Taunton Deane Borough Council

Executive – 5 February 2014

Treasury Management Strategy Statement and Investment Strategy

Report of the Strategic Finance Officer
(This matter is the responsibility of Executive Councillor Williams – Leader of the Council)

1. Executive Summary

- Council debt at the time of writing this report is £94.2m
- Short-term interest rates are currently 0.5% and are expected to be at this level for the next financial year.
- The Financial Services (Banking Reform) Act 2013 changes are reflected within the Treasury Management Strategy Statement for 2014/15.

2. Background

2.1 The purpose of this Treasury Management Strategy Statement and Investment Strategy (TMSS) is to approve:-

- The Treasury Management Strategy for 2014/2015 (Borrowing and Debt Rescheduling); and
- Use of Specified and Non-Specified Investments.

2.2 The treasury management service is an important part of the overall financial management of the Council's affairs

2.3 The bank base rate fell to 0.5% in March 2009 and has remained at that level ever since. Our advisors suggest that the interest rates will remain low for even longer, until at least March 2017. Some other institutions believe that they will rise before this date.

2.4 The recent drop in the ILO unemployment rate to 7.1% has led to a number of comments from various MPC members. Ian McCafferty stated "as we approach the 7.0% threshold, I am sure speculation is bound to increase about what we might do when the threshold is reached. Once we get there we will say more…" He also reiterated that 7.0% is a threshold, not a trigger, and "the MPC sees no immediate need to increase interest rates even if 7.0% were to be hit in the near future."

2.5 On 18 December 2013 the Financial Services (Banking Reform) Act 2013 became law. This Act includes the provision for bail in. A bail in is where investors either lose some of their investments or pay in more other than the tax payer bailing out a failing institution. It is expected that the bail-in provisions will come into force before 2016 and this may be within the financial year 2014/15.

3. Treasury Management Strategy Statement (TMSS) and Investment Strategy

3.1 This strategy is written looking at the Government's predictions for growth, advice from our Treasury advisors Arlingclose including their predictions on interest rates and changes in legislation governing financial institutions. The current economic outlook has a several key treasury management implications:

- Investment returns are likely to remain relatively low during 2014/15;
- Borrowing interest rates are currently attractive, but may remain low for some time.
- The timing of any borrowing will need to be monitored carefully; there will remain a cost of carry – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

3.2 This strategy looks to reduce the levels of investment per counterparty but includes more counterparties with whom we can invest any cash surpluses. To reduce exposure to risk and volatility we will continue to;

- Consider security, liquidity and yield, in that order.
- Consider alternative assessments of credit strength
- Spreading investments over a range of approved counterparties.
- Only investing for longer periods to gain higher rates of return where there are acceptable levels of counterparty risk.

3.3 The continuing historical low interest rates has led to significant reductions in investment income in the past years which impacts directly on the Council's budget.

3.4 The Council's General Fund capital financing requirement (CFR) for 2014/15 is £11.908m which is currently funded through internal borrowing. The council is able to borrow funds in excess of the current CFR up to the projected level in 2016/17 of £10.777m. The timing of any borrowing must be considered as mentioned in 3.1 above.

3.5 At its meeting on 23 January Corporate Scrutiny considered the TMSS. Questions were asked and answered by the Strategic Finance Officer. Corporate Scrutiny have asked that the Executive consider amending the limit for Loans to small businesses in table 4 "Investment Limits" from £2m to £3m.

3.6 Appendix 1 gives the full TMSS.

4. Finance Comments

4.1 This is a finance report and there are no further comments to make.

5. Legal Comments

5.1 There are no legal implications of this report.

6. Links to Corporate Aims

6.1 The TMSS supports the funding of projects as well as the general fund, which in turn support the Corporate Aims.

7. Environmental Implications

7.1 No environmental implications have been identified.

8. Community Safety Implications

8.1 No community safety implications have been identified.

9. Equalities Impact

9.1 After initial screening no Equality Impacts were identified for any specific group

10. Risk Management

10.1 There are both credit and liquidity risk surrounding treasury activities. This strategy looks to minimise the council's exposure to these risks.

11. Partnership Implications

11.1 There are no partnership implications of this report.

12. Recommendations

12.1 That Executive recommends to Council the approval of the Treasury Management Strategy Statement.

12.2 That Executive recommends to Council the approval of the Prudential Indicators in Appendix C of the Treasury Management Strategy Statement and Investment Strategy.

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Treasury Management Strategy Statement 2014/2015

Introduction

On 14 January 2004 the Council approved the adoption of the Chartered Institute of Public Finance and Accountancy's Treasury Management Code. This requires the Authority to approve a treasury management strategy before the start of each financial year.

In addition, the Department for Communities and Local Government (CLG) issued revised Guidance on Local Authority Investments in March 2010 that requires the Authority to approve an investment strategy before the start of each financial year.
This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Guidance.

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

External Context

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.
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.

Stronger growth data in 2013 (0.4% in Q1, 0.7% in Q2 and 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.

In the US expectations for the slowing in the pace of asset purchases ('tapering') by the Federal Reserve 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.

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 already manifesting in relation to holders of subordinated debt issued by the Co-op which will 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 VNAV (variable net asset value) 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.

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%.

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

For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.6%.

<u>Local Context</u>

The Authority currently has £94.2m of borrowing and £28.7m 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 below.

Table 1: Balance Sheet Summary and Forecast

	31.3.13 Actual £'000	31.3.14 Estimate £'000	31.3.15 Estimate £'000	31.3.16 Estimate £'000	31.3.17 Estimate £'000
General Fund CFR	7,535	8,604	11,908	11,337	10,777
HRA CFR	98,003	98,003	106,546	106,546	103,848
Total CFR	**105,538**	**106,607**	**118,454**	**117,883**	**114,625**
Less: External borrowing *	(94.198)	(94,198)	(92,198)	(92,198)	(89,500)
Internal (over) borrowing	**11,340**	**12,409**	**26,256**	**25,685**	**25,125**
Less: Usable reserves	(23,936)	(16,300)	(9,300)	(9,000)	(9,000)
(Investments) or New borrowing	**(12,596)**	**(3,891)**	**16,956**	**16,685**	**16,125**

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

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 Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

The Authority has an increasing CFR in 2014/15 due to the capital programme, but minimal investments and will therefore potentially be required to borrow up to £16.9m over the forecast period.

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Authority expects to comply with this recommendation during 2014/15.

Borrowing Strategy

The Authority currently holds £94.2 million of loans, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 1 shows that the Authority expects to borrow up to £16.9m in 2014/15. The Authority may however borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £183 million.

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.

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. 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. Arlingclose will assist the Council with this '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.

The 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 Somerset Pension Fund)
- capital market bond investors
- special purpose companies created to enable joint local authority bond issues.

The Council has previously raised the majority 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.

The Council holds £3m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. £3m of these LOBOS have options during 2014/15, and although the Council understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Council will take the option to repay LOBO loans at no cost if it has the opportunity to do so.

Short-term and variable rate 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: 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. Some bank 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 saving or reduction in risk.

Investment Strategy

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's average investment balance has ranged between £27million and £30million, and similar levels are expected to be maintained in the forthcoming year.

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.

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

<table>
<tr><th colspan="2">Counterparty</th><th>Cash limit</th><th>Time limit †</th></tr>
<tr><td rowspan="7">Banks and other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:</td><td>AAA</td><td rowspan="7">£2m each</td><td>10 years*</td></tr>
<tr><td>AA+</td><td>5 years*</td></tr>
<tr><td>AA</td><td>4 years*</td></tr>
<tr><td>AA-</td><td>3 years*</td></tr>
<tr><td>A+</td><td>2 years</td></tr>
<tr><td>A</td><td rowspan="2">1 year</td></tr>
<tr><td>A-</td></tr>
<tr><td colspan="2">The Authority's current account bank National Westminster Bank plc if it fails to meet the above criteria</td><td>£0.5m</td><td>next day</td></tr>
<tr><td colspan="2">UK Central Government (irrespective of credit rating)</td><td>unlimited</td><td>50 years**</td></tr>
<tr><td colspan="2">UK Local Authorities (irrespective of credit rating)</td><td>£3.5m each</td><td>50 years**</td></tr>
<tr><td colspan="2">UK Registered Providers of Social Housing whose lowest published long-term credit rating is A- or higher</td><td>£2m each</td><td>10 years**</td></tr>
<tr><td colspan="2">UK Registered Providers of Social Housing whose lowest published long-term credit rating is BBB- or higher and those without credit ratings</td><td>£1m each</td><td>5 years</td></tr>
<tr><td colspan="2">UK Building Societies without credit ratings</td><td>£1m each</td><td>1 year</td></tr>
<tr><td colspan="2">Money market funds and other pooled funds</td><td>£2m each</td><td>n/a</td></tr>
<tr><td colspan="2" rowspan="3">Any other organisation, subject to an external credit assessment and specific advice from the Authority's treasury management adviser</td><td>£1.5m each</td><td>3 months</td></tr>
<tr><td>£1m each</td><td>1 year</td></tr>
<tr><td>£100k each</td><td>5 years</td></tr>
</table>

† 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

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.

In addition, the Council may invest with organisations and pooled funds without credit ratings, following an external credit assessment and advice from the Authority's treasury management adviser.

Current Account Bank: Following a competitive tender exercise held in 2013, the Council's current accounts are held with National Westminster Bank plc which is currently rated above the minimum A- rating in table 2. Should the credit ratings fall below A-, the Council may continue to deposit surplus cash with National Westminster plc 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 receiving independent advice.

Building Societies: The Council takes additional comfort from the building societies' regulatory framework and insolvency regime where, 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 therefore 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 unrated building societies will therefore 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. .

Other Pooled Funds: The Council could consider using 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. 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 on the specific advice of the Authority's treasury management adviser.

Externally Managed Funds: The Council could choose to use external fund managers. The manager has scope to add value through the use of the investments listed in table 2 and must operate within the same limits. Performance is monitored and measured against the benchmark set for the fund, prevailing economic conditions and investment opportunities.

Risk Assessment and Credit Ratings: 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 the risk of investment default. The lowest available counterparty credit rating will be used to determine credit quality, unless an investment-specific rating is available. 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.

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 policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other Information on the Security of Investments: The 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.

When 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. In these circumstances, 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.

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

- denominated in pound sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
    - the UK Government,
    - a UK local authority, parish council or community council, or
    - a body or investment scheme of "high credit quality".

The Authority 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.

Non-specified Investments: Any investment not meeting the definition of a specified investment is classed as non-specified. 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. 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	£6m
Total investments without credit ratings or rated below [A-] (Excluding Local Authorities)	£4m
Total investments in foreign countries (excluding the UK) rated below [AA+]	£0m
Total non-specified investments	£10m *(=sum of the above?)*

Investment Limits: The Council's revenue reserves available to cover investment losses are forecast to be £16.3million on 31st March 2014. In order that no more than 25% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £4 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	£2.5m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£2.5m per group
Any group of pooled funds under the same management	£2.5m per manger
Negotiable instruments held in a broker's nominee account	£2.5m per broker
Foreign countries	£2.5m per country
Registered Providers	£4m in total
Building Societies	£4m in total
Loans to small businesses	£2m in total
Money Market Funds	£15m in total

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 £2.5 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 below.

Liquidity management: The Council uses a spreadsheet which details the Council's cash flow on a daily basis 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

<u>Treasury Management Indicators</u>

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

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating 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 rating	A

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	Target
Total cash available within 3 months	£6m

Interest Rate Exposures: This indicator is set to control the Authority'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	100%	100%	100%

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.

Maturity Structure of Borrowing: This indicator is set to control the Authority'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	50%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	50%	0%
10 years and within 20 years	100%	0%
20 years and within 30 years	100%	0%
30 years and within 40 years	100%	0%
40 years and within 50 years	100%	0%
50 years and above	100%	0%

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: 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:

	2014/15	2015/16	2016/17
Limit on principal invested beyond year end	£6m	£5m	£4.5m

<u>Other Items</u>

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

Policy on Use of Financial Derivatives: 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. LOBO loans and 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).

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 Authority 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 will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

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 and the relevant foreign country limit.

Policy on Apportioning Interest to the HRA: On 1st April 2012, the Authority notionally split each of its existing long-term loans 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 at the end of the year and interest transferred between the General Fund and HRA at the Council's average interest rate on investments, adjusted for credit risk.

Investment Training: The needs of the Council's treasury management staff for training in investment management are assessed every six months as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA.

Investment Advisers: 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 by holding quarterly meetings and tendering periodically. The last tender was completed in March 2013.

Investment of Money Borrowed in Advance of Need: 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 £94.2 million. The maximum period between borrowing and expenditure is expected to be two years, although the Authority is not required to link particular loans with particular items of expenditure.

Financial Implications

The budget for investment income in 2014/15 is £148k, based on an average investment portfolio of £25 million at an interest rate of 0.6%. The budget for debt interest paid in 2014/15 is £2.8 million, based on an average debt portfolio of £94.2 million at an average interest rate of 2.94%. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

Other Options Considered

The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Operations & Deputy CEO, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, 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

Appendix A – 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 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 the 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 housing price bubble, the Bank of England announced a curtailment of the Funding for Lending Scheme, which will henceforth concentrate on business lending only.
- The MOC will not hesitate to use macro prudential and regulatory tools to deal with emerging risk (such as curtailing the FLS). Absent risks to either price stability of 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 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. 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

Appendix B – Existing Investment & Debt Portfolio Position

	31/12/2013 **Actual Portfolio** **£m**	31/12/2013 **Average Rate** **%**
External Borrowing: PWLB - Fixed Rate	86,198	3.03%
PWLB – Variable Rate	5,000	0.54%
LOBO Loans	3,000	4.25%
Total External Borrowing	**94,198**	**2.94%**
Investments Short Term	28,700	0.6%
Net Debt	**65,498**	

Appendix C – Prudential Indicators

Prudential Indicators revisions to 2013/14 and 2014/15 – 2016/17

1. Background:

There is a requirement under the Local Government Act 2003 for local authorities to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the "CIPFA Prudential Code") when setting and reviewing their Prudential Indicators.

2. Gross Debt and the Capital Financing Requirement:

This is a key indicator of prudence. In order to ensure that over the medium term debt will only be for a capital purpose, the local 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.

If in any of these years there is a reduction in the capital financing requirement, this reduction is ignored in estimating the cumulative increase in the capital financing requirement which is used for comparison with **gross** external debt.

The s.151 officer reports that the Council had no difficulty meeting this requirement in 2013/14, nor are there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

3. Estimates of Capital Expenditure:

3.1 This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council Tax and in the case of the HRA, housing rent levels.

Capital Expenditure	**2013/14 Approved £'000**	**2013/14 Revised £'000**	**2014/15 Estimate £'000**	**2015/16 Estimate £'000**	**2016/17 Estimate £'000**
Non-HRA	3,553	7,254	**7,574**	667	667
HRA	14,805	9,186	**18,927**	7,515	7,415
Total	**18,358**	**16,440**	**26,501**	**8,182**	**8,082**

3.2 Capital expenditure will be financed or funded as follows:

Capital Financing	**2013/14 Approved £'000**	**2013/14 Revised £'000**	**2014/15 Estimate £'000**	**2015/16 Estimate £'000**	**2016/17 Estimate £'000**
Capital Receipts	1,229	1,468	**679**	0	0
Government Grants	787	1,602	**685**	310	310
Revenue Contributions	9,342	11,602	**10,858**	7,872	7,772
s.106 Funding	0	340	**0**	0	0
Unsupported borrowing	7,000	1,428	**14,279**	0	0
Total Financing and Funding	**18,358**	**16,440**	**26,501**	**8,182**	**8,082**

Table 1 shows that the capital expenditure plans of the Council cannot be funded entirely from sources other than external borrowing.

4. Ratio of Financing Costs to Net Revenue Stream:

4.1 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. This ratio can be negative for Councils in a net investment position. The definition of financing costs is set out in the Prudential Code.

4.2 The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**2013/14 Approved %**	**2013/14 Revised %**	**2014/15 Estimate %**	**2015/16 Estimate %**	**2016/17 Estimate %**
Non-HRA	(2.52)	(2.36)	**(2.41)**	(2.46)	(2.46)
HRA	12.03	12.42	**11.44**	10.78	10.50
Total	**9.51**	**10.06**	**9.03**	**8.32**	**8.04**

5. Capital Financing Requirement:

5.1 The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and financing.

Capital Financing Requirement	2013/14 Approved £'000	2013/14 Revised £'000	2014/15 Estimate £'000	2015/16 Estimate £'000	2016/17 Estimate £'000
Non-HRA	7,688	8,604	**11,908**	11,337	10,777
HRA	102,232	98,003	**106,546**	106,546	103,848
Total CFR	**109,920**	**106,607**	**118,454**	**117,883**	**114,625**

6. Incremental Impact of Capital Investment Decisions:

6.1 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 calculated by comparing the total revenue budget requirement of the current approved capital programme with an equivalent calculation of the revenue budget requirement arising from the proposed capital programme.

Incremental Impact of Capital Investment Decisions	2013/14 Approved £	2014/15 Estimate £	2015/16 Estimate £	2016/17 Estimate £
Increase in Band D Council Tax	3.15	**5.31**	(0.29)	(0.15)
Increase in Average Weekly Housing Rents	(0.59)	**0.69**	(0.02)	(0.02)

7. Authorised Limit and Operational Boundary for External Debt:

7.1 The Council has an integrated treasury management strategy and manages its treasury position in accordance with its approved strategy and practice. Overall borrowing will therefore arise as a consequence of all the financial transactions of the Council and not just those arising from capital spending reflected in the CFR.

7.2 The **Authorised Limit** sets the maximum level of external debt on a gross basis (i.e. excluding investments) for the Council. It is measured on a daily basis against all external debt items on the Balance Sheet (i.e. long and short term borrowing, overdrawn bank balances and long term liabilities). This Prudential Indicator separately identifies borrowing from other long term liabilities such as finance leases. It is consistent with the Council's existing commitments, its proposals for capital expenditure and financing and its approved treasury management policy statement and practices.

7.3 The Authorised Limit is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit).

7.4 The Operational Boundary has been set on the estimate of the most likely, i.e. prudent but not worst case scenario with sufficient headroom over and above this to allow for unusual cash movements.

7.5 The Operational Boundary links directly to the Council's estimates of the CFR and estimates of other cashflow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent but not worst case scenario but without the additional headroom included within the Authorised Limit.

	2013/14 **Approved £'000**	**2013/14** **Revised £'000**	**2014/15** **Estimate £'000**	**2015/16** **Estimate £'000**	**2016/17** **Estimate £'000**
Authorised Limit for External Debt	166,920	166,920	**182,733**	167,883	164,625
Operational Boundary for External Debt	146,920	146,920	**162,733**	147,883	144,625

7.6 The HRA has a debt cap of £115.8m which is a figure set by Central Government.

8. Adoption of the CIPFA Treasury Management Code:

8.1 This indicator demonstrates that the Council has adopted the principles of best practice.

Adoption of the CIPFA Code of Practice in Treasury Management
The Council approved the adoption of the CIPFA Treasury Management Code at its Executive meeting on 14 January 2004

The Council has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies, procedures and practices.

9. Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure:

9.1 These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. This Council calculates these limits on *(select as appropriate)* net principal outstanding sums, (i.e. fixed rate debt net of fixed rate investments / net interest paid (i.e. interest paid on fixed rate debt net of interest received on fixed rate investments)

9.2 The upper limit for variable rate exposure has been set to ensure that the Council is not exposed to interest rate rises which could adversely impact on the revenue budget. The limit allows for the use of variable rate debt to offset exposure to changes in short-term rates on investments

Interest Rate Exposures	**Existing level or Benchmark level at 31/03/13 %**	**2013/14 Approved %**	**2013/14 Revised %**	**2014/15 Estimate %**	**2015/16 Estimate %**	**2016/17 Estimate %**
Fixed						
Interest payable on fixed rate borrowing /Principal sums outstanding on fixed rate borrowing	94.69	100	100	100	100	100
Less: Interest receivable on fixed rate investments/ Principal sums outstanding on fixed rate investments	(14.04)	(100)	(100)	(100)	(100)	(100)
Variable						
Interest payable on variable rate borrowing/Principal sums outstanding on variable rate borrowing	5.31	50	50	50	50	50
Less: Interest receivable on variable rate investments/ Principal sums outstanding on variable rate investments	(52.96)	(100)	(100)	(100)	(100)	(100)

9.3 The limits above provide the necessary flexibility within which decisions will be made for drawing down new loans on a fixed or variable rate basis; the decisions will ultimately be determined by expectations of anticipated interest rate movements as set out in the Council's treasury management strategy.

10. Maturity Structure of Fixed Rate borrowing:

10.1 This indicator highlights the existence of any large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates and is designed to protect against excessive exposures to interest rate changes in any one period, in particular in the course of the next ten years.

10.2 It is calculated as the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate. The maturity of borrowing is determined by reference to the earliest date on which the lender can require payment.

10.3 LOBOs are classified as maturing on the next call date i.e. the earliest date that the lender can require repayment.

Maturity structure of fixed rate borrowing	**Existing level %**	**Lower Limit for 2013/14 %**	**Upper Limit for 2014/15 %**
under 12 months	2.12	0	50
12 months and within 24 months	0	0	50
24 months and within 5 years	7.11	0	50
5 years and within 10 years	26.54	0	50
10 years and within 20 years	56.80	0	100
20 years and within 30 years	0	0	100
30 years and within 40 years	0	0	100
40 years and within 50 years	4.25	0	100
50 years and above	3.18	0	100

11. Credit Risk:

11.1 The Council considers security, liquidity and yield, in that order, when making investment decisions.

11.2 Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Council's assessment of counterparty credit risk.

11.3 The Council also considers alternative assessments of credit strength, and information on corporate developments of and market sentiment towards counterparties. The following key tools are used to assess credit risk:

- Published credit ratings of the financial institution (minimum A- or equivalent) and its sovereign (minimum AA+ or equivalent for non-UK sovereigns);
- Sovereign support mechanisms;
- Credit default swaps (where quoted);
- Share prices (where available);
- Economic fundamentals, such as a country's net debt as a percentage of its GDP);
- Corporate developments, news, articles, markets sentiment and momentum;
- Subjective overlay.

11.4 The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

12. Upper Limit for total principal sums invested over 364 days:

12.1 The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested.

Upper Limit for total principal sums invested over 364 days	**2013/14 Approved**	**2013/14 Revised**	**2014/15 Estimate**	**2015/16 Estimate**	**2016/17 Estimate**
	£3.5m	£3.5m	£6m	£5m	£4.5m

Appendix D – MRP Statement 2014/15

Before the start of each financial year, the Council is required to determine the basis on which it will provide for the repayment of borrowing undertaken for the purpose of financing capital expenditure. This annual provision, known as Minimum Revenue Provision (MRP), is designed to ensure that authorities make prudent provision to cover the ongoing costs of their borrowing.

In 2008, the Government became less prescriptive offering Councils a number of options for calculating MRP. For the financial year 2013/14, the Council determined to calculate MRP as follows:-

- for supported borrowing, 4% on outstanding debt;
- for unsupported borrowing, the debt associated with asset divided by the estimated useful life of the asset;
- for capital grants and contributions to third parties, 4% (or 1/25th) per year on a straight line basis.

It is proposed the above policy remains for 2014/15.