Appendix 'B'

The County Council's Treasury Management Strategy 2014/15

Introduction and Legislative Framework

Under the Local Government Act 2003, local authorities must have regard to Statutory Proper Practices in their Treasury Management activities. In February 2012 the Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code).

These together require the County Council on an annual basis to set out its strategy in relation to key aspects of its treasury management operations over the coming year.

In addition, in accordance with government guidance on local authority investments, the Council is required to approve an investment strategy before the start of each financial year.

In line with these various requirements this strategy includes:

- The Annual Borrowing Strategy (1 below)
- The Council's Policy on Borrowing in Advance of Need (2 below)
- The Annual Investment Strategy (3 below)
- The Prudential Indicators (Annex A to this Appendix)
- The Annual MRP statement (Appendix C to the report)

In conjunction with the Treasury Management Policy Statement and the detailed Treasury Management Practices approved by the County Treasurer, these provide the policy framework for the engagement of the County Council with the financial markets in order to fund its capital investment programme and maintain the security of its cash balances.

Strategic Objectives of the Treasury Management Strategy

The County Council's Treasury Management Strategy is designed to achieve the following objectives:

a) To ensure the security of the principal sums invested which represent the County Council's various reserves and balances
b) To ensure that the County Council has access to cash resources as and when required
c) To minimise the cost of the borrowing required to finance the County Council's Capital Investment programme, and
d) To maximise investment returns commensurate with the County Council's policy of minimising risks to the security of capital and its liquidity position.

In the context of these objectives it will be the County Council's policy to hold as investments a sum as close to the cash value of its balance sheet as possible, matching both value and duration as closely as possible.

Setting the Treasury Management Strategy for 2014/15

In setting the treasury management strategy, the County Council must have regard to the following factors which will have a strong influence over the strategy adopted:

- economic forecasts,
- the level of the approved Capital Programme which generates the borrowing requirement,
- the current structure of the County Council's investment and debt portfolio
- prospects for interest rates and market liquidity.

Economic context

The Bank of England’s Monetary Policy Committee (MPC) through its recent forward guidance is committed to keeping policy rates low for an extended period using the Labour Force Survey unemployment rate of 7% as a threshold for when it would consider whether or not to raise interest rates, subject to certain knock-outs. Unemployment was 7.4% October 2013, but is not forecast to fall below the threshold until 2016, due to the UK’s flexible workforce.

The flow of credit to households and businesses is slowly improving but is still below pre-crisis levels. The fall in consumer price inflation from the high of 5.2% in September 2011 to 2.7% in September 2013 will allow real wage increases (i.e. after inflation) to slowly turn positive and aid consumer spending.

Stronger growth data in 2013 (0.4% in Q1, 0.7% in Q2 and 0.8% in Q3) alongside a pick-up in property prices mainly stoked by government initiatives to boost mortgage lending have led markets to price in an earlier rise in rates than warranted under Forward Guidance and the broader economic backdrop. However, with jobs growth picking up slowly, many employees working shorter hours than they would like and benefit cuts set to gather pace, growth is likely to only be gradual. The Council's adviser's Arlingclose forecast that the MPC will maintain its resolve to keep interest rates low until the recovery is convincing and sustainable.

In the US, in response to a generally improving economic outlook, the Federal Reserve has begun the process of slowing the pace of asset purchases, and despite recent disappointing employment data, this process of modest 'tapering' is likely to continue in the coming months with some commentators suggesting quantitative easing will be completed by year end. To date the muted reaction of bond and equity markets suggests the expectation of tapering was already factored in to asset prices.

Credit outlook

The credit risk of banking failures has diminished, but not dissipated altogether. Regulatory changes are being considered in the UK, US and Europe to move away

from the bank bail-outs of previous years to bank resolution regimes in which shareholders, bond holders and unsecured creditors are 'bailed in' to participate in any recovery process. This is already manifest in relation to holders of subordinated debt issued by the Co-op who will suffer a haircut on its conversion bail-in to alternative securities and/or equity There are also proposals for EU regulatory reforms to Money Market Funds which will, in all probability, result in these funds moving to a VNAV (variable net asset value) basis and thus losing their 'triple-A' credit rating wrapper. Diversification of investments between creditworthy counterparties to mitigate bail-in risk will become even more important in the light of these developments.

The Current Structure of the Portfolio

The Council's treasury portfolio (net of transferred debt) as at 31st December 2013 was as follows.

	Principal Amount £m	Current Interest Rate %
Call accounts	18.892	0.518
Short-term deposits	20.00	2.620
Long-term deposits	119.925	2.312
Bond Portfolio	423.515	2.956
Total Investments	**582.331**	**2.733**
Short-term loans	266.250	0.603
Long-term loans (Local Authorities)	60.00	1.805
Shared Investment Scheme	84.591	0.645
Long-term PWLB loans	338.850	3.017
Long-term market loans (LOBOs)	51.911	5.389
Total Borrowing	**801.602**	**2.028**
Net Borrowing	**219.270**	

The shared investment scheme relates to funds pooled with the County Council's investments by the Police and Crime Commissioner for Lancashire, Lancashire Combined Fire Authority and Lancashire District Councils. The objective of the scheme is to reduce the counterparty credit risk for those organisations by using the County Council as their investment counterparty. Although the sums invested are accounted for as borrowing by the County Council they are not included within capital financing calculations and will show as borrowing over and above the capital financing requirement. They will however be included within the authorised borrowing limit.

This scheme has proved more popular than anticipated, such that in order to avoid exceeding the borrowing limits set under the prudential code the County Council had to close this facility to the Lancashire District Councils in summer 2012. Since the external credit environment is still far from stable, this strategy will include in the calculation of the operational and authorised limits for the 2014/15 financial year,

additional headroom to enable the full operation of the scheme from the date the strategy becomes effective.

Prospects for Interest Rates and Market Liquidity

In planning the treasury management strategy, the Council will consider the prevailing and forecast interest rate situation. Regular forecasts of interest rates are provided by Arlingclose Ltd, treasury management advisers to the County Council.

Arlingclose's forecast is for short term interest rates to remain flat. Markets are still pricing in an earlier rise in rates than warranted under Forward Guidance and the broader economic backdrop. The MPC will not raise rates until there is a sustained period of strong growth. However, upside risks do weigh more heavily towards the end of the forecast horizon.

Arlingclose continue to project gilt yields on an upward path through the medium term. Their view is that the rise in yields since the Spring of 2013 was overdone given the still uncertain fundamental global outlook and risks surrounding the Eurozone, China and US.

The latest forecast provided by Arlingclose Ltd is shown in the table below:

	Bank Rate	3 Month LIBID	12 Month LIBID	5 year Gilt Yield	10 year Gilt Yield	25 year Gilt Yield	50 year Gilt Yield
Mar 14	0.50	0.45	0.90	1.45	2.55	3.25	3.45
Jun 14	0.50	0.45	0.95	1.50	2.60	3.30	3.50
Sep 14	0.50	0.50	0.95	1.55	2.65	3.35	3.55
Dec 14	0.50	0.55	0.95	1.60	2.70	3.40	3.60
Mar 15	0.50	0.65	1.00	1.65	2.75	3.45	3.65
Jun 15	0.50	0.75	1.05	1.70	2.80	3.50	3.70
Sep 15	0.50	0.75	1.10	1.75	2.85	3.55	3.75
Dec 15	0.50	0.75	1.15	1.85	2.90	3.65	3.80
Mar 16	0.50	0.75	1.20	1.95	3.00	3.75	3.85
Jun 16	0.50	0.75	1.25	2.10	3.10	3.85	3.95
Sep 16	0.50	0.80	1.30	2.30	3.30	4.05	4.05
Dec 16	0.50	0.80	1.40	2.50	3.50	4.15	4.15
Mar 17	0.50	0.80	1.40	2.50	3.50	4.15	4.15

In the above table 'bank rate' refers to the policy rate of the Bank of England.

'LIBID' is the London Interbank bid rate and can be used as a proxy for short term market interest rates. PWLB borrowing rates are based on 'Gilt Yield' and so this is a forecast of long term interest rates. The Council can borrow at 80 basis points above the gilt yield, so for example the current fixed interest rate to borrow funds from the PWLB over a 25 year period would be 3.25% + 0.80% = 4.05%.

This forecast of interest rates has been based on the following underlying factors and assumptions:

- Growth continues to strengthen with the second estimate for Q3 growth coming in at an unrevised 0.8%. The service sector remains the main driver of growth, boosted by a contribution from construction.
- The unemployment rate has fallen to 7.6%. The pace of decline in this measure will be dependent on a slower expansion of the workforce than the acceleration in the economy, alongside the extent of productivity.
- The CPI for November has fallen to 2.1%, a much more comfortable position for the MPC. Utility price increases are expected to keep CPI above the 2% target in 2014, before falling back again.
- The principal measure in the MPC's Forward Guidance on interest rates is the Labour Force Survey (LFS) unemployment rate. The MPC intends not to consider raising the Bank Rate from its current level of 0.5% at least until this rate has fallen to a threshold of 7%.
- The reduction in uncertainty and easing of credit conditions have begun to unlock demand, much of which has fed through to the housing market. In response to concerns over a house price bubble, the Bank of England announced a curtailment of the Funding for Lending Scheme (FLS), which will henceforth concentrate on business lending only.
- The MPC will not hesitate to use macro prudential and regulatory tools to deal with emerging risks (such as curtailing the FLS). Apart from responding to extreme risks to either price or financial stability, the MPC will only tighten policy when it is convinced about the sustained durability of economic growth.
- Federal Reserve monetary policy expectations - the slowing in the pace of asset purchases ('tapering') and the end of further asset purchases - will remain predominant drivers of the financial markets. Tapering of asset purchases will begin in Q1 2014. The US political deadlock over the debt ceiling will need resolving in Q1 2014.
- The European backstop mechanisms have lowered the risks of catastrophic meltdown. The slightly more stable economic environment at the aggregate Eurozone level could be undone by political risks and uncertainty in Italy, Spain and Portugal (doubts over longevity of their coalitions). The ECB has discussed plans for a third long term refinancing operation (LTRO), as credit conditions remain challenging for European banks.
- China data has seen an improvement, easing markets fears. Chinese leaders have signalled possible monetary policy tightening, but liquidity issues with the regional banks and local authorities may prove problematic.
- The on-going regulatory reform and a focus on bail-in debt restructuring is likely to prolong banking sector deleveraging and maintain the corporate credit bottleneck.

Impact of these factors on the Borrowing Strategy

In view of the above forecast the Council's borrowing strategy will be based upon the following information:-

Despite the gradually improving economic outlook, the UK still remains in a relatively low growth situation, with a continuing tight fiscal and loose monetary policy approach. It could be 2015 before there is a rise in official UK interest rates and the UK's safe haven status and minimal prospect of rate rises are expected to keep gilt yields in check through the near term. However,

- If it were felt that there was a significant risk of a sharp fall in long and short term rates, e.g. due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.
- If it became apparent that there was a significant risk of a much sharper rise in long and short term rates than that currently forecast, perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap. This approach is reflected in the Council's prudential indicators.

The Council’s chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Authority’s long-term plans change is a secondary objective.

Given the significant cuts to public expenditure and in particular to local government funding, the Council’s borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term instead. By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. Whilst such a strategy is most likely to be beneficial over the next year or so as official interest rates remain low, it is unlikely to be sustained in the medium-term. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose will assist the Council with this ‘cost of carry’ and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2014/15 with a view to keeping future interest costs low, even if this causes additional cost in the short-term, in order to protect the medium – long term financial interests of the Council.

In addition, the Council may borrow short-term (normally for up to one month) to cover unexpected cash flow shortages.

Impact of these factors on the Investment Strategy

In view of this the County Council's investment strategy will be based upon the following information:

- The continuing concerns in the financial markets over sovereign debt, particularly in the Eurozone are impacting negatively on the credit quality of bank counterparties, and the County Council will therefore look to reduce the duration of its exposure to bank counterparties in general.
- Given the level of risk involved in dealing with bank counterparties the County Council will look to diversify its portfolio further away from such counterparties while maintaining the highest credit quality of counterparties.

1. The Annual Borrowing Strategy

The Level of the Approved Capital Programme – the Borrowing Requirement

The County Council's estimated borrowing requirement for financing the capital programme in the current and the next three years is as follows:

	2013/14 Revised £m	**2014/15 £m**	**2015/16 £m**	**2016/17 £m**
Capital Programme Expenditure	**163.657**	**204.733**	**160.678**	**69.759**
Financed by:				
Capital Receipts	0.983	0	37.410	10.567
Grants and Contributions	147.437	146.850	53.757	31.637
Revenue Contributions	13.337	14.001	1.541	0.232
Borrowing	**1.900**	**43.882**	**67.970**	**27.323**
Add Maturing Debt to be replaced:				
Long Term PWLB	0	0	0	0
Short Term Market Borrowing	264.700	264.700	264.700	264.700
Less Transferred Debt	2.033	1.967	1.899	1.687
Less Statutory Charge to Revenue	37.228	35.655	35.789	35.249
Total Borrowing Requirement	**227.339**	**270.960**	**294.982**	**255.087**

At 31st March 2013 the County Council held £745.40 million of short and long-term loans as part of its strategy for funding previous years' capital programmes. The Council's borrowing requirement as at 31st March 2014 is expected to be £227.339 million, and is forecast to rise to £294.982 million by March 2016 as capital

expenditure is incurred. In addition, the Council may borrow for short periods of time to cover unexpected cash flow shortages.

The Council's borrowing position over the coming years is affected by a number of specific factors:

- The need to provide cash flow support for the Preston, South Ribble and Lancashire City Deal to cover the gap between the construction of infrastructure and the payment over of contributions from other organisations including the Government and developers. This borrowing is temporary.

- There is likely to be a similar need to provide even shorter term financial support in relation to the construction of the Heysham – M6 Link Road which is largely funded by government grant payable in arrears.

- An increase in underlying borrowing as the result of a strategic switch away from revenue financing of capital spending to borrowing in order to free revenue resources to meet the overall cost of downsizing the County Council,

The recent approach to borrowing adopted by the County Council has been to utilise short term market borrowing to take advantage of low interest rate policy. The table above assumes the continuation of this approach to funding. The approach is continually reviewed in order to ensure that the County Council's borrowing costs are minimised. However, short-term and variable rate loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

It can be seen from the above table that the borrowing requirement for 2014/15 is £270.960 million, largely as a result of needing to refinance maturing short term borrowing. There are a range of options available for the borrowing strategy in 2014/15.

- Variable rate borrowing is expected to be cheaper than fixed rate long term borrowing and will be attractive during the financial year, particularly as variable rates are closely linked to bank rates.
- Under 10 years rates are expected to be substantially lower than long term rates, so this opens up a range of choices that may allow the County Council to spread maturities away from concentration on long dated debt.

Against this background, the County Treasurer will, in conjunction with the County Council's advisors, monitor the interest rate situation closely and will adopt a pragmatic approach to delivering the objectives of this strategy within changing economic circumstances, but as interest rates are not forecast to rise in this year careful monitoring will ensure that borrowing is taken at the most appropriate time.

Given the increased cost of PWLB borrowing relative to other market options the County Council is likely to undertake future borrowing activity within the financial markets, taking advantage of the benefits of its AA+ credit rating.

All decisions on whether to undertake new or replacement borrowing to support previous or future capital investment will be subject to evaluation against the following criteria:

a) Overall need, whether a borrowing requirement to fund the capital programme or previous capital investment exists;
b) Timing, when such a borrowing requirement might exist given the overall strategy for financing capital investment, and previous capital spending performance;
c) Market conditions, to ensure borrowing that does need to be undertaken is achieved at minimum cost, including a comparison between internal and externally financed borrowing.
d) Scale, to ensure borrowing is undertaken on a scale commensurate with the agreed financing route.

All long term decisions will be documented reflecting the assessment of these criteria.

Sources of borrowing

The approved sources of long-term and short-term borrowing will be:

- Public Works Loan Board
- UK Local Authorities
- any institution approved for investments
- any other bank or building society authorised by the Prudential Regulation Authority to operate in the UK
- UK public and private sector pension funds
- capital market bond investors
- special purpose companies created to enable joint local authority bond issues, using the format of a Euro Medium Term Note programme.

Over recent years the PWLB's terms of business have become more proscriptive, simultaneously making borrowing, and especially repayment, less flexible and substantially more expensive.

Currently the public bond markets represent a cheaper source of funds than the PWLB but these markets have a somewhat different set of dynamics, than Councils are used to.

Councils have been used to "tapping" the PWLB for relatively small tranches of discreet funding at short notice. Accessing the Bond market requires a more systematic approach, but the ground work required is offset by the debt servicing savings achievable.

Public issues need to be of "marketable size" in order to provide investors with the degree of liquidity and price stability required. A syndicate of market makers are also required to further support liquidity and need to be in place at the point of issuance.

Therefore the Council will need to draw single large debt funds from the market of the order of £200-300m in order to achieve optimum cost savings. Transactions of this form will require more active debt management at both the point of issue and at the point of maturity. At issue, the generated cash-flow "hump" and its temporary effects on indicators will need to be managed, as will the opposite cash-flow effect at bond maturity, but again these effects are amply out- weighed by cost savings.

Borrowing Instruments

The County Council may only borrow money by use of the following instruments:

- bank overdrafts
- fixed term loans
- callable loans or revolving credit facilities where the County Council may repay at any time (with or without notice)
- lender's option borrower's option (LOBO) loans, but subject to a maximum of £50 million in total
- bonds, notes, bills, commercial paper and other marketable instruments
- sale and repurchase (repo) agreements

Loans may be borrowed at either a fixed rate of interest, or at a variable rate linked to a market interest rate, such as LIBOR, subject to the limits on interest rate risk approved each year in the *Treasury Management Strategy*.

Debt Restructuring

The County Council continuously monitors both its debt portfolio and market conditions to evaluate potential savings from debt restructuring.
All practical and cost effective refinancing opportunities will be analyzed and executed where appropriate.

2. Policy on Borrowing in Advance of Need

The County Council will not borrow more than or in advance of need with the objective of profiting from the investment of the additional sums borrowed.

However, borrowing in advance of need can be justified in the following circumstances:

a) Where there is a defined need to finance future capital investment that will materialise in a defined timescale of 2 years or less; and

b) Where the most advantageous method of raising capital finance requires the County Council to raise funds in a quantity greater than would be required in any one year, or

c) Where in the view of the County Treasurer, based on external advice, the achievement of value for money would be prejudiced by delaying borrowing beyond the 2 year horizon.

Having satisfied these criteria any proposal to borrow in advance of need would also need to be reviewed against the following factors:

a) Whether the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered and reflected in those plans and budgets, and the value for money of the proposal has been fully evaluated.

b) The merits and demerits of alternative forms of funding.

c) The alternative interest rate bases available, the most appropriate periods over which to fund and repayment profiles to use.

All decisions will be documented reflecting the assessment of these circumstances and criteria.

In addition the Shared Investment Scheme, which enables other local authorities in Lancashire to reduce their credit risk exposure, although accounted for as borrowing is not set against the Capital Financing Requirement. However this will form part of County Council's operational and authorised borrowing limits, but not included within the capital financing requirement calculation. For risk management purposes the County Council has set a cap of £150m on the total value of the shared investment scheme. The table below sets out an estimate of the relationship between the borrowing capital financing requirement and total borrowing during the current year and over the next three years.

- The shared investment scheme is assumed to contribute £150m to the borrowing total. The operation of the scheme is reviewed annually, but this table assumes it will operate for the next three years and shows the position if take-up reaches the limits of the scheme.

- In September 2013 the County Council's bank gave notice that a standing charge of £100,000 p.a. was to be levied on the County Council for the provision of the existing £20m overdraft facility. The facility was cancelled by the County Treasurer and replaced with the direct borrowing of £20m of funds to be held on call, so providing an equivalent liquidity position at a much reduced cost.

	31 Mar 2014 £m	31 Mar 2015 £m	31 Mar 2016 £m	31 Mar 2017 £m
Capital Financing Requirement (CFR)	1,038	1,047	1,079	1071
Less PFI liability	402	395	388	381
Borrowing CFR	636	645	677	669
Loans Borrowed (31March estimate)	806	815	847	839

Borrowing Above CFR	170	170	170	170
Comprising:				
Shared Investment Scheme	150	150	150	150
Replacement of Overdraft Facility Borrowing	20	20	20	20
Total	**170**	**170**	**170**	**170**

3. The Annual Investment Strategy

In making any investments of the reserves and other cash items held within its balance sheet the County Council must have regard to the relevant regulations under the Local Government Act 2003, the CLG Guidance on Local Government Investments, any revisions to that guidance, the Audit Commission's report on Icelandic investments and the latest revision of the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes. The Council's investment priorities are: -

(a) The security of capital, and
(b) The liquidity of its investments.

The County Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the County Council is low in order to give priority to security of its investments.

The counterparty credit matrix is at the heart of Lancashire County Council's Treasury Management Policy and Strategy and has always been conservatively constructed to protect the County Council against credit risk whilst allowing for efficient and prudent investment activity. However, the County Council does not rely solely on credit ratings in assessing counterparties. Other market information is also monitored such as information from the credit default swap (CDS) market and any press releases in general, thus ensuring the Council transacts with only the highest quality counter-parties. An example of how CDS data is set out in the Treasury Management Practices.

- **For short term lending of up to 1 year** that the short term ratings from the ratings agencies be used and that a counter-party must have a minimum of the following:

  Moody's P1
  S&P A1
  Fitch F1

  Short term ratings were specifically created by the agencies for money market investors placing deposits for up to one year as they reflect specifically the liquidity positions of the institutions concerned. The ratings of P1, A1 and F1 are

considered to be strong investment grade with a extremely high degree of confidence in the liquidity position of the body over at least a one year period.

- **For medium term investments** in the form of tradeable bonds or certificates of deposit (1yr to 5yrs, where immediate liquidation can be demonstrated), it is proposed that a blended average of the ratings be taken (averaging across all available ratings) , with a minimum of:

    - Long term AA3/AA-, and
    - Short term P1/F1+/A1+

- **For longer term investments (5yrs and above)** in the form of tradeable bonds where immediate liquidation can be demonstrated, it is proposed that a blended average of the ratings be taken, with a minimum of:

    - Long term AA2/AA
    - Short term P1/A1+/F1+

The detailed calculation methodology of the blended average will be agreed with the Council's advisers and set out in the Treasury Management Practices.

The limits for scale and duration of investment in specific categories which form the 2013/14 investment policy are set out in the table below.

Should an existing investment, due to a change in credit rating after a fixed deposit has been made, fall outside the policy, full consideration will be made, taking into account all relevant information, as to whether a premature settlement of the investment should be negotiated in order to protect the County Council.

The minimum sovereign rating for investment is AA.

Instrument	Credit Rating (blended average)	Maximum individual Investment(£m)	Maximum total Investment(£m)	Maximum Period
UK Government Gilts, Treasury Bills & bodies guaranteed by UK Govt	UK Government	100	unlimited	50 yrs
Sterling Supranational Bonds Sterling Sovereign Bonds	AA+	100	500	50 yrs
Term Deposits with UK and Overseas Banks (domiciled in UK) and Building Societies, Certificates of	P1/A1/F1	25	200	1yr

Instrument	Credit Rating (blended average)	Maximum individual Investment(£m)	Maximum total Investment(£m)	Maximum Period
Deposit up to 1yr				
Term Deposits with UK and Overseas Banks (domiciled in UK) and Building Societies, Certificates of Deposit.1yr to 5yr	AA- P1/A1+/F1+	100	400	5 yrs
Corporate Bonds (Medium term)	AA- P1/A1/F1	50	200	5yrs
Corporate Bonds (Long term)	AA P1/A1+/F1+	50	200	30yrs
Government Bond Repurchase agreements (Repo/Reverse Repo)	AA+	100	250	1yr
Bond Funds	AA Rated weighted average maturity 3yrs	100	250	These investments do not have a defined maturity date.
Debt Management Account Deposit Facility	Government Institution	unlimited	unlimited	364 days
UK Local Authorities (incl Transport for London)	Implied Government support	100	500	50yrs
Money Market Funds	AAA Rated, weighted average maturity 6 months	100	300	These investments do not have a defined maturity date.
Collateralised lending agreements backed by higher quality government or local government and supra national sterling securities.	AA, with AAA for any collateral used	100	250	25yrs

Instrument	Credit Rating (blended average)	Maximum individual Investment(£m)	Maximum total Investment(£m)	Maximum Period
Nationalised UK Banks	P1/A1/F1 Long term A Government support	100	400	In line with clearing system guarantee (currently 4 years.)

The placing of residual overnight deposits with the County Council's bank, National Westminster, will not count against the above individual limits but in practice a maximum balance of £50 million adhered to whenever possible.

Types of Investment

The CLG Guidance defines two types of investment, firstly specified investments which are those:

- denominated in pound sterling,
- due to be repaid within 12 months of the arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
    - the UK Government,
    - a UK local authority, parish council or community council, or
    - a body or investment scheme of "high credit quality".

Any investment not meeting the definition of a specified investment is classed as non-specified. Non-specified investments will be limited only to long-term investments, i.e. those that are due to mature 12 months or longer from the date of the arrangement. The County Council will not make any investments denominated in foreign currencies, or with low credit quality bodies, or any that are defined as capital expenditure by legislation, such as company shares.

The total limit on long-term investments and the total limit on non-specified investments is £600 million. This reflects the portfolio structure adopted by the County Council in order to reduce credit risk by holding a proportion of the portfolio in government and supranational securities, which although highly liquid have maturities in excess of 364 days. In practice they can be liquidated at one day's notice and are therefore central to achieving the County Council's liquidity objective.

In recent times, a wider range of investment instruments within the area of sterling deposits has been developed by financial institutions. All of these afford similar security of capital to basic sterling deposits but they also offer the possibility, although never of course the certainty, of increased returns. The County Treasurer will, in liaison with the County Council's external advisers, consider the benefits and drawbacks of these instruments and whether any of them are appropriate for the County Council. Because of their relative complexity compared to straightforward term deposits, most of them would fall within the definition of non-specified

investments. Decisions on whether to utilise such instruments will be taken after an assessment of whether their use achieves the Council's objectives in terms of reduction in overall risk exposure as part of a balanced portfolio.

Policy on Use of Financial Derivatives

Local authorities, including the County Council, have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans). However, previous legislation was understood to prevent the use of such tools where they were not embedded in other instruments.

The Localism Act 2011 includes a general power of competence that removes the uncertain legal position over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). The latest CIPFA Code requires local authorities to clearly detail their policy on the use of derivatives in their annual strategy.

The County Council will only use financial derivatives (such as swaps, forwards, futures and options) either on a standalone, or embedded basis, where it can be clearly demonstrated that as part of the prudent management of the Council's financial affairs the use of financial derivatives will have the effect of reducing the level of financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. This will be determined in liaison with the Council's external advisors.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit if applicable.

At all times the County Council will comply with CIPFA advice and guidance on the use of financial derivatives and have regard to CIPFA publications on risk management.

Performance Measurement

With base rates at exceptionally low levels, investment returns are likely to continue to be far lower than has been the case in recent years. However, in the knowledge that a portion of cash invested (such as PFI reserves) will not be required in the short term and to protect against continued low investment rates, investments may be made for longer time periods, depending on cash flow considerations and the prevailing market conditions.

The performance target on investments is a return above the average rate for 7 day notice money.

Impact on the County Council's Revenue Budget

The budget for financing charges which reflects the implementation of this strategy included within the County Council's budget is as shown below:

	Revenue Budget 2013/14 **£m**	**Revenue Budget 201415** **£m**	**Revenue Budget 2015/16** **£m**
Minimum Revenue Provision (MRP)	30.100	28.527	26.661
Interest Paid	21.157	22.005	21.794
Interest Earned	(18.635)	(19.425)	(19.728)
Grants Received	(0.273)	(0.273)	(0.273)
Total	**32.349**	**30.834**	**30.454**

The budgeted MRP for PFI schemes, included in the capital financing requirement calculation, is included for within the relevant service directorate budget rather than the financing charges budget.

These budgets reflect the following average interest rates:

	2013/14 %	2014/15 %	2015/16 %
Interest Paid	2.16	3.00	3.00
Interest Earned	2.78	3.20	3.20
Net Interest	0.53	0.23	0.23

Annex 'A'

PRUDENTIAL INDICATORS

In line with the relevant legislation the County Council has adopted the Prudential Code for Capital Finance in Local Authorities and the CIPFA Treasury Management in the Public Services Code of Practice as setting the framework of principles for its Treasury Management activities. In accordance with the requirements of these codes the County Council produces each year a set of prudential indicators which assist in the process of monitoring the degree of prudence with which the Council undertakes its Capital Expenditure and Treasury Management activities. Certain of these indicators also provide specific limits with regard to certain types of activity such as borrowing. These indicators are a consequence of the borrowing requirements and actions set out within the body of the Treasury Management Strategy.

(a) Adoption of CIPFA Treasury Management Code of Practice (2011)

2013/4	2014/15	2015/16	2016/17
Adopted for all years			

(b) Indicators on Capital Expenditure and Financing

The total capital expenditure in each year, irrespective of the method of financing estimated to be incurred by the County Council is as follows:

2012/13	2013/14	2014/15	2015/16	2016/17
Actual	**Estimate**	**Estimate**	**Estimate**	**Estimate**
£m	**£m**	**£m**	**£m**	**£m**
139.400	163.657	204.733	160.678	69.759

The estimated capital expenditure stated above will be financed by a mixture of borrowing, capital receipts, revenue contributions, grants and other contributions. A key control of the prudential system is the underlying need to borrow for capital purposes, which is represented by the cumulative effect of past borrowing decisions and future plans. This is shown as the capital financing requirement. This is not the same as the actual borrowing on any one day, as day to day borrowing requirements incorporate the effect of cash flow movements relating to both capital and revenue expenditure and income. The estimate of the capital financing requirement for each year is as follows, and includes the impact of PFI obligations.

2012/13	2013/14	2014/15	2015/16	2016/17
Actual	**Estimate**	**Estimate**	**Estimate**	**Estimate**
£m	**£m**	**£m**	**£m**	**£m**
1,074.218	1,038.890	1,047.117	1,079.298	1,071.372

(c) Prudence and Affordability

CIPFA's Prudential Code for Capital Finance in Local Authorities states the following as a key indicator of prudence:

"In order to ensure that, over the medium term, net borrowing will only be used for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of capital financing requirement in the preceding year, plus the estimates of any additional capital financing requirement for the current and next two financial years."

The Council's financial plans are prepared on this basis and, indeed the policy on borrowing in advance of need explicitly references this statement as part of the decision making criteria.

It is important to ensure that the plans for capital expenditure and borrowing are affordable in the long term. To this purpose the code requires an indicator which estimates the ratio of financing costs to the net revenue stream.

The financing costs are the interest payable on borrowing, finance lease or other long term liabilities and the amount defined by statute which needs to be charged to revenue to reflect the repayment of the principal element of the County Council's borrowing. Any additional payments in excess of the statutory amount or the cost of early repayment or rescheduling of debt would be included within the financing cost. Financing costs are expressed net of investment income.

The net revenue stream is defined as the amount required to be funded from Government Grants and local taxpayers, in effect the budget requirement. Estimates of the ratio of financing costs to net revenue (or budget requirement) are as follows:

2013/14	2015/16	2015/16	2016/17
Estimate	**Estimate**	**Estimate**	**Estimate**
%	**%**	**%**	**%**
4.92	4.67	5.19	5.39

The Prudential Code requires the estimated revenue impact of capital investment decisions in Band D Council Tax terms to be calculated. The figures exclude the borrowing costs required to meet commitments from 2012/13 and earlier years' programmes. The focus is, therefore, on the costs of future years Capital Programmes. The above figures are after deducting the estimated support received from the Government via the Revenue Support Grant. These are as follows:

2013/14	2014/15	2015/16	2016/17
Estimate	**Estimate**	**Estimate**	**Estimate**
£	**£**	**£**	**£**
34.76	44.80	19.77	25.11

It is important to note that the figures do not represent annual increases in Council Tax. Both the 2014/15 and 2015/16 figures will include the full year effects of decisions taken in 2013/14. Similarly, all three years include the effect of financing capital expenditure from revenue or internal loans. Provision for these already exists within the revenue budget. The estimated effect in Band D Council Tax terms of the net cost of the borrowing is:

	£
2014/15	2.94
2015/16	15.18
2016/17	24.42

(d) Prudence and Affordability

The County Council is required to approve an "authorised limit" and an "operational boundary" for external debt. The limits proposed are consistent with the proposals for capital investment and with the approved treasury management policy statement and practices. The limits also include provision for the £150m cap on the shared investment scheme. The indicators are split between borrowing and other long term liabilities, such as PFI projects. It is, therefore, proposed to set a limit for the County Treasurer to work within.

The authorised limit is a prudent estimate of external debt, which does not reflect the worst case scenario, but allows sufficient headroom for unusual cash flow movements. After taking into account the capital plans and estimates of cash flow and its risks, the proposed authorised limits for external debt are:

	2013/14 Revised	**2014/15**	**2015/16**	**2016/17**
	£m	**£m**	**£m**	**£m**
Borrowing	891.000	960.000	985.000	987.000
Other long term liabilities	500.000	490.000	480.000	470.000

The proposed operational boundary for external debt is based on the same estimates as the authorised limit. However, although it reflects a prudent estimate of debt, there is no provision for unusual cash flow movements. In effect, it represents the estimated maximum external debt arising as a consequence of the County Council's current plans. As required under the Code, this limit will be carefully monitored during the year. The proposed operational boundary for external debt is:

	2013/14 Revised	**2014/15**	**2015/16**	**2016/17**
	£m	**£m**	**£m**	**£m**
Borrowing	841.000	910.000	935.000	937.000
Other long term liabilities	450.000	440.000	430.000	420.000

The debt figures include transferred debt which is managed by the County Council on behalf of other authorities. The transferred debt included within the debt indicators is estimated to be:

2013/14	£41.547 m
2014/15	£39.579 m
2015/16	£37.680 m
2016/17	£35.993m

(e) Gross Debt and Capital Financing Requirement

As a measure of prudence and to ensure that over the medium term debt is only used for a capital purpose, the prudential code requires a comparison of gross debt and the capital financing requirement. The comparison for Lancashire County Council is shown below:

	2013/14	2014/15	2015/16	2016/17
	£m	£m	£m	£m
Capital Financing Requirement	636	645	677	669
Estimated Gross Debt at 31 March	806	815	847	839
Debt to CFR	127%	126%	125%	125%

The ratio of gross debt to capital financing requirement shows that gross debt is higher than the capital financing requirement. This is because the shared investment scheme and the replacement overdraft facility are currently accounted for as borrowing but not counted against the capital financing requirement.

Treasury Management Local Indicators

These indicators are not prudential indicator limits but locally set indicators to facilitate risk management within the County Council's debt and investment portfolios.

(a) Interest rate exposure

In order to control interest rate risk the County Council measures its exposure to interest rate movements. These indicators place limits on the overall amount of risk the County council is exposed to. The one year impact indicator calculates the theoretical impact on the revenue account of an immediate 1% rise in all interest rates over the course of one financial year.

	Upper Limit £m	Dec 2013 £m
Net Interest Payable at Fixed Rates	37.6	-1.7
Net Interest Payable at Variable Rates	5.0	1.3
One year impact of a 1% rise in rates	25.0	2.8

(b) Maturity structure of debt

Limits on the maturity structure of debt help control refinancing risk

	Lower Limit %	Upper Limit %	Dec 2013
Under 12 months		75	9
12 months and within 2 years		75	43
2 years and within 5 years		75	6
5 years and within 10 years		75	8
10 years and above	25	100	34

(c) Investments over 364 days

Limits on the level of long term investments helps to control liquidity, although the majority of these investments are held in available for sale securities.

	Upper limit £m	Dec 2013 £m
Total invested over 364 days	600	562

(d) Minimum Average Credit Rating

To control credit risk the County Council requires a very high credit rating from its treasury counterparties

	Benchmark	Dec 2013
Average counterparty credit rating	A+	AA

(e) Daily Liquidity

In the absence of an overdraft facility the County Council aims to maintain a daily liquidity balance on call of £20m. Other liquidity can be provided by short term borrowing or the sale of available for sale financial instruments.

	Minimum Requirement	Dec 2013
	£m	£m
Cash maintained on call	20	19