CAB2648
FOR DECISION
WARD(S): ALL

CABINET

11 FEBRUARY 2015

THE OVERVIEW AND SCRUTINY COMMITTEE

16 FEBRUARY 2015

TREASURY MANAGEMENT STRATEGY 2015/16

REPORT OF CHIEF FINANCE OFFICER

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RECENT REFERENCES:

CAB2554: Treasury Management Strategy 2014/15, 12 February 2014

AUD101: Treasury Management Stewardship Report for 2013/14, 25 Sept. 2014

AUD105: Treasury Management Mid-Year Review 2014/15, 4 December 2014

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 2015/16.

The Treasury Management training offered to all Members in November provided an explanation of the increasing risks from bank "bail-ins" and how this could be mitigated through further diversification into more secure asset classes during 2015/16. The proposed Investment Strategy set out in section 5 reflects these changes.

It should be noted that the Investment Strategy proposed is substantially different to that for 2014/15; it seeks to achieve greater diversification in response to the Bank Recovery and Resolution Directive and the Deposit Guarantee Schemes Directive which combine to leave public authorities and financial organisations as the only senior creditors likely to incur losses in a failing bank after July 2015.

The proposed Investment Strategy set out in Section 5, is trying to articulate the processes by which risk will be managed and investments selected and sets out the framework by which investments will be selected. It is believed that this risk management approach will allow higher limits to be set. Table 3 shows the proposed approved investment counterparty types and limits, (unlike in the past when a fixed Counterparty list has been approved). In addition to risk management this will aid efficiency and return, in the context of the Council managing increasingly higher average balances (pending the capital programme expenditure).

RECOMMENDATIONS: to Cabinet and Council:

1. That the Treasury Management Strategy (TMS) 2015/16 as set out in this report be approved and implemented from the date of the Council meeting, and also the following individual items as included in the TMS:

   - Annual Borrowing Strategy 2015/16 (see paragraph 4);
   - Annual Investment Strategy 2015/16 (see paragraph 5);
   - Prudential Indicators 2015/16 to 2017/18 (see Appendix C);
   - Minimum Revenue Provision (MRP) Policy Statement (see Appendix D).

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 2015/16

REPORT OF CHIEF FINANCE OFFICER

1. Introduction

1.1. In February 2012 the Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year.

1.2. In addition, the Department for Communities and Local Government (CLG) issued revised Guidance on Local Authority Investments in March 2010 that requires the Council to approve an investment strategy before the start of each financial year.

1.3. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Guidance.

1.4. The Council has potentially large exposures 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 Council's Treasury Management Strategy.

1.5. With effect from September 2014, HCC and WCC established arrangements for the joint discharge of functions under Section 101(1) and (5) of the Local Government Act 1972 and Section 9EA and 9EB Local Government Act 2000. Under this arrangement the HCC Investments and Borrowing team provide a Treasury Service which includes the management of WCC cash balances and the investment of surplus cash or sourcing of short-term borrowing in accordance with the agreed Treasury Management Strategy.

2. External Context

2.1. The following paragraphs explain the economic and financial background against which the Treasury Management Strategy is being set.

Economic background

2.2. There is momentum in the UK economy, with a continued period of growth through domestically-driven activity and strong household consumption. There are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP. However, inflationary pressure is currently extremely benign and is likely to remain low in the short-term. There have been large falls in unemployment but levels of part-time working, self-employment and underemployment are significant and nominal earnings growth remains weak and below inflation.

2.3. The Bank of England's Monetary Policy Committee's (MPC) focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee. Despite two MPC members having voted for an 0.25% increase in rates at each of the meetings between August and December 2014, the minutes of the January 2015 meeting showed unanimity in maintaining the Bank Rate at 0.5% as there was sufficient risk that low inflation could become entrenched and the MPC became more concerned about the economic outlook.

Interest rate forecast

2.4. The Council's treasury management advisor Arlingclose forecasts the first rise in official interest rates in August 2015 and a gradual pace of increases thereafter, with the average for 2015/16 being around 0.75%. Arlingclose believes the normalised level of the Bank Rate post-crisis to range between 2.5% and 3.5%. The risk to the upside (i.e. interest rates being higher) is weighted more towards the end of the forecast horizon. On the downside, Eurozone weakness and the threat of deflation have increased the risks to the durability of UK growth. If the negative indicators from the Eurozone become more entrenched, the Bank of England will likely defer rate rises to later in the year. Arlingclose projects gilt yields on an upward path in the medium term, taking the forecast average 10 year PWLB loan rate for 2015/16 to 2.7%. A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix A.

Credit outlook

2.5. The transposition of two European Union directives into UK legislation in the coming months will place the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors. The Bank Recovery and Resolution Directive promotes the interests of individual and small businesses covered by the Financial Services Compensation Scheme and similar European schemes, while the recast Deposit Guarantee Schemes Directive includes large companies into these schemes. The combined effect of these two changes is to leave public authorities and financial organisations (including pension funds) as the only senior creditors likely to incur losses in a failing bank after July 2015.

2.6. The continued global economic recovery has led to a general improvement in credit conditions since last year. This is evidenced by a fall in the credit default swap spreads of banks and companies around the world. However, due to the above legislative changes, the credit risk associated with making unsecured bank deposits will increase relative to the risk of other investment options available to the Council. While the likelihood of suffering a loss from the default of a bank remains unchanged, the 'bail-in' regime has significantly increased the impact a default would have in terms of the scale of loss the Council could be exposed to.

3. Local Context

3.1. The Council currently has £156.7m of borrowing and £42.9m of investments. This is set out in further detail at Appendix B. Forecast changes in these sums are shown in the balance sheet analysis in Table 1.

Table 1: Balance Sheet Summary and Forecast

	31.3.14 Actual £m	31.3.15 Estimate £m	31.3.16 Estimate £m	31.3.17 Estimate £m	31.3.18 Estimate £m
General Fund (GF) CFR	5.3	10.4	11.6	22.0	36.6
HRA CFR	160.4	160.9	165.6	168.5	168.5
Total CFR	**165.7**	**171.3**	**177.2**	**190.5**	**205.1**
Less: Other debt liabilities *	(1.8)	(1.5)	(1.2)	(0.8)	(0.5)
Borrowing CFR	**163.9**	**169.8**	**176.0**	**189.7**	**204.6**
Less: External borrowing **	(156.7)	(156.7)	(156.7)	(156.7)	(156.7)
Internal (over) borrowing	**7.2**	**13.1**	**19.3**	**33.0**	**47.9**
Less: GF Usable reserves	(17.2)	(16.8)	(12.1)	(11.9)	(12.1)
Less: HRA Usable reserves	(4.2)	(7.7)	(2.5)	(1.2)	(1.6)
Less: Working capital	(12.8)	(6.0)	(6.0)	(6.0)	(6.0)
New borrowing or (investments)	**(27.0)**	**(17.3)**	**(1.2)**	**13.9**	**28.2**

* finance leases (relating to the Environmental Services Contract) that form part of the Council's debt

** shows only loans to which the Authority is committed and excludes optional refinancing

3.2. 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.

3.3. The Council has an increasing CFR due to the capital programme over the coming years, and the Council's reserves will gradually reduce over the same period. This will require the Council to take out new borrowing towards the end of the forecast period.

3.4. CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the 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 2015/16.

4. Borrowing Strategy

4.1. The Council currently holds £156.7 million of loans, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in Table 1 shows that the Council does not expect to need to borrow in 2015/16. The Council may however borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £187.8 million.

Objectives

4.2. 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.

Strategy

4.3. 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.

4.4. By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. 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.

4.5. In addition, the Council may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages.

Sources

4.6. The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and its successor body
- UK local authorities
- any institution approved for investments (see below)
- any other bank or building society authorised 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 local authority bond issues

4.7. In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

4.8. The Council has previously raised all of its long-term borrowing from the PWLB 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.

Short-term and Variable Rate loans

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

Debt Rescheduling

4.10. The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also 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 cost saving or a reduction in risk.

5. Investment Strategy

5.1. The Council holds 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 £26m and £48m, and similar levels are expected to be maintained in the forthcoming year.

Objectives

5.2. Both the CIPFA Code and the CLG Guidance require the Council 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.

Strategy

5.3. Due to the increasing risk from bank 'bail-ins' and continued low returns from short-term unsecured bank investments, the Council aims to further diversify into more secure and/or higher yielding asset classes during 2015/16. This is especially the case for the estimated £16m that is available for longer-term investment. The majority of the Council's surplus cash is currently invested in short-term unsecured bank deposits, certificates of deposit and money market funds. **This diversification will therefore represent a substantial change in strategy over the coming year.**

Investment Limits

5.4. Given the impact of the Bank Recovery and Resolution Directive, and the recast Deposit Guarantee Schemes Directive, which has increased the credit risk that unsecured bank/building society investments could be 'bailed-in', the following investment limits are proposed to mitigate the risk whilst allowing sufficient flexibility to manage the Council's investment balances.

5.5. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Maximum limits will also be placed on fund managers, investments in industry sectors as below:

Table 2: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£5m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£5m per group
Any group of pooled funds under the same management	£5m per manager
Registered Providers	£6m in total
Money Market Funds	50% in total

Approved Counterparties

5.6. The Council may invest its surplus funds with any of the counterparty types in Table 3 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 3: Approved Investment Counterparties and Limits

Credit Rating	**Banks Unsecured**	**Banks Secured**	**Government**	**Corporates**	**Registered Providers**
UK Govt	n/a	n/a	£ Unlimited 30 years	n/a	n/a
AAA	£3m 5 years	£5m 20 years	£5m 30 years	£3m 20 years	£3m 20 years
AA+	£3m 5 years	£5m 10 years	£5m 25 years	£3m 10 years	£3m 10 years
AA	£3m 4 years	£5m 5 years	£5m 15 years	£3m 5 years	£3m 10 years
AA-	£3m 3 years	£5m 4 years	£5m 10 years	£3m 4 years	£3m 10 years
A+	£3m 2 years	£5m 3 years	£3m 5 years	£3m 3 years	£3m 5 years
A	£3m 13 months	£5m 2 years	£3m 5 years	£3m 2 years	£3m 5 years

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates	Registered Providers
A-	£3m 6 months	£5m 13 months	£3m 5 years	£3m 13 months	£3m 5 years
BBB+	£1m 100 days	£3m 6 months	£3m 2 years	£1m 6 months	£3m 2 years
BBB or BBB-	£1m next day only	£3m 100 days	n/a	n/a	n/a
None	£1m 6 months	n/a	£3m 25 years	n/a	£3m 5 years
Pooled funds	£5m per fund				

The foregoing table must be read in conjunction with the notes below:

Credit Rating

5.7. Investment decisions are made 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.

Banks Unsecured

5.8. Accounts, deposits, certificates of deposit and senior unsecured bonds 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. Unsecured investment with banks rated BBB or BBB- are restricted to overnight deposits at the Authority's current account bank NatWest (which is currently rated as BBB+).

Banks Secured

5.9. Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank/building society'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 highest 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/building society will not exceed the cash limit for secured investments.

Government

5.10. Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities (which generally do not have credit ratings) and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 30 years.

Corporates

5.11. Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Investing with any unrated corporate entity will be judged on a case-by-case basis and only considered if suitable security can be obtained for the Council's investment.

Registered Providers

5.12. Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services, they retain a high likelihood of receiving government support if needed.

Pooled Funds

5.13. Shares in diversified investment vehicles consisting of the 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. Money Market 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 pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

5.14. Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. 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.

Risk Assessment and Credit Ratings

5.15. Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. 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.

5.16. 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. 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

5.17. The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full 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.

5.18. Based on the available information and the advice of the Council's advisers, Arlingclose, the investment limits shown in Tables 2 and 3 may be reduced, and investing with certain counterparties may be suspended as necessary.

5.19. 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 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

5.20. 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".

5.21. The Council 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 money market funds and other pooled funds "high credit quality" is defined as those having a credit rating of A- or higher.

Non-specified Investments

5.22. 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, other than for the purchase of share capital in the Hampshire Community Bank (CAB2630 refers). 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), pooled funds that the Council intends to hold as long term investments (for more than a year), share capital in the Hampshire Community Bank and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in Table 4 below.

Table 4: Non-Specified Investment Limits

	Cash limit
Total long-term investments	£16m
Total investments without credit ratings or rated below A- (excluding investments with other local authorities)	£9m
Total non-Sterling investments	£0m
Total investments in foreign countries rated below AA+	£0m
Total non-specified investments	£25m

Liquidity Management

5.23. The Council has due regard for its future cash flows when determining the maximum period for which funds may prudently be committed. Historic cash flows are analysed in addition to significant future cash movements, such as payroll, grant income and council tax precept. Limits on long-term investments are set by reference to the Council's medium term financial position (summarised in Table 1) and forecast short-term balances.

6. Treasury Management Indicators

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

Interest Rate Exposures

6.2. 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 amount of principal borrowed or invested will be:

	2015/16	**2016/17**	**2017/18**
Upper limit on fixed interest rate investment exposure	£16.0m	£15.0m	£15.0m
Upper limit on variable interest rate investment exposure	£60.0m	£60.0m	£60.0m
Upper limit on fixed interest rate borrowing exposure	£183.8m	£193.6m	£204.7m
Upper limit on variable interest rate borrowing exposure	£91.9m	£96.8m	£102.35m

6.3. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Short-term instruments (with a maturity of less than one year) are classed as variable rate.

Maturity Structure of Borrowing

6.4. This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper	Lower
Under 12 months	25%	0%
12 months and within 24 months	25%	0%
24 months and within 5 years	25%	0%
5 years and within 10 years	25%	0%
10 years and within 20 years	50%	0%
20 years and within 30 years	50%	0%
30 years and within 40 years	75%	0%
40 years and within 50 years	100%	0%

6.5. 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.

Principal Sums Invested for Periods Longer than 364 days

6.6. 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:

	2015/16	2016/17	2017/18
Limit on principal invested beyond 364 days	£16m	£15m	£15m

7. Other Items

7.1. There are a number of additional items that the Council is obliged by CIPFA or CLG to include in its Treasury Management Strategy.

Policy on Use of Financial Derivatives

7.2. Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. callable deposits). The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

7.3. The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

7.4. Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit.

Policy on Apportioning Interest to the HRA

7.5. The Council has adopted the “two pool approach” whereby each of its long-term loans are split into General Fund and HRA pools. In the future, new long-term loans borrowed will be assigned in their entirety to one pool or the other. 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 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.

Investment Training

7.6. The needs of Hampshire County Council’s treasury management staff for delivering services to WCC, for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

7.7. Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.

7.8. CIPFA’s Code of Practice requires that the Council ensures that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities. All members were invited to a workshop presented by Arlingclose on 18 November 2014, which gave an update on treasury matters.

Investment Advisers

7.9. The Council has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled through quarterly review meetings with the Chief Finance Officer, Hampshire County Council Investments and Borrowing Team, and Arlingclose.

Investment of Money Borrowed in Advance of Need

7.10. 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. The total amount borrowed will not exceed the authorised borrowing limit of £187.4 million.

OTHER CONSIDERATIONS

8. 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.

9. RESOURCE IMPLICATIONS:

As set out in the body of the report.

10. RISK MANAGEMENT ISSUES

These are considered within the report.

BACKGROUND DOCUMENTS

These are included as appendices.

11. APPENDICES

Appendix A – Arlingclose Economic & Interest Rate Forecast October 2014

Appendix B – Existing Investment & Debt Portfolio Position

Appendix C – Prudential Indicators

Appendix D – Minimum Revenue Provision (MRP) Statement 2015/16

Arlingclose Economic & Interest Rate Forecast January 2015

Underlying assumptions:

- The UK economic recovery slowed towards the end of 2014, with economic and political uncertainty weighing on business investment. However, the Q3 growth rate of 0.7% remains slightly above the long run average, suggesting the recovery remains robust.
- Household consumption is key to the recovery in 2015. While we expect consumption growth to slow, given softening housing market activity and slower employment growth, the fall in inflation and resulting rise in both real (and nominal) wage growth and disposable income should support spending.
- Inflationary pressure is currently low (annual CPI is currently 0.5%) and is likely to remain so in the short-term. The fall in oil prices has yet to feed fully into the prices of motor fuel and retail energy and CPI is expected to fall further. Supermarket price wars are also expected to bear down on food price inflation.
- The MPC's focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee.
- Nominal earnings growth is strengthening, but remains relatively weak in historical terms, despite large falls in unemployment. Our view is that spare capacity remains extensive. The levels of part-time, self-employment and underemployment are significant and indicate capacity within the employed workforce, in addition to the still large unemployed pool. Productivity growth can therefore remain weak in the short term without creating undue inflationary pressure.
- However, we also expect employment growth to slow as economic growth decelerates. This is likely to boost productivity, which will bear down on unit labour costs and inflationary pressure.
- In addition to the lack of wage and inflationary pressures, policymakers are evidently concerned about the bleak prospects for the Eurozone. These factors will maintain the dovish stance of the MPC in the medium term. The MPC clearly believes the appropriate level for Bank Rate for the post-crisis UK economy is significantly lower than the previous norm. We would suggest this is between 2.5 and 3.5%.
- The ECB has introduced outright QE as expected. While this may alleviate some of the anxiety about the economic potential of the Eurozone, political risk remains significant (e.g. Greek election). Therefore fears for the Eurozone are likely to maintain a safe haven bid for UK government debt.

Forecast:

- We continue to forecast the first rise in official interest rates in Q3 2015, but the risks to this forecast are very much weighted to the downside. The February Inflation Report will be key to our review of the possible path for Bank Rate.

- We project a slow rise in Bank Rate. The pace of interest rate rises will be gradual and the extent of rises limited; we believe the normalised level of Bank Rate post-crisis to range between 2.5% and 3.5%.
- Market sentiment (derived from forward curves) has shifted significantly lower in the past three months; market expectations are now for a later increase in interest rates and a more muted increase in gilt yields.
- The short run path for gilt yields has flattened due to the sharp decline in inflation expectations. We project gilt yields on an upward path in the medium term.
- The short run path for gilt yields is flatter due to the deteriorating Eurozone situation. We project gilt yields on an upward path in the medium term.

	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Official Bank Rate													
Upside risk				0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.50**	**1.75**	**1.75**	**1.75**
Downside risk			0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00
3-month LIBID rate													
Upside risk	0.10	0.20	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	**0.55**	**0.60**	**0.80**	**0.90**	**1.05**	**1.15**	**1.30**	**1.40**	**1.55**	**1.65**	**1.80**	**1.95**	**2.00**
Downside risk	0.15	0.20	0.30	0.40	0.55	0.65	0.75	0.85	0.95	0.95	0.95	0.95	1.00
1-yr LIBID rate													
Upside risk	0.10	0.20	0.20	0.30	0.30	0.30	0.30	0.30	0.40	0.40	0.40	0.40	0.40
Arlingclose Central Case	**0.95**	**1.00**	**1.20**	**1.30**	**1.45**	**1.55**	**1.70**	**1.80**	**1.95**	**2.05**	**2.20**	**2.35**	**2.40**
Downside risk	0.15	0.20	0.30	0.50	0.55	0.60	0.65	0.70	0.75	0.80	0.80	0.80	0.80
5-yr gilt yield													
Upside risk	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.50	0.50
Arlingclose Central Case	**1.10**	**1.20**	**1.30**	**1.40**	**1.50**	**1.65**	**1.80**	**1.95**	**2.10**	**2.20**	**2.35**	**2.40**	**2.50**
Downside risk	0.35	0.35	0.40	0.45	0.50	0.50	0.55	0.60	0.65	0.70	0.70	0.70	0.75
10-yr gilt yield													
Upside risk	0.35	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.50	0.50	0.55	0.55
Arlingclose Central Case	**1.60**	**1.70**	**1.80**	**1.90**	**2.00**	**2.15**	**2.30**	**2.45**	**2.60**	**2.70**	**2.85**	**2.90**	**3.00**
Downside risk	0.35	0.35	0.40	0.45	0.50	0.50	0.55	0.60	0.65	0.70	0.70	0.75	0.80
20-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	**2.10**	**2.20**	**2.30**	**2.35**	**2.45**	**2.50**	**2.65**	**2.75**	**2.90**	**3.00**	**3.15**	**3.20**	**3.30**
Downside risk	0.35	0.40	0.50	0.60	0.70	0.75	0.75	0.75	0.80	0.85	0.85	0.90	0.90
50-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	**2.15**	**2.25**	**2.35**	**2.40**	**2.50**	**2.55**	**2.70**	**2.80**	**2.95**	**3.05**	**3.20**	**3.25**	**3.35**
Downside risk	0.35	0.40	0.50	0.60	0.70	0.75	0.75	0.75	0.80	0.85	0.85	0.90	0.90

Existing Investment & Debt Portfolio Position

	31.12.2014 **Actual Portfolio £m**	31.12.2014 **Average Rate %**
External Borrowing:		
Long term loans - PWLB	156.7	**3.3**
Total External Borrowing	**156.7**	
Investments:		
Direct Deposits		
- Barclays	3.0	
- Close Brothers	3.0	
- HSBC	2.0	
- Leeds Building Society	1.0	
- Lloyds	3.0	
- Nationwide	3.0	
- National Australia Bank	2.0	
- Rabobank	3.0	
- Svenska Handelsbanken	2.2	
	22.2	**0.81**
Certificates of Deposit		
- Credit Suisse	1.0	
- Deutsche Bank	1.0	
- Nordea	1.0	
- Standard Chartered	2.0	
	5.0	**0.61**
Floating Rate Notes		
- Cydesdale Bank	1.0	
- Yorkshire Building Society	1.0	
	2.0	**0.74**
Property Funds		
- CCLA Property Fund	**2.0**	**3.00***
Other Local Authorities	**5.0**	**0.90**
Money Market Funds		
- Federated	3.0	
- Goldman Sachs	0.7	
- Ignis	3.0	
	6.7	**0.46**
Total Investments	**42.9**	**1.35**
Net Debt	**113.8**	

***Year to date return (excluding unrealised capital growth)

Prudential Indicators 2015/16

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.

Capital Expenditure and Financing	2014/15 Revised £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
General Fund	8.7	17.3	20.7	16.6
HRA	9.9	23.1	22.6	18.2
Total Expenditure	**18.6**	**40.4**	**43.3**	**34.8**
Capital Receipts	1.9	6.9	11.0	1.9
Government Grants	0.9	2.9	2.3	0.4
Reserves	7.1	13.2	6.8	7.2
Revenue	3.1	10.4	7.6	7.0
Borrowing	5.6	7.0	15.6	18.3
Total Financing	**18.6**	**40.4**	**43.3**	**34.8**

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	31.03.15 Revised £m	31.03.16 Estimate £m	31.03.17 Estimate £m	31.03.18 Estimate £m
General Fund	10.4	11.6	22.0	36.6
HRA	160.9	165.6	168.5	168.5
Total CFR	**171.3**	**177.2**	**190.5**	**205.1**

The CFR is forecast to rise 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	**31.03.15 Revised £m**	**31.03.16 Estimate £m**	**31.03.17 Estimate £m**	**31.03.18 Estimate £m**
Borrowing	(156.7)	(156.7)	(156.7)	(156.7)
New borrowing	0.0	0.0	(13.9)	(28.2)
Finance leases	(1.5)	(1.2)	(0.8)	(0.5)
Total Debt	**(158.2)**	**(157.9)**	**(171.4)**	**(185.4)**

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 lease and other liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary	**2014/15 Revised £m**	**2015/16 Estimate £m**	**2016/17 Estimate £m**	**2017/18 Estimate £m**
Borrowing	175.0	183.0	193.2	207.3
Other long-term liabilities	1.5	1.2	0.8	0.5
Total Debt	**176.5**	**184.2**	**194.0**	**207.8**

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	2014/15 Revised £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Borrowing	175.7	186.3	194.2	208.5
Other long-term liabilities	1.9	1.5	1.0	0.6
Total Debt	**177.6**	**187.8**	**195.2**	**209.1**

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	2014/15 Revised %	2015/16 Estimate %	2016/17 Estimate %	2017/18 Estimate %
General Fund	0.99	1.06	1.94	6.15
HRA	19.25	18.89	18.79	18.36

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 earlier in this report.

Incremental Impact of Capital Investment Decisions	2015/16 Estimate £	2016/17 Estimate £	2017/18 Estimate £
General Fund - increase in annual band D Council Tax*	4.02	8.99	8.69
HRA - increase in average weekly rents	8.75	3.54	1.68

*the estimates reflect the first three years; due to timing, the benefits of various capital projects will not be realised until later.

Adoption of the CIPFA Treasury Management Code

The Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition in February 2012.

Annual Minimum Revenue Provision Statement 2015/16

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.

The Asset Life Method determines that MRP will be 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.

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.

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

The Chief Financial Officer recommends the approval of the above MRP Policy statement for use in 2015/16.

	31.03.15 Estimated CFR £m	**2015/16 Estimated MRP £m**
Unsupported capital expenditure after 31/03/2008	8.9	0.165
Voluntary Revenue Provision (VRP)	0.0	4.830*
Finance leases and Private Finance Initiative	1.5	0.321
Transferred debt	0.0	0
Loans to other bodies	0.0	0
Total General Fund	**10.4**	**5.316**
Assets in the HRA	160.9	0
Total HRA	**160.9**	**0**
Total	**171.3**	**5.316**

***** relates to disposal of unfinanced asset dependent on Silver Hill going unconditional