HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Audit Committee
Date:	14 December 2017
Title:	Treasury Management Monitoring Report 2017/18
Report From:	Director of Corporate Resources – Corporate Services

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1. Recommendations

1.1. That the mid-year review of treasury management activities be noted.

1.2. That the potential impact on the investment strategy of defaulting to a retail client with effect from 3rd January 2018 be noted.

1.3. That the Audit Committee notes the following recommendations agreed by County Council:

1.4. That the immediate commencement of applications for elected professional client status with all relevant institutions in order to ensure it can continue to implement an effective investment strategy be agreed.

1.5. In electing for professional client status County Council acknowledges and agrees to forgo the protections available to retail clients attached at Appendix 1.

1.6. That County Council approves delegated responsibility to the Section 151 Officer for the purposes of completing the applications.

2. Purpose

2.1. The Treasury Management Strategy for 2017/18 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

2.2. The Code also recommends that members are informed of Treasury Management activities at least twice a year (a mid year and a year end report). This report therefore ensures that the County Council is embracing best practice in accordance with CIPFA's recommendations.

2.3. Treasury Management is defined as: "the management of investments and cash flows, 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".

3. Economic Background

3.1. The following section outlines the key economic themes currently in the UK against which investment and borrowing decisions have been made in the year to date.

External Context

3.2. UK Consumer Price Inflation (CPIH) for the year to August 2017 was 2.7%, up from 2.6% in July 2017; the largest upward contributions came from housing and household services (mainly from owner occupiers' housing costs and, to a lesser extent, from electricity prices and Council Tax), and clothing and footwear (the rise in inflation in this category may reflect changes in the exchange rate in impacting on the cost of imported clothing). The most recent labour market data for July 2017 showed that the unemployment rate dropped to 4.3% (its lowest since the three months to May in 1975) but the squeeze on real wages (i.e. after inflation) is intensifying and resulting in negative real wage growth. Quarter 1 GDP data released in April and revised in May and June showed economic activity growing at a much slower pace of 0.2%, and the estimates of Quarter 2 GDP data released in July and August showed the economy growing at a rate of 0.3% over the quarter. The Bank of England made no change to Bank Rate or its Quantitative Easing policy (QE) at its meeting on 14 September 2017.

3.3. Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty and in the hope of gaining an enhanced mandate to enter the forthcoming Brexit negotiations. The surprise result has led to a minority Conservative government in a confidence and supply arrangement with the Democratic Unionist Party. This political impasse clearly results in an enhanced level of political uncertainty, however the potential for a so-called hard Brexit is now diminished, reducing the associated economic headwinds for the UK economy from a 'no deal' or otherwise unfavourable trade agreement.

3.4. The reaction from the markets on the election's outcome has been fairly muted; business confidence now hinges on the progress of Brexit negotiations, whether new trade treaties and arrangements are successfully concluded and whether or not the UK continues to remain part of the EU customs union post the country's exit from the EU.

3.5. In the face of this uncertainty, the County Council's treasury management advisor, Arlingclose, expects the Bank of England will look through periods of high inflation and maintain its low-for-longer stance on policy interest rates for an extended period.

Financial markets

3.6. Gilt yields displayed some volatility with a marked uptick in late June. This was largely due to the expectation of tapering of QE in the US and Europe, which also had an impact on gilts. The FTSE 100 reached a record high of

7548 in May but dropped off slightly towards the end of Quarter 1, and down to 7438 on 31 August. However this level is still considered high in comparison to recent trends.

Credit background

3.7. UK bank credit default swaps have continued their downward trend, reaching three year lows by the end of June. Bank share prices have not moved in any particular pattern.

3.8. Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. The County Council will work with Arlingclose to manage this situation as greater clarity is provided over the following months.

4. Investment Activity

4.1. The County Council holds invested funds representing income received in advance of expenditure plus balances and reserves held. The County Council is currently investing according to a low risk, high quality lending list as outlined in its Treasury Management Strategy.

4.2. The transposition of European Union directives into UK legislation places the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors through potential bail-in of unsecured bank deposits. (The outcome of the EU referendum does not alter the UK's legislated bail-in resolution regime.)

4.3. Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the County Council's aim to further diversify into more secure and/or higher yielding asset classes. The majority of the County Council's surplus cash was previously invested in short-term unsecured bank deposits, certificates of deposit and money market funds.

The County Council's investment holding was £587m at 31 August 2017, which was £16m (2.8%) greater than the same time last year. The table below shows investment activity for the County Council as at 31 August 2017 in comparison to the reported investment activity as at 31 March 2017:

Table 1: Investment Activity in 2017/18

Investments	Asset value on 31/03/2017 £m	Asset value on 31/08/2017 £m	Average Rate/Yield on 31/08/2017 %	Average Life on 31/08/2017 years
Short term Investments				
Banks and Building Societies:				
Unsecured	35.7	60.2	0.41	0.18
Secured	20.0	50.0	0.77	0.50
Money Market Funds	61.7	23.5	0.22	0.00
Local Authorities	116.8	160.8	1.07	0.59
Corporate Bonds	1.3	-	-	-
Registered Provider	-	20.0	1.79	0.41

	235.5	314.5	0.87	0.44
Long term Investments Banks and Building Societies: Secured Local Authorities	 70.0 97.5	 100.8 51.5	 0.59 2.15	 2.34 1.62
	167.5	152.3	1.12	2.10
Long term Investments – high yielding strategy Local Authorities Fixed deposits Fixed bonds Pooled Funds Pooled property* Pooled equity* Pooled multi-asset* Registered Provider	 20.0 10.0 45.0 20.0 10.0 5.0	 20.0 10.0 55.0 20.0 10.0 5.0	 3.96 3.78 4.10 6.45 4.52 3.40	 16.55 16.36 n/a n/a n/a 1.66
	110.0	120.0	4.45	14.37
TOTAL INVESTMENTS	513.0	586.8	1.67	1.92
Increase/ (Decrease) in Investments £m		73.8		

* Yield represents the average of each investment class' most recent dividend payments as a percentage of the asset value.

4.4. Cash balances in August are always greater than in March due to many government grants being front-loaded, and so March is generally the cash low point of the year. During the five-month period, the value of County Council cash liable to bank bail-in risk (unsecured bank investments and funds invested in money market funds) has been reduced, whilst the proportion of funds in high-yielding investments has increased. These movements have increased the diversification of the investment portfolio, reduced bail-in risk, and increased the average yield at 31 August 2017.

4.5. As part of the 2017/18 Investment Strategy the total amount targeted towards high yielding investments was increased to £200m. Investments yielding higher returns will contribute additional income to the County Council, although some come with the risk that they may suffer falls in the value of the principal invested.

4.6. Of the £200m available £120m has been invested (an increase of £10m since 31 March 2017), and a further £40m is committed to pooled property, equity and multi-asset funds. The investments in these pooled funds allow the County Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. The funds, which are operated on a variable net asset value (VNAV) basis offer diversification of investment risk, coupled with the services of a professional fund manager; they also offer enhanced returns over the longer term but are more volatile in the short-term. All of the County Council's pooled fund investments are in the respective fund's distributing share class which pay out the income generated.

4.7. Although money can be redeemed from the pooled funds at short notice, the County Council's intention is to hold them for at least the medium-term. Their performance and suitability in meeting the County Council's investment objectives are monitored regularly and discussed with Arlingclose.

Table 2: Pooled fund investments capital value at 31 August 2017

Pooled fund investments	Principal invested £m	Market value 31/08/17 £m	Capital yield (per annum) %
Pooled property	55.0	55.0	0.17
Pooled equity	20.0	21.6	7.95
Pooled multi-asset	10.0	10.0	-0.02
Total	**85.00**	**86.6**	**6.57**

4.8. Counterparty credit quality was assessed and monitored with reference to credit ratings (the County Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is BBB+ across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

4.9. The average cash balances were £610m during the year to 31 August 2017. The average interest rate earned on the County Council's investments at 31 August 2017 was 1.67%, which should be considered within the context of a low UK Base Rate of 0.25%, and very low short-term money market rates.

4.10. The Guidance on Local Government Investments in England gives priority to security and liquidity and the County Council's aim is to achieve a yield commensurate with these principles. This has been maintained by following the County Council's counterparty policy as set out in its Treasury Management Strategy for 2017/18.

5. Borrowing

5.1. The County Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31 March 2017 was £755m. Affordability and the "cost of carry" remained important influences on the County Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing.

5.2. For the County Council the use of internal resources in lieu of borrowing has, therefore, continued to be the most cost effective means of funding capital expenditure. No new long-term borrowing has taken place to date in 2017/18, or is planned for the remainder of the year. This has lowered overall treasury risk by reducing both external debt and temporary investments.

5.3. As at 31 August 2017 the County Council held £296m of loans, (a decrease of £37m on 31/03/2017), made up of Public Works Loans Board (PWLB) loans and market loans (including Lender's Option Borrower's Option (LOBO) loans), as part of its strategy for funding previous years' capital programmes.

5.4. The premia that applies to the premature repayment of the County Council's PWLB loans is still relatively expensive for the loans in the portfolio, and therefore unattractive for debt rescheduling. As a consequence, no PWLB debt rescheduling has taken place. However, consideration will continue to be given to an advantageous opportunity for the County Council to reduce or restructure its debt portfolio.

5.5. The County Council holds £20m of LOBO loans (down from the £73m historical balance, as explained in paragraphs 5.6 - 5.8) where the lender has the option to propose an increase in the interest rate at set dates, following which the County Council has the option to either accept the new rate or to repay the loan at no additional cost. None of the LOBO loan options were exercised by the lender in the year to date.

5.6. In June 2016 Barclays Bank informed the County Council of its decision to cancel all the embedded options within standard LOBO loans. This effectively converted £13m of the County Council's Barclays LOBO loans to fixed rate loans removing the uncertainty on both interest cost and maturity date. This waiver was been done by 'deed poll'; it is irreversible and transferable by Barclays to any new lender.

5.7. In July 2017, the County Council negotiated the repayment of £32m of LOBO loans, and repaid these at a saving in comparison to the total cost expected over the loans' lifetime.

5.8. In August 2017 the Royal Bank of Scotland also informed the County Council of its decision to cancel all the embedded options within standard LOBO loans, which effectively converted £8m of the County Council's loans to fixed rate loans. RBS then sold these two loans totalling £8m to Phoenix Life Assurance Limited (part of Phoenix Group Holdings).

6. MiFID II

6.1. The European Union, through its Market in Financial Instruments Directive (MiFID II), is aiming to improve the functioning of financial markets in light of the financial crisis and to strengthen investor protection. This changing of rules will impact how local authorities can access regulated financial services. Although the UK has voted to leave the EU, MiFID II will still be implemented in the UK on 03 January 2018 for three reasons. Firstly, the UK's residents remain members of the EU and subject to its laws until the UK leaves; secondly, the UK government is in favour of strengthening investor protection; and thirdly, UK firms will wish to continue providing financial services across the EU after the UK has left the EU, so will need to comply with equivalent regulations.

6.2. The Financial Conduct Authority (FCA) has some discretion over how to implement this directive in the UK, and it released its final policy statement on the subject in July 2017.

6.3. Local authorities are currently treated by financial services firms as “professional clients”, the middle of three categories, and the same as similar-sized companies. But from January 2018, the default position will be that local authorities are to be treated as “retail clients”, the same as individuals and small and medium-sized enterprises, which will entail some increased protection, but at the expense of higher fees, increased paperwork and reduced market access.

6.4. It is expected that “opting-up” will be the most favourable position for the County Council as it will allow all investment opportunities detailed within the investment strategy to be accessed, whilst being a retail investor will limit investment opportunities, for example no access to money market funds or brokers. Opting up to professional status will also allow continued access to the current asset classes the County Council is invested in, without the increased fees that retail asset classes demand. Opting up will mean the County Council will not be able to take advantage of the increased protections available to retail clients (retail protections are available at Annex 1 – this list was provided by the Local Government Association and represents protections for all different types of investment, including investments not applicable under the current treasury management strategy). However, this will not be a change from the current status, as these protections are not currently afforded to professional clients.

6.5. Local authorities will be permitted to “opt-up” to professional client status, providing they meet the following criteria:

6.6. the firm has assessed that the person authorised to carry out transactions on the local authority’s behalf has the expertise, experience and knowledge to give reasonable assurance in light of the nature of the transactions or services envisaged, that they are capable of making their own investment decisions and understanding the risks involved;

the size of the local authority’s investment portfolio (including cash deposits) exceeds £10 million; and

at least one of the following is true:

the local authority has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters;

the person authorised to carry out transactions on behalf of the local authority works or has worked in the financial sector (including as a treasury manager) for at least one year in a professional position, which requires knowledge of the services envisaged; or

the local authority is a Local Government Pension Scheme administering authority and is acting in that capacity (this was not included in the consultation).

6.7. Considering these criteria, the County Council should be able to opt up to professional client status to maintain the most favourable investment position possible, but this will be decided on a per investment basis in conjunction with the County Council’s Finance team. Significant work will be undertaken over the months to January 2018 to achieve this aim. So as to enable the opt-up process a number of recommendations have been included on page 1 of this appendix.

6.8. Applications can be made in respect of either all of the services offered by the institution (even if not already being accessed) or a particular service only. A local authority may wish to do the latter where the institution offers a wide range of complex instruments which the authority does not currently use and there is no intention to use the institution again once the current relationship has come to an end. It is recommended that officers determine the most appropriate basis of the application, either via full or single service.

6.9. Authorities are not required to renew elections on a regular basis but will be required to review the information provided in the opt-up process and notify all institutions of any changes in circumstances which could affect their status.

7. Compliance with Prudential Indicators

7.1. Within 2017/18 to date, the County Council operated within the Prudential Indicators for 2017/18, which were set in February 2017 as part of the County Council's Treasury Management Strategy Statement.

Authorised Limit and Operational Boundary for External Debt

7.2. CIPFA's Code of Practice requires authorities to set an authorised limit for external debt, defined as the sum of external borrowing and other long-term liabilities. The annual strategy report agreed by the County Council in February 2017 set an authorised limit for external debt of £960m.

7.3. This limit is based on the estimated CFR in order to enable it to be financed entirely from external borrowing should the County Council's internal reserves become depleted. The limit also includes an allowance for temporary borrowing to cover normal revenue cash flow requirements and unexpected outflows or delays in receiving cash.

7.4. The County Council has set an operational boundary for external debt reflecting the more likely scenario and consistent with the County Council's capital plans and Treasury Management Strategy. Temporary breaches of 2017/18 operational boundary can take place for cash flow reasons, but any sustained breach will lead to further investigation. The County Council approved an operational boundary for 2017/18 of £860m.

Table 3: Authorised Limit and Operational Boundary for External Debt

	Authorised Limit £m	Operational Boundary £m	2017/18 Actual £m
Borrowing*	750	690	445
Other long-term liabilities	210	170	57
Total Debt	960	860	502

7.5. During the period to 31 August 2017, borrowing remained well within the authorised limit and operational boundary, and no new long-term borrowing has been taken out.

8. Treasury Management Indicators

8.1. The County Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

8.2. The County Council has to set an upper limit on its fixed and variable interest rate exposures for both total investments and total external debt. This indicator is set to control the County Council's exposure to interest rate risk. The County Council approved the following upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed or invested. None of the limits have been exceeded.

Table 4: Interest Rate Exposures

	2017/18 limit	**Maximum to 31 August 2017**
Upper limit on fixed interest rate investment exposure	£375m	£132.5m
Upper limit on variable interest rate investment exposure	£700m	£556.2m
Upper limit on fixed interest rate borrowing exposure*	£960m	£445.1m
Upper limit of variable interest rate borrowing exposure	£960m	£56.9m

* Includes Waste Management and Street Lighting contracts

8.3. The limit for borrowing rate exposures has been set to enable maximum policy flexibility for the potential for refinancing e.g. from variable to fixed rate borrowing. The County Council's entire long-term debt portfolio is currently made up of fixed interest loans.

8.4. The upper limit for exposures for investments rates is based on an extreme case of the total investment balances, and to allow for all of this to be held at variable rates (investments with a maturity of less then one year) if necessary.

Maturity Structure of Borrowing

8.5. The Code also requires the County Council to set upper and lower percentage limits on the maturity structure of its long-term fixed rate borrowing during 2017/18. The following table shows the limits approved by the County Council. These have been set to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

Table 5: Maturity Structure of Borrowing

	Upper	Lower	Actual
Under 12 months	50%	0%	4.9%
12 months and within 24 months	50%	0%	0.0%
24 months and within 5 years	50%	0%	11.6%
5 years and within 10 years	75%	0%	17.3%
10 years and within 20 years	75%	0%	51.7%
20 years and within 30 years	75%	0%	14.5%
30 years and above	100%	0%	0.0%

Principal Sums Invested for Periods Longer than 364 days

8.6. The purpose of this indicator is to control the County Council's exposure to the risk of incurring losses by seeking early repayment of its investments. For 2017/18 the County Council restricted investments for periods of over a year to maximum of £375m. Although at 31 August 2017 the County Council had £272m of investments with over 364 days to their maturity, this indicator reached its peak in May 2017 at £302m.

CORPORATE OR LEGAL INFORMATION:

Links to the Strategic Plan

This proposal does not link to the Strategic Plan but, nevertheless, requires a decision because the management of the County Council's cash balance needs to be decided.

Other Significant Links

Links to previous Member decisions:	
Title	Date
Direct links to specific legislation or Government Directives	
Title	Date

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

Document	Location
None	

IMPACT ASSESSMENTS:

1. Equality Duty

1.1. The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

Eliminate discrimination, harassment and victimisation and any other conduct prohibited under the Act;

Advance equality of opportunity between persons who share a relevant protected characteristic (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, gender and sexual orientation) and those who do not share it;

Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

Due regard in this context involves having due regard in particular to:

The need to remove or minimise disadvantages suffered by persons sharing a relevant characteristic connected to that characteristic;

Take steps to meet the needs of persons sharing a relevant protected characteristic different from the needs of persons who do not share it;

Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity which participation by such persons is disproportionally low.

1.2. **Equalities Impact Assessment:**

Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

Warnings - loss of protections as a Professional Client

Professional Clients are entitled to fewer protections under the UK and EU regulatory regimes than is otherwise the case for Retail Clients. This document contains, for information purposes only, a summary of the protections that you will lose if you request and agree to be treated as a Professional Client.

1. Communicating with clients, including financial promotions

As a Professional Client the simplicity and frequency in which the firm communicates with you may be different to the way in which they would communicate with a Retail Client. They will ensure however that our communication remains fair, clear and not misleading.

2. Information about the firm, its services and remuneration

The type of information that the firm provides to Retail Clients about itself, its services and its products and how it is remunerated differs to what the firm provides to Professional Clients. In particular,

(A) The firm is obliged to provide information on these areas to all clients but the granularity, medium and timing of such provision may be less specific for clients that are not Retail Clients; and

(B) there are particular restrictions on the remuneration structure for staff providing services to Retail Clients which may not be applicable in respect of staff providing services to Professional Clients;

(C) the information which the firm provides in relation to costs and charges for its services and/or products may not be as comprehensive for Professional Clients as it would be for Retail Clients, for example, they are required when offering packaged products and services to provide additional information to Retail Clients on the risks and components making up that package; and

(D) when handling orders on behalf of Retail Clients, the firm has an obligation to inform them about any material difficulties in carrying out the orders; this obligation may not apply in respect of Professional Clients.

3. Suitability

In the course of providing advice or in the course of providing discretionary management services, when assessing suitability for Professional Clients, the firm is entitled to assume that in relation to the products, transactions and services for which you have been so classified, that you have the necessary level of experience and knowledge to understand the risks involved in the management of your investments. The firm will assess this information separately for Retail Clients and would be required to provide Retail Clients with a suitability report.

4. Appropriateness

For transactions where the firm does not provide you with investment advice or discretionary management services (such as an execution-only trade), it may be required to assess whether the transaction is appropriate.

In respect of a Retail Client, there is a specified test for ascertaining whether the client has the requisite investment knowledge and experience to understand the risks associated with the relevant transaction. However, in respect of a Professional Client, the firm is entitled to assume that they have the necessary level of experience, knowledge and expertise to understand the risks involved in a transaction in products and services for which they are classified as a Professional Client.

5. Dealing

A range of factors may be considered for Professional Clients in order to achieve best execution (price is an important factor but the relative importance of other different factors, such as speed, costs and fees may vary). In contrast, when undertaking transactions for Retail Clients, the total consideration, representing the price of the financial instrument and the costs relating to execution, must be the overriding factor in any execution.

6. Reporting information to clients

For transactions where the firm does not provide discretionary management services (such as an execution-only transactions), the timeframe for our providing confirmation that an order has been carried out is more rigorous for Retail Clients' orders than Professional Clients' orders.

7. Client reporting

Investment firms that hold a retail client account that includes positions in leveraged financial instruments or contingent liability transactions shall inform the Retail Client, where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. These reports do not have to be produced for Professional Clients.

8. Financial Ombudsman Service

The services of the Financial Ombudsman Service may not be available to you as a Professional Client.

9. Investor compensation

Eligibility for compensation from the Financial Services Compensation Scheme is not contingent on your categorisation but on how your organisation is constituted. Hence, depending on how you are constituted you may not have access to the Financial Services Compensation Scheme.

10. Exclusion of liability

The FCA rules restrict the firm's ability to exclude or restrict any duty of liability which the firm owes to Retail Clients more strictly than in respect of Professional Clients.

11. Trading obligation

In respect of shares admitted to trading on a regulated market or traded on a trading venue, the firm may, in relation to the investments of Retail Clients, only arrange for such trades to be carried out on a regulated market, a multilateral trading facility, a systematic internaliser or a thirdcountry trading venue. This is a restriction which may not apply in respect of trading carried out for Professional Clients.

12. Transfer of financial collateral arrangements

As a Professional Client, the firm may conclude title transfer financial collateral arrangements with you for the purpose of securing or covering your present or future, actual or contingent or prospective obligations, which would not be possible for Retail Clients.

13. Client money

The requirements under the client money rules in the FCA Handbook (CASS) are more prescriptive and provide more protection in respect of Retail Clients than in respect of Professional Clients.

It should be noted that at all times you will have the right to request a different client categorisation and that you will be responsible for keeping the firm informed of any change that could affect your categorisation as a Professional Client.