Leicestershire County Council

CABINET - 12 DECEMBER 2017

RECOMMENDED CHANGE TO TREASURY MANAGEMENT POLICY

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

PART A

Purpose of the Report

1. The purpose of this report is to recommend a change to the current treasury management policy to introduce the ability to invest in pooled private debt funds. This will increase the interest earned and provide additional support for the revenue budget, but will involve a marginal increase in risk.

Recommendation

2. It is recommended that the Cabinet approves the addition of pooled private debt funds to the list of acceptable investment types within the Annual Investment Statement, with a maximum cash investment of £40m.

Reasons for Recommendation

3. The change to the treasury management policy will enable the County Council to invest in private debt funds and thereby increase the interest earned relative to what could be earned by utilising cash deposits. Whilst this type of investment has a higher risk profile than cash deposits, the additional risk is not overly significant. Relative to the increase in risk, the additional income is considered to be highly attractive in an environment of low interest rates and significant pressure on the County Council's revenue budget.

Timetable for Decisions (including Scrutiny)

4. The Corporate Governance Committee considered a report on 17 November 2017 and supported the proposals.

5. The next available date to invest in the private debt fund market is January 2018 and in order to meet this date it will be necessary to complete all the necessary documentation before the end of December 2017.

Policy Framework and Previous Decisions

6. Treasury management is an integral part of the County Council's finances. The Treasury Management Strategy for 2017/18 was agreed by the Council in

February 2017 as part of the Council's Medium Term Financial Strategy 2017/18 – 2020/21 (MTFS).

7. The recommended addition of pooled private debt funds as an acceptable investment within the Annual Investment Strategy is an in-year change that requires the approval of the Cabinet. This will be reflected in the revised Treasury Management Strategy in the emerging MTFS for 2018/19 - 2021/22.

Resource Implications

8. Should the Cabinet agree to the recommendation to class pooled private debt funds as acceptable investment types within the Annual Investment Statement, It is intended that the Council will make a £20m investment in the Partners Group Multi Asset Credit Fund 2017 which will generate additional interest of circa £800,000 per annum to support the revenue budget.

Circulation under the Local Issues Alert Procedure

9. None.

Officers to Contact

Chris Tambini, Director of Finance
Corporate Resources Dept.
Tel: 0116 305 6199
E-mail: chris.tambini@leics.gov.uk

Colin Pratt, Investments Manager
Corporate Resources Dept.
Tel: 0116 305 7656
Email: colin.pratt@leics.gov.uk

PART B

Background

10. 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 with the return of capital deemed to be more important than the rate of return earned. The Council's current Treasury Management Policy is low risk and generally restricts investments to cash deposits with maturities of no more than one year, and lending to counterparties with very high credit ratings.

11. 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.

12. 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.

13. There are a large number of investment options that could potentially improve the level of interest earned from the Treasury Management function, 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 has been identified as an asset class that can be used to improve interest levels, whilst also involving levels of risk that are acceptably low.

Private Debt and Partners Group

14. 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 8 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.

15. 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.

16. 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.

17. 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 (London Inter Bank Offer Rate, which is the rate at which banks will lend to each other) + 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 charges for early repayment of loans will enhance returns.

18. There are significant numbers of private debt managers, but the Leicestershire 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.

19. 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.

20. The 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 will cause a problem from a liquidity perspective.

21. One particularly attractive aspect of private debt is that the underlying loans carry an interest rate that is linked to LIBOR 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.

22. 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 per annum 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.

23. 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 will not 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 (there are expected to be around 50 loans when the investment is fully deployed) provides a great deal of comfort that the risks are acceptable.

24. 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.

25. The investment will be classified as a capital investment, but this does not affect the attractiveness of it and does not cause undue concerns from an accounting perspective. The performance of the investment 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.

<u>Other relevant issues</u>

26. The £40m maximum investment amount provides flexibility to invest further monies into private debt funds, if this is felt to be appropriate. At the present

time there is no intention to make further investments in the asset class, but the flexibility 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.

27. Within the Annual Investment Strategy there is a requirement to classify investments as either ‘specified’ or ‘non-specified’. In broad terms a specified investment will be capable of repayment within one year and be made to a counterparty with a high credit rating; by implication non-specified investments are more risky than specified investments as they are either for longer periods of time or to lower-quality counterparties. Investment in pooled private debt funds will be classed as a non-specified investment.

28. The Corporate Governance Committee considered a report on this matter at its meeting on 17 November and expressed its support for the proposals.

Summary

29. 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.

30. The risks inherent within the recommended private debt fund are considered to be relatively low, and when judged at a portfolio level (the private debt fund will be circa 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 additional interest that is expected to be earned by the investment, relative to what might reasonably be expected from a cash deposit.

Background Papers

31. Report to the Corporate Governance Committee – 17 November 2017 – Recommended Change to Treasury Management Policy in Respect of the Lending of Surplus Balances
http://politics.leics.gov.uk/ieListDocuments.aspx?CId=434&MId=4825&Ver=4

Equality and Human Rights Implications

32. There are no equality and human rights implications directly arising from this report.