READING BOROUGH COUNCIL

REPORT BY HEAD OF FINANCE

TO:	**AUDIT & GOVERNANCE COMMITTEE**		
DATE:	**29 JANUARY 2015**	**AGENDA ITEM:**	**4**
TITLE:	**DRAFT TREASURY STRATEGY & INVESTMENT STATEMENT FOR 2015/16**		
LEAD COUNCILLOR:	**COUNCILLOR STEVENS**	**PORTFOLIO:**	**CHAIRMAN OF AUDIT & GOVERNANCE COMMITTEE**
SERVICE:	**ALL**	**WARDS:**	**BOROUGHWIDE**
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1. PURPOSE OF REPORT AND EXECUTIVE SUMMARY

1.1 CIPFA recommends that prior to Councils approving their Annual Treasury Strategy & Investment Statement, that it should be considered by the Council's Audit Committee as part of the overall governance arrangements.

1.2 The statement will in due course form part of the Council's overall budget proposals, presented as part of the Budget Report to Council in February.

1.3 This draft strategy may see some amendments to ensure it is consistent with the remainder of the budget proposals, but major change impacting 2015/16 is not anticipated. A short presentation will be made at the Committee to highlight key treasury management issues.

2. RECOMMENDED ACTION

2.1 That the committee considers the draft Treasury Strategy & Investment Statement for 2015/16.

3. POLICY CONTEXT

The Council is required to have a Treasury Strategy & Investment Statement in place in order to comply with legislative requirements and recommended professional practice, As the strategy is linked to the Council's overall budget strategy, it is formally considered and approved as part of the budget (as some of the prudential indicator limits are formally reserved to Council to set). This report enables Audit & Governance to consider the draft statement for 2015/16 (at Annex A) ahead of Cabinet & Council in February.

4. THE PROPOSAL

The draft Treasury Management Strategy Statement is attached in the Appendix. There will be a brief presentation at the Committee meeting to explain the key treasury issues the council is likely to face over the next year.

5. CONTRIBUTION TO STRATEGIC AIMS

Proper management of the Council's Treasury position helps support the overall achievement of the Council's financial objectives and service strategies.

6. COMMUNITY ENGAGEMENT AND INFORMATION

The Council does not directly consult with the community on this particular issue, though occasionally receives queries about its treasury activity to which an appropriate response is made.

7. EQUALITY IMPACT ASSESSMENT

An EIA is not relevant at this time.

8. LEGAL IMPLICATIONS

None, at this stage.

9. FINANCIAL IMPLICATIONS

As set out in the draft statement

10. BACKGROUND PAPERS

The statement has been prepared using a template provided by Arlingclose, adapted for Reading's needs.

CIPFA Treasury Management & Prudential Codes and guidance notes.

Treasury Management Strategy Statement 2015/16

Contents

Annexes

1 Introduction

1.1 The Treasury Management Strategy Statement (TMSS) is an annual statement the Council is required to approve each year of our intended treasury activity, setting constraints under which that activity will (usually) operate. Given the technical nature of the subject, by way of introduction the statement is intended to explain

- how the Council tries to minimise net borrowing costs over the medium term
- how we ensure we have enough money available to meet our commitments
- how we ensure reasonable security of money we have lent and invested
- how we maintain an element of flexibility to respond to changes in interest rates
- how we manage treasury risk overall.

1.2 The Authority has 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 Authority to approve a treasury management strategy before the start of each financial year. DCLG guideline 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.

1.3 The purpose of this TMSS is, therefore, to approve the:

- Treasury Management Strategy for 2015/16
- Annual Investment Strategy for 2015/16
- Prudential Indicators for 2015/16, 2016/17 and 2017/18
- MRP Statement (in connection with debt repayment)

1.4 The Authority has both 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.

2 External Context

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

2.2 The Bank of England focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Monetary Policy Committee (MPC). Despite two MPC members having voted for a 0.25% increase in rates at each of the meetings August 2014 onwards, some Committee members have become more concerned that the economic outlook is less optimistic than at the time of the August and November *Inflation Reports*.

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

2.4 The continued global economic recovery has led to a general improvement in credit conditions since last year. This is evidenced by a fall in the credit default swap spreads of banks and companies around the world. However, due to the above legislative changes, **the credit risk associated with making unsecured bank deposits will increase** relative to the risk of other investment options available to the Council.

3 Interest rate forecast

3.1 Our treasury management advisor, Arlingclose, currently forecasts the first rise in official interest rates in August 2015 and a gradual pace of increases thereafter, with the average for 2015/16 being around 0.75%. Arlingclose believes the normalised level of the Bank Rate post-crisis to range between 2.5% and 3.5%. The risk to the upside (i.e. interest rates being higher) is ultimately more towards the end of the forecast horizon. On the downside, Eurozone weakness and the threat of deflation have increased the risks to the durability of UK growth. If the negative indicators from the Eurozone become more entrenched, the Bank of England will likely defer rate rises to later in the year. CCLA, one of our money market fund managers recently advised that a consensus "city" view was that Bank Rate would rise very steadily over the next 4-5 years to 1.75-2%. With regard to longer term yields, Arlingclose projects gilt yields on an upward path in the medium term, taking the forecast average 10 year PWLB loan rate for 2015/16 to 3.40%. A key theme of all these forecasts is that there is likely to be short term money available to borrow at low interest rates for the foreseeable future.

3.2 A more detailed economic and interest rate forecast provided by the Arlingclose is attached at ***Appendix A***.

3.3 For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.4%, and that new long-term loans will be borrowed at an average rate of 1%.

4 Local Context

4.1 The Council currently (31 December) has £316.7m of borrowing and £47.8m 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.

<u>Table 1: Balance Sheet Summary and Forecast</u>

	31.3.14 Actual £m	**31.3.15 Estimate £m**	**31.3.16 Estimate £m**	**31.3.17 Estimate £m**	**31.3.18 Estimate £m**
General Fund CFR	208.2	214.0	245.5	262.5	275.0
HRA CFR	194.9	194.2	194.9	192.9	195.0
Total CFR	**403.1**	**408.2**	**439.4**	**455.4**	**460.0**
Less: Other debt liabilities *	-34.0	-33.4	-32.6	-31.9	-31.0
Borrowing CFR	**369.1**	374.8	406.8	423.5	**429.0**
Less: External borrowing **	319.9	**316.7**	**307.2**	**300.7**	294.5
Maximum External Borrowing Requirement	**49.2**	58.1	99.6	122.8	**134.5**
Less: Other Cash Balances (Working capital & reserves)	**83.5**	80.0	75.0	65.0	**60.0**
Cumulative Investments/ New Borrowing Requirement	**-34.3**	**-21.9**	**24.6**	**57.8**	**74.5**

* finance leases and PFI liabilities that form part of the Authority's debt

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

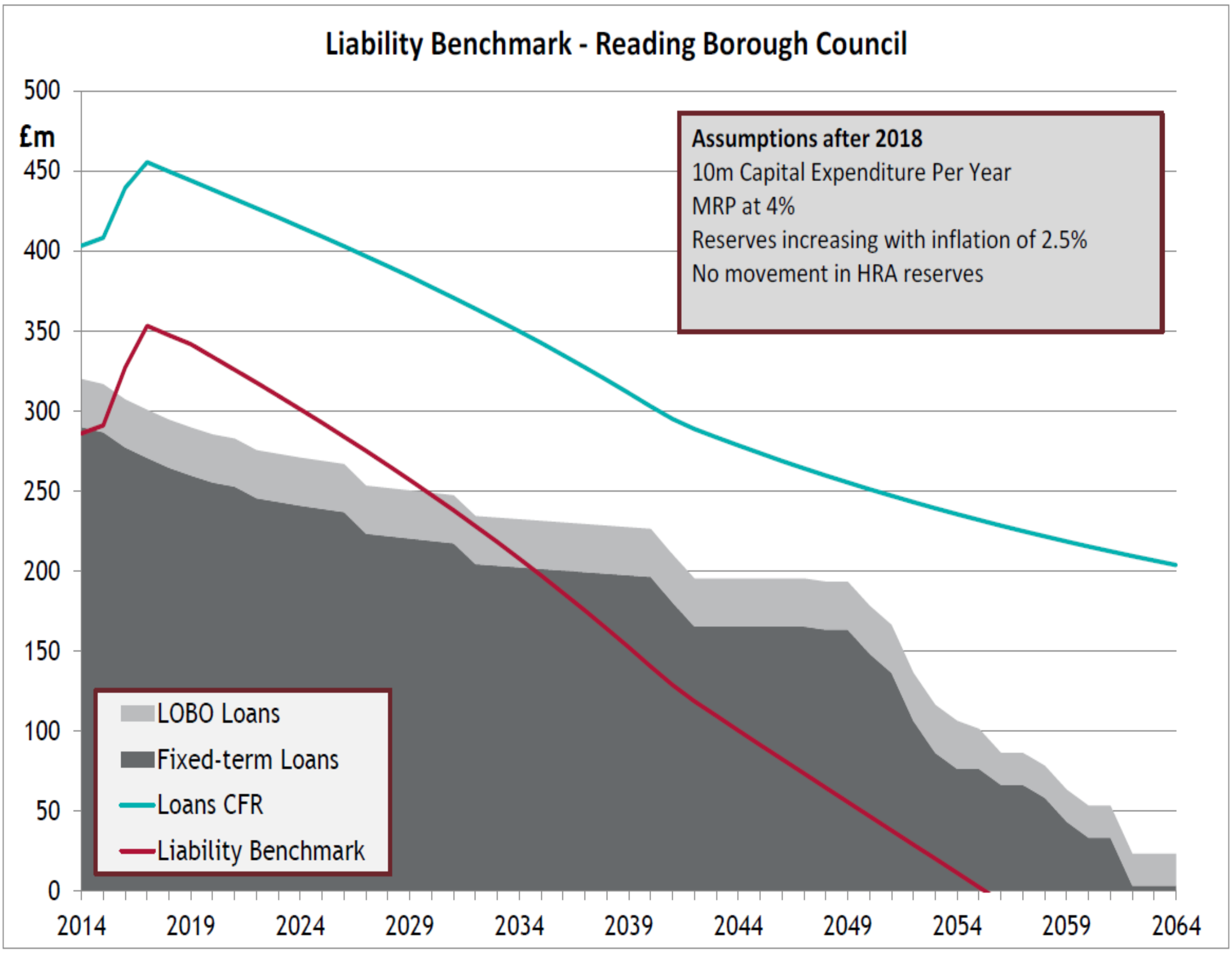
4.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, subject to normally holding a minimum investment balance of currently £10m.

4.3 The Authority has an increasing CFR due to borrowing funding the capital programme and reducing other cash balances, that over time will use up the cash currently invested, and we will need to borrow up to £75m over the forecast period, though at most £25m of this will be required in 2015/16.

4.4 CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Authority expects to comply with this recommendation during 2015/16 and the subsequent years.

4.5 To assist with its long-term treasury management strategy, the Authority and its advisers have created a liability benchmark, which forecasts the Authority's need to borrow over a 50 year period. Following on from the current 3 year capital programme forecasts in table 1 above, the benchmark assumes:

- capital expenditure funded by borrowing as set out in table in Section 2 of Annex C
- minimum revenue provision on new capital expenditure based on an average 25 year asset life
- income, expenditure and reserves all increase by 2.5% inflation a year



4.6 The chart shows that we'll have an increasing borrowing requirement over the next 3-4 years, but after that our borrowing needs will fall. This implies that the borrowing we need to do should be of a relatively short term nature, subject to developments in the interest rate environment.

5 Borrowing Strategy

5.1 The Council currently holds £316.7 million of loans, a decrease of £11.5 million over the last year, reflecting our present strategy for funding the capital programme by using "internal borrowing" and reducing investments. However, the balance sheet forecast in table 1 (and our detailed treasury budget analysis) suggests we will need to borrow up to £25m towards the end of 2015/16. The Council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £400 million.

5.2 Objectives: Our main 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 Authority's long-term plans change is a secondary objective.

5.3 Strategy**:** 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 currently expected to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

5.4 By doing so we are 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 us with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2015/16 with a view to keeping future interest costs low, even if this causes additional costs in the short-term.

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

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

Public Works Loan Board (PWLB)
UK local authorities
any institution approved for investments (see below)
any other bank or building society authorised to operate in the UK
UK public and private sector pension funds
capital market bond investors through the Local Capital Finance Company (the Municipal Bond Agency) and other special purpose companies created to enable local authority bond issues
any other party that establishes a presence in the LA market not covered by the above categories.

5.7 In addition, capital finance may be raised by the following methods that are not borrowing, subject to the Head of Finance being satisfied the use of the method provides value for money to the Council/ These are generally classed as other debt liabilities:

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

5.8 We have previously raised the majority of our long-term borrowing from the PWLB but continue to investigate other sources of finance, such as local authority loans and bank loans, that may be available at more favourable rates.

5.9 **LGA Bond Agency:** In particular we subscribed as one of 37 founding shareholders in the Local Capital Finance Company (LCFC) which was launched last year by the Local Government Association and is expected to be formally established in 2014 as an operating alternative to the PWLB. LCFC plans to issue bonds on the capital markets and lend the proceeds to local authorities. Because LCFC is structured as a company, rather than being a "government agency", borrowing will be slightly more complicated than via the PWLB; borrowing authorities will 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 different lead times, probably initially several weeks between committing to borrow and knowing the exact interest rate payable. As part of our commitment to the launch the Head of Finance has indicated that in principle, and subject to a final consideration at the time we will participate as a smaller borrower in an early bond issue by the Agency. Key issues and progress will be reported to Policy Committee and/or Audit & Governance Committee as appropriate.

5.10 The Authority holds £30m 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 Authority has the option to either accept the new rate or to repay the loan at no additional cost. £25m of these LOBOS have options during 2015/16, and although the Authority understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Authority will take the option to repay LOBO loans at no cost if it has the opportunity to do so. Total borrowing via LOBO loans will be limited to £50m. We also understand that because banking regulation has impacted how banks account for these loans, some LOBO lenders have been approaching local authorities offering early settlement terms. Should such an approach be received we will evaluate it with the assistance of Arlingclose as treasury advisor.

5.11 Short-term and Variable Rate loans: These loans leave the Authority 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.

6 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 Authority 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. The way the PWLB formula works makes this relatively unlikely to be pursued.

7 Investment Strategy

7.1 The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's investment balance has ranged between £34.0m and £74.2 million but lower levels are expected to be maintained in the forthcoming year.

7.2 Objectives: Both the CIPFA Code and the CLG Guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk receiving unsuitably low investment income.

7.3 Strategy: Given the increasing risk and continued low returns from short-term unsecured bank investments, the Council aims to further diversify into more secure and/or higher yielding asset classes during 2015/16. All of the Council's surplus cash is currently invested in short-term unsecured bank deposits, call accounts and money market funds. At the end of 2013/14 our working capital was almost £40m, and whilst this fluctuates during the year, a figure of this magnitude is not unusual. In the circumstances we propose examining the case before 31/3/15 of beginning to invest up to half this sum, i.e. up to £20m that in a longer-term investment, with a 5 year+ view. Initially CCLA's Property Fund, which is an investment vehicle designed solely for collective investments by local authorities in the UK property market, in which an increasing number of authorities have invested over the last 12 months. This diversification will therefore represent a substantial change in our investment strategy over the coming year. The long term performance of such funds has been to yield up to around 5%pa, though with the risk that from time to time the capital value may be eroded in the short term. Such investments will only be undertaken after taking treasury advice from Arlingclose and on the specific authority of the Head of Finance.

Approved Counterparties: The Authority may invest its surplus funds with any of the counterparty types in table 2 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 2: Approved Investment Counterparties and Limits

Counterparty		**Cash limit**	**Time limit †**
Banks and other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:	AAA	£20m each	10 years*
	AA+		5 years*
	AA		4 years*
	AA-		3 years*
	A+		2 years
	A		1 year
	A-		
The Authority's current account bank Lloyds Bank plc should circumstances arise when it does not meet the above criteria		£1m	next day***
UK Central Government (irrespective of credit rating)		unlimited	50 years**
UK Local Authorities (irrespective of credit rating)		£20m each	50 years**
UK Registered Providers of Social Housing whose lowest published long-term credit rating is A- or higher		£5m each	10 years**
UK Registered Providers of Social Housing whose lowest published long-term credit rating is BBB- or higher and those without credit ratings		£2m each	5 years
UK Building Societies without credit ratings		£10m each	1 year
Money market funds and other pooled funds (including the CCLA Property Fund)		Up to £20m each	n/a
Any other organisation, subject to an external credit assessment and specific advice from the Authority's treasury management adviser		£5m each	3 months
		£1m each	1 year
		£100k each	5 years

† the time limit is doubled for investments that are secured on the borrower's assets
* but no longer than 2 years in fixed-term deposits and other illiquid instruments
** but no longer than 5 years in fixed-term deposits and other illiquid instruments

***this category was previously provided to enable overnight urgent lending to the Co-Operative Bank – we do not expect Lloyds Bank to fall into this category.

Table 3: Current Counterparty List as at 31st December 2014

Country/ Domicile	Counterparty	Maximum Counterparty Limit %/£m	Maximum Group Limit (if applicable) %/£m	Maximum Maturity Limit (term deposits and instruments without a secondary market)	Maximum Maturity Limit (negotiable instrument)
UK	Co-operative Bank (for banking & liquidity purposes only)				
UK	Clydesdale Bank (for banking & liquidity purposes only)		10%		
UK	Santander UK Plc (Banco Santander Group)	10		2 years	5 years
UK	Bank of Scotland (Lloyds Banking Group)	20	22.5%	2 years	5 years
UK	Lloyds TSB (Lloyds Banking Group)	20		2 years	5 years
UK	Barclays Bank Plc	20		2 years	5 years
UK	HSBC Bank Plc	20		2 years	5 years
UK	Nationwide Building Society	10		2 years	5 years
UK	NatWest (RBS Group)	0		2 years	5 years
UK	Royal Bank of Scotland (RBS Group)	0		2 years	5 years
UK	Standard Chartered Bank	10		2 years	5 years

2 years is the maximum approved duration for term deposits and illiquid investments (those without a secondary market), although in practice the Authority may be investing on a shorter term basis depending on operational advice of the authority's treasury management adviser.

5 years is the maximum approved duration for negotiable instruments such as Certificates of Deposits, Medium Term Notes and Corporate Bonds, although in practice the Authority may be investing for shorter periods depending on operational advice of the authority's treasury management adviser.

7.4 These tables must be read in conjunction with the notes below

7.5 Credit Rating: Investment decisions are made by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

7.6 Banks and Building Societies ascribed by Arlingclose 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 or BBB- are restricted to overnight deposits at the Authority's current account bank.

7.7 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

7.8 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.

7.9 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.

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

7.11 Pooled Funds**:** Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Money Market Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

7.12 Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority 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 Authority's investment objectives will be monitored regularly.

7.13 Risk Assessment and Credit Ratings: Credit ratings are obtained and monitored by the Authority'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.

7.14 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.

7.15 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 any significant doubts about its credit quality, even though it may meet the normal credit rating criteria for lending.

7.16 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 Authority'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.

7.17 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:
  - 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.

7.18 Non-specified Investments: Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in table 3 below.

Table 4: Non-Specified Investment Limits

	Cash limit
Total long-term investments	Higher of £30m or 30% of total investments
Total investments without credit ratings or rated below A-	Lower of £30m or 40% of total investments
Total investments with institutions domiciled in foreign countries rated below AA+	£0m
Total non-specified investments	£30m

7.19 Investment Limits: The Authority's revenue reserves available to cover investment losses are forecast to be c. £[18] million on 31st March 2015/2016 {forecast from 2014/15 budget report}. In order that no more than 10% 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 normally be £20 million (though the Head of Finance may increase this for very short periods should cash flow and market conditions require a temporary increase. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts (e.g King and Shaxson), foreign countries and industry sectors as below:

Table 5: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£20m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£20m per group
Any group of pooled funds under the same management	£20m per manager
Negotiable instruments held in a broker's nominee account	£5m per broker
Foreign countries	£5m in total
Registered Providers	£5m in total
Unsecured investments with Building Societies	£5m each
Loans to unrated corporates (including loans to small business via a pooled fund)	£5m in total
Money Market Funds	£10m each

8 Liquidity Management

8.1 The Council uses purpose-built (web-based) cash flow forecasting software to help 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 Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Authority's medium term financial plan and cash flow forecast.

9 Treasury Management Indicators

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

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

	Target
Portfolio average credit score	*6.0*

9.2 **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 (above estimated cash flow requirements)	£10m

9.3 **Interest Rate Exposures**: This indicator is set to control the Authority's exposure to interest rate risk. This Authority calculates these limits on net principal outstanding sums, (i.e. fixed rate debt net of fixed rate investments, as percentage of fixed rate debt).

	2015/16	2016/17	2017/18
Upper limit on fixed interest rate exposure	120%	120%	120%
Upper limit on variable interest rate exposure	50%	50%	50%

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.

9.4 **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:

<table>
<tr><th>Maturity Structure of Borrowing</th><th>Upper</th><th>Lower</th></tr>
<tr><td>Under 12 months</td><td>25%</td><td>0%</td></tr>
<tr><td>12 months and within 24 months</td><td>25%</td><td>0%</td></tr>
<tr><td>24 months and within 5 years</td><td>25%</td><td>0%</td></tr>
<tr><td>5 years and within 10 years</td><td>25%</td><td>0%</td></tr>
<tr><td>10 years and within 20 years</td><td>100%</td><td rowspan="5">40%</td></tr>
<tr><td>20 years and within 30 years</td><td>100%</td></tr>
<tr><td>30 years and within 40 years</td><td>100%</td></tr>
<tr><td>40 years and within 50 years</td><td>100%</td></tr>
<tr><td>50 years and above</td><td>100%</td></tr>
</table>

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

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

	2015/16	2016/17	2017/18
Limit on principal invested beyond year end	£20m	£20m	£10m

10 Policy on Use of Financial Derivatives

10.1 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).

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

10.3 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.

11 Policy on Apportioning Interest to the HRA: Reform of the Housing Revenue Account Subsidy system was completed at the end of 2011/12, when we were required to pay DCLG £147.8m. Prior to 2012/13 we were required to recharge interest expenditure and income attributable to the HRA in accordance with Determinations issued by DCLG. The Council has adopted a policy that it will continue to manage its debt as a single pool using the same regime that applied prior to self financing which will set out how interest charges attributable to the HRA will be determined, because self financing did not result in a material change to the average interest rate paid. However, it is intended to review this approach during the course of 2015/16.

11.2 The HRA also has a notional cash balance which may be positive or negative. This balance is measured each month and interest transferred between the General Fund and HRA at the net average rate earned by the Council on its portfolios of treasury investments and short-term borrowing.

11.3 **Investment Training:** The needs of the Authority's treasury management staff for training in investment management are assessed 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. Relevant staff are also encouraged to study professional qualifications from CIPFA, and other appropriate organisations.

11.4 **Investment Advisers:** The Authority has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. We have at least two meetings per annum with Arlingclose, and make contact whenever advice is needed.

11.5 **Investment of Money Borrowed in Advance of Need**: The Authority 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 Authority 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 Authority's overall management of its treasury risks.

11.6 The total amount borrowed will not exceed the authorised borrowing limit of £400 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.

12 Financial Implications

12.1 The estimate for investment income in 2015/16 is £100k, based on an average investment portfolio of at least £25 million at an interest rate of 0.4%. The budget for debt interest paid in 2015/16 is £11.3 million, based on an average debt portfolio of £307 million at an average interest rate of 3.7%. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

13 Other Options Considered

13.1 The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Head of Finance (as Chief Financial Officer), having consulted as necessary, 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 may be higher	Increased risk of losses from credit related defaults, but any such losses may 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
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 and there will be premature repayment costs that are likely to exceed any gain, at least in the short term

Annex A - Arlingclose Economic & Interest Rate Forecast December 2014

Underlying assumptions:

- The UK economic recovery has continued. Household consumption remains a significant driver, but there are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP in 2015.
- We expect consumption growth to slow, given softening housing market activity, the muted outlook for wage growth and slower employment growth. The subdued global environment suggests there is little prospect of significant contribution from external demand.
- Inflationary pressure is currently low (annual CPI is currently 1.3%) and is likely to remain so in the short-term. Despite a correction in the appreciation of sterling against the US dollar, imported inflation remains limited. We expect commodity prices will remain subdued given the weak outlook for global growth.
- The MPC's focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee.
- Nominal earnings growth remains weak and below inflation, despite large falls in unemployment, which poses a dilemma for the MPC. Our view is that spare capacity remains extensive. The levels of part-time, self-employment and underemployment are significant and indicate capacity within the employed workforce, in addition to the still large unemployed pool. Productivity growth can therefore remain weak in the short term without creating undue inflationary pressure.
- However, we also expect employment growth to slow as economic growth decelerates. This is likely to boost productivity, which will bear down on unit labour costs and inflationary pressure.
- In addition to the lack of wage and inflationary pressures, policymakers are evidently concerned about the bleak prospects for the Eurozone. These factors will maintain the dovish stance of the MPC in the medium term.
- The continuing repair of public and private sector balance sheets leave them sensitive to higher interest rates. The MPC clearly believes the appropriate level for Bank Rate for the post-crisis UK economy is significantly lower than the previous norm. We would suggest this is between 2.5 and 3.5%.
- While the ECB is likely to introduce outright QE, fears for the Eurozone are likely to maintain a safe haven bid for UK government debt, keeping gilt yields artificially low in the short term.
- The probability of potential upside risks crystallising have waned a little over the past two months. The primary upside risk is a swifter recovery in the Eurozone.

Forecast:

- We continue to forecast the first rise in official interest rates in Q3 2015; general market sentiment is now close to this forecast. There is momentum in the economy, but inflationary pressure is benign and external risks have increased, reducing the likelihood of immediate monetary tightening.

- We project a slow rise in Bank Rate. The pace of interest rate rises will be gradual and the extent of rises limited; we believe the normalised level of Bank Rate post-crisis to range between 2.5% and 3.5%.

- Market sentiment (derived from forward curves) has shifted significantly lower in the past two months; market expectations are now for a later increase in interest rates and a more muted increase in gilt yields.
- The short run path for gilt yields is flatter due to the deteriorating Eurozone situation. We project gilt yields on an upward path in the medium term.

	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Official Bank Rate													
Upside risk				0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.50**	**1.75**	**1.75**	**1.75**
Downside risk			0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00
3-month LIBID rate													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	**0.60**	**0.75**	**0.90**	**1.05**	**1.20**	**1.35**	**1.50**	**1.60**	**1.70**	**1.80**	**1.90**	**2.00**	**2.10**
Downside risk	0.15	0.20	0.30	0.40	0.55	0.65	0.75	0.85	-0.95	-0.95	-0.95	-0.95	-1.00
1-yr LIBID rate													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	**1.00**	**1.05**	**1.20**	**1.35**	**1.50**	**1.65**	**1.80**	**1.95**	**2.10**	**2.20**	**2.30**	**2.40**	**2.50**
Downside risk	-0.15	-0.20	-0.30	-0.50	-0.55	-0.60	-0.65	-0.70	-0.75	-0.80	-0.80	-0.80	-0.80
5-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	**1.45**	**1.60**	**1.75**	**1.90**	**2.00**	**2.15**	**2.25**	**2.35**	**2.45**	**2.50**	**2.55**	**2.60**	**2.60**
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.60	-0.65	-0.70	-0.70	-0.70	-0.70
10-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	**2.00**	**2.10**	**2.20**	**2.30**	**2.40**	**2.50**	**2.60**	**2.70**	**2.75**	**2.80**	**2.85**	**2.90**	**2.95**
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.55	-0.55	-0.60	-0.60	-0.60	-0.60
20-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	**2.55**	**2.65**	**2.75**	**2.85**	**2.95**	**3.00**	**3.05**	**3.10**	**3.15**	**3.20**	**3.25**	**3.30**	**3.30**
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.50	-0.55	-0.55	-0.60	-0.60	-0.60	-0.60
50-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	**2.65**	**2.70**	**2.80**	**2.90**	**3.00**	**3.05**	**3.10**	**3.15**	**3.20**	**3.25**	**3.30**	**3.55**	**3.60**
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.55	-0.55	-0.60	-0.60	-0.60	-0.60

Annex B - Existing Investment & Debt Portfolio Position

	31/12/14 **Actual Portfolio** **£m**	31/12/14 **Average Rate** **%**
External Borrowing:		
PWLB – Fixed Rate	**281.9**	**3.60**
PWLB – Variable Rate	**4.8**	**0.57**
LOBO Loans	**30.0**	**4.18**
Total External Borrowing	**316.7**	**3.60**
Other Long Term Liabilities:		
PFI	**33.8**	**n/a**
Finance Leases	**1.0**	**n/a**
Total Gross External Debt	**351.5**	**n/a**
Investments:		
Short-term investments	47.8	0.7
Total Investments	**47.8**	**0.7**
Net Debt	**303.7**	**n/a**

Annex C - Prudential Indicators 2015/16

1 Background

The council is required to have regard to the Chartered Institute of Public Finance and Accountancy's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Authority 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: The Authority's planned capital expenditure and financing may be summarised as follows

Capital Expenditure and Financing	**2014/15 Revised £m**	**2015/16 Estimate £m**	**2016/17 Estimate £m**	**2017/18 Estimate £m**
General Fund	59.96	65.51	33.03	13.38
HRA	9.53	13.89	10.87	9.89
Total Expenditure	69.49	79.40	43.90	23.27
Capital Receipts	16.68	13.92	7.87	6.89
Government Grants	32.54	18.09	6.09	5.39
S106	1.87	3.53	1.25	0.75
Borrowing	18.40	43.86	28.69	10.24
Total Financing	69.49	79.40	43.90	23.27

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

Capital Financing Requirement	**31.03.15 Revised £m**	**31.03.16 Estimate £m**	**31.03.17 Estimate £m**	**31.03.18 Estimate £m**
General Fund	214.0	245.5	262.5	275.0
HRA	194.2	194.9	192.9	195.0
Total CFR	408.2	439.4	455.4	460.0

The CFR is forecast to rise by £50m over the next three years as capital expenditure financed by debt exceeds resources put aside for debt repayment.

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

Debt	31.03.15 Revised £m	31.03.16 Estimate £m	31.03.17 Estimate £m	31.03.18 Estimate £m
Borrowing	316.7	326.8	343.5	349
Finance leases	1.0	0.9	0.8	0.7
PFI liabilities	33.7	32.8	31.8	31.0
Total Debt	**351.4**	**360.5**	**376.1**	**380.7**

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

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

Operational Boundary	2014/15 Revised £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Borrowing	390	400	400	400
Other long-term liabilities	40	40	40	40
Total Debt	**430**	**440**	**440**	**440**

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

Authorised Limit	2014/15 Revised £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Borrowing	400	410	410	410
Other long-term liabilities	40	40	40	40
Total Debt	**440**	**450**	**450**	**450**

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

Ratio of Financing Costs to Net Revenue Stream	2014/15 Approved %	2014/15 Revised %	2015/16 Estimate %	2016/17 Estimate %	2017/18 Estimate %
General Fund	9.9	9.3	10.1	12.5	16.5
HRA	26.9	26.3	25.9	25.7	25.3

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

Incremental Impact of Capital Investment Decisions	2014/15 Budget Estimate £	2014/15 Revised Estimate £	2015/16 Estimate £	2016/17 Estimate £	2017/18 Estimate £
Increase in Band D Council Tax (in-year)	11.69	6.81	15.80	10.30	3.65
Increase in Band D Council Tax (on-going)	49.34	28.75	66.57	43.29	15.33
Increase in Average Weekly Housing Rents	0.63	0.35	0.49	0.32	0.32

Annex D – MRP Statement 2015/16

This statement has been revised – the main revision is to move to an "annuity based" MRP system for new capital from 2013/14. Over the life of assets all debt will be repaid, but the annuity method seeks to equalise total financing costs over the asset life with the consequence that generally less debt will be paid off in early years.

1. In 2008/09 and subsequent years identify the general fund adjusted CFR as at 31 March 2008 (excluding the amounts therein in relation to assets under construction) and then apply the 4% reducing balance method to the remaining portion of the CFR in subsequent years. {This continues the practice we had before 2008/09 for historic debt}

2. From 2009/10 where we were able to identify the use of "supported borrowing" we will also apply the CFR (reducing balance) method. {This reflected how supported borrowing was funded at that time in the grant system}

3. For new borrowing from 2008/09 to 2011/12, in respect of asset lives where assets were not funded by borrowing (including assets under construction as at 31 March 2008) we will use an asset life method. We set standard categories of asset life to streamline processes, and these included.

   - major new buildings on Council owned land where a 40-60 year asset life (unless the design life is demonstrably shorter) will be appropriate
   - freehold land – 60 years
   - leasehold land – the life of the lease
   - major extensions to existing buildings, or major remodelling of infrastructure – where a 20-40 year asset life may be more appropriate (according to the design life of the extension/remodelling)
   - major refurbishment of existing buildings – where a 20 year life can reasonably be presumed
   - major transport infrastructure or regeneration schemes (i.e. new roads or major remodelling of junctions) – 30 years (or according to the design life of the infrastructure/regeneration if materially different)
   - other transport capital expenditure – 15 years
   - small items capitalised revenue expenditure – 10 years
   - vehicles, where typically a 5 year life will be reasonable for smaller vehicles; in some cases (e.g. refuse freighters 7-8 years, in line with maintenance contracts) a longer life will be appropriate

   We will keep this categorisation under review

4. The asset life method will be used for assets under construction at 31 March 2008 when they are eventually completed unless we are able to identify that their funding was from "supported" borrowing, in which case the CFR method will be used

5. Where investments are made in financial instruments that score as capital expenditure where the Council expects full repayment, no MRP will be made

6. No new borrowing financed capital expenditure was incurred in 2012/13 and no new "supported" borrowing arose after that time. We changed the approach for borrowing financed assets after that time to an annuity method, using asset lives (largely as

above) and an assumed constant interest rate at the average rate of interest we incurred in the year the expenditure was incurred.

7. From 2013/14 the Council makes an MRP in the HRA of 2% of outstanding HRA debt plus unused "notional" major repairs allowance from the "self-financing" settlement.

8. In addition to MRP determined as above the Council makes MRP in respect of leased and PFI assets that are on balance sheet, which will be equal to the notional debt repayment implicit in the lease/PFI agreement due in each financial year.

Based on the Authority's estimate of its Capital Financing Requirement on 31st March 2015, the estimate for MRP is as follows:

	31.03.2015 Adjusted CFR* £m	**2015/16 Estimated MRP £m**
Capital expenditure before 01.04.2007	68.425	2.737
Capital expenditure after 31.03.2007	101.193	6.066
Finance leases and Private Finance Initiative	33.400	0.300
Total General Fund	**203.02**	**9.103**
Housing Revenue Account	194.227	3.885
Total	**397.25**	**12.988**

*MRP is required to be made on the basis of the adjusted CFR; the adjustment reflected the position at the start of the Prudential System in 2003.The adjustment is a reduction.