*

    It further states, *“Those charged with governance also have a personal responsibility to ensure that they have the appropriate skills and training for their role”.*

70. SCC Officers would be able and willing to provide a level of training, if the PCC CFO thought that there would be no conflict of interest.

71. SCC could also facilitate training via an independent third party, and have contacts within a number of money market brokers and fund managers who could provide training.

72. As and when needed, briefing sheets could be prepared and distributed to keep the PCC and the PCC CFO/CEO abreast of current developments.

RECOMMENDATIONS

The PCC is recommended to: -

(i) Approve the Treasury Management Strategy for the financial year 2017-18.

(ii) Approve the Annual Investment Strategy for the financial year 2017-18.

(iii) Note the Prudential Indicators for the financial years 2017-2020.

Mark Simmonds
Chief Finance Officer, Office of the PCC for Avon & Somerset

For further information please contact Mark Simmonds, Chief Finance Officer, on (01275) 816380 or e-mail: Mark.Simmonds@avonandsomerset.police.uk

PCC Lending Counterparty Criteria 2017-18 Appendix A

The following criteria will be used to manage counterparty risks to PCC Investments for new deposits from the time that the new Treasury Management Strategy Statement, (which includes the Annual Investment Strategy) is passed by the PCC at its meeting in February 2017: -

Deposits - Any Financial Institution that is authorised by the PRA to accept deposits, or is a passported EEA institution, which is entitled to accept deposits in the UK, or is a UK Building Society can be lent to subject to the rating criteria below at the time of the deposit.

Unrated Building Societies
Unrated Building Societies as identified by suitable creditworthiness indicators (Better than average Liquid Assets to Funding Ratio, Wholesale Funding Ratio, Capital to Lending Ratio, Non-Performing loans) can be used, with a maximum of £1m per Society and a maximum maturity of 1 year.

Marketable Instruments – Any bank, other organisation, or security whose credit ratings satisfy the criteria below: -

Rating of Counterparty or Security
Deposits of less than 13 months duration (Refer to long-term ratings only)
Fitch BBB+ or above
S&P BBB+ or above
Moody's Baa1 or above

The maximum deposit / investment amount for any authorised counterparty or security that has as a minimum at least two ratings of the three above will be £7m (approximately 10.5% of average investments during 2016-17 (to December).

The maximum deposit / investment amount for any authorised counterparty or security that has as a minimum - Fitch AA-, S&P AA-, and Moody's Aa3, will be £8m (approximately 12.0% of average investments 2016-17 (to December).

Deposits of more than 13 months (Refer to long-term ratings)
Fitch AA- or above
S&P AA- or above
Moody's Aa3 or above

The maximum deposit amount for more than 13 months for any authorised counterparty that has as a minimum all three ratings above will be £3m. This figure is to be included in the overall figure above.

The allowed deposit amounts above are the single maximum per counterparty at any one time, and that counterparty must be rated as above or better by at least two of the three ratings agencies. Short-term ratings will be monitored and considered, but in relative rather than absolute terms.

It remains the PCC's policy to suspend or remove institutions that still meet criteria, but where any other indicators give rise to concern. Also, when it is

deemed prudent, the duration of deposits placed is shortened or lengthened, depending on counterparty specific metrics, or general investment factors. Where deposits held were made under previous criteria, there will be no compulsion to terminate those deposits to meet new criteria, where a penalty would be incurred.

The table below gives a definition and rough comparison of various ratings by the three main agencies: -

Definitions of Rating Agency Ratings

	Fitch		Moody's		S&P	
Short-Term	**F1+**	Exceptionally strong	**P-1**	Superior	**A-1+**	Extremely strong
	F1	Highest quality			**A-1**	Strong
	F2	Good quality	**P-2**	Strong	**A-2**	Satisfactory
	F3	Fair quality	**P-3**	Acceptable	**A-3**	Adequate
	B	Speculative	**NP**	Questionable	**B and below**	Significant speculative characteristics
	C	High default risk				
	(+) or (-)		**(1,2, or 3)**		**(+) or (-)**	
Long-Term	**AAA**	Highest quality	**Aaa**	Exceptional	**AAA**	Extremely strong
	AA	V High quality	**Aa**	Excellent	**AA**	Very strong
	A	High quality	**A**	Good	**A**	Strong
	BBB	Good quality	**Baa**	Adequate	**BBB**	Adequate capacity
	BB	Speculative	**Ba**	Questionable	**BB and below**	Significant speculative characteristics
	B	Highly Speculative	**B**	Poor		
	CCC	High default risk	**Caa**	Extremely poor		

Financial Groups
For Financial Groups (where two or more separate counterparties are owned by the same eventual parent company) investments can be split between entities, but an overall limit equal to the highest rated constituent counterparty within the group will be used.

Operational Bank Accounts
Amounts contained in operational bank accounts with the PCC's main Bank (currently Nat West) will not count in the calculation of Nat West's limit as defined above. In the event of unexpected receipts after 2pm on any given working day, money may be placed in an instant access Nat West call account overnight, in breach of the above limits. Whenever this occurs the total lending to Nat West must be reduced to back within their limit on the following working day.

If the PCC's current bankers, Nat West have their ratings downgraded below the minimum criteria, the instant access Call Account facility may still be used for short-term liquidity requirements and business continuity arrangements.

Country Limits
Excluding the UK, there will be a limit of (approximately) 12% of total investments in any one country. For 2017-18, this will be £8m, 12% of average balances for 2016-17 to December (£66.2m), rounded up to the nearest £1m.

Money Market Funds
Until such time as proposed regulatory changes come into effect, Constant Net Asset Value (CNAV) Money Market Funds must be rated by at least two of the main three ratings agency, and must have the following ratings.

Fitch AAAmmf Moody's Aaa-mf Standard & Poor's AAAm

Subject to the above, deposits can be made with the following limits: -

The lower of £8m or 0.5% of the total value for individual Funds.
No more than 50% of total deposits outstanding are to be held in CNAV MMFs.

VNAV Pooled Funds
Currently, not all Variable Net Asset Value (VNAV) Funds carry a rating. Many VNAV bond funds are not rated. Equity, multi-asset and property funds are also not credit rated. The decision to invest in a particular asset class or fund will be based on the evaluation of the risk/reward characteristics including volatility, expected income return and potential for capital growth.

Furthermore, proposed regulatory changes would see many CNAV Funds becoming VNAV, and a rating could not be sought. In this case, as currently, VNAV Funds will be considered on an individual basis.

No more than £30m of total deposits outstanding are to be held in VNAV Funds.

Public Sector Bodies
Any UK Local Authority or Public Body will have a limit of £5m and a maximum maturity of 5 years.

The UK Government Debt Management Office (DMADF) will be unlimited in amount and duration.

Other Indicators
As had previously been the case with SCC, and is now a requirement of the revised CLG guidance, the PCC will use a range of indicators, not just credit ratings. Among other indicators to be taken into account will be: -

- Credit Default Swaps and Government Bond Spreads.
- GDP, and Net Debt as a Percentage of GDP for sovereign countries.
- Likelihood and strength of Parental Support.
- Banking resolution mechanisms for the restructure of failing financial institutions, i.e. bail-in.
- Share Price.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.
- Underlying security or collateral for 'covered instruments'.
- Other macroeconomic factors.