Rother District Council **Agenda Item: 7.2**

Report to	-	Audit and Standards Committee
Date	-	11 December 2017
Report of the	-	Executive Director of Resources
Subject	-	Treasury Management Mid-Year Review

Recommended: It be **RESOLVED:** That:

1) the changes to the Treasury Management Strategy Statement for 2017/18 as set out in Appendix 3 to the report be noted;

2) the Chief Finance Officer's (Service Manager - Finance and Welfare) comments on the level of risk set out in paragraphs 11-15 of the report be noted; and

3) the revisions to the Annual Investment Strategy for 2017/18 be approved.

Service Manager: Robin Vennard

Introduction

1. Cabinet approved the Council's 2017/18 Investment Strategy in February this year. The investment strategy requires regular reports to be presented to this Committee on the Council's treasury management activities. Members are also reminded that investment activity is also reported through the Members' Bulletin. In managing its treasury management activities, the Council follows the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011).

2. The primary requirements of the Code are as follows:

   i. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

   ii. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

   iii. Receipt by the full Council of an annual Treasury Management Strategy Statement (TMSS) – including the Annual Investment Strategy and Minimum Revenue Provision Policy – for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.

iv. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

v. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit and Standards Committee.

3. This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management.

4. At its meeting on the 2 October, Cabinet supported a Property Investment Strategy which will be considered by full Council on the 18 December 2017. If approved, the Strategy will initially result in a transfer of £7 million from cash reserves to property related investments. Subsequent to Cabinet's decision, the Government and CIPFA announced a review of the Treasury Management Code of Practice and the Prudential Code. This review will particularly focus on non-treasury investments and especially on the purchase of property with a view to generating income. The consultation can be found at:

   https://www.gov.uk/government/consultations/proposed-changes-to-the-prudential-framework-of-capital-finance

5. Such purchases could involve undertaking external borrowing to raise the cash to finance these purchases, or the use of existing cash balances. This, together with Government concern over the scale of property investment by local government, leads to a degree of uncertainty at present in relation to these activities. This is discussed in more detail later in this report.

6. Whilst there is uncertainty at present, it is important to note that the existing investment strategy will struggle to meet the Council's future income aspirations. Therefore whilst the demands being placed on the Treasury Management Strategy will increase during this period of instability and declining returns from the Council's existing portfolio, the future strategy will need to maintain its focus on prudent management with regard to security and liquidity and the predictability of returns.

Treasury Management Strategy and Annual Investment Strategy review

7. The Council traditionally has made all its investments through the use of call and deposit accounts with the major financial UK institutions. In addition the Council holds a Government Gilt valued at £1.121m which is a legacy of the previous arrangements with the external fund managers.

8. In the last year the Council have additionally invested £5 million in two tranches in the Churches, Charities, Local Authorities' (CCLA) Property Investment Fund. The current dividend yield as at September 2017 is 4.60%.

9. As mentioned in the introduction, the Council has been developing alternative investment strategies that would look to invest a significant proportion of the Council's strategic cash balances in property assets that have the potential to provide returns that are far in excess of the returns that can be obtained from the Council's treasury management investments currently and for the

foreseeable future. Updated details of these non-treasury investments can be seen in Appendix 3 to include the Property Investment Strategy.

10. Whilst these strategies are outside of the scope of the current Treasury Management Strategy and largely relate to years beyond 2017/18, they have a significant impact on the Treasury Management Strategy for 2017/18 in terms of the types and duration of investments that can be made.

Alternative Investment Strategies – Property Investment

11. The Medium Term Financial Strategy identified the need to generate additional income from investments and property as part of the approach to balance the revenue budget in future years. The Council has been developing plans that look to invest the Council's cash resources in alternative investments and is developing a number of strategies that look to provide income returns that could replace the reducing interest income from traditional treasury investments.

12. The first strategy is the Property Investment Strategy which allocates £7 million to make investments in property that are expected to generate annual returns in the 5% (£350,000) to 7% (£490,000) range. Discussions have been ongoing with the Council's treasury advisors, legal advisors and external auditors to agree the legal powers the Council can rely on to make such investments and their accounting treatment. The initial legal advice is shown at Confidential Appendix 5 (Agenda Item 10.1 on this Agenda).

13. In summary the advice shows there are several powers that a Council can use. It is likely for this initial investment that reliance will be placed upon the investment powers in Section 12 of the Local Government Act 2003. These powers allow local authorities to invest both for treasury management purposes (including investment of Council funds) and for any purpose relevant to their functions. Investment powers are used on the strength of financial return irrespective of location and appear to be most relevant to the Council's purposes as reported to Cabinet for investing current cash funds. As a treasury activity, these investments will be treated as a financial instrument for accounting purposes.

14. Assuming reliance is placed on Section 12 of the Local Government Act 2003, then as stated above, the investment will be considered a treasury investment. The advantages of this are that the Council can invest for any purpose. It also preserves a balance of cash above £10 million which allows the Council to elect to be a Professional client for Markets in Financial Instruments Directive (MIFID II) purposes as detailed in paragraph 20 to 25 below. The disadvantages are that these investments could be subject to International Financial Reporting Standard (IFRS) 9 detailed in paragraphs 16 and 17 below. Members also need to recognise there is an increase in risk associated with property related investments and funds will move away from near risk-free cash deposit investments. Property is less liquid and clearly the capital value can fall as well as rise. Under IFRS 9 when investments are rising in value then reserves will increase but a fall in value will reduce the value of reserves. Members need to be confident that the Council has sufficient levels of reserves to manage these changes.

15. These factors need to be recognised by Members and influence the total overall amount of risk the Council is willing to take with the treasury management investments. Before any investments are made, Officers will continue with discussions with the Council's advisors and the external auditors taking account of the proposed use of investment powers and any changes finally agreed to treasury and accounting requirements.

International Financial Reporting Standard 9

16. At the same time changes to the prudential code are being consulted on, the Chartered Institute of Public Finance and Accountancy has announced changes resulting from amendments to IFRS 9, which will see the removal of the "available-for-sale" classification in the Code of Practice on Local Authority Accounting, which currently allows gains and losses on financial instruments to be held in reserves until realised (i.e. the asset has been sold).

17. Assets held in this category will now move into the "fair value through profit or loss" category. This means gains and losses from changes in fair value of assets will be reflected in surpluses and deficits in the Provision of Services line in local authority accounts. If the Property Investments are treated as a treasury activity then there is the likelihood of changes in valuation being charged to the general fund. Currently there is no expectation that there will be a statutory override to reverse the impact of the IFRS on the general fund.

Property Investments beyond the initial £7m

18. For the Council to invest beyond the initial £7m this would require the use of borrowing. As such it would not be possible to rely on the Section 12 investment powers but rather spending powers. As referred to in the introduction, the Government have commenced a consultation on changes to the prudential framework of capital finance. This governs the Council's capital activities and how they are accounted for. The Government are proposing to require repayments of borrowing (Minimum Revenue Provision, MRP) based on the life of the property asset with a maximum of 40 years for property and 50 years for land. If implemented retrospectively then the changes could have significant financial implications for local authorities who have borrowed to fund this type of investment. It is likely that Councils will have not provided for the repayment of the borrowing with the expectation that long term capital property values will exceed the amount of borrowing. With this change the Councils will likely be making a negative return or at best a very small financial margin on the rental returns against the interest costs.

19. If implemented prospectively then for future investments the financial returns will also be minimal or negative. With such marginality the impact of voids and capital maintenance increases the financial risk and makes these investments much less attractive. It may be possible to avoid MRP through how the investment is planned to be managed but this is unclear at present. The consultation concludes on the 22 December 2017 but there is no indication as yet of the date for publication of the final changes.

Implementation of the Markets in Financial Instruments Directive (MIFID II)

20. Under the current UK regulatory framework, local authorities are automatically categorised as ‘professional’ clients for investment purposes, both in terms of their treasury management and pension fund administration functions.

21. Following the introduction of the European Markets in Financial Instrument Directive 2014/65 (“MiFID II”) from 3 January 2018, local authorities will lose this automatic right to be categorised as professional clients. Financial service providers such as banks, investment fund managers, brokers and advisors will have to treat them as retail clients, unless they are ‘opted up’ to professional client status. The criteria for ‘opting up’ in the UK are specified by the Financial Conduct Authority (FCA). They require an assessment of quantitative factors (relating to the nature and scale of the client’s business); and qualitative factors (relating to the expertise, experience and knowledge of key decision makers).

22. The aim of the assessment is to demonstrate whether, in the light of the nature of the transactions or services envisaged, the client is capable of making its own investment decisions and understanding the risks involved. It is for the service provider to determine whether or not, based on the information submitted by clients, the appropriate ‘opting up’ criteria are met.

23. MiFID II allows for retail clients which meet certain conditions to elect to be treated as professional clients (to ‘opt up’). There are two tests which must be met by the client when being assessed by the financial institution: the quantitative and the qualitative tests.

24. The election to professional status must be completed with all financial service providers prior to the change of status on 3 January 2018. Failure to do so would result in providers having to take ‘appropriate action’ in accordance with their own internal compliance procedures, which could include termination of their relationship with the Fund.

25. For authorities with under £10million in total investments, this option will not be available. Authorities will not be required to renew their elections on a regular basis but they will be required to review the information provided in the opt-up process and notify providers of any material changes in circumstance which could affect their status. Officers are making the necessary applications through the Council’s treasury advisors.

Investment Portfolio 2017/18

26. The following paragraphs describe the recent investment activity and the level of investment returns currently being generated.

27. In accordance with the Code, it is the Council’s priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council’s risk appetite. As set out in Appendix 1, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low with the Bank rate now at 0.25%. The Council’s cash levels and cash flow profiles as well as restrictions on maximum deposit duration contribute to a low risk and short-term strategy. Given this risk adverse environment, investment returns are likely to remain low.

28. The Council held £30m of investments as at 30 September 2017 and the investment portfolio yield to 30 September 2017 is £85,166. The average rate of return is 1.13%. The Chief Financial Officer (Service Manager - Finance and Welfare) confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2017/18.

29. The Council's budgeted investment return for 2017/18 is £235,000, and the estimated outturn position is £300,000, a surplus of £65,000 which is mainly due to the additional investment in CCLA.

Conclusion

30. The Council's current treasury management and investment strategies remain robust in managing the Council's cash funds. The economic outlook remains difficult for a net investor such as the Council and supports the Council's financial strategy to reduce reliance on investment returns.

Malcolm Johnston
Executive Director of Resources

Risk Assessment Statement
There are no direct risks arising from this report. Failure to follow the Council's investment strategy could increase the risk of financial loss.

Capita Asset Services – Economic Commentary

GLOBAL OUTLOOK

1. World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October, the IMF upgraded its forecast for world growth from 3.2% to 3.6% for 2017 and 3.7% for 2018.

2. In addition, inflation prospects are generally muted and it is particularly notable that wage inflation has been subdued despite unemployment falling to historically very low levels in the UK and US. This has led to many comments by economists that there appears to have been a fundamental shift downwards in the Phillips curve (this plots the correlation between levels of unemployment and inflation e.g. if the former is low the latter tends to be high). In turn, this raises the question of what has caused this? The likely answers probably lay in a combination of a shift towards flexible working, self-employment, falling union membership and a consequent reduction in union power and influence in the economy, and increasing globalisation and specialisation of individual countries, which has meant that labour in one country is in competition with labour in other countries which may be offering lower wage rates, increased productivity or a combination of the two. In addition, technology is probably also exerting downward pressure on wage rates and this is likely to grow with an accelerating movement towards automation, robots and artificial intelligence, leading to many repetitive tasks being taken over by machines or computers. Indeed, this is now being labelled as being the start of the fourth industrial revolution.

KEY RISKS - central bank monetary policy measures

3. Looking back on nearly ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as Quantitative Easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

4. The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the US, and may soon start in the UK, on reversing those measures i.e. by raising central rates and reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of an on-going reduction in spare capacity in the economy, and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this then also encouraged investors into a search for yield and into investing in riskier assets such as equities. This resulted in bond markets and equity market prices both rising to historically high

valuation levels simultaneously. This, therefore, makes both asset categories vulnerable to a sharp correction. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery by taking too rapid and too strong action, or, alternatively, let inflation run away by taking action that was too slow and/or too weak. **The potential for central banks to get this timing and strength of action wrong are now key risks**.

5. There is also a potential key question over whether economic growth has become too dependent on strong central bank stimulus and whether it will maintain its momentum against a backdrop of rising interest rates and the reversal of QE. In the UK, a key vulnerability is the low level of productivity growth, which may be the main driver for increases in wages; and decreasing consumer disposable income, which is important in the context of consumer expenditure primarily underpinning UK GDP growth.

6. A further question that has come to the fore is whether an inflation target for central banks of 2%, is now realistic given the shift down in inflation pressures from internally generated inflation, (i.e. wage inflation feeding through into the national economy), given the above mentioned shift down in the Phillips curve.
    - Some economists favour a shift to a lower inflation target of 1% to emphasise the need to keep the lid on inflation. Alternatively, it is possible that a central bank could simply ‘look through’ tepid wage inflation, (i.e. ignore the overall 2% inflation target), in order to take action in raising rates sooner than might otherwise be expected.
    - However, other economists would argue for a shift UP in the inflation target to 3% in order to ensure that central banks place the emphasis on maintaining economic growth through adopting a slower pace of withdrawal of stimulus.
    - In addition, there is a strong argument that central banks should target financial market stability. As mentioned previously, bond markets and equity markets could be vulnerable to a sharp correction. There has been much commentary, that since 2008, QE has caused massive distortions, imbalances and bubbles in asset prices, both financial and non-financial. Consequently, there are widespread concerns at the potential for such bubbles to be burst by exuberant central bank action. On the other hand, too slow or weak action would allow these imbalances and distortions to continue or to even inflate them further.
    - Consumer debt levels are also at historically high levels due to the prolonged period of low cost of borrowing since the financial crash. In turn, this cheap borrowing has meant that other non-financial asset prices, particularly house prices, have been driven up to very high levels, especially compared to income levels. Any sharp downturn in the availability of credit, or increase in the cost of credit, could potentially destabilise the housing market and generate a sharp downturn in house prices. This could then have a destabilising effect on consumer confidence, consumer expenditure and GDP growth. However, no central bank would accept that it ought to have responsibility for specifically targeting house prices.

7. **UK**. After the UK surprised on the upside with strong economic growth in 2016, **growth in 2017 has been disappointingly weak**; quarter 1 came in at only +0.2% (+2.0% y/y) and quarter 2 was +0.3% (+1.7% y/y). The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the EU referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 80% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year while robust world growth has also been supportive. However, this sector only accounts for around 10% of GDP so expansion in this sector will have a much more muted effect on the overall GDP growth figure for the UK economy as a whole.

8. While the Bank of England is expected to give forward guidance to prepare financial markets for gradual changes in policy, the Monetary Policy Committee, (MPC), meeting of 14 September 2017 managed to shock financial markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise soon. The Bank of England Inflation Reports during 2017 have clearly flagged up that it expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. The Bank revised its forecast for the peak to just over 3% at the 14 September meeting MPC. (Inflation actually came in at 3.0% in September and is expected to rise slightly in the coming months.) This marginal revision in the Bank's forecast can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment having already fallen to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of automation and globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so this would cause additional inflationary pressure over the next few years.

9. It therefore looks likely that the MPC will increase Bank Rate to 0.5% in November but, if not, in February 2018. The big question after that will be whether this will be a one off increase, followed by a long delay before the next increase, or the start of a slow, but regular, series of increases in Bank Rate during 2018 and onwards. Towards the end of October, short sterling rates are indicating that financial markets do not expect a second increase until November 2018 with a third increase in August 2019 i.e. a slow pace of increases. However, some forecasters are flagging up that they expect growth to accelerate significantly towards the end of 2017 and then into 2018. This view is based primarily on the coming fall in inflation, (as the effect of the effective devaluation of sterling after the EU referendum drops out of the CPI statistics), which will bring to an end the negative impact on consumer spending power. In addition, a strong export performance will compensate for weak

services sector growth. If this scenario was indeed to materialise, then the MPC would have added reason to embark on an ongoing series of slow but gradual increases in Bank Rate during 2018 and onwards.

10. It is also worth noting the contradiction within the Bank of England between action in 2016 and in 2017 by two of its committees. After the shock result of the EU referendum, the Monetary Policy Committee (MPC) voted in August 2016 for emergency action to cut Bank Rate from 0.50% to 0.25%, restarting £70bn of QE purchases, and also providing UK banks with £100bn of cheap financing. The aim of this was to lower borrowing costs, stimulate demand for borrowing and thereby increase expenditure and demand in the economy. The MPC felt this was necessary in order to ward off their expectation that there would be a sharp slowdown in economic growth. Instead, the economy grew robustly, although the Governor of the Bank of England strongly maintained that this was because the MPC took that action. However, other commentators regard this emergency action by the MPC as being proven by events to be a mistake. Then in 2017, we had the Financial Policy Committee (FPC) of the Bank of England taking action in June and September over its concerns that cheap borrowing rates, and easy availability of consumer credit, had resulted in too rapid a rate of growth in consumer borrowing and in the size of total borrowing, especially of unsecured borrowing. It, therefore, took punitive action to clamp down on the ability of the main banks to extend such credit! Indeed, a PWC report in October 2017 warned that credit card, car and personal loans and student debt will hit the equivalent of an average of £12,500 per household by 2020. However, averages belie wide variations in levels of debt with much higher exposure being biased towards younger people, especially the 25 -34 year old band, reflecting their lower levels of real income and asset ownership.

11. One key area of risk is that consumers may have become used to cheap rates since 2008 for borrowing, especially for mortgages. It is a major concern that many consumers may have over extended their borrowing and have become complacent about interest rates going up after Bank Rate had been unchanged at 0.50% since March 2009 until falling further to 0.25% in August 2016. This is why forward guidance from the Bank of England continues to emphasise slow and gradual increases in Bank Rate once they start. However, consumer borrowing is a particularly vulnerable area in terms of the Monetary Policy Committee getting the pace and strength of Bank Rate increases right - without causing a sudden shock to consumer demand, confidence and thereby to the pace of economic growth.

12. Moreover, while there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two to three years will actually pan out.

13. **EU.** Economic growth in the EU, (the UK's biggest trading partner), had been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and has now gathered substantial strength and momentum thanks to this stimulus. GDP growth was 0.5% in quarter 1 (2.0% y/y) and 0.6% in quarter 2 (2.3% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in September inflation was

1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019. It has started forward guidance on its intentions to start slowing down the amount of monthly QE purchases of debt but has not yet set a timeframe for this or the pace.

14. **USA.** Growth in the American economy was notably erratic and volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1%, resulting in an overall annualised figure of 2.1% for the first half year. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.2%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with four increases in all and three increases since December 2016; and there could be one more rate rise in 2017, which would then lift the central rate to 1.25 – 1.50%. There could then be another four increases in 2018. At its September meeting, the Fed said it would start in October to gradually unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

15. **CHINA**. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

16. **JAPAN** has been struggling to stimulate consistent significant growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

<u>Brexit timetable and process</u>

17. March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50
18. March 2019: initial two-year negotiation period on the terms of exit. In her Florence speech in September 2017, the Prime Minister proposed a two year transitional period after March 2019.
19. UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy will leave the single market and tariff free trade at different times during the two year transitional period.
20. The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
21. The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
22. If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
23. On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.
24. The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.

Appendix 2

Approved countries for investments as at 23.10.2017

Since publication of the Treasury management Strategy and annual Investment Strategy in February 2017 the approved list of countries has changed as detailed below.

Based on lowest available rating

AAA

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Finland
- Hong Kong
- U.S.A.

AA

- Abu Dhabi (UAE)
- France
- U.K.

AA-

- Belgium
- Qatar

Treasury Management Practice – Credit and Counterparty Risk

Specified Investments:

1. All such investments will be sterling denominated, with maturities up to maximum of 1 year, meeting the minimum 'high' quality criteria where applicable.

2. A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the following categories:

	Minimum Credit Criteria	Maximum of total investments	Max. maturity period
Debt Management Agency Deposit Facility	--	100%	6 months
Local authorities	--	50%	1 year subject to guidance
UK banks and building societies	Refer to Creditworthiness Policy	100%	1 year
Term deposit - UK banks and building societies	Refer to Creditworthiness Policy	100%	1 year
UK Government Gilts	UK sovereign rating	50%	1 year subject to guidance
Bonds issued by multilateral development banks	AAA	20%	6 months subject to guidance
Ultra-Short Dated Bond Funds with a credit score of 1.25	AAA	100%	Liquid
Ultra-Short Dated Bond Funds with a credit score of 1.5	AAA	100%	Liquid
Money Market Funds	AAA	100%	Liquid
CDs or corporate bonds with banks and building societies	Refer to Creditworthiness Policy	20%	1 year
UK Government Treasury Bills	UK sovereign rating	20%	1 year

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

Non-specified investments: – are any other type of investment (i.e. not defined as specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investments would include any sterling investments.

Non-specified investments A maximum of £15 million will be held in aggregate in non-specified investment.

Maturity greater than 1 year.

	Non Specified Investment Category	**Limit (£ or %)**
a.	Supranational bonds greater than 1 year to maturity (a) Multilateral development bank bonds – these are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Reconstruction and Development Bank etc.). (b) A financial institution that is guaranteed by the United Kingdom Government (e.g. National Rail, the Guaranteed Export Finance Company [GEFCO]) The security of interest and principal on maturity is on a par with the Government and so very secure. These bonds usually provide returns above equivalent gilt edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	AAA long term ratings (or other of your choice)
b.	The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.	
c.	Certificates of deposit issued by banks and building societies. Refer to Creditworthiness Policy	£3m – 10% of fund
d.	Property funds – the use of these instruments can be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. This Authority will seek guidance on the status of any fund it may consider using.	Specific authorisation required from Members
e.	Property purchases. The criteria for any purchase of property for investment purposes will meet the following broad criteria in the approved Property Investment Strategy (PIS) – Appendix 4. Appropriate due diligence will also be undertaken before investment of this type is undertaken.	In accordance with the PIS governance arrangements

PROPERTY INVESTMENT STRATEGY

1. The Council will seek to maintain a diversified and balanced portfolio of investment assets, having regard to the considerations set out below.

2. Established property investment practice has evolved based on long standing markets for assets in mainstream sectors such as offices, retail, industrial and residential. Investing in these traditional asset categories in a balanced fashion, allows for a lower risk investment when compared to emerging markets such as Student Accommodation, Nursing Homes and Medical Centres.

3. The Council will consider opportunities within a geographical area broadly bounded by the A23 / M23 to the West, the M25 to the North and the M2 to the East, and within a 90 minute drive time radius of Bexhill; this therefore includes a number of established commercial centres including Crawley / Gatwick, Brighton, Tunbridge Wells, Maidstone and Ashford.

4. Freehold tenure is preferred to leasehold. Freehold provides for greater levels of security than a leasehold asset that would effectively decrease in value over time.

5. Properties should preferably be let to a single tenant on a full repairing lease, in order to minimise management input. Properties with more than one tenant may be considered however if the management requirements are considered to be minimal. Whilst properties let to only one tenant may present a level of risk of a void in the event of tenant failure or at the end of the lease, detailed financial due diligence would be undertaken to ascertain their financial stability.

6. At this stage, the Council will seek investments that are already producing an income from day one, with existing tenants in place, rather than properties with vacant accommodation or development sites where the return on investment is deferred.

7. The general principle is that properties will be acquired in order to retain for their income, but the Council may consider disposals where there is significant capital appreciation, or where capital is sought for re-investment elsewhere.

8. Based on the above considerations and taking into account market conditions, a suggested lot size of between £2m and £10m is recommended. This is to avoid the lower part of the local market where private high net worth individuals would be seeking to invest and also the high end, where Pension Funds and Life Assurance Funds tend to dominate.

9. Opportunities may be sought that lend themselves to a potential to increase rental income than is currently being realised.

10. Taking all of the above considerations into account, the following specific criteria are proposed:

- Minimum Income Yield of 5% an average over 10 years.
- Individual Properties or Portfolios.
- Lot size of £2m – £10m.
- Freehold.
- Single tenanted preferred, or multi tenanted where management input is minimal.
- Asset categories: likely to focus on Industrial, Office, Retail, Leisure, Trade Counter; but others may be considered.
- Geographically located within a 90 minute travel to work area from Bexhill.

11. It is proposed that external specialist property investment advisors be retained on each transaction, advising on suitability having undertaken detailed pre purchase due diligence, including valuation, risk analysis and lease / title reviews.

12. The risks of each potential investment will be considered by carrying out due diligence to include the following:
    - Valuation.
    - Market Conditions.
    - Covenant strength of tenants.
    - Terms of leases.
    - Structural surveys.
    - Funding options.
    - Future costs.

13. It is proposed that, initially, the management of the portfolio be delivered from existing resource within the Council's Estates team. There will however be times when specialist external advice is needed and this work will be commissioned on an 'as required' basis, funded from the income from the assets. This approach is to be reviewed regularly, including on-going resource requirements, as the portfolio grows.

14. Funding for the acquisition of assets should be reviewed on a case-by-case basis but could be derived from a number of sources:
    - Receipts from previous property disposals.
    - Receipts from proposed land / property disposals in future years.
    - Reallocation of some of the funds currently held in reserves.

15. An initial budget of £7m will be set aside to invest, with further tranches subject to approval in due course.

16. The Council will monitor the performance of its investment portfolio against this performance target. Assets will be disposed of and the funds invested elsewhere where there are business reasons for doing so.

17. The Council will review this strategy as the portfolio develops and as the Council's business needs evolve.