

Taunton Deane Borough Council

Executive – 4 February 2016

Draft Treasury Management Strategy Statement, Annual Investment Strategy and Minimum Revenue Policy 2016/2017

Report of the Finance Manager

(This matter is the responsibility of Executive Councillor Williams – Leader of the Council)

1. Executive Summary

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| 1.1 | The purpose of this report is to inform Members of the recommended strategy for managing the Council's cash resources including the approach to borrowing and investments. It also seeks the formal approval of the Treasury Management Strategy Statement, Annual Investment Strategy and MRP Policy which must be approved by Full Council by 31 March each year in line with regulations. |
| 1.2 | The Draft Strategy has been prepared taking into account professional advice and information from the Council's treasury management advisor Arlingclose. |
| 1.3 | The strategy continues to prioritise security and liquidity of cash over investment returns. |
| 1.4 | The Council currently has external borrowing of £92.2m, which is all attributable to the Housing Revenue Account. |
| 1.5 | The Council's investment balances fluctuate and currently range between £33m and £52m. |
| 1.6 | The Bank Base Rate has remained at 0.5% for several years and is currently forecast to remain at this level until the third quarter of 2016. |

2. Background Information

- 2.1 The full Draft Treasury Management Strategy Statement (TMSS), Annual Investment Strategy (AIS) and Minimum Revenue Provision (MRP) Policy are attached to this report. Due to the nature of the subject, and also in order to comply with both legislative and policy requirements, the documents contain a significant amount of technical detail and data.

- 2.2 The TMSS and related policies have been prepared taking into account the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes (“the Code”) and CLG Guidance on Local Government Investments (“the Guidance”).
- 2.3 The key principles of the Code are as follows:
- Ensuring that public bodies put in place the necessary framework to ensure the effective management and control of treasury management activities;
 - That the framework clearly states that responsibility for treasury management lies clearly within the organisation and that the Strategy clearly states the appetite for risk;
 - That value for money and suitable performance measures should be reflected in the framework.
- 2.4 The Code also identifies four clauses to be adopted and these are as follows:
- The creation and maintenance of a policy statement and suitable treasury management practices which set out the means of achieving the policies and ensuring management and control.
 - The minimum reports (to the body that approves the budget) should be an annual strategy and plan prior to the start of the financial year, a mid-year review and an annual report after its close. A local authority should ensure that its reporting enables those responsible for treasury management to effectively discharge their duties.
 - Details of delegated responsibility for implementation and monitoring of policies and for the execution and administration of treasury management decisions. For this Council the delegated person is the Section 151 Officer.
 - Details of the body responsible for the scrutiny of treasury management strategy and policies. For this Council the delegated body is the Corporate Scrutiny Committee.
- 2.5 The Council’s finance officers have worked closely with Arlingclose, our treasury advisor, to consider the requirements of the Code and Guidance and determine the proposed TMSS, AIS and MRP Policy that ensure compliance and provide a set of ‘rules’ for the Council to follow in dealing with investments, borrowing and cash flow management.
- 2.6 The current core principles remain in place within the proposed TMSS for 2016/17, which is to prioritise security (avoiding loss of council funds) and liquidity (quick access to cash) over return (interest costs and income).

2.7 However the TMSS for 2016/17 continues to recognise the increasing risks due to the new regulations in respect of 'bail in' for banks. In response to this risk and the wider ongoing risks in the financial sector the treasury strategy continues to build in greater "diversification" – so that we will hold surplus funds in a wider range of investments/accounts i.e. we are spreading the risk. Table 2 within the TMSS sets this out in a useful summary.

3. Treasury Management Strategy Statement

3.1 Council approves the strategy in advance of the new financial year and receives annual and mid-year reports, in accordance with the Code.

3.2 This Strategy is written in continuing challenging and uncertain economic times. The current economic outlook has several key treasury management implications

- Investment returns are likely to remain relatively low during 2016/17
- Borrowing interest rates are currently attractive but are likely to 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.

3.3 This Strategy looks to reduce exposure to risk and volatility at this time of significant economic uncertainty by

- Considering security, liquidity and yield, in that order
- Considering 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.

3.4 The historically low interest rate situation has led to significant reductions in investment income in the past years which impacts directly on the Council's budget.

3.5 The Council's general fund capital financing requirement (CFR) for 2016/17 is £6.855m which is currently funded through internal borrowing. The timing of any borrowing must be considered as mentioned in 3.2 above.

3.6 The Council's Housing Revenue Account (HRA) CFR for 2016/17 is £110.571m which is currently funded through external borrowing of £92.198m plus internal borrowing of £18.373m. The Government sets a debt cap for the HRA which currently limits borrowing to £115.8m.

3.7 Attached to this report is the draft recommended full Treasury Management Strategy Statement, Annual Investment Strategy and MRP Policy.

4. Corporate Scrutiny Committee Comments

4.1 Corporate Scrutiny Committee considered and noted the report at its meeting on 21 January 2016.

5. Finance Comments

5.1 The estimated costs and income of financing have been reflected in the Council's MTFP forecasts for the General Fund and Housing Revenue Account.

5.2 For the General Fund, there is a significant impact in terms of budget savings through the proposed new MRP policy. This moves from the current approach which charges MRP at 4% per year, to a new approach which proposes calculating MRP based on a weighted average asset life of 45.57 years. This equates to an MRP rate of 2.19% and has enabled the Council to release budget savings of £382,000 in 2015/16 with ongoing annual savings of £234,000 from 2016/17 as reflected in the Budget Report included on the agenda for this committee.

5.3 This is on the basis that the revised MRP Policy is approved from 1 April 2015.

6. Legal Comments

6.1 There are no legal implications of this report.

7. Links to Corporate Aims

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

8. Environmental Implications

8.1 No environmental implications have been identified.

9. Community Safety Implications

9.1 No community safety implications have been identified.

10. Equalities Impact

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

11. Risk Management

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

12. Partnership Implications

12.1 No partnership implications have been identified.

13. Recommendations

- 13.1 That Executive recommends to Full Council the approval of the Treasury Management Strategy Statement (TMSS), Annual Investment Strategy and revised MRP Policy as included with this report.
- 13.2 That Executive recommends to Full Council the approval of the Prudential Indicators included within the TMSS which include limits for borrowing and investment.
- 13.3 That Executive recommends to Full Council the change to the Council's Minimum Revenue Provision (MRP) policy is applied with effect from 1 April 2015.

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Taunton Deane Borough Council

Treasury Management Strategy Statement and Annual Investment Strategy 2016/17, and Revised MRP Policy 2015/16 & 2016/17

Introduction

In February 2011 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.

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.

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.

The Council 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 is, therefore, central to the Council's treasury management strategy.

External Context

Economic background: Domestic demand has grown robustly, supported by sustained real income growth and a gradual decline in private sector savings. Low oil and commodity prices were a notable feature of 2015, and contributed to annual CPI inflation falling to 0.1% in October. Wages are growing at 3% a year, and the unemployment rate has dropped to 5.4%. Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 3.5%. These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was an encouraging 2.3% a year in the third quarter of 2015. Although speeches by the Bank of England's Monetary Policy Committee (MPC) members sent signals that some were willing to countenance higher interest rates, the MPC held policy rates at 0.5% for the 81st consecutive month at its meeting in November 2015. Quantitative easing (QE) has been maintained at £375bn since July 2012.

The outcome of the UK general election, which was largely fought over the parties' approach to dealing with the deficit in the public finances, saw some big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

China's growth has slowed and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. US domestic growth has accelerated but the globally sensitive sectors of the US economy have slowed. Strong US labour market data and other economic indicators however suggest recent global turbulence has not knocked the American recovery off course. The Federal Reserve did not raise policy rates at its meetings in October and November, but

the statements accompanying the policy decisions point have made a rate hike in December 2015 a real possibility. In contrast, the European Central Bank finally embarked on QE in 2015 to counter the perils of deflation.

Credit outlook: The varying fortunes of different parts of the global economy are reflected in market indicators of credit risk. UK Banks operating in the Far East and parts of mainland Europe have seen their perceived risk increase, while those with a more domestic focus continue to show improvement. The sale of most of the government's stake in Lloyds and the first sale of its shares in RBS have generally been seen as credit positive.

Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the UK, USA and Germany. The rest of the European Union will follow suit in January 2016, while Australia, Canada and Switzerland are well advanced with their own plans. Meanwhile, changes to the UK Financial Services Compensation Scheme and similar European schemes in July 2015 mean that most private sector investors are now partially or fully exempt from contributing to a bail-in. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however remain stubbornly low.

Interest rate forecast: The Authority's treasury advisor Arlingclose projects the first 0.25% increase in UK Bank Rate in the third quarter of 2016, rising by 0.5% a year thereafter, finally settling between 2% and 3% in several years' time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted towards the downside.

A shallow upward path for medium term gilt yields is forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Arlingclose projects the 10 year gilt yield to rise from its current 2.0% level by around 0.3% a year. The uncertainties surrounding the timing of UK and US interest rate rises are likely to prompt short-term volatility in gilt yields.

A more detailed economic and interest rate forecast provided by Arlingclose 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 0.91%, and that new long-term loans will be borrowed at an average rate of 2.80%.

Local Context

The Council currently has £92.198m of borrowing and £46.822m 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

	31.3.15 Actual £'000	31.3.16 Estimate £'000	31.3.17 Estimate £'000	31.3.18 Estimate £'000	31.3.19 Estimate £'000
General Fund CFR	6,695	9,260	9,164	8,984	8,804
HRA CFR	98,441	104,147	107,073	107,073	103,573
Total CFR	105,136	113,407	116,237	116,057	112,377
Less: External borrowing	(92,198)	(92,198)	(89,500)	(85,500)	(82,500)
Internal borrowing	12,938	21,209	26,737	30,557	29,877
Less: Usable reserves	(33,283)	(33,432)	(32,298)	(35,883)	(39,094)
(Investments) or New borrowing	(20,345)	(12,223)	(5,561)	(5,326)	(9,217)

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.

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 Council expects to comply with this recommendation during 2016/17.

Borrowing Strategy

The Council currently holds £92.198m of loans, as part of its strategy for funding previous years' capital programmes. This sum increased significantly in March 2012 when the Council took on £82m of loans through the introduction of HRA Self Financing and the abolition of the old Housing Subsidy system. The balance sheet forecast in table 1 shows that the Council does not expect to borrow in 2016/17. The Council may, however, borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £220 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. 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 2016/17 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 (PWLB) and its successor body
- 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 Somerset Pension Fund)
- capital market bond investors
- special purpose companies created to enable joint local authority bond issues
- UK local authorities

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.

LGA Bond Agency: UK Municipal Bonds Agency PLC was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

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 at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. 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. 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.

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 Council's average investment balance has ranged between £33 million and £52 million, this is expected to reduce in 2016/17 as more of the Capital Programme is delivered.

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 of receiving unsuitably low investment income.

Given the increasing risk and continued low returns from short-term unsecured bank investments, the Council aims to continue to diversify into more secure and/or higher yielding asset classes during 2016/17. This is especially the case for the estimated £20m that is available for longer-term investment. Less of the Council's surplus cash is now invested in short-term unsecured bank deposits, certificates of deposit and money market funds but has been moved to more secure covered bonds. This diversification represents a continuation of our current investment strategy over the coming year.

The Council may invest its surplus funds with any of the counterparties in table 2 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 2: Approved Investment Counterparties and Limits

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	£ unlimited 50 years	n/a	n/a
AAA	£3m 5 years	£6m 20 years	£6m 50 years	£3m 20 years	£3m 20 years
AA+	£3m 5 years	£6m 10 years	£6m 25 years	£3m 10 years	£3m 10 years
AA	£3m 4 years	£6m 5 years	£6m 15 years	£3m 5 years	£3m 10 years
AA-	£3m 3 years	£6m 4 years	£3m 10 years	£3m 4 years	£3m 10 years
A+	£3m 2 years	£6m 2 years	£3m 10 years	£3m 3 years	£3m 5 years
A	£3m 13 months	£6m 13 months	£3m 10 years	£3m 2 years	£3m 5 years
A-	£3m 6 months	£6m 6 months	£3m 10 years	£3m 13 months	£3m 5 years
BBB+	£1m 100 days	£3m 100 days	£1m 2 years	£1m 6 months	£1m 2 years
BBB	£1m Next day only	£3m 100 days	n/a	n/a	n/a
None	£1m 6 months	n/a	£6m 25 Years	£50k 5 Years	£3m 5 Years
Pooled funds	Up to 50% of total investments limited to £6m each fund				

This table must be read in conjunction with the notes below

Investment decisions are made by reference to the lowest published long-term credit rating from Fitch, Moody's or Standards and 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.

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

Banks Unsecured: 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 are restricted to overnight deposits at the Council's current account bank Nat West.

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

Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities 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 50 years.

Corporates: 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. Loans to unrated companies will only be made as part of a diversified pool in order to spread the risk widely.

Registered Providers: Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers, 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. The Council will consider investing with unrated Registered Providers with adequate credit safeguards, subject to receiving independent advice.

Pooled Funds: Shares in diversified investment vehicles consisting of 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 fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility 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.

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.

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 Council's treasury management advisors.

Risk Assessment and Credit Ratings: Credit ratings are obtained and monitored by the Council's treasury advisors, who will notify changes in ratings as they occur. When 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 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: 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 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: 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 Council defines “high credit quality” organisations as those having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher. For money market funds and other pooled funds “high credit quality” is defined as those having a credit rating of A- or higher.

Non-specified Investments: Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. The Council does, on occasion, grant loans to small organisations for the purpose of furthering service provision within the Council’s area but these loans fall outside of the scope of the Council’s treasury management activities. 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	£20m
Total investments without credit ratings or rated below BBB+	£10m
Total non-specified investments	£30m

Investment Limits: The Council’s General Fund revenue reserves available to cover investment losses are forecast to be £21,878 million on 31st March 2016. 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 £6 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. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country since the risk is diversified over many countries.

Table 4: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£6m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£6m per group

Any group of pooled funds under the same management	£15m per manager
Negotiable instruments held in a broker's nominee account	£20m per broker
Foreign countries	£6m per country
Registered Providers	£14m in total
Loans to unrated corporates	£6m in total
Money Market Funds	£28m 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 Council 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 £6 million in total,
- certificates of deposit,
- covered bonds, 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.

Treasury Management Indicators

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

Security: The Council 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 Council 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 Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

	2016/17	2017/18	2018/19
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 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	50%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	75%	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 long-term principal sum invested to final maturities beyond the period end will be:

	2016/17	2017/18	2018/19
Limit on principal invested beyond year end	£30m	£30m	£30m

Other Items

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: 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 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 and forward starting transactions, 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 Council 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 Advisors: The Council has appointed Arlingclose Limited as treasury management advisors 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 £220 million. The maximum period between borrowing and expenditure is expected to be two years, although the Council is not required to link particular loans with particular items of expenditure.

Financial Implications

The budget for investment income in 2016/17 is £366,800 (General Fund = £314,000, HRA = £52,800). The budget for debt interest paid in 2016/17 is £2.838 million (All HRA). 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 (S151 Officer), 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 but any such losses will be greater
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 but any such losses will be smaller
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

Arlingclose Economic and Interest Rate Forecast December 2015

Underlying assumptions:

- The global economy is facing a period of slower growth, as China reorients slowly towards domestic demand. Lower demand for raw materials will depress growth in mainly developing countries where extraction is the primary industry and countries particularly reliant on exports will also face more challenging conditions.
- Countries with stronger domestic demand, such as the UK and US, will be able to weather a temporary global slowdown, helped by lower commodity prices. However, persistently slower growth will have economic repercussions for these countries.
- Additional US monetary policy tightening will be gradual and not pre-planned. The US economy will absorb the rise in interest rates without choking off growth.
- UK economic growth will slow further but remain within the long-term trend range. Economic growth softened in Q3 2015 but remained reasonably robust at 2.3% year-on-year.
- Inflation is currently very low and, will likely remain so over the next twelve months, on the back of low commodity prices and expectations that UK monetary policy will be tightened (strengthening sterling). The CPI rate will rise towards the end of 2016.
- Domestic demand is key for UK growth. Household spending has been and will remain the key driver of GDP growth through 2016. Consumption will continue to be supported by real wage and disposable income growth.
- On the back of strong consumption, business investment has strengthened, which should drive some productivity growth. However, the outlook for business investment may be tempered by the looming EU referendum, increasing uncertainties surrounding global growth and recent financial market shocks.
- Annual average earnings growth was 2.4% (including bonuses) in the three months to October. With low inflation, real earnings and income growth continue to run at relatively strong levels and could feed directly into unit labour costs and households' disposable income. Improving productivity growth should support pay growth in the medium term and may alleviate the wage pressure on companies. The development of wage growth is one of the factors being closely monitored by the MPC.

- Longer term rates will be tempered by international uncertainties and weaker inflation pressures.

Forecast:

- Arlingclose maintains its projection for the first rise in Bank Rate in Q3 2016. Risks remain weighted to the downside. Arlingclose projects a slow rise in Bank Rate. The appropriate level for Bank Rate will be lower than the previous norm and will be between 2 and 3%.
- Arlingclose project medium term gilt yields on a shallow upward path in the medium term, with interest rate and inflation expectations remaining subdued.
- The uncertainties surrounding UK and US monetary policy, and global growth weakness, are likely to continue to prompt short term volatility in gilt yields.

	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Average
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	0.50	0.50	0.50	0.31
Arlingclose Central Case	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.50	1.50	1.50	1.12
Downside risk				-0.25	-0.50	-0.50	-0.75	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-0.73
3-month LIBID rate														
Upside risk	0.30	0.30	0.30	0.35	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.36
Arlingclose Central Case	0.60	0.70	0.80	0.95	1.05	1.15	1.30	1.40	1.50	1.60	1.65	1.70	1.75	1.24
Downside risk		-0.30	-0.45	-0.55	-0.65	-0.80	-0.90	-1.05	-1.10	-1.20	-1.20	-1.20	-1.20	-0.83
1-yr LIBID rate														
Upside risk	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.45	0.45	0.41
Arlingclose Central Case	1.20	1.35	1.45	1.55	1.70	1.80	1.95	2.00	2.10	2.15	2.15	2.15	2.15	1.82
Downside risk	-0.25	-0.35	-0.50	-0.60	-0.70	-0.85	-0.95	-1.10	-1.15	-1.25	-1.25	-1.25	-1.25	-0.88
5-yr gilt yield														
Upside risk	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.56
Arlingclose Central Case	1.30	1.38	1.45	1.53	1.60	1.68	1.75	1.83	1.90	1.98	2.05	2.13	2.20	1.75
Downside risk	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25	-1.25	-0.94
10-yr gilt yield														
Upside risk	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.56
Arlingclose Central Case	1.90	1.95	2.00	2.05	2.10	2.15	2.20	2.25	2.30	2.35	2.40	2.45	2.50	2.20
Downside risk	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25	-1.25	-0.94
20-yr gilt yield														
Upside risk	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.56
Arlingclose Central Case	2.50	2.53	2.55	2.58	2.60	2.63	2.65	2.68	2.70	2.73	2.75	2.78	2.80	2.65
Downside risk	-0.40	-0.50	-0.55	-0.65	-0.75	-0.85	-0.95	-1.05	-1.10	-1.15	-1.20	-1.20	-1.20	-0.89
50-yr gilt yield														
Upside risk	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.56
Arlingclose Central Case	2.50	2.55	2.60	2.63	2.65	2.68	2.70	2.73	2.75	2.78	2.80	2.83	2.85	2.69
Downside risk	-0.35	-0.45	-0.50	-0.60	-0.70	-0.80	-0.90	-1.00	-1.05	-1.10	-1.15	-1.15	-1.15	-0.84

Existing Investment and Debt Portfolio Position

	31/12/2016 Actual Portfolio £m	31/12/2016 Average Rate %
External Borrowing:		
PWLB - Fixed Rate	84,198	3.03%
PWLB – Variable Rate	5,000	0.54%
LOBO Loans	3,000	4.25%
Total External Borrowing	92,198	2.80%
Investments		
Short Term	46,822	0.91%
Net Debt	45,376	

Prudential Indicators 2016/17

1. Background

- 1.1 The Local Government Act 2003 requires the Council to have regard to CIPFA'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.

2. Estimates of Capital Expenditure

- 2.1 The Council's planned capital expenditure and financing may be summarised as follows:

Capital Expenditure	2015/16 Revised £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Non-HRA	12,283	2,444	314	168
HRA	16,621	14,552	8,873	9,015
Total	28,904	16,996	9,187	9,183

- 2.2 Capital expenditure will be financed as follows:

Capital Financing	2015/16 Revised £'000	2016/17 Revised £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Capital Receipts	2,014	979	205	143
Capital Grants	782	472	84	0
Revenue Contributions	15,062	11,612	8,898	9,040
Borrowing	11,046	3,933	0	0
Total	28,904	16,996	9,187	9,183

3. Capital Financing Requirement

- 3.1 The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.
- 3.2 The CFR is forecast to increase during 2016/17 as the Council supports significant capital investment in the HRA, and then decrease in 2017/18

decreasing again in 2018/19 as capital expenditure financed by debt is outweighed by resources put aside for debt repayment.

Capital Financing Requirement	31.03.16 Revised £'000	31.03.17 Estimate £'000	31.03.18 Estimate £'000	31.03.19 Estimate £'000
General Fund	9,260	9,164	8,984	8,804
HRA	104,147	107,073	107,073	103,573
Total CFR	113,407	116,237	116,057	112,377

4. Gross Debt and the Capital Financing Requirement

- 4.1 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 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.
- 4.2 The S151 officer reports that the Council had no difficulty meeting this requirement in 2015/16, 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.

Debt	31.03.16 Revised £'000	31.03.17 Estimate £'000	31.03.18 Estimate £'000	31.03.19 Estimate £'000
Borrowing	92,198	89,500	85,500	82,500

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

5. Operational Boundary for External Debt

- 5.1 The Operational Boundary is based on the Council's estimate of the 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.

	2015/16 Revised £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Operational Boundary for External Debt	200,000	200,000	200,000	200,000

6. Authorised Limit for External Debt

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

	2015/16 Revised £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Authorised Limit for External Debt	220,000	220,000	220,000	220,000

7. Ratio of Financing Costs to Net Revenue Stream

- 7.1 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, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2015/16 Revised %	2016/17 Estimate %	2017/18 Estimate %	2018/19 Estimate %
General Fund	(2.38)	(2.25)	(2.41)	(2.59)
HRA	9.88	10.43	12.04	11.96
Total	7.50	8.18	9.63	9.37

8. Incremental Impact of Capital Investment Decisions

- 8.1 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	2016/17 Estimate £	2017/18 Estimate £	2018/19 Estimate £
Increase in Band D Council Tax	1.98	0.25	0.13
Increase in Average Weekly Housing Rents	1.57	0.95	0.97

9. Adoption of the CIPFA Treasury Management Code:

- 9.1 This indicator demonstrates that the Council has adopted the principles of best practice. The Council adopted the CIPFA Treasury Management in the Public Services: Code of Practice 2011 Edition in February 2011. The Council has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies, procedures and practices.

Annual Minimum Revenue Provision (MRP) Statement 2015/16 and 2016/17

1. Where the Council finances capital expenditure by debt, it must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP) although there has been no statutory minimum set aside since 2008. The Local Government act 2003 requires the Council to have regard to the Department for Communities and Local Government Guidance on Minimum Revenue Provision (the DCLG guidance most recently issued in 2012).
2. The broad aim of the CLG Guidance is to ensure that debt is repaid over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.
3. The CLG Guidance requires the Council to approve an Annual MRP Statement each year and recommends a number of options for calculating a prudent amount of MRP. Amendment regulation 4(1) of the 2008 Capital Financing and Accounting Regulations which details the MRP rules, revised the former regulations and replaced them with a basic duty for a council each year to make an amount of MRP which it considers to be “**prudent**”. The regulation does not in itself define “prudent provision”, however, the MRP guidance makes recommendations to authorities on the interpretation of that term.
4. The MRP methodology has been reviewed this year to ensure that our approach is appropriate for our financial stability and is robust and prudent for future capital expenditure. A number of options were considered and the most appropriate is that of the Equal Instalment Method whereby MRP is linked to weighted asset life. This has meant for Taunton Deane Borough Council that the repayments have been extended to a 45.57 year period.
5. On balance the weighted average useful life approach appears to be a prudent approach and takes into consideration the materiality of each asset and its recorded remaining useful life. The weighted average is then applied to the class of asset then applied across the whole fixed asset base. This should give a robust basis to support the asset life applied to MRP calculations and be appropriate for audit scrutiny.
6. In forthcoming years this base calculation will stay the same but any additional CFR will be calculated separately and added to the MRP as a distinct calculation thus protecting the original calculation and adding to it where appropriate.

