Kent Police and Crime Commissioner

Treasury Management Strategy 2017/18

1 March 2017

Introduction

1. Treasury management can be defined as the management of the Commissioner's investments and cash flows, banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

2. The Commissioner is required to operate a balanced budget, which means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Any surplus money is invested in low risk counterparties or instruments commensurate with a low risk appetitive providing security of capital and sufficient liquidity initially before investment return.

3. The second main function of treasury management is the funding of the Commissioner's capital programme. This provides a guide to when substantial funding is required to support the programme and will identify any requirement for the Commissioner to borrow money to fund particular projects. The Commissioner has no outstanding borrowing and the capital programme has not identified a need to borrow during 2017/18 so this strategy focuses on the investment plans of the Commissioner with a short section on short term borrowing.

Statutory Requirements

4. The Commissioner has adopted the Chartered Institute of Public Finance and Accountancy's (Cipfa) Treasury Management in the Public Services Code of Practice which requires the Commissioner to approve a treasury management strategy before the start of each financial year.

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

    a) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Commissioner's treasury management activities.
    b) Creation and maintenance of Treasury Management Practices which set out the manner in which the Commissioner will seek to achieve those policies and objectives.
    c) Receipt by the Commissioner of an annual Treasury Management Strategy Statement - 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.

d) Delegation by the Commissioner of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
e) Delegation by the Commissioner of the role of scrutiny of treasury management strategy and policies to a specific named body. In this respect the Commissioner has chosen to delegate this responsibility to the Joint Audit Committee

6. The Commissioner has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Commissioner's treasury management strategy.

7. Should the assumptions on which this strategy is based change significantly the Commissioner will be asked to approve a revised Treasury management strategy. Circumstances in which this may occur would include, for example, a large unexpected change in interest rates, the Commissioner's capital programme or in the level of investment balances.

Financial Environment

8. The major external influence on the Commissioner's treasury management strategy for 2017/18 will be the UK's progress in negotiating a smooth exit from the European Union (EU). Financial markets, wrong footed by the referendum outcome, have since been weighed down by uncertainty over whether leaving the EU also means leaving the single market. Negotiations are expected to start once the UK formally triggers exit in early 2017 and last for at least 2 years. Uncertainty over future economic prospects will therefore remain throughout 2017/18.

9. The fall and continuing weakness in sterling and the near doubling in the price of oil in 2016 have combined to drive inflation expectations higher. The bank of England is forecasting that consumer price inflation (CPI) will breach its 2% target in 2017, the first time since late 2013, but the Bank is expected to look through inflation overshoots over the course of 2017 when setting interest rates so as to avoid derailing the economy.

10. Initial post-referendum economic data showed that the feared collapse in business and consumer confidence has not immediately led to lower GDP growth. However, the prospect of leaving the single market has dented business confidence and resulted in a delay in new business investment and, unless counteracted by higher public spending or retail sales, will weaken economic growth in 2017/18.

11. Looking overseas, with the US economy and its labour market showing steady improvement, the market has priced in a high probability of the Federal Reserve

increasing interest rates in 2017/18. The Eurozone meanwhile has continued to struggle with very low inflation and lack of momentum of growth and the European Central Bank has left the door open for further quantative easing.

12. The impact of political risk on financial markets remains significant over the next year. With challenges such as immigration, the rise of populist, anti-establishment parties and with the French presidential and general elections and the German federal elections all potentially providing upsets.

13. In regard to the credit outlook, markets have expressed concern over the financial viability of a number of European banks recently. Sluggish economies and continuing fines for pre-crisis behaviour have weighed on bank profits, and any future slowdown will exacerbate concerns in this regard.

14. Bail in legislation which ensures that large investors including local authorities will rescue failing banks instead of tax payers in the future has now been fully implemented in the European Union, Switzerland, and USA, while Australia and Canada are progressing with their own plans. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Commissioner; returns from bank deposits however continue to fall.

15. In regard to the forecast on interest rates, the Commissioner's treasury advisors are Arlingclose and their forecast is for the UK bank rate to remain at 0.25% during 2017/18. The Bank of England has highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further falls in the bank rate look less likely. A negative bank rate is currently perceived by some policy makers to be counterproductive but although it is a low probability, it cannot be entirely ruled out in the medium term, particularly if the UK enters a recession as a result of concerns over leaving the EU.

16. Gilt yields have risen sharply, but remain at low levels. Arlingclose expect yields to decline when the Government triggers Article 50. Long term economic fundamentals remain weak and the quantative easing (QE) stimulus provided by central banks globally has only delayed the fallout from the build-up of public and private sector debt. The Bank of England has defended QE as a monetary policy tool, and further QE in support of the UK economy in 2017/18 remains a possibility to keep long term interest rates low.

Treasury Management Strategy 2017/18

17. The Treasury Management strategy for 2017/18 in respect of the treasury management function is based upon the CFO to the PCC view, supplemented with leading market forecasts provided by Arlingclose, our treasury advisers.

Annual Investment Strategy

18. The Commissioner holds significant invested funds, representing income received in advance of expenditure plus balances and reserves. In the past 12

months the Commissioners investment balance has been at any one time up to £90m, and similar levels are expected to be maintained in 2017/18.

19. The Commissioner will have regard to the DCLG's Guidance on Local Government Investments and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes. Both require the Commissioner to invest funds prudently, and to have regard to the security and liquidity of investments before seeking the highest rate of return. The Commissioner's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Commissioner will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

20. As mentioned earlier, there is a small risk that the Bank of England could set its Bank Rate at or below zero, which would likely feed through to negative interest rates on all low risk, short term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity even though this may be less than the amount originally invested.

21. The Commissioner's current policy allows access to low risk investment options, including money market funds and that offer a high degree of diversification. However, we engaged specialist treasury advisors, Arlingclose Ltd to advise on the strategy generally and particularly further potential counterparty diversification options for the future.

22. Given the increasing risk and falling returns from short term unsecured bank investments the Commissioner aims to diversify into more secure and/or higher yielding asset classes during 2017/18. This is especially the case for the funds available for longer term investment. Currently most of the Commissioners surplus cash is invested in short term unsecured bank deposits and money market funds. For 2017/18 the Commissioner will allow investment into other pooled funds, including cash plus, short bonds and for the longer term, property funds. Investment in a property fund offers enhanced returns over the longer term, which should help mitigate inflation risk, but is more volatile in the short term. A longer term investment horizon is therefore key to ride out changes in the capital value of the fund whilst receiving income/dividend payments on a regular basis. The Commissioner has stipulated which property funds are available to invest in based on advice from Arlingclose. Because these funds are a long term investment and have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Commissioner's investment objectives will be monitored regularly.

23. In accordance with the above, and in order to minimise exposure to credit risk, the Commissioner has stipulated the minimum credit quality of counterparties for inclusion in the lending list. The creditworthiness methodology used to create the counterparty list takes account of the ratings and watches published by all three ratings agencies, with a full understanding of what the ratings represent, as well

as other creditworthiness information as outlined in the appendix Using information from Arlingclose, counterparties' credit ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

24. It is proposed to apply the following prudent but flexible strategy:

    a) Secured lending (i.e. covered bonds) up to a maximum of £10m with each institution for a maximum duration of 3 years (aggregate limit of £15m). Each secured lending counterparty/instrument in this category must have the equivalent of AAA rating.
    b) Unsecured lending with up to £5m and up to thirteen months with a single bank but subject to a limit of £5m with the group. This is subject to each bank's long term bank rating not falling below A- or equivalent on any of Moody's, Standard and Poor's and Fitch ratings
    c) Unsecured lending with Santander UK and Nationwide up to £5m and up to six months providing their respective long term ratings do not fall below A- or equivalent on any of Moody's, Standard and Poor's or Fitch ratings.
    d) Overseas Banks up to £5m and up to 13 months term, providing their long term bank ratings does not fall below A+ or equivalent on any of Moody's, Standard and Poor's and Fitch ratings and the country ratings do not fall below AA. The maximum invested in any country outside the UK will be £15m.
    e) Short term Money Market Funds. – Up to £5m each.
    f) Other local authorities, up to £10m and up to a two year term
    g) Other pooled funds including cash plus, short bonds and property funds – up to £5m
    h) Unlimited but effectively the balance with the DMO and/or Treasury Bills.

25. It is assumed that deposits will be placed in order of priority, (a) to (f) above, but category (b) to (f) can be used interchangeably depending on liquidity requirements and relative yields available. Call accounts, term deposits, Money Market Funds and certificates of deposits (with appropriate custody) will be the normal instruments employed, with the addition of covered bonds to access secured lending. The CFO to the PCC will agree detailed instructions with the dealing team consistent with the above. For the purposes of this strategy, high grade assets refer to their credit ratings assigned by Moody's, Fitch and S&P. Also for the purpose of the strategy, the approved non specified investments are limited to those set in paragraph 24 (a) and (f), over 1 year. The maximum lending of 24 (a) and (f – over one year) will be £20m.

26. The amount outstanding in relation to Icelandic bank exposure now stands at £484,000 as at 10 February 2017. Of this, £419,000 is held in escrow in ISK (Giltnir) and £64,000m is subject to managed distributions (Heritable)

Borrowing

27. The Commissioner has no outstanding borrowing and there is no current or planned long term borrowing in the Commissioner's on-going capital programme.

Therefore that aspect has not been considered as part of the treasury management strategy and accordingly the formal authorised external borrowing limit (excluding other long term liabilities such as PFI and leases) will be again be zero for 2017/18.

28. However, there may be times when short term borrowing is required to cover cash flows due to errors or delayed receipts etc. If this is required then no borrowing should take place without the express permission of the CFO to the Commissioner.

Management and Execution

29. The existing 2016/17 Strategy is expected to deliver an average return of 0.5% or £450,000. This compares to interest earned for 2015/16 of 0.5% or £488,000.

30. As normal, the strategy will be managed by the CFO to the Commissioner who has engaged the treasury management team of Kent County Council to execute the actual dealing in line with the above on a day-to-day basis. Execution will also be informed by daily/weekly updates from Arlingclose on counter-party risk changes and profiles. In addition, the CFO will monitor the wider trade press in respect of treasury management risks and trends. The CFO will decide on duration periods within the term limits set above depending on current circumstances, and will notify the KCC dealing team accordingly, with the current instruction being that duration limits should not exceed the lower of the advice offered by Arlingclose and the maximum limits set out in paragraph 24 above.

31. No new investments will be placed with institutions suspended or placed on negative ratings watch by Arlingclose. The CFO will meet with Arlingclose to review their advice and views at least quarterly.

32. The CFO will recommend any changes in the above strategy to the Commissioner as circumstances change but in moments of urgency the CFO will have the authority to reduce portfolio risk by reducing term periods, deposit limits or allowable categories in the face of changing market conditions and his professional view that such changed conditions makes the set strategy too risky. Where possible and practical such changes will be agreed and documented with the Commissioner in advance but if not possible due to leave or absence a report will be made by the CFO to the commissioner within 5 working days of any changes being implemented.

33. The Commissioner has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. Meetings are held regularly on a quarterly basis. The quality of this service is controlled by the CFO to the Commissioner.

34. The CFO to the PCC has some treasury management experience and will assess his training needs regularly. The CFO will receive support from the Finance Officer of the OPCC and will ensure a relevant training programme is in place. Both the CFO and the Finance Officer will review training opportunities, courses, seminars and conferences provided by Arlingclose and CIPFA.

35. Treasury Management strategy and implementation and compliance with best practice and the Cipfa Code will be part of the annual core Internal Audit programme of work. The JAC will review the final internal audit report and any recommendations and make appropriate comments

Rob Phillips
Chief Finance Officer
February 2017

Attached as Annex A – Additional Information and Relevant Definitions

Annex A – Additional Information and Definitions relevant to the Strategy

Credit Rating: Investment limits are set by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

Banks Unsecured: These investments include accounts, deposits and certificates of deposit with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.

Secured Lending: Covered bonds and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

Pooled Funds: Shares in diversified investment vehicles consisting of any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Risk Assessment and Credit Ratings: Credit ratings are obtained and monitored by the Commissioner's treasury advisers, Arlingclose, who will notify changes in ratings as they occur to the CFO and the execution team at KCC. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- No new investments will be made,
- Any existing investments that can be recalled or sold at no cost will be, and
- Full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as “rating watch negative” or “credit watch negative”) so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. No new investments will be placed with institutions suspended or placed on negative ratings watch by Arlingclose. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other Information on the Security of Investments: The PCC and the CFO understand that credit ratings are good, but not perfect, predictors of investment default. Regard will therefore be given to other available information on the credit quality of the organisations, in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2007 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the PCC will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Commissioner’s cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

Specified Investments: The CLG Guidance defines specified investments as those:

- denominated in pound sterling,
- Due to be repaid within 12 months of 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”.

The Commissioner defines “high credit quality” organisations and securities as those having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher. For short term money market funds “high credit quality” is defined as those having a credit rating of [AAA] or equivalent. Categories (b) to (f – if less than 12months) in the Strategy, paragraph 24, fall into the category of specified investments and the relevant investment limits are set out in that paragraph.

Non-specified Investments: Any investment not meeting the definition of a specified investment is classed as non-specified. The Commissioner does not intend to make any investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and schemes not meeting the definition on high credit quality. Categories (a) and (f, for over 12 months) in the Strategy, paragraph 24, fall in to the definition of non-specified investments and the relevant investment limits are set out in that paragraph. Property Funds are also non-specified as they do not have a credit rating and should be treated as long-term. The maximum of (a) and (f over 12 months) will be £20million.

Policy on Use of Financial Derivatives: In the absence of any legal power to do so, the Commissioner will not use standalone financial derivatives (such as swaps, forwards, futures and options). Derivatives embedded into loans and investments, including pooled funds and forward starting transactions, may be used, and the risks that they present will be managed in line with the overall treasury risk management strategy

Liquidity Management:
The Commissioner uses cash flow forecasting to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Force being made to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Commissioner's medium term financial plan and cash flow forecast.

Principal Sums Invested for Periods Longer than 364 days: This controls the Commissioner's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

	2017/18	**2018/19**	**2019/20**
Limit on principal invested beyond year end	£20m	£10m	£5m