REPORT TO	DATE OF MEETING
Governance Committee	1 February 2017

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SUBJECT	PORTFOLIO	AUTHOR	ITEM
Treasury Management & Investment Strategies 2017/18	Finance	M L Jackson	9(b)

SUMMARY AND LINK TO CORPORATE PRIORITIES

To present for the consideration of Governance Committee the Draft Treasury Management Strategy, the Draft Investment Strategy, and the Draft Minimum Revenue Provision Policy for 2017/18.

RECOMMENDATIONS

Governance Committee is asked to note and comment on:

The Draft Treasury Management Strategy for 2017/18.
The Draft Annual Investment Strategy for 2017/18, including Financial Institutions and Investment Criteria.
The Draft Annual Minimum Revenue Provision (MRP) Policy Statement for 2017/18.

DETAILS AND REASONING

The Local Government Act 2003 gave local authorities greater discretion over capital expenditure by allowing prudential borrowing. It also sought to strengthen governance by making compliance with the Chartered Institute of Public Finance and Accountancy (CIPFA)'s Prudential Code and CIPFA's Treasury Management Guidance, statutory requirements. The former requires the production of Indicators showing that expenditure is affordable; the latter requires the approval of an annual Treasury Management Strategy incorporating Treasury Indicators and limits.

Consequential to the Prudential Borrowing powers is a requirement that authorities should make prudential provision for the repayment of borrowing (MRP). This is to be the subject of an annual MRP policy statement to be made to the full Council prior to the start of each year.

Finally local authorities have, through the Local Government Act 2003, also been given greater discretion in investing surplus cash. They are required however, by guidance issued by the Department for Communities and Local Government (DCLG), to prepare an annual Investment Strategy to identify how that discretion should be applied.

This report therefore brings together these related requirements. The Governance Committee's role is to scrutinise these policies and practices, while the Council is required to approve them.

TREASURY MANAGEMENT POLICY STATEMENT & TREASURY MANAGEMENT PRACTICES (TMPs)

The Council's Treasury Management Policy Statement was updated and approved by Council on 2 March 2016. This report has been prepared in accordance with the approved Policy.

The Council's Treasury Management Practices (TMPs) were also updated and approved by Council on 2 March 2016. No changes to the TMPs are required at present.

PRUDENTIAL INDICATORS 2017/18 to 2019/20

Local authorities have discretion to incur capital expenditure in excess of the capital resources provided by government, or those resources resulting from the sale of assets or the receipt of contributions from other parties. To do this however increases a Council's indebtedness and ultimately leads to a charge to the revenue budget.

To manage that process, Councils must set certain Indicators. These are designed to indicate that the expenditure is prudent and affordable. The following Prudential Indicators will be presented to Cabinet on 20 February 2017 prior to recommending approval by Council on 1 March 2017:

- Prudential Indicator 1 – Capital Expenditure
- Prudential Indicator 2 – Capital Financing Requirement (CFR)
- Prudential Indicator 3 – Ratio of financing costs to the net revenue stream
- Prudential Indicator 4 – Incremental impact of capital investment decisions on the Band D Council Tax
- Prudential Indicators 5 and 6 – Adoption of CIPFA Code of Practice and the Treasury Management Policy Statement
- Prudential Indicator 7 – Net borrowing compared to CFR
- Prudential Indicator 8 – Operational Boundary for External Debt
- Prudential Indicator 9 – Authorised Limit for External Debt

Most of these Prudential Indicators can be prepared only by reference to the proposed revenue budget and capital programme for the following years, and therefore are presented to the Cabinet which considers these, and the Council meeting which approves them. Descriptions of the indicators follow.

Prudential Indicator 1 - Capital Expenditure

This Prudential Indicator will summarise the latest estimates of capital expenditure, and the methods of financing the capital programme for 2016/17 to 2019/20. It will show separately the cost of capital works at Leisure Centres, undertaken by Serco on behalf of South Ribble Community Leisure Trust. Since the assets are owned by the Council, this has to be accounted for as a form of finance lease.

Prudential Indicator 2 – Capital Financing Requirement (CFR)

The CFR is a measure of the Council's indebtedness resulting from its capital programme. It increases when the Council incurs unfinanced (borrowing) capital expenditure or finance lease liabilities. Its importance lies in the fact that it results in a charge to the revenue account, either from the lessor to discharge his debt, or an internal charge to make provision to finance the expenditure (the Minimum Revenue Provision - MRP).

It should be noted that this indebtedness does not result in the Council having an immediate need to take out additional borrowings. This is because the Council has various reserves, and the cash which supports those reserves can be used temporarily as internal borrowing instead of external borrowing.

The CFR is important therefore because it creates a charge to the Council's General Fund, which therefore has an impact on Council Tax.

No external borrowing to finance capital expenditure is currently planned in the period 2016/17 to 2019/20. The difference between the CFR and other long-term liabilities indicates the level of internal borrowing used to finance capital investment. The opportunity cost of using internal resources rather than external borrowing is the loss of interest that could have been earned had the cash been invested. However, the rate of interest payable on borrowing would be higher.

Prudential Indicator 3 – Ratio of financing costs to the net revenue stream

This indicator shows the proportion of the Council's budget (i.e. the costs it has to meet from government grants and local taxation including the net local share retained business rates), that is required to meet the costs associated with capital financing (interest and principal, net of interest received).

Prudential Indicator 4 – Incremental impact of capital investment decisions on the band D Council Tax

This indicator shows the cumulative effect on Council Tax levels of the changes between the capital programme to be approved this year and the programme approved a year ago. It has to be stressed that the complexity, and notional nature, of the calculations mean that the figures should only be treated as being indicative.

Prudential Indicators 5 and 6

The Council has a statutory obligation to have regard to the CIPFA Code of Practice, and is required to adopt both the Code and the Treasury Management Policy Statement therein. The CIPFA Code of Practice was adopted by Council on 3 March 2010, as was the Treasury Management Policy Statement. The TM Policy Statement was then updated and approved by Council on 2 March 2016.

Adoption of the CIPFA Code of Practice and the TM Policy Statement is reflected in Financial Regulations (Treasury Management – investments, borrowings, and trust funds).

Prudential Indicator 7 - Net Borrowing compared to CFR

The Prudential Code requires authorities to make comparison between net borrowing and the Capital Financing Requirement. At its greatest, net borrowing should not exceed the current year's CFR plus the estimated increases in CFR for the following two years. The figures to be reported to Cabinet and Council will demonstrate that the council has met this requirement.

Prudential Indicator 8 - The Operational Boundary for External Debt

The Council is required to set two limits on its external debt (i.e. the amounts it owes to lessors and any amounts it borrows directly, from the Public Works Loan Board for example). The first is the Operational Boundary. This should reflect the most likely, but not worst case scenario consistent with the Council's budget proposals.

Whilst the CFR (Prudential Indicator 2) is being temporarily financed from internal cash balances/cash flow it is not expected that additional external borrowings will be required in the years covered by this strategy. The proposed operational boundary therefore will reflect the expected leasing liabilities.

Prudential Indicator 9 - The Authorised Limit

This is the second limit. It should allow headroom above the Operational Boundary to accommodate the fluctuations that can occur in cash flows. The Authorised Limit tends to include headroom for any temporary borrowing that might be required for cash flow management purposes.

TREASURY MANAGEMENT STRATEGY 2017/18

Background

The treasury management service fulfils an important role in the overall financial management of the Council's affairs. It deals with "*the management of the authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks"* (CIPFA) .

Reporting

This strategy statement has been prepared in accordance with the current Code. A mid-year monitoring report and a final report on actual activity, after the year-end, will be submitted to the Council. Additional reports will be made to the Governance Committee during the year as required.

Economic outlook and expected movement in interest rates

As the advice of the Council's current treasury advisors, Capita Asset Services, is presented in detail in the Treasury Management Activity report on this agenda, it is not repeated in this report. The Treasury Strategy report to Cabinet and Council will include economic advice, updated where necessary to include recent developments.

Borrowing strategy

The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt. This is possible because cash, supporting the Council's reserves, balances and cash flow, has been used as a temporary measure. This strategy is prudent as investment returns are low and the range of counterparties is narrow. External borrowing to finance capital expenditure would tend to increase cash balances further, but the likelihood is that the average rate of return would fall as a result of having to place cash with counterparties such offering lower interest rates.

Cash balances are expected to remain adequate throughout the period. On this basis no further long-term borrowing should be necessary, although there is the possibility of short-term borrowings being necessary to cover fluctuations in cash flow, particularly at the end of the financial year. For this reason the Authorised Limit (Prudential Indicator 9) should allow headroom to permit some temporary borrowing if required for cash flow management.

Icelandic Investment

Heritable

No further repayment in respect of the Heritable claim has been received to date during 2016/17. So far a total of £1.974m has been received, and the Council is aiming to recover the remaining £0.040m balance of the original claim submitted in 2008. Any further repayments by Heritable would benefit the council's revenue budget, as the balance of the investment has been impaired in full in the balance sheet, which means that no value has been attributed to it.

Treasury Management Limits on Activity

The Council is required to set the following Treasury Indicators. The purpose of these is to minimise the risk resulting from movements in interest rates.

Treasury Indicator 1 – Upper limit on Variable rate exposure

The Council is exposed to interest rate movements on its invested cash. The amount varies significantly over the course of the year, and during each month, and is affected by changes to the timing of receipts and payments. At any one point, much of the balance will consist of cash collected (typically business rates and council tax) on behalf of other bodies – Government, County, Police, and Fire – which will be paid over shortly afterwards. During 2016/17 this indicator was increased from £42m to £45m, reflecting experience in the first half of the year. In early January, cash balances peaked at £44.1m, just under the upper limit. This is usually when the balance is at its highest, and it is not anticipated that it will be as close to the upper limit for the remainder of 2016/17.

It is proposed that the indicator be set to £46m for 2017/18, and be kept at the same level for the following three years, to be reviewed annually or mid-year if necessary.

Upper limit on variable rate exposure	2016/17 Revised £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m
Upper limit -	**45.0**	**46.0**	**46.0**	**46.0**

Treasury Indicator 2 – Upper limit on fixed rate exposure

The Council is exposed to fixed rate interest on the finance lease liabilities. The maximum estimated exposure is based on the Operational Boundary (Prudential Indicator 8), and this indicator will be proposed to Cabinet and Council when the Prudential Indicator has been updated to reflect budget proposals.

Treasury Indicator 3 - Maturity structure of borrowing

The Council is required to determine upper and lower limits for the maturity structure of its borrowings. The Council will have no external borrowings at 31 March 2017, and none are currently envisaged over the period covered by this strategy. Therefore the upper and lower limits are shown in Table 10 following.

Maturity structure of borrowing	As at 31/3/17	
	Lower Limit	Upper Limit
Under 12 months	0%	0%
12 months to 2 years	0%	0%
2 to 5 years	0%	0%
5 to 10 years	0%	0%
10 years and above	0%	0%

Use of the Council’s cash balances instead of external debt is a form of temporary internal borrowing at a variable rate. The cost of the internal borrowing is effectively the rate of interest that could have been earned had the cash remained available for investment rather than being used to finance capital expenditure temporarily. The opportunity cost of internal borrowing will remain low while average interest rates achievable continue to be low.

Treasury Indicator 4 – Total principal sums invested for greater than 364 days

It is not planned to make any investments for banks or buildings societies periods over 364 days. Such investments would be "non-specified", as explained in the Investment Strategy below. However, because of the limited availability of suitable high credit quality banks and building societies as investment counterparties, **it is proposed that the maximum period for investments with UK local authorities should be increased to 2 years; that the limit per local authority should be no more than £5m; and that no more than £5m should be invested for greater than one year.** This proposal is reflected in the list of investment counterparties presented in the Investment Strategy below.

Use of Treasury Advisors

The Council recognises that responsibility for treasury decisions cannot be delegated to its treasury advisor, but remain its responsibility at all times.

Performance Indicators

Investments – the generally accepted indicator is 7-day LIBID (The London Interbank Bid rate). This is the rate that could be obtained by the "passive" deposit of money onto the money market. Active investment, in normal times, should outperform this. Average 7-day LIBID plus 15% has been set as a performance indicator for Shared Financial Services. As indicated in the Treasury Management Activity report, actual investment returns have exceeded this target, and the approach to investment will continue to be use of high credit quality counterparties offering a better return than the Debt Management Office, where possible. Changes to the investment counterparty limits as recommended in the Investment Strategy will help the council to achieve its rate of return performance target.

INVESTMENT STRATEGY 2017/18

Introduction

Under the Power in Section 15 (1) of the Local Government Act 2003 the DCLG has issued Guidance on Local Government Investments. Each Authority is recommended to produce an annual strategy that sets out its policies to manage investments, giving priority to security and liquidity ahead of yield. This strategy follows the guidance.

The major element in the guidance is that authorities should distinguish between lower risk (specified investments), and other investments (non-specified). These terms are explained in more detail below.

The specific issues to be addressed in the Investment Strategy are as follows:

- How "high" credit quality is to be determined.
- How credit ratings are to be monitored.
- To what extent risk assessment is based upon credit ratings, and what other sources of information on credit risk are used.
- The procedures for determining which non-specified investments might prudently be used
- Which categories of non-specified investments the Council may use.
- The upper limits for the amounts which may be held in each category of non-specified investment and the overall total.
- The procedures to determine the maximum periods for which funds may be committed.
- The process adopted for reviewing and addressing the needs of Council members and treasury management staff for training in investment management.

- The Authority’s policies on investing money borrowed in advance of spending needs. The statement should identify measures to minimise such investments including limits on (a) amounts borrowed, and (b) periods between borrowing and expenditure.

South Ribble Borough Council’s Strategy for 2017/18

Objectives

The Council’s investment priorities are:
- The security of capital and
- The liquidity of its investments.

The Council will also aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity.

The borrowing of monies purely to invest or on-lend and make a return is unlawful, and this Council will not engage in such activity. The Council will restrict borrowing in excess of its immediate need, to that envisaged to be required in the following eighteen months.

Use of Specified and Non-Specified Investments

Specified investments are those
- made with high “quality” institutions, the UK Government or a local authority,
- are for periods of less than one year; and
- are denominated in sterling.

Other investments are “non-specified”. These could include investments in gilts, bond issues by other sovereign bodies and those issued by multilateral development banks, commercial paper, and any deposits for a period exceeding one year.

Council policy in recent years has been only to make specified investments. While this remains the proposal in respect of banks and building societies, **members are asked to consider increasing the maximum period for investments with UK local authorities to two years, subject to a maximum of £5m being invested for over one year.** Such investments would be technically “non-specified”, which in theory reflects a greater degree of risk associated with less liquid investments. However, despite the financial challenges which local authorities are facing at present and for the foreseeable future, there is no reason at present to regard the risk associated with a 2-year investment with local authorities as being unacceptable.

Property Funds are included within the Table below, however it is proposed that these are removed from the strategy before its approval by Council as part of the budget process. This option has not been pursued since its inclusion within the strategy as very few are relevant to the investment of our cash balances. In addition this options has also become less attractive since some Property Fund were temporarily frozen following the EU Brexit Referendum.

Counterparty Selection Criteria

In determining which institutions are “High Quality” the Council uses the creditworthiness service provided by Capital Asset Services. This combines the credit ratings from all three major rating agencies (Fitch, Moody’s, and Standard & Poor’s) in a sophisticated modelling process. It does not however rely solely on these ratings, but also uses

- Credit watches and credit outlooks from the agencies
- Credit Default Spreads (CDS) to give early warning of likely changes in ratings
- Sovereign ratings to select counterparties from only the most credit worthy countries

These factors are combined in a scoring system, and results in counterparties being colour coded:

- Yellow – suggested maximum duration 5 years
- Purple – suggested maximum duration 2 years
- Blue (used for nationalised and part-nationalised UK Banks) – 1 year
- Orange – 1 year
- Red – 6 months
- Green – 3 months
- No colour – not to be used

Monitoring of Credit Ratings

Capital Asset Services supply rating warnings and changes immediately following their issuance by the rating agencies. The colour coded counterparty lists are reissued weekly, updated by such changes. Members of the Shared Financial Services' Financial Accountancy team are also registered with the three credit rating agencies so that ratings can be checked online independently of Capita. Capita's credit rating documents are also available online on its Passport web site.

Capita's advice in respect of specific types of investment counterparties is presented as Appendix A. In addition, Capita have provided advice about the Markets in Financial Instruments Directive (MiFID). Implementation of the directive from early 2018 has the potential for restricting access to certain investment types, which could have an impact on investment earnings. The full implications of implementing the directive may not be known for some time. It is even possible that it could restrict the ability of local authorities to lend to each other, which would tend to mean that more councils would rely on the DMO as a "safe haven" for their cash, admittedly at a very low rate of interest.

Time and Money Limits

The limits applying to each category of institution are specified in the table following – "Financial Institutions and Investment Criteria". The changes proposed from the limits for 2016/17 are highlighted in **bold**. Specifically the proposed changes are as follows:

- UK Local Authorities – increase maximum period to 2 years, increase investment limit to £5m per authority, maximum of £5m can be invested for more than one year
- UK-incorporated Institutions (banks and building societies) – increase investment limit to £5m per group or independent institution
- Non-UK Banks (currently EU banks with UK offices accepting deposits in sterling) – increase investment limit to £4m per group or independent institution, and maximum invested in this category of institution to £8m
- Money Market Funds (MMFS - CNAV) – increase investment limit to £5m per fund

Non-UK banks would be considered only if they had a suggested investment duration of at least 6 months, and this had been consistent for a long period. Investments would be restricted to a limited selection of EU countries, but not all of the maximum of £8m would be invested in banks from the same country.

The council has used three "instant access" MMFs during 2016/17: BlackRock, Federated, and Standard Life. Deposits tend to be placed for short periods to help manage the council's cash flow. The interest rates offered during 2016/17 have continued to decline, but they are still better than available from the DMO.

Member and Staff Training

We will be scheduling appropriate awareness training for councillors in 2017/18. Treasury management staff in the Shared Financial Services' Financial Accountancy team will attend seminars provided by the Council's treasury advisor where appropriate.

Financial Institutions and Investment Criteria (2017/18 Investment Strategy)

Investment Counterparties 2017/18

Category	Institutions	CAS Colour Code	Maximum Period	Limit per Institution
Banks & Building Societies: Call Accounts /Term Deposits / Certificates of Deposit (CDs)				
Government related/guaranteed	DMADF (DMO) UK Local Authority	Yellow Yellow	6 months **2 years**	Unlimited **£5m per LA**
UK part-nationalised institutions	Royal Bank of Scotland group	Blue	1 year	£5m per group
UK-incorporated Institutions	UK banks and building societies of high credit quality	Orange Red Green	1 year 6 months 3 months	**£5m per group (or independent institution)**
Non-UK Banks	Non-UK banks of high credit quality	Orange Red Green	1 year 6 months 3 months	**£4m per group (or independent institution); £8m in total for this category**
Money Market Funds				
Money Market Funds (CNAV) **	MMFs of high credit quality - AAA rated		Instant access	**£5m per fund**
Enhanced Money Market Funds (VNAV)	EMMFs of high credit quality - AAA rated		T+2 or T+3	£3m per fund; £6m in total for this category
Property Funds				
Property Funds	Specific Funds to be selected based on CAS guidance & undertaking due diligence checks			£2m in total for this category

Changes from the Investment Counterparties maximum periods and limits for 2016/17 are in **bold.**

** Funds used by the council in 2016/17 were BlackRock, Federated, and Standard Life.

ANNUAL STATEMENT OF MINIMUM REVENUE PROVISION (MRP) POLICY 2017/18

Regulations specify the minimum provision that a Council must make for the repayment of its debt. This is referred to as the Minimum Revenue Provision (MRP).

The Council will assess their MRP for 2017/18 in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

The major proportion of the MRP for 2017/18 relates to debt incurred prior to 2008/9. MRP will continue to be charged on this at the rate of 4%, in accordance with option 1 of the guidance. There are some capital schemes since then which generate a further MRP liability (i.e. capital expenditure which is not financed by any grant or contribution e.g. vehicles). The MRP liability on this will be based on the estimated useful life of the asset, using the equal annual instalment method of calculation (option 3 of the guidance).

Estimated life periods will be determined under by determined by the Council's Chief Financial Officer with reference to the guidance. As some types of capital expenditure are not capable of being related to an individual asset, the MRP will be assessed on a basis which most reasonably reflects the anticipated period of benefit arising from the expenditure.

WIDER IMPLICATIONS

In the preparation of this report, consideration has been given to the impact of its proposals in all the areas listed below, and the table shows any implications in respect of each of these. The risk assessment which has been carried out forms part of the background papers to the report.

FINANCIAL	The financial implications are covered in the report.
LEGAL	The strategy ensures compliance with various regulations and statutory codes of practice.
RISK	The Council's treasury management strategy and policies are designed to ensure the effective control and management of the risks associated with such activities.
THE IMPACT ON EQUALITY	There are no adverse implications for equality issues
OTHER (see below)	

Asset Management	*Corporate Plans and Policies*	*Crime and Disorder*	*Efficiency Savings/Value for Money*
Equality, Diversity and Community Cohesion	*Freedom of Information/ Data Protection*	*Health and Safety*	*Health Inequalities*
Human Rights Act 1998	*Implementing Electronic Government*	*Staffing, Training and Development*	*Sustainability*

BACKGROUND DOCUMENTS

CIPFA Treasury Management in the Public Services: Code of Practice & Guidance Notes
CIPFA Prudential Code for Capital Finance in Local Authorities
CIPFA Standards of Professional Practice: Treasury Management
DCLG Guidance on Local Government Investments
DCLG Guidance on Minimum Revenue Provision

APPENDIX A

The following is the advice of the Council's treasury management advisors - Capita Asset Services

Investment Counterparties

We remain in a very difficult investment environment. Whilst counterparty risk appears to have eased, market sentiment has still been subject to bouts of, sometimes, extreme volatility and economic forecasts abound with uncertainty. However, we also have a very accommodating monetary policy - reflected in a 0.25% Bank Rate. As a consequence, authorities are not getting much of a return from deposits. Against this backdrop it is, nevertheless, easy to forget recent history, ignore market warnings and search for that extra return to ease revenue budget pressures. In this respect, we are seeing an increase in investment "opportunities" being offered to clients or being discussed in the wider press. What then, should you consider when these are offered?

Do not look at the return, look at the product.

We suggest that you "look under the bonnet" when considering pooled investment vehicles, although this applies to any investment opportunity. It is not enough that other councils are investing in a scheme or an investment opportunity: you are tasked through market rules to understand the "product" and appreciate the risks before investing. A quotation from the Financial Conduct Authority puts the environment in context.

The main risks in the industry for the coming year are firms designing products that: -

- *aren't in the long-term interest of consumers*
- *don't respond to their needs*
- *encompass a lack of transparency on what's being sold*
- *lead to a poor understanding by consumers of risk*
- *shift toward more complex structured products that lack oversight.*

Alternative investment instruments

The particular asset classes we have spoken on at our seminars include the following:

- Enhanced Money Market Funds
- Corporate Bonds - direct, passive and active external management
- Property Funds
- Equity Funds

There are varying degrees of risks associated with such asset classes and these need comprehensive appreciation. It is not just credit risk that needs to be understood, but liquidity and interest rate / market risk as well, although these can often be intertwined. Any option in which an investor hopes to generate an elevated rate of return will almost always introduce a greater level of risk. By carefully considering and understanding the nature of these risks, an informed decision can be taken.

Property funds

A number of our clients are actively considering, or have already commenced investing in property funds. Where not already undertaken, this may require an addition to your list of non-specified investments in your Annual Investment Strategy (AIS). You may wish to specify an appropriate monetary limit based upon an assessment of your reserves and balances going forward.

Each authority will also need to evaluate whether investing in a particular property fund will qualify as being capital expenditure or not. If deemed capital expenditure an application (spending) of capital resources would be required. Authorities should seek guidance on the status of any fund

they may consider using. Appropriate due diligence should also be undertaken before investment of this type is undertaken.

Building societies

Only five building societies, at the time of writing, have the necessary ratings to render them suitable for consideration by clients who follow our suggested credit assessment methodology. This is a limited number, as the great majority of building societies do not have credit ratings, while a few do have ratings but they are not high enough ratings to qualify to get into one of our suggested colour bands. If clients wish to use building societies as part of their own strategy, then they need to consider what metrics they will use to determine suitability and how these will be monitored.

Challenger banks

The vast majority of local authorities do not include challenger banks in their counterparty lists. At present, they do not have credit ratings and so would fall outside of most investment strategy criteria. However, we expect that some of these entities may get ratings in coming years, so we will continue to keep this area under review.

Money Market Funds (MMFs)

Over the next few years, the EU will be working on developing proposals which may require these funds to move from Constant net asset value (CNAV) to Low Volatility net asset value (LVNAV). These reforms are still to be agreed and are unlikely to be ready for implementation in 2017/18. Whenever these changes occur, we will advise clients on the implications and how best these can be approached.

Commentary on Investment Issues (mid-January 2017)

There is a high degree of volatility in the global markets. The initial downside pressures resulting from the UK Brexit decision reverted back higher in more recent times over the potential inflation threat building in the UK economy. Interest rate expectations have been similarly affected, first pushing lower in anticipation of a near-term rate cut, to more recently, where there is no expectation of any change in either direction for some while to come. This volatility could remain in situ for some time to come, certainly until there is greater clarity surrounding the consequences for the economy of the vote, and the deal that can be negotiated around a withdrawal.

While the economic outlook for the UK and US improved through much of 2014, 2015 saw something of a slowing in activity, especially through the latter stages of the year. This weakening has also flowed through much of this year. While the domestic situation remains reasonably positive, especially in the US, underlying, and in some cases growing, international concerns are expected to see the respective central banks hold back from previously projected levels of policy tightening. In the US, after the recent FOMC policy minutes, the markets (futures contracts), are now pricing in a two-thirds chance of rate increase this December. The elephant in the room remains Trump. Markets are trying to fathom what his presidency will actually mean in terms of fiscal stimulus, and what impact this could have on monetary policy going forwards.

Closer to home markets have increasingly priced in no change in Bank Rate for the foreseeable future. However, less than a month ago, it was pricing in a near certainty of a rate cut before year end. Such volatility in expectations will persist.

For the Eurozone the future remains tepid at best, in spite of ECB policy action and a bounce in growth in the first quarter of the year. Growth pulled back in Q2, as expected and stayed relatively weak in Q3. Progress within the currency bloc will continue to be hampered by a number of fundamental issues, not least stubbornly high unemployment, in all bar one or two countries.

The actions/words, or inactions, of central bankers are likely to continue to be the key themes dominating market sentiment in the coming months. However, in light of the change in UK political/economic outlook there will be an increased level of political influence on the markets for some time, as the process of extracting the UK from the EU commences, and, in all probability, drags on. The Trump election success in the US adds to the weight that politics will have on market sentiment.

Central banks have undertaken enormous support programmes in recent years, in an effort to stabilise the world economy. However, can they be unwound without causing material market turbulence in the future – such as that seen in emerging markets in early 2014? While the US has already commenced minimising the levels of increased support, the full unwinding of policy support for major economies will take many years to accomplish. Equally, how easily can the UK reverse forty years of EU membership without any detrimental effect to itself or its former partners, and will this prove a test case / template that other EU members might watch with a view to similar action, with the risk of a break-up of the EU.

Counterparty quality remains the key factor when making investment decisions. Policy rates are not expected to tighten for some considerable time. As such, some of the longer dated deals on offer continue to present some potential advantage.

As with any investment, please check that these are both suitable for your own individual strategy, and allowable within the confines of your investment strategy.

Markets in Financial Instruments Directive (MiFID II)

The Markets in Financial Instruments Directive (MiFID) is the EU legislation that regulates firms who provide services to clients linked to 'financial instruments' (shares, bonds, units in collective investment schemes and derivatives), and the venues where those instruments are traded. The new MiFID II environment is set to commence on 3rd January 2018, having been delayed by a year due to slower than anticipated progress in a number of key areas.

There is a key change affecting Local Authorities. Under the new regime, Local Authorities will be deemed "Retail" clients by default. They will have the option to "opt-up" to "Professional" client status, or remain as "Retail". Treasury Solutions currently categorise their clients as "Per Se Professional" but this is being replaced by the "opt-up" procedure.

In order to opt-up, clients will need to meet qualitative and quantitative test criteria.

Qualitative Test Criteria

- *"Firms must undertake an adequate assessment of the expertise, experience and knowledge of the client to give reasonable assurance in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved (COBS 3.5.3R(1))"*

The qualitative test criteria are provided as guidance and it will be down to each investment counterparty to set its particular criteria. Rather than a simple pro-forma that could be used to meet each individual request, there are likely to be differences in each approach from each individual financial institution and fund manager. The differences could simply depend on the nature of the potential investment a client may make with the entity, or there could be other factors that also play a role. Unfortunately, what is likely to be consistent is that each approach will require a lot of form filling!

Quantitative Test Criteria

- *A re-calibrated quantitative test (based on COBS 3.5.3R(2)) – the criteria in paragraph (a)* ***and*** *the criteria in either paragraph (b) or (c) must be satisfied:*
- *the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds* ***£15,000,000***
- *(b) the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters*
- *(c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged*

While some elements of this part of the opt-up criteria will be relatively simple to meet, even here there are some elements that could be open to interpretation. For example, with the £15m portfolio – at what stage would this be calculated? Would this be a balance sheet date, which could prove an issue for some clients who normally wind down balances at year end? Other options could be quarter end positions over a period of time, which would show average balances that could allow some clients to better meet the stated requirement than a balance sheet position would.

Another consideration would be how to satisfy sections (b) / (c) when you might be considering a new asset class for investing. For example, if you were considering a Short Dated Bond Fund as a new type of investment, you would struggle to meet the requirements of (b), and may even have issues dealing with (c) as well, even if you have been working in a professional position for at least one year. It could be that undertaking a formal selection process would allow you to meet criteria, or by some other means. However, once again, without clear guidance as to how investment counterparties are going to produce their own assessment processes, it is difficult to say at this stage.

It is important to note that the option to opt-up is not a one off exercise. It will need to be undertaken with each and every counterparty / fund manager that a client may wish to transact. In some circumstances it may even be the case that a client may not wish to take up the option to opt up, preferring instead to maintain its "Retail" status. However, as highlighted in the consultation process, the decision to maintain "Retail" status may limit the investment options available, compared to "Professional" status. The decision may rest on what options are available under each status, and which is, therefore, most appropriate for each individual client. As such, there may be instances where a client is deemed "Professional" by some counterparties, but "Retail by others.

Capita Asset Services - Treasury Solutions are discussing these matters with investment counterparties including financial institutions and fund managers. These discussions have been on-going since MiFID II was first proposed and will continue through to its implementation and beyond.

We will help you where possible, and keep you updated as pertinent information materialises. In addition, our discussions with you will focus on the implications for retaining "Retail" status, in terms of the product set and any additional "protection" (this is not monetary, but the way that a client is treated) that may be provided.

We expect that as a retail customer or as a professional customer you will be able to access and place deposits as you do today but there remains a deal of uncertainty as to how the new regime will be implemented for investments and the implications it may have for you. However, we would stress that financial institutions and fund managers will not be looking to narrow their potential Local Authority customer base by making opt-up criteria (where appropriate) too complex or time consuming to complete.

Consultation Paper III – 4. Client Classification – Extract of FCA text	Impact on Treasury Solutions ("TS") or its Local Authority Clients
Ref: 4.24 Implications for Consumers (Local Authorities) The re-calibrated quantitative threshold (as set out in paragraph 4.13) is specifically designed to ensure that only smaller, less sophisticated local authorities (such as parish and town councils acting in their treasury function capacity) are likely to fall below the required threshold. We believe this threshold will serve to identify local authorities for whom more complicated financial services may not be appropriate given their level of resources and potentially lower level of knowledge and expertise, and therefore should be treated as retail, rather than professional clients. The resultant increased regulatory protections for these local authorities should reduce the risk of them being sold services or products which they may not understand, and prevent future cases of local authorities incurring significant losses, as seen in the recent past. This change should also have the benefit of enhancing investor protections for local authority treasury reserves.	This states the FCA reasoning behind the change and the quantitative criteria set for Retail clients to be able to opt-up to Professional status.
Ref: 4.26 Restricted Access to Certain Services Local authorities classified as retail clients may be unable to access the services of certain investment firms (e.g. alternative asset managers without retail permissions). This will be mainly limited to smaller local authorities and more complex products or services, and should not affect local authorities acting as pension fund administrators. We believe this potential restriction is proportionate given the likelihood that such local authorities are less sophisticated consumers (as discussed further below).	Acknowledgement by the FCA that this might result in restrictions to some services.
Ref: 4.29 Rationale for the Portfolio Size Requirement The increased portfolio size requirement of £15m is proposed on the basis that £10m typically reflects the average portfolio size of smaller local authorities. We consider that this threshold is set at a more meaningful level, given the relative size of local authorities' resources. This requirement, combined with the qualitative test, is aimed at precluding smaller, less sophisticated local authorities acting in their main capacity as treasury managers from being opted-up inappropriately.	While this is still a proposal it may be worthwhile for each client to consider if the FCA view and portfolio size requirement is appropriate. It should be noted that the previous Discussion Paper from the FCA gave three options and their preferred option (Option B) was one where the portfolio size requirement was £20 million so that this proposal is at a slightly lower level.