DECISION-MAKER:	AUDIT COMMITTEE COUNCIL
SUBJECT:	TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL LIMITS 2012/13 to 2014/15
DATE OF DECISION:	26 JANUARY 2012 15 FEBRUARY 2012
REPORT OF:	HEAD OF FINANCE (CHIEF FINANCIAL OFFICER)
STATEMENT OF CONFIDENTIALITY	
NOT APPLICABLE	

BRIEF SUMMARY

This report explains the context within which the Council's treasury management activity operates and sets out a proposed strategy for the coming year in relation to the Council's cash flow, investment and borrowing, and the management of the numerous risks related to this activity.

The core elements of the 2012/13 strategy are :

- To continue to make use of short term variable rate debt to take advantage of the current market conditions of low interest rates.
- To constantly review longer term forecasts and to lock in to longer term rates through a variety of instruments, as appropriate during the year, in order to provide a balanced portfolio against interest rate risk.
- To secure the best short term rates for borrowing and investments consistent with maintaining flexibility and liquidity within the portfolio.
- To invest surplus funds prudently, the Council's priorities being:
    - Security of invested capital
    - Liquidity of invested capital
    - An optimum yield which is commensurate with security and liquidity.
- To approve borrowing limits that provide for debt restructuring opportunities and to pursue debt restructuring where appropriate and within the Council's risk boundaries

With overall annual expenditure in excess of £600M and an extensive capital programme, the Council is required to actively manage its cash-flows on a daily basis. The requirement to invest or to borrow monies to finance capital programmes, and to cover daily operational needs, is an integral part of daily cash and investment portfolio management. As at 31 March 2012 the Council's loan portfolio is expected to be £324M and the total value of investments is forecast at £50M. The Balance Sheet position as at 31 March 2011 showed the value of debt as £226M and the value of investments as £36M. The main reason for the increase in debt is due to the housing reform detailed below.

The Council's Capital Financing Requirement (CFR), which measures the Council's underlying need to borrow for capital purposes and represents the cumulative capital expenditure that has not yet been financed, is a key driver of borrowing strategy.

Reform of the housing subsidy system has had a major impact on the Housing Revenue Account (HRA) element of the CFR and will require the Council to take on additional debt currently estimated at £75.5M to fund a one off settlement to central government in return for abolishing the annual subsidy payment. The projected CFR for 31 March 2012 is £444M, of which £265M is attributed to the General Fund and the remaining £179M to the HRA.

The Council's current strategy is to minimise borrowing to below its CFR, the difference representing balances, reserves, provisions and working capital. This approach lowers interest costs and reduces credit risk and relieves pressure on the Council's counterparty list. Borrowing is restricted to a few highly secure sources. These include: the Public Works Loan Board (PWLB), commercial banks, the European Investment Bank, structured finance, and products associated with other local authorities. Additionally, borrowing is restricted by two limits: the Authorised Limit, a statutory limit that sets the maximum level of external borrowing on a gross basis, and the Operational Boundary, which is determined by both the estimated CFR and day to day cash flow movements. For 2012/13 the proposed Authorised Limit is £911M and proposed Operational Boundary is £869M. These are substantially higher than our actual level of debt but they allow for a full debt restructure to be undertaken if an appropriate opportunity arises.

Throughout the year, capital expenditure levels, market conditions and interest rate levels are monitored to minimise borrowing costs over the medium to longer term and to maintain stability. The differential between debt costs and investment earnings continues to be acute, resulting in the use of internal resources in lieu of borrowing often being the most cost effective means of financing capital expenditure. An additional strand of the strategy is to actively monitor opportunities arising for debt rescheduling in order to deliver savings in interest costs but with minimal risk, and to balance the ratio of fixed rate to variable rate debt within the portfolio.

In order to service the Council's day to day cash needs, the Council maintains a portfolio of short term investments. The Council's investment priorities are: the security of invested capital, the liquidity of invested capital, and the optimum yield that is commensurate with security and liquidity, in that order. The report details the Council's investment strategy, explains the institutions (counterparties) with whom the Council is permitted to invest, the limits related to the size of individual investments and the overall holding with institutions. In the annual review of this strategy several amendments to the investment options have been suggested. These include: the addition of Corporate Bonds, the addition of a new counterparty; Bank Nederlandese Gemeenten and a reduction in our minimum credit rating from A+ to A- to allow the Council to continue investing with the main UK banks that are deemed systemically important to the UK economy.

As a result of continued pressure and uncertainty within the financial markets, the security of any investment is the key consideration in decision making and a cautious approach will always be adopted. Whilst this report identifies all permitted options in investment decision making, tighter controls govern daily activity limiting the number of counterparties with whom investments will be placed and the value of the total holding with any single institution. Regular monitoring of all institutions on the counterparty list is part of daily treasury management. In any period of significant stress in the markets, the default position will be to invest with the governments Debt Management Office (DMO).

The impact of interest rates is crucial to all treasury management activity and forecasts of interest rate movements are taken into account in developing treasury management strategy. Consequently, this strategy is kept under review and, taking market information into account, will be realigned, if required, in line with evolving market conditions and expectations for future interest rates.

In November 2011 CIPFA revised its Treasury Management Code of Practice and these amendments have been incorporated within the strategy and additionally a revised Treasury Management Policy Statement issued.

RECOMMENDATIONS:

AUDIT COMMITTEE

It is recommended that Audit Committee:

(i) Endorse the Treasury Management Strategy for 2012/13 as outlined in the report.

(ii) Note that the indicators as reported have been set on the assumption that the recommendations in the Capital Update report will be approved. Should the recommendations change, the Prudential Indicators may have to be recalculated.

(iii) Note that due to the early timing of this report, changes may still be required following the finalisation of capital and revenue budgets and therefore any significant changes to this report will be highlighted in the final version that is presented to Full Council.

COUNCIL

It is recommended that Council:

(i) Approve the Council's Treasury Management (TM) Strategy and Prudential Indicators for 2012/13, 2013/14 and 2014/15, as detailed within the report; and note and agree in particular the lowering of the minimum credit rating, as recommended by our advisors, from A+ to A- (as detailed in paragraph 32).

(ii) Approve the 2012 MRP Statement (as detailed in paragraph 47)

(iii) Approve the Annual Investment Strategy (as detailed in paragraphs 26-45)

(iv) Approve the adoption of the revised Treasury Management Code of Practice & Guidance notes and subsequent amendments (as detailed in paragraph 64)

(v) Note that at the time of writing this report the recommendations in the Capital Programme Update report, submitted to Council on the 15 February 2012, have not yet been approved. The indicators in the report are based on the assumption that they will be approved, but should the recommendations change, the Prudential Indicators may have to be recalculated

(vi) Continue to delegate authority to the Chief Financial Officer (CFO), following consultation with the Cabinet Member for Resources, Leisure and Culture, to approve any changes to the Prudential Indicators or borrowing limits that will aid good treasury management.

For example, an increase in the percentage for variable rate borrowing to take advantage of the depressed market for short term rates. Any amendments will be reported as part of quarterly financial and performance monitoring and in revisions to the TM Strategy.

(vii) Note the continued use of the Interest Equalisation Reserve, the creation of which was approved to help to manage the impact on annual budget decisions of volatility and the ultimate increase in interest rates which will be felt when the Council locks back into long term fixed rates. The Reserve will be maintained at an appropriate level and savings arising from lower than anticipated interest rates be added to the equalisation reserve to further protect the Council from future increase in debt charges where it is prudent to do so.

REASONS FOR REPORT RECOMMENDATIONS

1. In order to comply with Part 1 of the Local Government Act 2003, and the established treasury management procedures that have been adopted by the Authority, each year the Council must set certain borrowing limits and approve a treasury management strategy which includes:

- Treasury Management Strategy for 2012/13 – Borrowing; paragraphs 18-22, Debt Rescheduling; paragraphs 23-25, Investments; paragraphs 26-45.
- MRP Statement – Paragraph 47.
- Prudential Indicators – Paragraphs 53-74. (Note that the Authorised Limit is a statutory limit).
- Use of Specified and Non-Specified Investments – Paragraphs 27-34.

ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

2. Alternative options for borrowing would depend on decisions taken on the review of the capital programme, which are being taken at Full Council on 15 February 2012.

DETAIL (Including consultation carried out)

CONSULTATION

3. The proposed Capital Programme Update report on which this report is based has been subject to separate consultation processes.

BACKGROUND

4. The Local Government Act 2003 introduced a system for borrowing based largely on self-regulation by local authorities themselves. The basic principle of the new system is that local authorities will be free to borrow as long as their

capital spending plans are affordable, prudent and sustainable.

5. 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 local authorities to determine a Treasury Management Strategy Statement (TMSS) and Prudential Indicators on an annual basis. The TMSS also incorporates the Annual Investment Strategy (AIS), as required under the Investment Guidance issued by the Department for Communities and Local Government's (CLG).

6. Treasury Management is about the management of risk. The Authority is responsible for its treasury decisions and activity. No treasury management activity is without risk. The successful identification, monitoring and control of risk is the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the Council. The main risks to the Council's treasury activities are:

   - Liquidity Risk (Inadequate cash resources)
   - Market or Interest Rate Risk (Fluctuations in interest rate levels and thereby in the value of investments).
   - Inflation Risks (Exposure to inflation)
   - Credit and Counterparty Risk (Security of Investments)
   - Refinancing Risks (Impact of debt maturing in future years).

   Legal & Regulatory Risk (i.e. non-compliance with statutory and regulatory requirements, risk of fraud).

7. The purpose of this TMSS is to allow Council to approve:

   - Treasury Management Strategy for 2012/13
   - Prudential Indicators for 2012/13, 2013/14 and 2014/15
   - 2012 MRP Statement
   - Annual Investment Strategy 2012/13
   - Adoption of the revised Treasury Management Code of Practice & Guidance notes and subsequent amendments

8. The strategy takes into account the impact of the Council's Revenue Budget and Capital Programme on the Balance Sheet position, the Prudential Indicators and the current and projected Treasury position (Appendix 1). The outlook for interest rates (Appendix 2) has also been taken into account in developing this strategy

9. The Council acknowledges that effective TM will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in TM, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management. To aid the Council in carrying out its TM function, it has appointed TM Advisors (Arlingclose), who advise the Council on strategy and provide market information to aid decision making. However it should be noted that the decisions are taken independently by the CFO taking into account

this advice and other internal and external factors.

10. The CIPFA TM Code was revised in November 2011 and as per requirements of the Prudential Code and Council are asked to approve the adoption of the revised code.

11. All treasury activity will comply with relevant statue, guidance and accounting standards.

BALANCE SHEET AND TREASURY POSITION

12. The underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) together with Balances and Reserves are the core drivers of Treasury Management Activity.

13. The Authority's current level of debt and investments is set out at Appendix 1.

14. The Authority is able to borrow funds in excess of the current level of its CFR up to the projected level in 2014/15. The Authority is likely to only borrow in advance of need if it felt the benefits of borrowing at interest rates now compared to where they are expected to be in the future, outweighs the current cost and risks associated with investing the proceeds until the borrowing was actually required.

15. The forecasted movement in the CFR in coming years is one of the Prudential Indicators (PIs). The movement in actual external debt and usable reserves combine to identify the Authority's borrowing requirement and potential investment strategy in the current and future years. This shows that the capital expenditure plans of the Authority cannot be funded entirely from sources other than external borrowing.

	2011/12 Estimate £M	**2012/13 Estimate £M**	**2013/14 Estimate £M**	**2014/15 Estimate £M**
General Fund CFR	**265**	**265**	**264**	**264**
Housing CFR**	**179**	**176**	**176**	**177**
Total CFR	**444**	**441**	**440**	**441**
Less: Existing Profile of Borrowing and Other Long Term Liabilities	393	416	409	404
Cumulative Maximum External Borrowing Requirement	**51**	**25**	**31**	**37**
Balances & Reserves	36	21	17	15
Cumulative Net Borrowing Requirement / (Investments)	**15**	**4**	**14**	**22**

***This figure reflects the increase resulting from Housing Reform*

The existing profile of borrowing and other long term liabilities does not include potential LOBO (Lender's Option Borrower's Option) loan maturities which may or may not occur. All of the LOBO loans are currently in their call state

REFORM TO THE COUNCIL HOUSING SUBSIDY SYSTEM

16. The Council housing self-financing reforms involve the removal of the housing subsidy system by transferring a one-off allocation of national housing debt in return for the retention in the future of all rental income that is currently pooled under the subsidy regime. Settlement date is 28 March 2012 and will result in the Council increasing it's debt by the sum of £75.5M to fund the currently estimated settlement figure of £75.5M in return for the cessation of the annual subsidy payment to central government that currently amounts to £6.5M per annum.

The Council has the option of borrowing externally from the PWLB or the market and, in conjunction with treasury advisors, considered a mix of financial instruments to spread Treasury risks. In a departure from current Treasury practice this portfolio will be entirely ring-fenced to the HRA and hence eliminate any potential liability on the General Fund through complex statutory recharging methodologies.

On the 20 September 2011, HM Treasury announced the PWLB rates offered to local authorities would be temporarily reduced to allow councils to borrow at lower levels for their one-off HRA reform settlement payment. This will enable the Council to borrow at around 0.13% above the equivalent gilt yield (current borrowing rates are 1% above the gilt yield) to fund the HRA transaction. These lower rates will be available on 26 March 2012 only. Although various sources of borrowing will be considered, it is likely that due to the temporary reduction, all HRA reform financing will be sourced from the PWLB, utilising fixed rate loans with varying maturities. The current forecast interest rate for this borrowing is 4% and this has been built into the HRA business plan.

In order to monitor how the HRA is managing its debt portfolio a new prudential indicators (paragraph 74) has been introduced which shows how the actual and estimated debt compares to the Indicative Debt Cap which is a limit set as part of the housing determination. This limit of HRA indebtedness has been set at £201M for 2012/13 and the following two years.

OUTLOOK FOR INTEREST RATES

17. The economic interest rate outlook provided by the Council's treasury advisor, Arlingclose, is attached at Appendix 2, and indicates that rates are likely to remain lower for longer. The Council also monitors other sources of market information and will reappraise its strategy from time to time and, if required, realign it with evolving market conditions and expectations for future interest rates.

BORROWING STRATEGY

18. Treasury management and borrowing strategies in particular, continue to be influenced not only by the absolute level of borrowing rates but also the relationship between short and long term interest rates. The interest rate forecast provided in Appendix 2 indicates that an acute difference between short and longer term interest rates is expected to continue.

This difference creates a “cost of carry” for any new longer term borrowing where the proceeds are temporarily held as investments because of the difference between what is paid on the borrowing and what is earned on the investment. Whilst the cost of carry can be assumed to be a reasonably short-term issue since borrowing is often for longer dated periods (anything up to 50 years) it cannot be ignored against a backdrop of uncertainty and affordability constraints in the Authority’s wider financial position

As indicated in the table in paragraph 15, the Authority has a gross and net borrowing requirement and will be required to borrow up to £25M in 2012/13. The Authority will adopt a flexible approach to this borrowing in consultation with its treasury management advisers. The following issues will be considered prior to undertaking any external borrowing:

- Affordability;
- Maturity profile of existing debt;
- Interest rate and refinancing risk;
- Borrowing source.

Sources of Borrowing and Portfolio implications

19. In conjunction with advice from its treasury advisor, the Authority will keep under review the following borrowing sources:

- PWLB
- Local authorities
- Commercial banks
- European Investment Bank
- Money markets
- Capital markets (stock issues, commercial paper and bills)
- Structured finance
- Leasing

20. The cost of carry has resulted in an increased reliance upon shorter dated and variable rate borrowing. This type of borrowing injects volatility into the debt portfolio in terms of interest rate risk but is counterbalanced by its affordability and alignment of borrowing costs with investment returns. The Authority’s exposure to shorter dated and variable rate borrowing is kept under regular review by reference to the difference or spread between variable rate and longer term borrowing costs. A narrowing in the spread by 0.5% between the variable rate and the 30 year fixed maturity will result in an immediate and formal review of the borrowing strategy to determine whether the exposure to shorter dated and variable rates is maintained or altered.

21. The Council has exposed itself to interest rate risk by taking out variable debt. This was and continues to be very financially favourable in current markets but does mean that the Council must monitor markets to ensure it is not caught out. During 2012/13 the Council will continue to review and take action as necessary to lessen this risk through a balanced combination of :-

- longer term fixed maturity loans,
- medium term Equal Instalment of Principle (EIP) loans which are currently cheaper than longer term fixed,
- longer term PWLB variable loans which have the option to be fixed at very short notice for a small fee and
- variable rate investments to take advantage of increasing interest rates, mainly through the use of money market funds (MMF).

In order to mitigate these risks further, the Council approved the creation of an Interest Equalisation Reserve in 2009. At that point a major debt restructuring exercise was undertaken in order to take advantage of market conditions and produce net revenue savings. In achieving this, the Council has exposed itself to short term variable interest rate risk and whilst in the current climate of low interest rates this remains a sound strategy, at some point when the market starts to move, the Council will need to act quickly to lock into fixed long term rates which may be at similar levels to the debt it restructured. Furthermore, the volatility in the financial markets means that interest costs and investment income will continue to fluctuate for some time.

It was therefore recommended that an Interest Equalisation Reserve be created to help to manage volatility in the future and ensure that there was minimal impact on annual budget decisions or council tax in any single year. The Reserve will be maintained at an appropriate level and savings arising from lower than anticipated interest rates be added to the equalisation reserve to further protect the Council from future increase in debt charges where it is prudent to do so.

22. The Authority has £9M exposure to LOBO loans all of which can be “called” within 2012/13. A LOBO is called when the Lender exercises their right to amend the interest rate on the loan at which point the Borrower can accept the revised terms or reject them and repay the loan. LOBO loans present a potential refinancing risk to the Authority since the decision to call a LOBO is entirely at the lender’s discretion.

Any LOBOs called will be discussed with the treasury advisers prior to acceptance of any revised terms. The default position will be the repayment of the LOBO without penalty i.e. the revised terms will not be accepted.

DEBT RESCHEDULING

23. The Authority’s debt portfolio can be restructured by prematurely repaying loans and refinancing them on similar or different terms to achieve a reduction in risk and/or savings in interest costs.

24. The lower interest rate environment and changes in the rules regarding the premature repayment of PWLB loans has adversely affected the scope to undertaken meaningful debt restructuring although occasional opportunities arise. The rationale for undertaking any debt rescheduling would be one or more of the following:

    - Savings in risk adjusted interest costs
    - Rebalancing the interest rate structure of the debt portfolio

- Changing the maturity profile of the debt portfolio

25. Borrowing and rescheduling activity will be reported to the Audit Committee in the Annual Treasury Management Report and a mid year update. Regular treasury management reports will also be presented as part of quarterly monitoring to Cabinet.

INVESTMENT POLICY AND STRATEGY

26. Guidance from CLG on Local Government Investments in England requires that an Annual Investment Strategy (AIS) be set. The Council's investment priorities are:

- Security of the invested capital;
- Liquidity of the invested capital;
- An optimum yield which is commensurate with security and liquidity

27. Investments are categorised as 'Specified' or 'Non Specified' investments based on the criteria in the CLG Guidance. Specified investments are sterling denominated investments with a maximum maturity of one year. T hey also meet the "high credit quality" as determined by the Authority and are not deemed capital expenditure investments under Statute. Non specified investments are, effectively, everything else.

Potential instruments for the Council's use within its investment strategy are detailed below.

Investment	Specified	Non-Specified
Term deposits with banks and building societies	✓	✓
Term deposits with other UK local authorities	✓	✓
Certificates of deposit with banks and building societies	✓	✓
Gilts	✓	✓
Treasury Bills (T-Bills)	✓	×
Bonds issued by Multilateral Development Banks	✓	✓
Local Authority Bills	✓	×
Commercial Paper	✓	×
Corporate Bonds	✓	✓
AAA rated Money Market Funds	✓	×
Other Money Market and Collective Investment Schemes	✓	✓
Debt Management Account Deposit Facility	✓	×

28. The (CFO), under delegated powers, will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. Decisions taken on the core investment portfolio will be reported quarterly to Cabinet.

29. Credit markets remain in a state of distress as a result of the excessive and poor performing debt within the financial markets. In a number of countries the extent and implications of the debt they have built up has led to a sovereign debt crisis resulting in Standard & Poor's rating agency, lowering the long-term ratings on nine Eurozone Sovereigns. It is against this backdrop of uncertainty that the Authority's investment strategy is framed.

30. A number of changes have been implemented to the investment strategy for 2012/13 in response to changes in the CLG Guidance and evolving conditions in financial markets. This results in the inclusion of corporate bonds which the CLG have indicated will become an eligible non-capital investment from 1 April 2012. However, the principal amendments are in relation to the individual institutions with which the Authority is prepared to lend its funds.

31. The Authority and its advisors, Arlingclose Ltd, select countries and financial institutions after analysis and ongoing monitoring of:

- Published credit ratings for financial institutions (minimum long term rating of A- or equivalent for counterparties; AA+ or equivalent for non-UK sovereigns)
- Credit Default Swaps (where quoted)
- Economic fundamentals (for example Net Debt as a percentage of GDP)
- Sovereign support mechanisms
- Share Prices
- Corporate developments, news, articles, markets sentiment and momentum
- Subjective overlay – or, put more simply, common sense.

Any institution can be suspended or removed should any of the factors identified above give rise to concern.

32. As reported in the Quarter 2 monitoring report to Cabinet, the rating agencies undertook a systematic review of UK Banking Institutes which was completed in October 2011 and resulted in a downgrading of long-term ratings of a number of counterparties on the Council's lending list. The downgrades did not represent deterioration in the financial strength of the UK government or the banking system but reflected the fact that the government is now more likely to allow smaller institutions to fail if they get into financial difficulty. As a result the Council now only has two counterparties which meet our current criteria of A+ who are actively in the market to take local authority investments.

33. In order to provide a pragmatic framework to allow flexibility throughout the financial year and to allow the Council to continue investing with the main UK banks that are deemed systemically important to the UK economy, our advisors have recommended that the minimum credit rating should be reduced to A-.

Although there is no absolute guarantee there remains an implied level of government support for these banks as a number are deemed Globally Systemically Important Financial Institutions (G-SIFI). The countries and institutions that will meet the revised criteria for term deposits, Certificates of Deposit (CDs) and call accounts are included in Appendix 3.

34. It remains the Authority's policy to make exceptions to counterparty policy established around credit ratings, but this is conditional and directional. What this means is that an institution that meets criteria may be suspended, but institutions not meeting criteria will not be added.

35. The Authority banks with the Co-Operative Bank which at the current time does not meet the revised minimum credit criteria of A- (or equivalent) long term. The Co-Operative Bank current rating sits one notch below the revised criteria and has a stable outlook. However, few of the banks which meet our criteria are actively in the tendering process for local authority banking and it is a costly and complicated process. With this in mind, despite the credit rating being below the Authority's minimum criteria, it will continue to be used for short term liquidity requirements (overnight and weekend investments) and business continuity arrangements.

<u>Investment Strategy</u>

36. With short term interest rates forecast to be low for even longer, an investment strategy will typically result in a lengthening of investment periods, where cash flow permits, in order to lock in higher rates of acceptable risk adjusted returns. The problem in the current environment is finding an investment counterparty providing acceptable levels of counterparty risk.

37. In order to diversify an investment portfolio largely invested in cash, investments will be placed with a range of approved investment counterparties in order to achieve a diversified portfolio of prudent counterparties, investment periods and rates of return. Maximum investment levels with each counterparty will be set to ensure prudent diversification is achieved.

38. Money market funds (MMFs) will be utilised, but good treasury management practice prevails and whilst MMFs provide good diversification the Authority will also seek to diversify any exposure by utilising more than one MMF. The Authority will also restrict its exposure to MMFs with lower levels of funds under management and will not exceed 0.5% of the net asset value of the MMF. Where MMF's participate, the Council utilises the facilities of a MMF portal to make subscriptions and redemptions. The portal procedure involves the use of a clearing agent however the Council's funds are ring fenced throughout the process.

39. The Council's current level of investments is presented at Appendix 1.

40. The Council's in-house investments are made with reference to the outlook for the UK Bank Rate and money market rates.

41. In any period of significant stress in the markets, the default position is for investments to be made with the DMO or in UK Treasury Bills. Rates of interest available are below equivalent money market rates, but the returns are an acceptable trade-off for the guaranteed security of the Council's capital.

42. The UK Bank Rate has been maintained at 0.5% since March 2009, and is anticipated to remain at low levels throughout 2012/13. Short term money market rates are likely to remain at very low levels for an extended period, which will have a significant impact on investment income and which has been reflected in the budget forecast.

Collective Investment Schemes (Pooled Funds)

43. The Council has evaluated the use of Pooled Funds and determined the appropriateness of their use within the investment portfolio. Pooled funds enable the Council to diversify the assets and the underlying risk in the investment portfolio and provide the potential for enhanced returns. Any investment in pooled funds will be regularly monitored for both performance and to ensure their continued suitability in meeting the Council's investment objectives.

The Use of Financial Instruments for the Management of Risks

44. Investments which constitute capital expenditure: Investments meeting the definition of capital expenditure can be financed from capital or revenue resources. They are also subject to the CLG's Guidance on "non-specified investments". Placing of such investments has accounting, financing and budgetary implications. Whilst it is permissible to fund capital investments by increasing the underlying need to borrow, it should be noted that under the CLG's Minimum Revenue Provision (MRP) Guidance, MRP should be applied over a 20 year period. The Council has determined that it is not currently prudent to make investments which constitute capital expenditure. These would presently need to be sourced from revenue and therefore the requirement for MRP would make the investment not viable.

45. The use of financial instruments for the management of risks: Currently, Local Authorities' legal power to use derivative instruments remains unclear. The General Power of Competence enshrined in the Localism Act is not sufficiently explicit. Consequently, the authority does not intend to use derivatives. Should this position change, the Council may seek to develop a detailed and robust risk management framework governing the use of derivatives, but this change in strategy will require full Council approval.

BALANCED BUDGET REQUIREMENT

46. The Council complies with the provisions of S32 of the Local Government Finance Act 1992 to set a balanced budget.

2012/13 MRP STATEMENT

47. The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI 2008/414) place a duty on local authorities to make a prudent provision for debt redemption.

Guidance on MRP has been issued by the Secretary of State. Local authorities are required to “have regard” to such Guidance under section 21(1A) of the Local Government Act 2003.

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 to provide for the repayment of debt principal.*

MRP in 2012/13: Option 1 and 2 will be used for the majority of General Fund historic debt particularly that deemed to be supported through the Revenue Support Grant. For major projects where capital expenditure is funded from prudential borrowing Option 3 will be used to provide MRP over the life of the asset to which the borrowing was applied.

Following the HRA self-financing settlement, HRA debt will increase from £104M to £179M with a borrowing cap of £201M. It is proposed that the HRA will make provision within its business plan to show that it can pay down this debt over the life of the 30 year business plan.

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.

If it is ever proposed to vary the terms of the original MRP Statement during the year, a revised statement would be put to Full Council at that time.

MONITORING AND REPORTING ON THE ANNUAL TREASURY OUTTURN AND PRUDENTIAL INDICATORS

48. The Chief Financial Officer will report to the Audit Committee on treasury management activity / performance as follows:

    (a) A mid year review against the strategy approved for the year.

    (b) An outturn report on its treasury activity, no later than 30 September after the financial year end.

49. In addition, a quarterly update will be presented to Cabinet as part of Quarterly Revenue Financial Monitoring.

REVISION TO THE CIPFA TREASURY MANAGEMENT CODE OF PRACTICE AND GUIDANCE NOTES

50. CIPFA revised the TM Code and associated Guidance Notes in November 2011. This revision is an update to the TM Code and Guidance Notes last published in November 2009 and approved by Council in February 2010. The TM Code has been reviewed and updated following recent developments and the regulatory changes relating to the Localism Act 2011, including housing finance reform and the introduction of the General Power of Competence.

Below are the principle changes to the code:

- The Council must explicitly state in their TMSS whether they plan to use derivative instruments to manage risks, and ensure they have the legal power to do so. (Paragraph 45).
- The Council will need to make reference to their high level approach to borrowing and investment in their Treasury Management Policy Statement. (See Appendix 4 for the revised Treasury Management Policy Statement)
- Less focus has been placed on the 'minimum credit limits' for investment counterparties, with more focus on the 'minimum acceptable credit quality. (Paragraphs 31-32).
- New treasury indicator: Upper limits on the proportion of net debt to gross debt; to highlight where an authority may be borrowing in advance of its cash requirement. (Paragraph 65).
- The Council may wish to create a new treasury indicator which considers credit risk. (Paragraph 69-72).
- Expansion of the risk management chapter (paragraphs 69 -72).
- New Section in the TM Code Guidance Notes on the 'Treasury Management Implications of the Housing Self-Financing Reform. (Paragraph 16).

<u>TRAINING</u>

51. CIPFA's revised Code requires the CFO to ensure 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. Member training was last undertaken on the 12 January 2012 and it is the intention to rerun this later in the year. The Council adopts a continuous performance and development programme to ensure staff is regularly appraised and any training needs addressed. Treasury staff also attend regular training sessions, seminars and workshops which ensure their knowledge is up to date and relevant. Details of training received are maintained as part of the performance and development process.

<u>INVESTMENT CONSULTANTS</u>

52. The CLG's Guidance on local government investments recommend that the Investment Strategy should state:

- Whether and, if so, how the Authority uses external contractors offering information, advice or assistance relating to investment and
- How the quality of any such service is controlled.

The Council has a contract in place with Arlingclose to provide a treasury advisory service, which details the agreed schedule of services. Performance is measured against the schedule of services to ensure the services being provided are in line with the agreement.

However it should be noted that the decisions are taken independently by the CFO taking into account this advice and other internal and external factors.

PRUDENTIAL INDICATORS

Background

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

Net Borrowing and the Capital Financing Requirement

54. This is a key indicator of prudence. In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that the net external borrowing does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional increases to the CFR for the current and next two financial years.

The CFO reports that the Authority had no difficulty meeting this requirement in 2011/12, nor are there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

There is a significant difference between the gross external borrowing requirement and the net external borrowing requirement represented by the Council’s level of balances, reserves, provisions and working capital. The Council’s current strategy is only to borrow to the level of its net borrowing requirement. The reasons for this are to reduce credit risk, take pressure off the Council’s lending list and also to avoid the cost of carry existing in the current interest rate environment

Estimates of Capital Expenditure

55. It is a requirement of the Prudential Code to ensure that capital expenditure remains within sustainable limits and, in particular, to consider the impact on council tax and in the case of the HRA, housing rent levels.

Capital Expenditure	**2011/12 Approved £000's**	**2011/12 Revised £000's**	**2012/13 Estimate £000's**	**2013/14 Estimate £000's**	**2014/15 Estimate £000's**
General Fund	69,426	81,678	54,334	15,349	468
HRA	25,892	25,742	31,493	32,632	34,506
Total	**95,318**	**107,420**	**85,827**	**47,981**	**34,974**

Capital expenditure is expected to be financed as follows:

Capital Financing	2011/12 Approved £000's	2011/12 Revised £000's	2012/13 Estimate £000's	2013/14 Estimate £000's	2014/15 Estimate £000's
Capital receipts	11,676	8,107	21,187	10,852	2,720
Government Grants	36,998	52,110	19,950	6,009	468
Revenue contributions	7,371	6,928	4,774	584	117
Major Repairs Allowance	13,096	13,096	17,172	17,388	17,718
Revenue	15,579	12,015	13,301	3,374	7,321
Total Financing	**84,720**	**92,256**	**76,384**	**38,207**	**28,344**
Supported borrowing	0	0	0	0	0
Unsupported borrowing	10,598	15,164	9,443	9,774	6,630
Total Funding	**10,598**	**15,164**	**9,443**	**9,774**	**6,630**
Total Financing & Funding	**95,318**	**107,420**	**85,827**	**47,981**	**34,974**

Ratio of Financing Costs to Net Revenue Stream

56. 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 borrowing costs. The ratio is based on costs net of investment income. The upper limit for this ratio is currently set at 10% to allow for known borrowing decision in the next two years and to allow for additional borrowing affecting major schemes. The table below shows the likely position based on the proposed capital programme. The table below indicates that HRA will go above this as a result of the HRA debt buyout but these costs have been built into their 30 year business plan. The overall indicator is well within the 10% limit.

Ratio of Financing Costs to Net Revenue Stream	2011/12 Approved %	2011/12 Revised %	2012/13 Estimate %	2013/14 Estimate %	2014/15 Estimate %
General Fund	7.09%	5.51%	4.27%	3.62%	2.92%
HRA	5.75%	5.52%	10.92%	11.05%	10.84%
Total	7.49%	6.73%	8.25%	8.47%	8.47%

Capital Financing Requirement (CFR)

57. The CFR measures the Council's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and its' financing.

Capital Financing Requirement	2011/12 Approved £M	2011/12 Revised £M	2012/13 Estimate £M	2013/14 Estimate £M	2014/15 Estimate £M
General Fund	255	265	265	264	264
HRA	106	179	176	176	177
Total CFR	**361**	**444**	**441**	**440**	**441**

The year–on-year change in the CFR is due to the following:

Capital Financing Requirement	2011/12 Approved £M	2011/12 Forecast £M	2012/13 Estimate £M	2013/14 Estimate £M	2014/15 Estimate £M
Balance B/F	**360**	**361**	**444**	**441**	**440**
Capital expenditure financed from borrowing	11	19	15	18	15
HRA debt buyout & principal repayments		75	(8)	(8)	(6)
Revenue provision for debt Redemption.	(8)	(7)	(8)	(7)	(6)
Movement in Other Long Term Liabilities	(2)	(4)	(2)	(4)	(2)
Cumulative Maximum External Borrowing Requirement	**361**	**444**	**441**	**440**	**441**

Actual External Debt

58. This indicator is obtained directly from the Council's balance sheet. It is the closing balance for actual gross borrowing plus other long-term liabilities. This Indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

Actual External Debt as at 31/03/2011	£ £000's
Borrowing	225,803
Other Long-term Liabilities	71,722
Total	**297,525**

Incremental Impact of Capital Investment Decisions

59. This indicator is intended to estimate the impact of capital investment decisions on the council tax and rent levels in future years. It compares what the capital financing costs are expected to be with the current approved capital programmes (i.e. the programmes approved in September 2011) with what the capital financing costs are estimated to be if the capital reports proposed elsewhere on the agenda are approved. It is intended to show how the decision to approve the new programme will impact in future years i.e. what the effect of any new borrowing will be on council tax and housing rents. (Much of the increase over the 3 years is as a result of adding the 2013/14 schemes to the capital programme and additional unsupported borrowing).

60. For the HRA, the reality is that the rent levels are set under the Government's rent restructuring formula, which is independent of the level of capital investment and borrowing. The calculation of the indicator ignores this factor. The incremental impact of capital investments decisions are estimated to be:

Incremental Impact of Capital Investment Decisions	2011/12 Approved £	2012/13 Estimate £	2013/14 Estimate £	2014/15 Estimate £
Increase in Band D Council Tax	6.76	2.94	3.29	4.34
Increase in Average Weekly Housing	17.03	(2.41)	2.53	(12.71)

Authorised Limit and Operational Boundary for External Debt

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

62. The ***Authorised Limit*** sets the maximum level of external borrowing on a gross basis (i.e. not net of investments) for the Council. It is measured on a daily basis against all external borrowing items on the Balance Sheet (i.e. long and short term borrowing, overdrawn bank balances and long term liabilities). This Prudential Indicator separately identifies borrowing from other long term liabilities such as finance leases. It is consistent with the Council's existing commitments, its proposals for capital expenditure and financing and its approved treasury management policy statement and practices.

The Authorised Limit has been set on the estimate of the most likely, prudent but not worst case scenario with sufficient headroom over and above this to allow for unusual cash movements, for example a complete debt restructure which requires monies to be borrowed in advance of repayment of existing debt. The Authorised Limit is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit).

Authorised Limit for External Debt	2011/12 Approved £000's	2011/12 Revised £000's	2012/13 Estimate £000's	2013/14 Estimate £000's	2014/15 Estimate £000's
Borrowing	486	696	832	852	840
Other Long-term Liabilities	77	79	79	81	86
Total	**563**	**775**	**911**	**933**	**926**

The limit from 2012/13 have been increased to accommodate the increased debt taken on as a result of Housing Subsidy Reform; there was no need to revise the existing limit as there is sufficient headroom to accommodate the additional £75.5m.

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

Operational Boundary for External Debt	2011/12 Approved £000's	2011/12 Revised £000's	2012/13 Estimate £000's	2013/14 Estimate £000's	2014/15 Estimate £000's
Borrowing	471	665	794	813	802
Other Long-term Liabilities	71	75	75	78	82
Total	**542**	**740**	**869**	**891**	**884**

The CFO has delegated authority, within the above limits for any individual year, to effect movement between the separately agreed limits for borrowing and other long term liabilities. Decisions will be based on the outcome of financial option appraisals and best value considerations. Council will be notified of any use of this delegated authority

Adoption of the CIPFA Treasury Management Code

64. This indicator demonstrates that the Council has adopted the principles of best practice and all subsequent updates as detailed in paragraph 52.

The Council approved the adoption of the CIPFA Treasury Management Code at its Council meeting on 19th February 2003.

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

Gross and Net Debt

65. This is a new indicator which was intended to highlight a situation where the Council is planning to borrow in advance of need. However in its current format it does not work as intended and our advisors have been in contact with CIPFA who have just confirmed that until further formal guidance is issued, local authorities should still include this indicator within their Treasury Strategies but state on what basis it has been drawn up. We have completed the indicator on the expected position at year end and have included internal borrowing in the gross debt figure.

Gross and Net Debt	**2011/12 Estimate £M**	**2012/13 Estimate £M**	**2013/14 Estimate £M**	**2014/15 Estimate £M**
Outstanding Borrowing (at nominal Value) inc of internal borrowing	409	439	423	416
Other Long-term Liabilities (at nominal value)	79	79	81	86
Gross Debt	**488**	**518**	**504**	**502**
Less Investments	**50**	**33**	**33**	**33**
Net Debt	**438**	**485**	**471**	**469**

Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

66. The following Prudential Indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. The upper limit for variable rate exposure has been set to ensure that the Council is not exposed to interest rate rises, which could adversely impact on the revenue budget. The limit allows for the use of variable rate debt to offset exposure to changes in short term rates on investments.

	Existing level at 31/12/2011 %	2011/12 Approved %	2012/13 Estimate %	2013/14 Estimate %	2014/15 Estimate %
Upper Limit for Fixed Interest Rate Exposure	100	100	100	100	100
Upper Limit for Variable Interest Rate Exposure	50	50	50	50	50

The Council will also limit and monitor large concentrations of fixed rate debt needing to be replaced. The limits provide the necessary flexibility within which decisions will be made for drawing down new loans on a fixed or variable rate basis; the decisions will ultimately be determined by expectations of anticipated interest rate movements as set out in the Council's TM strategy. As all LOBO are now in their call options they have been included as under 12 months within this indicator.

Maturity Structure of Fixed Rate borrowing

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

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

	Lower Limit %	Upper Limit %	Actual Fixed Debt as at 31/12/2011 £000's	Average Fixed Rate as at 31/12/2011 %	Fixed Rate as at 31/12/2011 %	Compliance with set Limits?
Under 12 months	0	45	15,504	1.03	7.69	Yes
12 months and within 24 months	0	45	5,000	4.08	2.48	Yes
24 months and within 5 years	0	50	9,000	2.78	4.47	Yes
5 years and within 10 years	0	75	106,981	3.23	53.10	Yes
10 years and within 20 years	0	75	0	0.00	0.00	Yes
20 years and within 30 years	0	75	10,000	4.68	4.96	Yes
30 years and within 40 years	0	75	30,000	4.62	14.89	Yes
40 years and within 50 years	0	75	25,000	3.89	12.41	Yes
50 years and above	0	100	0	0.00	0.00	Yes
			201,484	**3.45%**	**100.00**	

Credit Risk

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

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

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

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

72. The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms. Our advisors collate quarterly investment information across their client base, (approximately 93 Local Government clients) and present in a graphical format how we compare with regards to counterparty credit quality and maturity of investments, this will be presented as part of quarterly monitoring to demonstrate our relative performance.

<u>Upper Limit for total principal sums invested over 364 days</u>

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

Upper Limit for total principal sums invested over 364 days	2011/12 Approved £M	2011/12 Revised £M	2012/13 Estimate £M	2013/14 Estimate £M	2014/15 Estimate £M
	50	50	50	50	50

<u>HRA Limit on Indebtedness</u>

74. Local authorities are required to report the level of the HRA CFR compared to the level of debt which is imposed (or subsequently amended) by the DCLG at the time of implementation of self – financing.

HRA Limit on Indebtedness	2011/12 Revised £m	2012/13 Estimate £m	2013/14 Estimate £m	2014/15 Estimate £m
HRA Debt Cap (as prescribed by CLG) *	201.3	201.3	201.3	201.3
HRA CFR	179.3	175.5	176.2	177.4
Difference	22.0	25.8	25.1	23.9

**N.B. This may change following the final determinations due out at the end of January 2012.*

RESOURCE IMPLICATIONS

Capital

75. The Capital implications are considered as part of the General Fund Capital Programme report and HRA Capital Programme report elsewhere on the Council agenda.

Revenue

76. The Revenue implications are considered as part of the General Fund Revenue Budget report and HRA Revenue Budget report elsewhere on the Council agenda.

Property/Other

77. None

LEGAL IMPLICATIONS

Statutory Power to undertake the proposals in the report:

78. Local Authority borrowing is regulated by Part 1, of the Local Government Act 2003, which introduced the new Prudential Capital Finance System. From 1 April 2004, investments are dealt with, not in secondary legislation, but through guidance. Similarly, there is guidance on prudent investment practice, issued by the Secretary of State under Section 15(1)(a) of the 2003 Act. A local authority has the power to invest for "any purpose relevant to its functions under any enactment or for the purposes of the prudent management of its financial affairs". The reference to the "prudent management of its financial affairs" is included to cover investments, which are not directly linked to identifiable statutory functions but are simply made in the course of treasury management. This also allows the temporary investment of funds borrowed for the purpose of expenditure in the reasonably near future; however, the speculative procedure of borrowing purely in order to invest and make a return remains unlawful.

Other Legal Implications:

79. None

POLICY FRAMEWORK IMPLICATIONS

80. This report has been prepared in accordance with CIPFA's Code of Practice on Treasury Management

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SUPPORTING DOCUMENTATION

Non-confidential appendices are in the Members' Rooms and can be accessed on-line

Appendices

1.	Existing Portfolio Projected forward
2.	Economic and Interest Outlook
3.	Recommended Sovereign and Counterpart List
4.	Treasury Management Policy Statement

Documents In Members' Rooms

1.	
2.	

Integrated Impact Assessment

Do the implications/subject/recommendations in the report require an Integrated Impact Assessment to be carried out.	No

Other Background Documents

Title of Background Paper(s)		Relevant Paragraph of the Access to Information Procedure Rules / Schedule 12A allowing document to be Exempt/Confidential (if applicable)
1.	ANNUAL TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL LIMITS 2011/12 TO 2013/14 – Council 16 February 2011	
2.		

Integrated Impact Assessment and Other Background documents available for inspection at:

WARDS/COMMUNITIES AFFECTED:	