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FOR DECISION
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CABINET - 12 FEBRUARY 2014

THE OVERVIEW AND SCRUTINY COMMITTEE - 17 FEBRUARY 2014

TREASURY MANAGEMENT STRATEGY 2014/15

REPORT OF CHIEF FINANCE OFFICER

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RECENT REFERENCES:

CAB2455 Treasury Management Strategy 2013/14, 13 February 2013

AUD070 Treasury Management Stewardship Report for 2012/13, 24 Sept. 2013

AUD073 Treasury Management Mid-Year Review 2013/14, 3 December 2013

EXECUTIVE SUMMARY:

This report sets out the proposed Treasury Management Strategy, the Annual Investment Strategy, the Prudential Indicators and the Minimum Revenue Provision Policy Statement for the Council for 2014/15.

RECOMMENDATIONS: to Cabinet and Council:

1. That the Treasury Management Strategy (TMS) 2014/15 as set out in this report be approved and also the following individual items as included in the TMS:

   - Treasury Management Policy Statement (see paragraph 2);
   - Minimum Revenue Provision (MRP) Policy Statement (see paragraph 3);
   - Annual Investment Strategy 2014/15 (see paragraph 11);
   - Prudential Indicators 2014/15 to 2016/17 (see Appendix C).

2. Note that the Treasury Management Strategy be kept under regular review to take account of any changes in the current global economic situation.

To The Overview and Scrutiny Committee:

1. That the Committee considers whether it wishes to make any observations or recommendations to Council on the report.

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TREASURY MANAGEMENT STRATEGY 2014/15

REPORT OF CHIEF FINANCE OFFICER

1 Introduction and Background

1.1 Local Authority (LA) treasury management activities are prescribed by statute. A local authority in England or Wales may borrow or invest for any purpose relevant to its functions, under any enactment, or for the purpose of the prudent management of its financial affairs. LAs are required to keep under review how much they can afford to borrow. LAs are prohibited by legislation from (a) borrowing for the explicit purpose of re-investment (b) increasing their risks beyond their underlying treasury exposures with a view to making a profit (c) speculating.

1.2 LAs are not constrained by law in the types of investments they may make or the investment instruments they may use but in practice are constrained by Department for Communities and Local Government (DCLG) guidance. DCLG stresses "the prudent investment strategy of security, liquidity and yield" which means that first and foremost LAs must ensure the security of the principal sum invested (i.e. get back their full investment) then the liquidity (i.e. have funds available when needed) and so should consider the length of an investment and only when these two requirements are satisfied should the yield or return on the investment be considered.

1.3 Where LAs finance capital expenditure by debt, regulations stipulate that they must set aside an annual contribution from their revenue accounts to make prudent provision for the repayment of debt in later years. This provision is termed Minimum Revenue Provision (MRP) even though a statutory "minimum" has not been prescribed since 2008. The MRP is set aside against general fund reserves as non-useable thus reducing the overall amount as available for spend by the Council.

1.4 LAs with the responsibility for Housing Revenue Accounts (HRA) no longer have to make a MRP for HRA capital expenditure. The DCLG determined that annual depreciation was to be charged to the HRA from 2012 and onwards with depreciation set aside in the HRA's Major Repairs' Reserve (MRR) for future capital spend or to repay HRA debt. Interim arrangements (over a 5 year timeframe) allow authorities such as this, whereby annual depreciation was greater than an authority's notional Major Repairs Allowance (MRA) (calculated on the basis of DCLG guidance) to set aside the MRA figure instead in ordered to minimise any adverse impact on rents.

1.5 The abolition of the housing subsidy in April 2012 meant that, in addition to the Council having to borrow to buy itself out of the arrangement, it had to allocate existing and future borrowing costs between GF and HRA as the statutory method of apportioning debt charges between the two for accounting purposes; the loans themselves remain an overall debt of the Council and therefore were not required to be split at source.

1.6 The CIPFA Prudential Code requires authorities to self-regulate the affordability, prudence and sustainability of their capital expenditure and borrowing plans, by setting estimates and limits and by publishing actuals, for a range of prudential indicators. The code imposes clear governance procedures for the setting and revising of prudential indicators to ensure LAs deliver accountability in taking capital financing, borrowing and treasury management decisions.

1.7 The Council adopted the Chartered Institute of Public Finance and Accountancy’s Treasury Management in the Public Services: Code of Practice in February 2002.

2 **Treasury Management Policy Statement**

2.1 The Council defines its treasury management activities as:

> “the management of its 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”.

2.2 The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of the treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities focus on their risk implications for the Council and any financial instruments entered into to manage these risks.

2.3 The Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

2.4 The prime objectives of the Council’s treasury management activities are security, liquidity and then yield. The Council’s borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk and refining risk. The source from which the borrowing is taken and the type of borrowing will allow the Council transparency and control over its debt.

2.5 The setting and revising of all the prudential indicators, including the treasury management indicators, follow the same route as for setting and revising of the Council's budget.

2.6 The Council receives reports on its treasury management policies, practices and treasury management activities in the form prescribed in its TMPs.

2.7 The Council follows proper accounting practices as specified in the CIPFA Code of Practice on Local Authority Accounting in the United Kingdom when accounting for treasury management activities.

3 Minimum Revenue Provision Policy Statement

3.1 The DCLG Guidance requires the Council to approve its annual Minimum Revenue Provision (MRP) statement. The DCLG Guidance provided four options for calculating a prudent amount of MRP and this Council opted for option 3; the Asset Life Method.

3.2 The Asset Life Method determines that MRP will calculated on the basis of charging the unfinanced capital expenditure over the expected useful life of the relevant assets based on either an equal instalment method or an annuity method, starting in the year after the asset becomes operational; MRP on purchases of freehold land will be charged over 50 years; and MRP on expenditure not related to fixed assets but which has been capitalised by regulation or direction will be charged over 20 years.

3.3 Leases brought on Balance Sheet under International Financial Reporting Standards (IFRS) based Accounting Code of Practice will match the annual principal repayment for the associated deferred liability.

3.4 No MRP will be charged in respect of the Housing Revenue account (HRA).

3.5 The Chief Finance Officer recommends the approval of the above MRP Policy statement for use in 2014/15.

4 Policy on Apportioning Interest to the HRA

4.1 On 1st April 2012, the Council adopted the "two pool" approach to the HRA debt, meaning that any long-term loans borrowed are assigned to either a General Fund pool or a HRA pool. Interest payable and other costs/income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged/credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. This balance will be measured each month and interest will be transferred between the General Fund and HRA applying the following rates:

- the PWLB 3 month variable loan rate is applied to a deficit balance
- the risk free Debt Management Office rate is applied to a surplus balance.

5 **Governance and Regulatory Framework**

5.1 The annual Treasury Management Strategy Statement (TMSS) has been prepared in accordance with the Chartered Institute of Public Finance and Accountancy Code of Practice for Treasury Management in Public Services, 2011 (the “CIPFA TM Code”) under Financial Procedure Rule 5.4. (CAB313, 13 February 2002 refers). The Council, having adopted the CIPFA TM Code, is required to approve the annual TMSS before the commencement of the financial year in which it will be effective.

5.2 In addition, the Department for Communities and Local Government (CLG) requires an Annual Investment Strategy (AIS) to be approved before the commencement of the year. The AIS has been prepared in accordance with the revised Guidance on Local Authority Investments issued by the CLG in March 2010 and is included in the TMSS.

5.3 The Council sets its Prudential Indicators for the forthcoming and following years before the forthcoming year in accordance with the requirements of the CIPFA Prudential Code for Capital Finance in Local Authorities to determine and keep under review how much money the Authority can afford to borrow.

5.4 The Local Government Act 2003 requires LAs to have regard to the DCLG Guidance on MRP most recently issued. The Guidance recommends four options for calculating a prudent provision (but this does not preclude other methods) and this Council uses Option 3: Asset Life Method. The DCLG requires the Authority to approve an annual MRP Statement each year.

5.5 The Council delegates responsibility for the monitoring of its Treasury Management Policies and Practices (TMPs) to the Audit Committee. The responsible officer for the administration of treasury management decisions is the Council’s Chief Finance Officer (s151officer) who will act in accordance with the Council’s policy statement, TMP’s and CIPFA’s Standard of Professional Practice on Treasury Management.

6 **Purpose**

6.1 The purpose of reporting the treasury management strategy together with the prudential indicators before the start of the year is to ensure that treasury management activities follow the same route as for setting the budget. This holistic approach provides a robust risk management system for ensuring that treasury management activities support the Council’s business through:

- treasury management policy statement and practices;
- strategy on proposed treasury management activities for the year including any use of financial instruments for the prudent management of those risks;
- prudential indicators to ensure that the Council's capital investment plans are affordable, prudent and sustainable and should a situation arise that there is a danger of this not being the case, take remedial action.

6.2 The annual reporting cycle (with an annual report before the start of year and a report after year end with a midyear review in between) provides an effective control mechanism by which it can be ensured that the treasury management function is supportive of the Council's business and service objectives (with priority given to security and liquidity over yield) when investing funds.

7 **Risk Management**

7.1 The Council has borrowed and invested substantial sums of money and therefore is exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. Maintaining a prudent investment strategy with regard to security, liquidity and yield presents practical day-to-day challenges for LA staff, their advisers, bankers and brokers. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

7.2 The Council acknowledges treasury risk management as:

> The on-going activity of adjusting the treasury exposures in the light of changing market or domestic circumstances. The Council is aware that doing nothing does not avoid or minimise risks because a risk can also be in the failure to take advantage of opportunities to optimise the Council achieving its planned objectives.

7.3 Arlingclose Limited supports the Council's in-house treasury management function in the role of treasury management adviser and provides specific advice on investment, debt and capital finance issues. The Council acknowledges that treasury management cannot be delegated outside the authority and the quality of this service is kept under review by officers. The Council holds quarterly meetings with Arlingclose and the service is subject to the Council's tendering procedures.

7.4 Staff training needs in investment management are assessed as part of the staff appraisal process and additionally when the responsibilities of individual members of staff change. Staff attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.

Borrowing and Investment

8 **External Context**

8.1 **Economic background:** The Bank of England's Monetary Policy Committee (MPC) through its recent forward guidance is committed to keeping policy rates low for an extended period using the Labour Force Survey unemployment rate of 7% as a threshold for when it would consider whether or not to raise interest rates, subject to certain knock-outs. Unemployment was 7.7% in August 2013, but is not forecast to fall below the threshold until 2016, due to the UK's flexible workforce.

8.2 The flow of credit to households and businesses is slowly improving but is still below pre-crisis levels. The fall in consumer price inflation from the high of 5.2% in September 2011 to 2.7% in September 2013 will allow real wage increases (i.e. after inflation) to slowly turn positive and aid consumer spending.

8.3 Stronger growth data in 2013 (0.4% in Q1, 0.7% in Q2 and an initial estimate of 0.8% in Q3) alongside a pick-up in property prices mainly stoked by Government initiatives to boost mortgage lending have led markets to price in an earlier rise in rates than warranted under Forward Guidance and the broader economic backdrop. However, with jobs growth picking up slowly, many employees working shorter hours than they would like and benefit cuts set to gather pace, growth is likely to only be gradual. Arlingclose forecasts the MPC will maintain its resolve to keep interest rates low until the recovery is convincing and sustainable.

8.4 In the US expectations for the slowing in the pace of asset purchases ('tapering') by the Federal Reserve (Fed) and the end of further asset purchases will remain predominant drivers of the financial markets. The Fed did not taper in September and has talked down potential tapering in the near term. It now looks more likely to occur in early 2014 which will be supportive of bond and equity markets in the interim.

8.5 **Credit outlook:** The credit risk of banking failures has diminished, but not dissipated altogether. Regulatory changes are afoot in the UK, US and Europe to move away from the bank bail-outs of previous years to bank resolution regimes in which shareholders, bond holders and unsecured creditors are 'bailed in' to participate in any recovery process. This is manifested already in relation to holders of subordinated debt issued by the Co-op which will likely suffer a "haircut" on its conversion bail-in to alternative securities and/or equity. There are also proposals for EU regulatory reforms to Money Market Funds which will, in all probability, result in these funds moving to a variable net asset value (VNAV) basis and losing their 'triple-A' credit rating wrapper. Diversification of investments between creditworthy counterparties to mitigate bail-in risk will become even more important in the light of these developments.

8.6 **Interest rate forecast:** Arlingclose's forecast is for the Bank Rate to remain flat until late 2016, the risk to the upside (i.e. rates being higher) are weighted more heavily towards the end of the forecast horizon, as the table below shows. Gilt yields are expected to rise over the forecast period with medium- and long-dated gilts expected to rise by between 0.7% and 1.1%.

8.7 A more detailed economic and interest rate forecast provided by the Council's treasury management advisor is attached at Appendix A.

8.8 For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.5%, and that new long-term loans will be borrowed at an average rate of 4%.

9 Local Context

9.1 The Council had, at 31 December 2013, £156.7m of borrowing and £36.7m of investments. Forecast changes in these sums are shown in the balance sheet analysis in Table 1 below.

Table 1: Balance Sheet Summary and Forecast

	31.3.13 Actual £m	**31.3.14 Estimate £m**	**31.3.15 Estimate £m**	**31.3.16 Estimate £m**	**31.3.17 Estimate £m**
General Fund (GF) CFR	(1.0)	12.6	26.6	26.3	25.7
HRA CFR	163.4	163.4	160.4	166.9	166.9
Total CFR	**162.4**	**176.0**	**187.0**	**193.2**	**192.6**
Less: Other long-term liabilities *	-2.1	-1.8	-1.5	-1.2	-0.8
Borrowing CFR	**160.3**	**174.2**	**185.5**	**192.0**	**191.8**
Less: External borrowing **	-156.7	-156.7	-156.7	-156.7	-156.7
Internal (over) borrowing	**3.6**	**17.5**	**28.8**	**35.3**	**35.1**
Less: GF Usable reserves	-10.6	-9.0	-5.6	-6.0	-6.2
Less: HRA Usable reserves	-3.2	-1.4	-1.5	-1.4	-1.6
Total Usable Reserves	**-13.8**	**-10.4**	**-7.1**	**-7.4**	**-7.8**
Less: Working capital	2.4	2.5	2.6	2.7	2.7
Investments/New borrowing (-)	**7.8**	**-9.6**	**-24.3**	**-30.6**	**-30.0**

* finance leases that form part of the Authority's debt
**only shows loans to which the Authority is committed and excludes optional refinancing

9.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, subject to holding a minimum investment balance of £5m.

9.3 The Council has a forecast increasing CFR, due to the capital programme, and reducing investments and therefore is forecasting a requirement to borrow up to £192m over the forecast period.

9.4 CIPFA's Prudential Code recommends that an authority's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2014/15.

9.5 It is necessary to identify the CFR separately for each of the General Fund (GF) and Housing Revenue Account (HRA) in order to:

- measure the underlying need to borrow for capital purposes;
- divide the financing costs between the GF and HRA in the form of interest on borrowing for capital purposes or for capital investment as well as a share of interest from revenue balances;
- ensure compliance with HRA limit on Indebtedness (and hence affordability) for English LAs.

10 **Borrowing Strategy**

10.1 The Council currently holds £156.7 million of loans, the same as the previous year. The balance sheet forecast in Table 1 shows that the Council expects to increase its borrowing in 2014/15. In addition the Council may wish borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £193m for 2014/15.

10.2 The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans, should the Council's long-term plans change, is a secondary objective.

10.3 Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead. By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. Whilst such a strategy is most likely to be beneficial over the next 2-3 years as official interest rates remain low, it is unlikely to be sustained in the medium-term.

10.4 The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. The Council's Treasury Advisers will assist the Council with this calculation of 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2014/15 with a view to keeping future interest costs low, even if this causes additional cost in the short-term. In addition, the Council may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages.

10.5 The Council's approved sources of long-term and short-term borrowing are:

- Public Works Loan Board
- UK local authorities
- any institution approved for investments (see below)
- any other bank or building society authorised by the Prudential Regulation Authority to operate in the UK
- UK public and private sector pension funds (except the Hampshire Pension Fund)
- capital market bond investors
- special purpose companies created to enable joint local authority bond issues.

10.6 The Council raises all of its long-term borrowing from the Public Works Loan Board, but it continues to investigate other sources of finance, such as local authority loans and bank loans, that may be available at more favourable rates.

10.7 Short-term and variable rate loans leave the Council exposed to the risk of short-term interest rate rises and therefore are subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

10.8 The PWLB allows debt rescheduling whereby authorities repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Some bank lenders also may be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall saving or reduction in risk.

11 Annual Investment Strategy (AIS)

11.1 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £21m and £45m. However levels are expected to reduce in the forthcoming year with planned spending on the capital programme.

11.2 Both the CIPFA Code and the DCLG Guidance require an authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council'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 receiving unsuitably low investment income.

11.3 The Council may invest its surplus funds with any of the counterparties in Table 2 below, subject to the cash and time limits shown.

Table 2: Approved Investment Counterparties (specified)

Counterparty		Cash limit	Time limit †
Banks and other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:	AAA	£3m each	10 years*
	AA+		5 years*
	AA		4 years*
	AA-		3 years*
	A+		2 years
	A		1 year
	A-		
The Authority's current account bank Nat West plc if it fails to meet the above criteria		£4m	next day
UK Central Government (irrespective of credit rating)		unlimited	50 years**
UK Local Authorities (irrespective of credit rating)		£3m each	50 years**
UK Registered Providers of Social Housing whose lowest published long-term credit rating is [A-] or higher		£3m each	10 years**
UK Registered Providers of Social Housing whose lowest published long-term credit rating is [BBB-] or higher and those without credit ratings		£1m each	5 year
UK Building Societies without credit ratings		£1m each	1 year
Money market funds and other pooled funds		£3m each or 10% of funds	n/a
Any other organisation, subject to an external credit assessment and specific advice from the Authority's treasury management adviser			
		£1m each	1 year
		£100k each	5 years

† the time limit is doubled for investments that are secured on the borrower's assets
* but no longer than 2 years in fixed-term deposits and other illiquid instruments

** but no longer than 5 years in fixed-term deposits and other illiquid instruments

11.4 There is no intention to restrict investments to bank deposits and investments may be made with any public or private sector organisations that meet the above credit rating criteria. This reflects a lower likelihood that the UK and other governments will support failing banks as the bail-in provisions in the Banking Reform Act 2014 and the EU Bank Recovery and Resolution Directive are implemented.

11.5 In addition, the Council may invest with organisations and pooled funds without credit ratings, following an external credit assessment and after considering advice received from the Council's appointed treasury management adviser. The institutions with which the Council has dealings are listed below.

Current Account Bank: Following a competitive tender exercise held in 2013, the Council's current accounts are held with NatWest which is currently rated at the minimum A- rating in table 2. Should the credit ratings fall below A-, the Council may continue to deposit surplus cash with NatWest providing that investments that can be withdrawn on the next working day and that the bank maintains a credit rating no lower than BBB- (the lowest investment grade rating).

Registered Providers: Formerly known as Housing Associations, Registered Providers of Social Housing are tightly regulated by the Homes and Communities Agency and retain a high likelihood of receiving Government support if needed. The Council will consider investing with unrated Registered Providers with adequate credit safeguards, subject to having taken and considered independent advice.

Building Societies: The Council takes additional comfort from the building societies' regulatory framework and insolvency regime where currently, in the unlikely event of a building society liquidation, the Council's deposits would be paid out in preference to retail depositors. The Council will consider investing with unrated building societies where independent credit analysis shows them to be suitably creditworthy. The Government has announced plans to amend the building society insolvency regime alongside its plans for wide ranging banking reform and investments in lower rated and hence unrated building societies will be kept under continuous review.

Money Market Funds: These funds are pooled investment vehicles consisting of money market deposits and similar instruments. They have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Council. Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts, while funds whose value changes with market prices and/or have a notice period will be used for longer investment periods. Note: the requirement for AAA ratings has been removed following EU proposals to stop money market funds from having credit ratings.

Other Pooled Funds: The Council will continue to use pooled bond, equity and property funds that offer enhanced returns over the longer term, but are potentially more volatile in the shorter term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. This is because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.

Other Organisations: The Council may also invest cash with other organisations, for example by making loans to small businesses. Because of the higher perceived risk of unrated businesses, such investments may provide considerably higher rates of return. They will however only be made following a favourable external credit assessment and after considering specific advice of the Council's treasury management adviser.

Credit Ratings: The lowest available counterparty credit rating will be used to determine credit quality, unless an investment-specific rating is available. 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;
- 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 [A-] 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. This will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Risk measure of investment default: The Council uses long-term credit ratings from the three main rating agencies Fitch Ratings, Moody's Investors Service and Standard & Poor's Financial Services to assess this risk. Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify the Council of changes in ratings as they occur. Credit ratings cannot to be relied upon in isolation for identifying counterparties and so are considered alongside generally available market and other information such as the quality of financial press, market data, government support for banks, including the ability and willingness of the relevant government to provide adequate support.

11.6 The Council understands that credit ratings are good, but not perfect, predictors of investment default and therefore full regard will 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.

11.7 In circumstances where deteriorating financial market conditions affect the creditworthiness of all organisations as happened in 2008 and 2011, this is not generally reflected in credit ratings but can be seen in other market measures, the Council 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 Council's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office 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.

11.8 **Specified Investments:** The DCLG 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 Council defines "high credit quality" organisations 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 money market funds and other pooled funds "high credit quality" is defined as those having a credit rating of [A-] or higher.

11.9 **Non-specified Investments:** Any investment not meeting the definition of a specified investment is classed as non-specified. The Council 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. Limits on non-specified investments are shown in Table 3 below.

Table 3: Non-Specified Investment Limits

	Cash limit
Total long-term investments	£5m
Total investments without credit ratings or rated below [A-]	£5m
Total investments in foreign countries rated below [AA+]	£5m
Total non-specified investments	£15m

11.10 **Investment Limits**: The Council's revenue reserves available to cover investment losses are forecast to be £9 million on 31st March 2015. The investment limits proposed are set to ensure that in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £3 million. A group of banks under the same ownership or a group of funds under the same management will be treated as a single organisation for limit purposes. Limits will also be placed on investments in brokers' nominee accounts (e.g. King & Shaxson), foreign countries and industry sectors as below:

Table 4: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£3m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£3m per group
Any group of pooled funds under the same management	£3m per manager
Foreign countries	£3m per country
Registered Providers	£6m in total
Building Societies	£6m in total
Loans to small businesses	£3m in total
Money Market Funds	£15m in total

11.11 **Approved Instruments:** The Council may lend or invest money using any of the following instruments:

- interest-bearing bank accounts,
- fixed term deposits and loans
- callable deposits and loans where the Authority may demand repayment at any time (with or without notice),
- callable deposits and loans where the borrower may repay before maturity, but subject to a maximum of £3 million in total,
- certificates of deposit,
- bonds, notes, bills, commercial paper and other marketable instruments and
- shares in money market funds and other pooled funds.

Investments may be made at either a fixed rate of interest, or at a variable rate linked to a market interest rate, such as LIBOR, subject to the limits on interest rate exposures as set out below.

11.12 **Liquidity management:** The Council uses cash flow forecasts to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a pessimistic basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast.

12 **Treasury Management Indicators**

The Council measures and manages its exposures to treasury management risks using the following indicators.

12.1 **Security**: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target
Portfolio average credit score	5.0

12.2 **Interest Rate Exposures**: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

	2014/15	**2015/16**	**2016/17**
Upper limit on fixed interest rate exposure	100%	100%	100%

Upper limit on variable interest rate exposure	66%	66%	66%

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

12.3 **Maturity Structure of Borrowing**: This indicator is set to control the Council's exposure to refinancing risk. The upper limits on the maturity structure of fixed rate borrowing will be:

	Upper 2014/15 £m
Under 12 months	20
12 months and within 24 months	20
24 months and within 5 years	20
5 years and within 10 years	30
10 years and within 30 years	120
30 years and within 40 years	50
40 years and within 50 years	50
50 years and above	50

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

12.4 **Principal Sums Invested for Periods Longer than 364 days**: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

Sums invested for more than 364 days	**2014/15**	**2015/16**	**2016/17**
Limit on principal invested beyond year end	£5m	£5m	£5m

13 Investment of Money Borrowed in Advance of Need

13.1 The Council may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

13.2 The total amount borrowed will not exceed the authorised borrowing limit of £193 million. The maximum period between borrowing and expenditure is expected to be two years, although the Council is not required to link particular loans with particular items of expenditure.

14 **Financial Implications**

14.1 The budget for interest income receivable in 2014/15 is £70,000 based on an average investment portfolio of £9.3 million at an interest rate of 0.75%. The budget for debt interest payable in 2014/15 is £5.2 million, based on a debt portfolio of £156.7 million at an average interest rate of 3.3%.

15 **Other Borrowing and Investment Options Considered**

15.1 The above strategy is thought to represent an appropriate balance between risk management and cost effectiveness. Some alternative strategies, which were evaluated, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Reduced risk of losses from credit related defaults
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs will be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long term costs will be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs will be less certain

OTHER CONSIDERATIONS

16 COMMUNITY STRATEGY AND PORTFOLIO PLANS (RELEVANCE TO):

Effective treasury management will provide support towards the achievement of all of the Council's business and service objectives, the delivery of actions in Portfolio Plans and the Community Strategy.

17 RESOURCE IMPLICATIONS:

As set out in the body of the report.

18 RISK MANAGEMENT ISSUES

These are considered within the report (see section 7).

BACKGROUND DOCUMENTS

Included as appendices.

APPENDICES

Appendix A - Arlingclose Economic & Interest Rate Forecast December 2013

Appendix B - Existing Investment & Debt Portfolio Position

Appendix C - Prudential Indicators and MRP Statement 2014/15

Arlingclose Economic & Interest Rate Forecast December 2013

Underlying assumptions:

- Growth continues to strengthen with the second estimate for Q3 growth coming in at an unrevised 0.8%. The service sector remains the main driver of growth, boosted by a contribution from construction.
- The unemployment rate has fallen to 7.6%. The pace of decline in this measure will be dependent on a slower expansion of the workforce than the acceleration in the economy, alongside the extent of productivity.
- The CPI for November has fallen to 2.1%, a much more comfortable position for the monetary policy committee (MPC). Utility price increases are expected to keep CPI above the 2% target in 2014, before falling back again.
- The principal measure in the MPC's Forward Guidance on interest rates is the Labour Force Survey (LFS) unemployment rate. The MPC intends not to raise the Bank Rate from its current level of 0.5% at least until this rate has fallen to a threshold of 7%.
- The reduction in uncertainty and easing of credit conditions have begun to unlock demand, much of which has fed through to the housing market. In response to concerns over a house price bubble, the Bank of England announced a curtailment of the Funding for Lending Scheme, which will henceforth concentrate on business lending only.
- The MPC will not hesitate to use macro prudential and regulatory tools to deal with emerging risks (such as curtailing the FLS). Absent risks to either price stability or financial stability, the MPC will only tighten policy when it is convinced about the sustained durability of economic growth.
- Federal Reserve monetary policy expectations - the slowing in the pace of asset purchases ('tapering') and the end of further asset purchases - will remain predominant drivers of the financial markets. Tapering of asset purchases will begin in Q1 2014. The US political deadlock over the debt ceiling will need resolving in Q1 2014.
- The European backstop mechanisms have lowered the risks of catastrophic meltdown. The slightly more stable economic environment at the aggregate Eurozone level could be undone by political risks and uncertainty in Italy, Spain and Portugal (doubts over longevity of their coalitions). The ECB has discussed a third LTRO, as credit conditions remain challenging for European banks.
- China data has seen an improvement, easing markets fears. Chinese leaders have signalled possible monetary policy tightening.

- On-going regulatory reform and a focus on bail-in debt restructuring of is likely to prolong banking sector deleveraging and maintain the corporate credit bottleneck.

Forecast:

- Our projected path for short term interest rates remains flat. Markets are still pricing in an earlier rise in rates than warranted under Forward Guidance and the broader economic backdrop. The MPC will not raise rates until there is a sustained period of strong growth, however, upside risks weight more heavily at the end of our forecast horizon.

- We continue to project gilt yields on an upward path through the medium term. The recent climb in yields was overdone given the soft fundamental global outlook and risks surrounding the Eurozone, China and US.

	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Official Bank Rate													
Upside risk		0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	1.00
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**
Downside risk													
3-month LIBID rate													
Upside risk	0.20	0.25	0.30	0.35	0.40	0.50	0.55	0.60	0.65	0.70	0.75	0.90	0.95
Arlingclose Central Case	**0.45**	**0.45**	**0.50**	**0.55**	**0.65**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.80**	**0.80**	**0.80**
Downside risk			0.05	0.10	0.20	0.30	0.30	0.30	0.30	0.30	-0.35	-0.35	-0.35
1-yr LIBID rate													
Upside risk	0.35	0.30	0.35	0.40	0.45	0.50	0.60	0.70	0.75	0.75	0.75	0.80	0.80
Arlingclose Central Case	**0.90**	**0.95**	**0.95**	**0.95**	**1.00**	**1.05**	**1.10**	**1.15**	**1.20**	**1.25**	**1.30**	**1.40**	**1.40**
Downside risk	-0.25	-0.25	-0.25	-0.30	-0.35	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
5-yr gilt yield													
Upside risk	0.50	0.75	0.75	0.75	0.85	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	**1.45**	**1.50**	**1.55**	**1.60**	**1.65**	**1.70**	**1.75**	**1.85**	**1.95**	**2.10**	**2.30**	**2.50**	**2.50**
Downside risk	-0.50	-0.50	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.65	-0.75	-0.80	-0.80	-0.80
10-yr gilt yield													
Upside risk	0.50	0.50	0.50	0.65	0.75	0.85	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	**2.55**	**2.60**	**2.65**	**2.70**	**2.75**	**2.80**	**2.85**	**2.90**	**3.00**	**3.10**	**3.30**	**3.50**	**3.50**
Downside risk	-0.50	-0.50	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.65	-0.75	-0.80	-0.80	-0.80
20-yr gilt yield													
Upside risk	0.50	0.75	0.75	0.75	0.85	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	**3.25**	**3.30**	**3.35**	**3.40**	**3.45**	**3.50**	**3.55**	**3.65**	**3.75**	**3.85**	**4.05**	**4.15**	**4.15**
Downside risk	-0.50	-0.50	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.65	-0.70	-0.75	-0.80	-0.80
50-yr gilt yield													
Upside risk	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	**3.45**	**3.50**	**3.55**	**3.60**	**3.65**	**3.70**	**3.75**	**3.80**	**3.85**	**3.95**	**4.05**	**4.15**	**4.15**
Downside risk	-0.50	-0.50	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.65	-0.70	-0.75	-0.80	-0.80

Existing Investment & Debt Portfolio Position

	Actual Portfolio 31/12/13 £m	**Average Rate %**
Total External Borrowing - (PWLB – Fixed Rate)	156.7	**3.3**
Other Long Term Liabilities:		
Embedded leases	1.8	2.2
Total Gross External Debt	**158.5**	
Investments (*Managed in-house)*		
Short-term investments	34.7	0.5
Pooled Funds *(Local Authority Mutual Investment Trust)*	2.0	5.3
Total Investments	**36.7**	
Net Debt	**121.8**	

Prudential Indicators and MRP Statement 2014/15

Introduction

The Local Government Act 2003 requires the Council to have regard to the Chartered Institute of Public Finance and Accountancy's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Estimates of Capital Expenditure: The Council's planned capital expenditure and financing may be summarised as follows. Further detail is provided in the Budget and Council Tax report elsewhere on this agenda.

Capital Expenditure and Financing	2013/14 Revised £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
General Fund	10.1	28.6	1.1	0.8
HRA	10.7	17.1	21.2	14.2
Total Expenditure	**20.8**	**45.7**	**22.3**	**15.0**
Capital Receipts	1.8	2.2	0.2	0.2
Government Grants & contributions	1.0	5.4	2.7	1.8
Reserves	7.3	9.9	6.7	6.5
Revenue	3.2	7.2	6.2	6.5
Borrowing	0	0	6.5	0
Total Financing	**13.3**	**24.7**	**22.3**	**15.0**

Estimates of Capital Financing Requirement: The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31.03.14 Revised £m	31.03.15 Estimate £m	31.03.16 Estimate £m	31.03.17 Estimate £m
General Fund	12.6	26.6	26.3	25.7
HRA	163.4	160.4	166.9	166.9
Total CFR	**176.0**	**187.0**	**193.2**	**192.6**

The CFR is forecast to rise by £17m over the next three years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	31.03.14 Revised £m	31.03.15 Estimate £m	31.03.16 Estimate £m	31.03.17 Estimate £m
Borrowing	156.7	180.7	186.7	186.7
Finance leases	1.8	1.5	1.2	0.8
Total Debt	**158.5**	**182.2**	**187.9**	**187.5**

Total debt is expected to remain below the CFR during the forecast period.

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt. It links directly to the Council's estimates of capital expenditure, the capital financing requirement and cash flow requirements and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance leases that are not borrowing but form part of the Authority's debt.

Operational Boundary	2013/14 Revised £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Borrowing	171.0	182.0	188.2	187.6
Other long-term liabilities	4.0	4.0	4.0	4.0
Total Debt	**175.0**	**186.0**	**192.2**	**191.6**

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	**2013/14 Revised £m**	**2014/15 Estimate £m**	**2015/16 Estimate £m**	**2016/17 Estimate £m**
Borrowing	176.0	187.0	193.2	192.6
Other long-term liabilities	6.0	6.0	6.0	6.0
Total Debt	**182.0**	**193.0**	**199.2**	**198.6**

Ratio of Financing Costs to Net Revenue Stream: This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**2013/14 Revised %**	**2014/15 Estimate %**	**2015/16 Estimate %**	**2016/17 Estimate %**
General Fund	(1.9)	(0.4)	0.6	0.8
HRA	20.5	19.3	19.0	18.3

Incremental Impact of Capital Investment Decisions: This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax and housing rent levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme proposed.

Incremental Impact of Capital Investment Decisions	**2014/15 Estimate £**	**2015/16 Estimate £**	**2016/17 Estimate £**
General Fund - increase in annual band D Council Tax	0.09	0	0.01
HRA - increase in average weekly rents	**0**	0	0.05