Leicestershire County Council

CORPORATE GOVERNANCE COMMITTEE – 17TH NOVEMBER 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RECOMMENDED CHANGE TO TREASURY MANAGEMENT POLICY IN RESPECT OF THE LENDING OF SURPLUS BALANCES

Purpose of the Report

1. To seek the views of the Corporate Governance Committee about a recommended change to the permitted investments within the Treasury Management Policy, with a view to improving returns with a manageable increase in risk. These views will be included in a report to the Cabinet in December 2017, with a view to making an actual investment early in 2018 if the change is agreed.

Background

2. The CIPFA Code of Practice on Treasury Management highlights the three main elements of Treasury Management Policy as Security, Liquidity and Yield in that order. Or, put another way, return of capital is much more important than the rate of return earned. The Council's current Treasury Management Policy is low risk and generally restricts investments to maturities of no more than one year, and to counterparties with very high credit ratings.

3. The low risk approach adopted within Treasury Management has served the authority well and Leicestershire has never invested with any of the institutions that have led to capital being put at risk, the most recent of which were the Icelandic Banks. Despite the low risk approach the returns achieved within Treasury Management have been at the higher end of expectations, and these returns have been achieved largely by being willing to lend monies for as long as allowed within the Policy to acceptable counterparties. Premiums within longer-term lending rates, relative to the expected trajectory of base rates over the period ahead, have been a feature of markets for a number of years.

4. It is well documented that the Council's revenue budget is under increasing pressure, and as a result it has been necessary to review almost every activity to try to deliver services in the most cost-effective manner possible. Interest from Treasury Management activities goes

towards supporting the revenue budget, so higher levels of interest will help to reduce savings required elsewhere.

5. There are a large number of investment options that could potentially improve the level of interest earned, but most of them come with levels of risk that are considered inappropriate given the wish to ensure that the capital invested is protected as far as possible. As the Administering Authority of a £4bn Pension Fund the Council has a higher level of investment expertise than most other Local Authorities and, as a result, is better placed to be able to assess the potential benefits and risks of different types of investment. Private Debt is an asset class that could be used to improve interest levels, whilst also involving levels of risk that are acceptably low.

Private Debt

6. The Leicestershire County Council Pension Fund currently has over £200m invested in 'private debt', with a further £90m committed to investments that will be made over the next 9 months. When this committed capital is invested the asset class will make up about 7.5% of the Fund's total assets, in-line with its strategic asset allocation for the asset class. All of this money will be invested through Partners Group, and the investment will be within three different pooled investment vehicles; Partners Group launch a new Private Debt Fund on an annual basis.

7. Private Debt can be broadly defined as loans from one party to another that are not tradeable on a recognised securities exchange. For many years the banking sector originated the vast majority of debt required by medium-sized companies (who are the main borrowers from the Partners Group funds) but a much tighter regulatory capital regime means that there are now attractive investment opportunities for investors with capital to commit to the asset class. The requirement for financial institutions to hold a larger amount of regulatory capital to cover the risks associated with loans means that the banking system cannot currently supply all the debt required by the corporate world.

8. Partners Group is an independent investment manager with over £40bn of assets under management, and their entire focus is on private markets. They have over 850 institutional investors, of which 150 are in the UK, and they have been running private debt portfolios since 2010. Despite the fact that they commenced investment in the asset class in the aftermath of the Global Financial Crisis – a time at which many companies had balance sheets that were under great stress – they have experienced a very low level of defaults. They have a sizeable team of industry experts that carries out deep due diligence prior to any investment, they will almost always secure a position that is high in the capital structure of a company and the loan will often be secured against specific assets owned by the company.

9. Partners Group are targeting profitable companies with industry-leading positions, strong and stable cash flows, experienced management and supportive institutional owners. They are not looking to take risky, high-return positions in turn-around situations but despite this the returns available to investors are very attractive; their funds target a return of LIBOR + 4-6% net of all fees. The majority of this return will come from the interest paid on the loans by borrowers but items such as arrangement fees and penalties for early repayment of loans will enhance returns.

10. There are significant numbers of private debt managers, but the Pension Fund was attracted to Partners Group because of its global footprint, the size of its investment team, the risk-return profile that is targeted and its historic focus on not losing capital. The Pension Fund has invested with them since 2014 and the returns achieved have been exactly as expected, which is very reassuring.

11. Each Partners Group private debt fund has a lifespan of approximately 5 years. In the first year money is drawn from investors as loans are made and, on average, these loans will have maturities of around 4 years. If any loans are repaid during the early years of the fund the monies can be ‘recycled’ into new loans as long as the maturity date of any new loans is within the original lifespan of the fund. Repayment of capital will be gradual, rather than in a single lump sum at the end of the fund, and will generally be in years 4 and 5. Any investment made should be considered to be ‘tied-up’ for 5 years.

12. Leicestershire County Council has significant cash balances that are lent as part of its treasury management activities. Much of the cash balance relates to cash flow (for example grants being paid in advance of expenditure) and to earmarked funds/provisions that are required to meet expected future expenditure. There is little risk that these cash balances will fall to such an extent that investing £20m in a Partners Group private debt fund (the intended recommendation to Cabinet, if they agree the necessary change to the Treasury Management Policy) will cause a problem from a liquidity perspective.

13. One particularly attractive aspect of private debt is that the underlying loans carry an interest rate that is linked to LIBOR (London Inter Bank Offer Rate, which is the rate at which banks will lend to each other), and if rates rise the interest earned will rise accordingly. Given that we are almost undoubtedly in a rising interest rate environment, this protection is very valuable.

14. If the Treasury Management Policy were to remain in its current form, it would be expected that the loan portfolio would produce a return of around LIBOR. Even at the lower end of the target return range, an additional £800,000 p.a. interest would be expected from a £20m investment in a Partners Group private debt fund and this will assist in

reducing the impact of savings required in the Medium Term Financial Strategy.

15. The investment is not entirely without risk and there is a reliance on the investment manager to be able to identify and structure loans that generate attractive rates of return without undue levels of risk. The due diligence carried out by the Pension Fund, and the manager's track record in the asset class, gives a high degree of confidence that this can be achieved. There can be no guarantee that there won't be defaults within the fund but the combination of the high position within the capital structure that the loans will sit, the fact that there will often be assets specifically backing the loans and the diversification of borrowers within the fund provides a great deal of comfort that the risks are acceptable.

16. Whilst clearly there is a hope that there are no defaults within the fund, the additional return that is expected (relative to maintaining the current Treasury Management Policy) gives substantial assurance that the return will more than justify the additional risk.

17. The Council is currently liaising with its treasury management advisors about various technical aspects of the accounting treatment of the proposed investment. These technical aspects do not have an impact on the overall attractiveness of an investment.

18. The performance of the investment, if it is approved by Cabinet, will be reported to the Corporate Governance Committee as part of the quarterly treasury management report. To all-intents-and-purposes the investment in a pooled private debt fund replaces what would otherwise have been a cash investment, so it should still be considered a treasury management decision and be reported accordingly.

Intended recommendation to Cabinet

19. Subject to any comments made by this Committee, it is intended that a report will be produced for the Cabinet meeting to be held on 12th December 2017 that will recommend the following:

(i) that pooled Private Debt funds be added to the list of acceptable investments included within the Annual Investment Strategy that forms part of the Treasury Management Policy, with a maximum investment amount of £40m;

(ii) that an investment of £20m (plus catch-up interest) is approved within the Partners Group Multi Asset Credit Fund 2017.

20. The £40m maximum investment amount provides flexibility to invest further monies into private debt funds, if this is felt to be appropriate. Further investments will not be made without the approval of the Cabinet and, if practical, Corporate Governance Committee will be

asked for comments prior to any report on the matter to the Cabinet. At the present time there is no intention to recommend future investments in the asset class, but the headroom is necessary in order to allow a commitment into a replacement fund in the period in which the original investment is maturing and repaying capital.

Summary

21. Leicestershire's current Treasury Management Policy is very low risk and this remains broadly appropriate. The increasingly difficult budgetary position means that it is sensible to take a small amount of additional risk, in the expectation that this additional risk will be justified by the higher returns achieved by investing in a high-quality pooled private debt fund.

22. The risks inherent within the private debt fund are considered to be relatively low, and when judged at a portfolio level (the private debt fund will be c.10% of the total treasury management portfolio) the overall risk within treasury management will remain low. The increased level of risk appears adequately compensated for by the £800,000 p.a. additional interest that is expected to be earned by the investment, relative to what might reasonably be expected from a cash deposit.

Resource Implications

23. Treasury Management Policy should not be based solely on a desire to maximise interest earned, and security of the sum invested should always be the main consideration. The proposals highlighted in this report are considered to be a sensible balance between additional risk and additional return, and are expected to produce £800,000 additional interest per annum for the 5 year term of the investment.

Equality and Human Rights Implications

24. There are no discernible equality and human rights implications.

Recommendation

25. The Committee is asked to consider this report and to provide any comments that it would like Cabinet to consider.

Background Papers

None.

Circulation under the Local Issues Alert Procedure

None

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