

**HAMPSHIRE COUNTY COUNCIL****Decision Report**

<b>Decision Maker:</b>	Audit Committee
<b>Date:</b>	13 February 2014
<b>Title:</b>	Treasury Management Strategy and Investment Strategy 2014/15 to 2016/17
<b>Reference:</b>	5570
<b>Report From:</b>	Director of Corporate Resources - Corporate Services

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## **1 Summary**

- 1.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public Services (the "CIPFA TM Code") and the Prudential Code require authorities to determine the Treasury Management Strategy Statement (TMSS) and Prudential Indicators (PIs) on an annual basis. The TMSS also includes the Annual Investment Strategy (AIS) that is a requirement of the Department for Communities and Local Government's (DCLG) Investment Guidance.
- 1.2 As per the requirements of the Prudential Code, Hampshire County Council adopted the CIPFA Treasury Management Code at its meeting on 18 February 2010. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Guidance.
- 1.3 The purpose of this TMSS is, therefore, to approve:
- Treasury Management Strategy for 2014/15
  - Annual Investment Strategy for 2014/15, including proposals for changes to the investment of the County Council's cash balances to increase the yield earned on investments.
  - Prudential Indicators for 2014/15, 2015/16 and 2016/17 shown in Appendix D
  - Minimum Revenue Provision (MRP) Statement shown in Appendix E
- 1.4 The County Council has potentially large exposures to financial risks through its investment and borrowing activity, including the loss of invested funds and the effect of changing interest rates. The

successful identification, monitoring and control of risk is therefore central to the Council's treasury management strategy.

## **2 Economic Outlook**

- 2.1 The flow of credit to households and businesses is slowly improving but is still below pre-crisis levels. The fall in consumer price inflation (CPI) from the high of 5.2% in September 2011 to the Bank of England's target of 2.0% in December 2013 will allow real wage increases (i.e. after inflation) to slowly turn positive and aid consumer spending.
- 2.2 The Bank of England's Monetary Policy Committee (MPC) through its recent Forward Guidance is committed to keeping interest rates low for an extended period, using the Labour Force Survey unemployment rate of 7% as a threshold for when it would consider whether or not to raise interest rates, subject to certain conditions. Unemployment fell to 7.1% in January 2014.
- 2.3 Stronger growth data in 2013 (0.4% in Q1, 0.7% in Q2 and 0.8% in Q3) alongside a pick-up in property prices mainly stoked by Government initiatives to boost mortgage lending have led markets to price in an earlier rise in interest rates than warranted under Forward Guidance and the broader economic backdrop. The Council's treasury management advisers, Arlingclose, forecast that the MPC will maintain its resolve to keep interest rates at their current level of 0.5% into 2017, until the recovery is convincing and sustainable. A more detailed economic and interest rate forecast provided by Arlingclose is attached in Appendix A.
- 2.4 The credit risk of banking failures has diminished, but not dissipated altogether. Regulatory changes are afoot in the UK (Banking Reform Act 2014), and Europe (EU Bank Recovery and Resolution Directive) to move away from the bank 'bail-outs' of previous years to bank resolution regimes in which shareholders, bond holders and unsecured creditors are 'bailed in' to participate in any recovery process. In the event of a 'bail in' investors funds would be top-sliced to meet the losses of the failing bank and restore it to an acceptable level of financial health, resulting in a capital loss to those investors. This is already manifest in relation to holders of subordinated debt issued by the Co-operative Bank (which the Council does not invest in) whose investment has been partially converted into less valuable equity. As a result, to mitigate the greater risk to bank investments posed by the prospect of 'bail-ins', the County Council will look to reduce the exposure of its cash investments to any individual counterparty, as well as continue to invest in only those institutions that are assessed as lower risk by meeting its credit criteria.

## **3 Balance Sheet Position and Capital Financing Requirement**

- 3.1 As at 31 December 2013 the County Council had £373m of borrowing and £544m of investments. This is set out in further detail at Appendix

B. Forecast changes in these sums are shown in the balance sheet analysis in Table 1 below.

**Table 1: Balance Sheet Summary and Forecast**

	31.3.13 Actual £m	31.3.14 Estimate £m	31.3.15 Estimate £m	31.3.16 Estimate £m	31.3.17 Estimate £m
Capital Financing Requirement	705	761	769	761	739
Less: Other long-term liabilities					
- Street Lighting PFI	-60	-93	-119	-116	-113
- Waste Management Contract	-74	-70	-65	-60	-55
Borrowing CFR	571	598	585	585	571
Less: External borrowing					
- Public Works Loan Board	-306	-296	-281	-270	-248
- Market Loans (LOBOs)	-73	-73	-73	-73	-73
Internal (over) borrowing	192	229	231	242	250
Usable reserves	-419	-404	-401	-410	-420
Working capital	-176	-181	-185	-190	-195
Resources for investments	-595	-585	-586	-600	-615
New borrowing or (investments)	-403	-356	-355	-358	-365

- 3.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. Internal borrowing has the dual advantages of reducing the Council's investment balances exposure to counterparty risk and its cost of carry, the difference between the cost of borrowing and the return on investment if funds are borrowed before they are actually required.
- 3.3 The Council's CFR is forecast to increase in the current and next financial year, in particular as the Street Lighting PFI programme continues to be rolled out. The Council's reserves are forecast to remain stable and therefore the relatively small increase in borrowing CFR (activity that could result in actual borrowing) can be absorbed by the Council's cash balances.
- 3.4 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 2014/15 and the following two years.

## **4 Borrowing Strategy**

- 4.1 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.
- 4.2 The Council currently holds £373m of loans made up of £300m of loans from the Public Works Loan Board (PWLB) and £73m of market loans. These loans were taken between 1989 and 2011, when the Council's cash balances were considerably lower than they are today, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in Table 1 shows that the Council has investment resources that give the option to borrow internally to fund the capital programme, rather than take out new loans.
- 4.3 Internal borrowing has the dual advantages of reducing the County Council's investment balances exposed to counterparty risk and its cost of carry - the difference between the cost of borrowing (currently 4% for a 20 year PWLB maturity loan) and the return on investment (currently less than 1%) if funds are borrowed before they are actually required. Internal borrowing has therefore been the County Council's preferred source of borrowing for a number years and is the strategy for 2014/15 and the coming years in the current interest rate environment.
- 4.4 The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. If the benefits from reducing the internally borrowed position are sufficient then the Council will enter into new long-term borrowing agreements, whilst remaining within its authorised limit for borrowing of £870m.
- 4.5 In addition, the Council may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages. 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.
- 4.6 If long-term borrowing is necessary the County Council will investigate potential sources of finance. The approved sources of long-term and short-term borrowing are:
- Public Works Loan Board
  - UK local authorities
  - any institution approved for investments (see below)
  - any other bank or building society authorised by the Prudential Regulation Council to operate in the UK

- UK public and private sector pension funds (except the Hampshire Pension Fund)
- capital market bond investors
- special purpose companies created to enable joint local Council bond issues.

4.7 **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. There is currently no financial benefit to the Council in using any of its current reserves to repay loans, as the premium that is added by the PWLB to any loans that are repaid is still relatively expensive for the loans in the portfolio in comparison to the returns available from continuing to invest reserves. However, consideration will continue to be given to any advantageous opportunity to reduce or restructure the debt portfolio in the future.

4.8 The County Council's £73m market loans are 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 Authority has the option to either accept the new rate or to repay the loan at no additional cost. In the current interest rate climate it is unlikely that any lender will exercise their options but there remains an element of refinancing risk. The Council will take the option to repay any LOBO loan at no cost if it has the opportunity to do so.

## 5 Investment Strategy – options for higher yielding investments

5.1 The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £447m and £664m, and similar levels are expected to be maintained in the forthcoming year.

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

5.3 The yield that the County Council can achieve from its current investments is decreasing due to the combination of Bank of England's base rate being held at 0.5% and the Government's Funding for Lending Scheme, which is reducing the banks' need to attract investments. The average yield on the County Council's investments as at 31 December 2013 was 0.88%. Options to increase the income that the County Council receives have been considered by the Transformation to 2015 programme, as part of the Council's overall

strategy for managing further reductions in funding over the coming years.

- 5.4 As shown in Table 1 above the County Council's total cash balances are expected to remain relatively stable over the medium term. It is proposed that £90m of the cash balances could be used to target higher returns. This amount has been set at a relatively small percentage of the County Council's total cash balance and based on the stability of the County Council's reserves. The proposed allocations of the cash balances are as follows in order to target an overall 2% return over the next 5 years.

**Table 2: Proposed investment allocation**

Asset class	Indicative allocation	Expected average annual return in the next 5 years
Cash – banks and building societies (less than 1 year)	£220m	1.20%
Cash – other Local Authorities (up to 5 years)	£200m	1.96%
Higher yielding investments	£90m	4.00%
Total/Weighted average	£510m	2.00%

- 5.5 Investments with other local authorities form part of the current Investment Strategy and are usually made for up to 5 years, but the County Council has a total of £15m of investments with three other local authorities made in 2012, which were for up to 24 years at an average rate of 3.94% per annum. These were made on an exceptional basis as part of the business case for the Street Lighting PFI scheme, however further long-term investments (up to 30 years) with other local authorities could be made by the County Council to create a high yielding segment of its portfolio as shown in the table above.

- 5.6 There are a number of advantages for the County Council in making long-term investment with other local authorities:

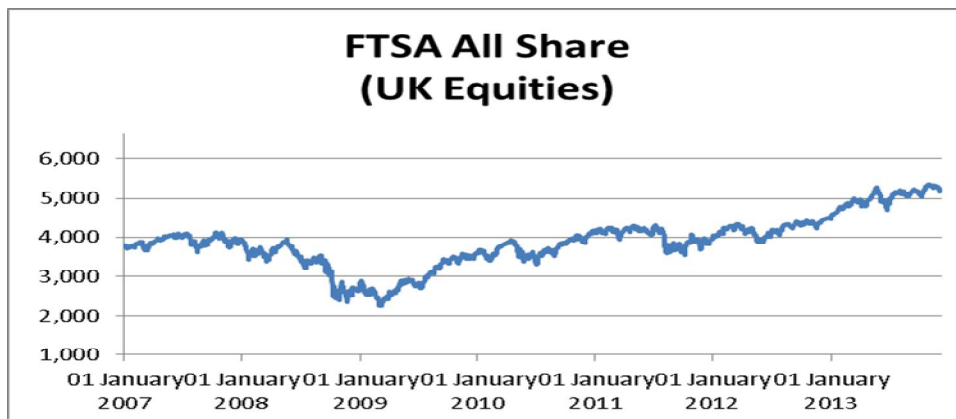
- Security of capital – investors with local authorities are protected by Local Government legislation that allows repayment from future Council Tax revenues if debts or investments are not repaid on time.
- Level of returns – are currently in line with what the County Council would be targeting from high yielding investments of around 4% pa.
- No entry fees.
- Ability to end the arrangements – although the investments can be for a fixed term of up to 30 years, the County Council's treasury management advisor Arlingclose, can broker deals with other local authorities looking to borrow that would have 6 monthly break clauses. This would enable the County Council to recall its funds if they were required, for example if its cash balances fell very

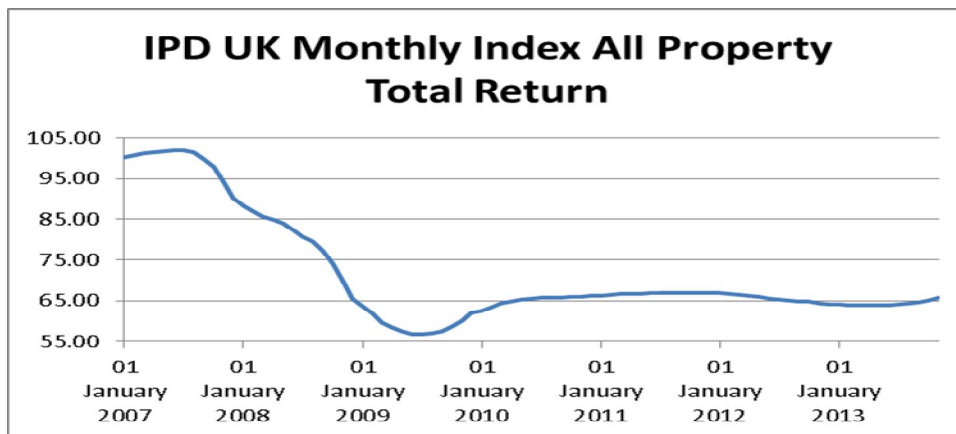
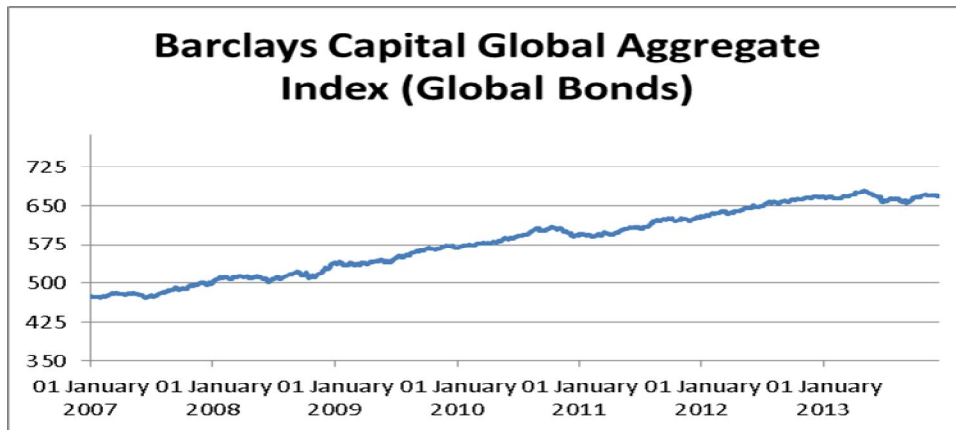
significantly. The County Council would only incur a financial penalty if it recalled the investment and interest rates had changed to the extent that a discount on repayment was due.

5.7 The alternative to further long-term local authority investments as a source of higher yielding investments is investment in other asset classes, such as:

- Property pooled funds – large well established funds that purchase properties with good covenants and long leases linked to Retail Price Inflation (RPI). Property funds should deliver relatively stable annual returns from rental income and offer good diversification from the alternative of equity investments. The only specific disadvantage of these funds is that with one exception of a specific Local Authority fund, these investments would have to be accounted for as capital expenditure and income when the investment is ultimately sold.
- Equity income funds – either UK or Global funds focussing on companies which produce strong income i.e. dividend returns. These funds are likely to underperform general equity market returns but also suffer less volatility in their value.
- Pooled bond funds – funds investing in both corporate and government debt either in the UK or globally. These funds should offer steady income streams from the bond coupons, which whilst generally lower than equity income should also suffer less volatility in their overall value.
- Multi-asset (or Absolute Return) funds – pooled funds investing in a range of asset types including equities, bonds and alternative investments (such as hedge funds). These funds typically aim to pay an annual return to investors and emphasise capital protection.

5.8 All of these asset classes have variable values determined by the markets they are traded on. The graphs below show the changes in index values since 2007 for each of the three main asset classes of equities, bonds and commercial property. The indices are for total returns, both capital growth in the asset's values and income from dividends, interest or rent.





5.9 Each investment within the higher yielding portfolio would be subject to detailed due diligence taken from Arlingclose or similar experts, which could include those advising the Pension Fund, but it is important to be clear about the risks that the new asset classes pose:

- Loss of capital – this would be mitigated by the due diligence in the selection of funds and diversification in the portfolio. However, at any given point, particularly in the short-term, the value of the investment may be less than the amount originally invested. In other words, the County Council would not get all its money back if it wished to redeem in the short-term. In the longer term, it would be hoped that the value of the investment would recover, but there is always the risk that the County Council invests at the ‘wrong time’, i.e. the investment value was at a peak level which it takes a number of years to return to. The graphs above highlight not only the volatility in the values of investments but also the potential that equities and bonds values are at or near a peak and the risk of loss of value is possibly heightened in the short-term.
- Illiquidity – given the variability of capital values and the possibility at any given time the value of the investment may be less than the amount originally invested, these types of investments should generally be held over at least the medium (5 years) and not viewed as a source of short-term liquidity. The amount of funds that could be invested in these type of assets have been set based

on the stability of the County Council's reserves that indicate that these funds can be invested at least for the medium term. The relatively small amount of funds that have been set aside for potential investment in these sorts of assets mean that even if the Council's cash balances were to fall, investments in this portfolio would not have to be sold or recalled at an inopportune time, when the value may be below that which the County Council had invested and would result in a loss.

- Entry and exit fees – there is a bid/offer spread for buying and selling these type of investments, this is particularly significant for property funds where transaction costs (e.g. stamp duty) are high and can be as much as 7%. In practice this mean that the County Council's investment will immediately be worth less than it has paid following its initial investment, and if there is no appreciation in capital values it is likely to take more than a year's income return to recover this loss. There may be the opportunity to minimise the bid/offer spread through buying and selling on the secondary market but opportunities cannot be guaranteed. The bid/offer spread will be taken into account for each investment as part of the due diligence assessment.
- Volatility in returns – but returns can be expected to be much higher than cash investments over at least the medium term.

5.10 In order to generate higher investment returns the preferred option is long-term investments with other local authorities, where the County Council's capital will not be at risk, rather than investing in riskier asset classes, such as equities, bonds and property. This is dependant on being able to find enough local authorities wanting long-term loans, which Arlingclose advise it is reasonable to assume, although this is unproven. If there are not sufficient opportunities to fill the £90m allocation for higher yielding investments with long-term local authority investments, then suitable investments in equities, bonds and property as outlined in this report will be utilised.

## 6 Investment Strategy

6.1 The Council may invest its surplus funds with any of the types of counterparties in Table 3 below, subject to the cash and duration limit shown.

**Table 3: Approved Investment Counterparties**

Counterparty	Cash limit	Time limit
Banks and other organisations whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's meets the Council's minimum rating of A- or equivalent (see Appendix C for the current list)	£80m each	2 years
The Council's current account bank (NatWest) if it fails to meet the above criteria	£70m	Over night

<b>Counterparty</b>	<b>Cash limit</b>	<b>Time limit</b>
UK Central Government (irrespective of credit rating)	unlimited	5 years
UK Local Authorities (irrespective of credit rating)	£40m each	30 years
UK Registered Providers of Social Housing whose lowest published long-term credit rating is A- or higher. Formerly known as Housing Associations, Registered Providers of Social Housing are tightly regulated by the Homes and Communities Agency and retain a high likelihood of receiving government support if needed.	£20m each (no more than 50% of total funds with registered providers)	5 years
Money market funds: These funds are pooled investment vehicles consisting of money market deposits and similar instruments. They have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager.	£30m each (no more than 50% of total funds with MMFs)	n/a
Other pooled funds: pooled bond, equity and property funds that offer enhanced returns over the longer term, but are potentially more volatile in the shorter term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments.	£20m each, £90m in total (no more than 10% of funds total value when investing)	n/a
Any other organisation, subject to an external credit assessment and specific advice from the Council's treasury management adviser	£80m each	2 years

6.2 The counterparty limit for banks and building societies is being reduced from £90m to £80m, which is being set to allow for peaks in the cash balance, such as when Revenue Support Grant is received in April and May. Operationally the amount invested with any individual counterparty will be reduced, through the use of more counterparties that meet the Authority's credit criteria. This will ensure that the Council has a greater level of diversification in its cash investments across a range of creditworthy counterparties, which is increasingly important to mitigate the risk of the loss of the Council's capital in a bank 'bail-in' as banking regulations change as outlined in paragraph 2.4. This reflects a lower likelihood that the UK and other governments will support failing banks as the 'bail-in' provisions in the Banking Reform Act 2014 and the EU Bank Recovery and Resolution Directive are implemented.

6.3 **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 where the Council may demand repayment at any time (with or without notice),
  - callable loans where the borrower may demand repayment at any time, but subject to a maximum of £170m in total,
  - certificates of deposit,
  - bonds, notes, bills, commercial paper and other marketable instruments, and
  - shares in money market funds and other pooled funds.
- 6.4 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. Investments are generally made with mainly UK high-street banks and building societies (shown in Appendix C), which the Council can place investments with directly into call accounts or term deposits. The Council also considers investing in other counterparties, mainly overseas banks (shown in Appendix C), where it can only invest in certificates of deposit. Throughout the coming year counterparties that were previously only accessible via certificates of deposit may accept direct investments, and therefore these distinctions are not fixed.
- 6.5 **Liquidity management:** The Council has due regard for its future cash flows when determining the maximum period for which funds may prudently be committed. Historic cash flows are analysed in addition to significant future cash movements, such as payroll, grant income and council tax precept. Limits on long-term investments are set by reference to the Council's forecast medium term financial position (summarised in Table 1) and forecast short-term cash balances.
- 6.6 **Current Account Bank:** The Council's current account is held with NatWest, which is currently rated at the minimum A- rating in Table 2. Should the credit ratings fall below A- the Council may continue to deposit surplus cash with NatWest providing that investments can be withdrawn on the next working day, and that the bank maintains a credit rating no lower than BBB- (the lowest investment grade rating).
- 6.7 **Risk Assessment and Credit Ratings:** The Council uses long-term credit ratings from the three main rating agencies Fitch Ratings, Moody's Investors Service and Standard & Poor's Financial Services to assess the risk of investment default. The lowest available counterparty credit rating will be used to determine credit quality, unless an investment-specific rating is available. Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:
- no new investments will be made,
  - any existing investments that can be recalled or sold at no cost will

be, and

- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.
- 6.8 Where a credit rating agency announces that a A- rating is on review for possible downgrade (also known as “rating watch negative” or “credit watch negative”) so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.
- 6.9 **Other Information on the Security of Investments:** It is accepted 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.
- 6.10 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, Treasury Bills or Gilts 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.
- 6.11 The current list of approved counterparties and current duration limits for investments is shown in Appendix C. It is recommended that authority is delegated to the Director of Corporate Resources to manage the Council’s investments according to the risk assessment process outlined above and to amend the list of approved counterparties, cash limit and duration limit (up to the maximum cash limit and duration outlined in this Strategy) as appropriate to most effectively manage the Council’s investments.
- 6.12 **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 Council, parish council or community council, or
  - a body or investment scheme of “high credit quality”.

6.13 **Non-specified Investments:** Any investment not meeting the definition of a specified investment is classed as non-specified. The Council defines ‘high credit quality’ organisations as those having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher. The Council does not intend to make any investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in Table 4 below.

**Table 4: Non-Specified Investment Limits**

	<b>Cash limit</b>
Total long-term investments	£250m
Total investments without credit ratings or rated below A- (excluding investments with other local authorities)	£170m
Total non-Sterling investments	£0m
Total investments in foreign countries rated below AA+	£0m
Total non-specified investments	£420m

## 7 Treasury Management Indicators

7.1 **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. This limit has been increased in line with the proposal to make long-term investments with other local authorities to increase the yield from the investment portfolio. The limits on the total principal sum invested to final maturities beyond the period end will be:

	<b>2014/15</b>	<b>2015/16</b>	<b>2016/17</b>
Limit on principal invested beyond year end	£250m	£250m	£250m

7.2 **Interest Rate Exposures:** This indicator is set to control the Council’s exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the principal borrowed or

invested will be:

	2014/15	2015/16	2016/17
Upper limit on fixed interest rate investment exposure	£250m	£250m	£250m
Upper limit on variable interest rate investment exposure	£750m	£750m	£750m
Upper limit on fixed interest rate borrowing exposure	£810m	£800m	£770m
Upper limit on variable interest rate borrowing exposure	£810m	£800m	£770m

7.3 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, therefore the limit for fixed interest rate exposure is in line with the limit for investment beyond the 2014/15 year-end. The limits for exposure to fixed and variable rate borrowing have been set to give the Council maximum flexibility in the event of debt rescheduling.

7.4 **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	75%	0%
20 years and within 30 years	75%	0%
30 years and above	100%	0%

## 8 Other Items

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

8.2 **Use of Financial Derivatives:** 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 will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

8.3 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. The use of financial derivatives is not planned as part of the implementation of the Treasury Management Strategy and any changes to this would be reported to members in the first instance.

- 8.4 **Investment Training:** The needs of the Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.
- 8.5 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.
- 8.6 CIPFA's Code of Practice requires that the Council ensures that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities. Members of the Finance and General Purposes Committee were invited to a workshop presented by Arlingclose on 19 November 2013, which gave an update on treasury matters.
- 8.7 **Investment Advisers:** The Council has appointed Arlingclose as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled through quarterly review meetings with the Director of Corporate Resources and her staff and Arlingclose.
- 8.8 **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 £870m.

## 9 Recommendation

- 9.1 The Audit Committee are asked to note the following recommendations that are being reported to Cabinet and Full Council:
- Treasury Management Strategy and Annual Investment Strategy for 2014/15, (and for the rest of 2013/14) including:
  - Prudential Indicators for 2014/15, 2015/16 and 2016/17 – Appendix D

- Minimum Revenue Provision (MRP) Statement – Appendix E
- That authority is delegated to the Director of Corporate Resources to manage the Council’s investments according to the risk assessment process in the Investment Strategy and to amend the list of approved counterparties, cash limit and duration limit (up to the maximum cash limit and duration outlined in this Strategy) as appropriate to most effectively manage the Council’s investments.

**CORPORATE OR LEGAL INFORMATION:****Links to the Corporate Strategy**

<b>This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision for Cabinet to note the mid-year review of treasury management activities.</b>
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**Other Significant Links****Links to previous Member decisions:**

<u>Title</u>	<u>Reference</u>	<u>Date</u>

**Direct links to specific legislation or Government Directives**

<u>Title</u>	<u>Date</u>

**Section 100 D - Local Government Act 1972 - background documents**

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

DocumentLocation

None

**IMPACT ASSESSMENTS:**

**1. Equalities Impact Assessment:**

- 1.1. Equality objectives are not considered to be adversely affected by the proposals in this report.

**2. Impact on Crime and Disorder:**

- 2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

**3. Climate Change:**

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

## Appendix A – Arlingclose Economic & Interest Rate Forecast December 2013

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

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

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

## Appendix B – Existing Investment & Debt Portfolio Position

	31.12.2013 Actual Portfolio £m	31.12.2013 Average Rate %
External Borrowing:		
PWLB – Fixed Rate	300	
Other Loans	73	
<b>Total External Borrowing</b>	<b>373</b>	<b>4.93</b>
Other Long Term Liabilities:		
Street Lighting PFI	93	
Waste Management Contract	70	
<b>Total Gross External Debt</b>	<b>536</b>	<b>-</b>
Investments:		
Direct Deposits (banks and building society)	343	0.79
Certificates of Deposit	0	-
Money Market Funds	5	0.45
Other Local Authorities	181	0.83
Other Local Authorities (PFI savings)	15	3.94
<b>Total Investments</b>	<b>544</b>	<b>0.96</b>
<b>Net Investments</b>	<b>8</b>	<b>-</b>

## Appendix C – Current approved counterparty list and duration limits

Moody's	Long-term credit rating		Country/ Domicile	Counterparty	Maximum Duration
	FITCH	S&P			
Direct deposits (e.g. call accounts, term or notice deposits)					
A2	A	A	UK	Barclays Bank	12 months
Aa3	AA-	AA-	UK	HSBC Bank	12 months
A2	A	A	UK	Nationwide Building Society	12 months
Aa3	AA-	AA-	Sweden	Svenska Handelsbanken	12 months
A2	A	A	UK	Lloyds TSB	6 months
A3	A	-	UK	Close Brothers	100 days
Aa3	AA-	AA-	UK	Goldman Sachs International Bank	100 days
A3	A-	-	UK	Leeds Building Society	100 days
A3	A	A-	UK	NatWest	overnight
A2	A	A	UK	Santander UK	overnight
Certificates of deposit					
A1	AA-	AA-	UK	Standard Chartered	12 months
Aa2	AA-	AA-	Australia	Australia and NZ Banking Group	12 months
Aa2	AA-	AA-	Australia	Commonwealth Bank of Australia	12 months
Aa2	AA-	AA-	Australia	National Australia Bank	12 months
Aa2	AA-	AA-	Australia	Westpac Banking Corp	12 months
Aa3	AA-	A+	Canada	Bank of Montreal	12 months
Aa2	AA-	A+	Canada	Bank of Nova Scotia	12 months
Aa3	AA-	A+	Canada	Canadian Imperial Bank of Commerce	12 months
Aa3	AA	AA-	Canada	Royal Bank of Canada	12 months
Aa1	AA-	AA-	Canada	Toronto-Dominion Bank	12 months
Aa3	AA-	AA-	Finland	Nordea Bank Finland	12 months
A2	A+	A	Germany	Deutsche Bank AG	12 months
Aaa	AAA	AAA	Netherlands	Bank Nederlandse Gemeenten	12 months
Aa2	AA-	AA-	Netherlands	Rabobank	12 months
Aa3	A+	A+	US	JP Morgan Chase Bank	12 months
Aa3	A+	AA-	Finland	Pohjola Bank	6 months
Aa1	AA-	AA-	Singapore	DBS	6 months
Aa1	AA-	AA-	Singapore	Oversea Chinese Banking Corporation	6 months
Aa1	AA-	AA-	Singapore	United Overseas Bank	6 months
A2	A+	A	Germany	Landesbank Hessen-Thuringen	100 days
A2	A+	A+	Netherlands	ING Bank	100 days
A1	A	A	Switzerland	Credit Suisse	100 days

	Long-term credit rating			Country/ Domicile	Counterparty	Maximum Duration
	Moody's	FITCH	S&P			
A2	A+	A+	France*	BNP Paribas	Suspended	
A2	A	A	France*	Credit Agricole CIB/SA	Suspended	
A2	A	A	France*	Societe Generale	Suspended	

\* Investing with French Banks is currently suspended as France does not currently meet the minimum sovereign rating of AA-

## Appendix D - Prudential Indicators 2014/15

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

**Estimates of Capital Expenditure:** The Council's planned capital expenditure and financing may be summarised as follows.

<b>Capital Expenditure and Financing</b>	<b>2013/14 Revised £m</b>	<b>2014/15 Estimate £m</b>	<b>2015/16 Estimate £m</b>	<b>2016/17 Estimate £m</b>
<b>Total Expenditure</b>	<b>222</b>	<b>284</b>	<b>218</b>	<b>166</b>
Capital receipts	14	8	14	6
Government Grants	63	114	96	92
Capital reserve	9	41	18	1
Revenue contributions	26	29	29	28
Capital contributions (from other bodies)	18	31	31	21
Contributions from reserves	6	19	4	5
<b>Total Financing</b>	<b>136</b>	<b>242</b>	<b>192</b>	<b>153</b>
Supported borrowing	30	4	0	0
Prudential borrowing	21	9	26	13
Finance lease	35	29	0	0
<b>Total Funding</b>	<b>86</b>	<b>42</b>	<b>26</b>	<b>13</b>
<b>Total Financing and Funding</b>	<b>222</b>	<b>284</b>	<b>218</b>	<b>166</b>

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

	31.03.14 Revised £m	31.03.15 Estimate £m	31.03.16 Estimate £m	31.03.17 Estimate £m
Capital Financing Requirement	769	761	739	717

The CFR is forecast to increase over the coming years before falling as capital expenditure financed by debt is matched by the resources put aside for debt repayment.

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

	31.03.14 Revised £m	31.03.15 Estimate £m	31.03.16 Estimate £m	31.03.17 Estimate £m
Debt				
Borrowing	369	351	343	321
Finance leases	163	184	176	168
<b>Total Debt</b>	<b>532</b>	<b>535</b>	<b>519</b>	<b>489</b>

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

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

Operational Boundary	2013/14 Revised £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Borrowing	630	620	620	600
Other long-term liabilities	170	190	180	170
<b>Total Debt</b>	<b>800</b>	<b>810</b>	<b>800</b>	<b>770</b>

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

Authorised Limit	2013/14 Revised £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Borrowing	660	640	640	630
Other long-term liabilities	210	230	220	210
<b>Total Debt</b>	<b>870</b>	<b>870</b>	<b>860</b>	<b>840</b>

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

Ratio of Financing Costs to Net Revenue Stream	2013/14 Revised	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
General Fund	7.58%	7.53%	7.40%	7.30%

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

Incremental Impact of Capital Investment Decisions	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
General Fund - increase in annual band D Council Tax	£1.41	£3.30	£4.09

**Adoption of the CIPFA Treasury Management Code:** The Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition on 18 February 2010

## **Appendix E – Annual Minimum Revenue Provision Statement 2014/15**

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 since 2008. The Local Government Act 2003 requires the Council to have regard to the [Department for Communities and Local Government's Guidance on Minimum Revenue Provision (the DCLG Guidance) most recently issued in 2012.

The broad aim of the DCLG 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.

The DCLG 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. The four MRP options available are:

- Option 1: Regulatory Method
- Option 2: CFR Method
- Option 3: Asset Life Method
- Option 4: Depreciation Method

*NB This does not preclude other prudent methods.*

**MRP in 2014/15:** Options 1 and 2 may be used only for supported (i.e. financing costs deemed to be supported through Revenue Support Grant from Central Government) capital expenditure funded from borrowing. Methods of making prudent provision for unsupported capital expenditure include Options 3 and 4 (which may also be used for supported capital expenditure if the Council chooses).

The Council will apply Option 1/Option 2 in respect of supported capital expenditure funded from borrowing and Option 3/Option 4 in respect of unsupported capital expenditure funded from borrowing.

MRP in respect of leases and Private Finance Initiative schemes brought on Balance Sheet under the International Financial Reporting Standards (IFRS) based Accounting Code of Practice will match the annual principal repayment for the associated deferred liability.

Capital expenditure incurred during 2014/15 will not be subject to a MRP charge until 2015/16