COUNCIL - 20TH FEBRUARY 2014

THE PRUDENTIAL CODE FOR CAPITAL FINANCE IN LOCAL AUTHORITIES – SETTING OF PRUDENTIAL INDICATORS 2013/14 – 2016/17 AND TREASURY MANAGEMENT STRATEGY 2014/15-16/17

Hinckley & Bosworth Borough Council

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REPORT OF THE DEPUTY CHIEF EXECUTIVE (CORPORATE DIRECTION)

WARDS AFFECTED: ALL WARDS

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1. PURPOSE OF REPORT

This report outlines the Council's prudential indicators for 2013/14 - 2016/17 and sets out the expected treasury operations for this period. It fulfils four key legislative requirements:

- The reporting of the **prudential indicators,** setting out the expected capital activities (as required by the CIPFA Prudential Code for Capital Finance in Local Authorities - Section A). The treasury management prudential indicators are now included as treasury indicators in the CIPFA Treasury Management Code of Practice;

- The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year (as required by Regulation under the Local Government and Public Involvement in Health Act 2007 - also Section A);

- The **treasury management strategy statement** which sets out how the Council's treasury service will support the capital decisions taken above, the day to day treasury management and the limitations on activity through treasury prudential indicators. The key indicator is the **Authorised Limit**, the maximum amount of debt the Council could afford in the short term, but which would not be sustainable in the longer term. This is the Affordable Borrowing Limit required by s3 of the Local Government Act 2003. This is in accordance with the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code and shown at Section B;

- The **investment strategy** which sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss. This strategy is in accordance with the CLG Investment Guidance and also shown in Section B.

The above policies and parameters provide an approved framework within which the officers undertake the day to day capital and treasury activities.

2. RECOMMENDATIONS

Members approve the key elements of these reports:

1. The Prudential Indicators and Limits for 2013/14 to 2016/17 contained within Section C of the report, including the Authorised Limit Prudential Indicator.

2. The Minimum Revenue Provision (MRP) Statement contained within Section 3 Part B which sets out the Council's policy on MRP.

3. The Treasury Management Strategy 2013/14 to 2016/17, and the Treasury Prudential Indicators contained within Section C.

4. The Investment Strategy contained in the Treasury Management Mtrategy and the detailed strategy in Appendix 1.

3. BACKGROUND TO THE REPORT

A) The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

CIPFA defines treasury management as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

B) The Capital Prudential Indicators 2013/14 - 2016/17

Introduction

1. The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, reflecting the outcome of the Council's underlying capital appraisal systems.

   The Council's capital expenditure plans are the key driver of treasury management activity. Financing of capital expenditure plans are reflected in prudential indicators, which are designed to assist members overview and confirm capital expenditure plans.

2. Within this overall prudential framework there is an impact on the Council's treasury management activity - as it will directly impact on borrowing or investment activity. As a consequence the treasury management strategy for 2012/13 to 2015/16 is included in section C to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

   Where the Council is acting as accountable body and is required to keep fund separate from its main treasury activities, cashflow and treasury management implications will be reported separately at the appropriate level.

The Capital Expenditure Plans

3. The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. A certain level of capital expenditure is grant supported by the Government; any decisions by the Council to spend above this level will be considered unsupported capital expenditure. This unsupported capital expenditure needs to have regard to:

- Service objectives (e.g. strategic planning);
- Stewardship of assets (e.g. asset management planning);
- Value for money (e.g. option appraisal);
- Prudence and sustainability (e.g. implications for external borrowing and whole life costing);
- Affordability (e.g. implications for the council tax and rents);
- Practicality (e.g. the achievability of the forward plan).

4. The revenue consequences of capital expenditure, particularly the unsupported capital expenditure, will need to be paid for from the Council's own resources.

5. This capital expenditure can be paid for immediately (by applying capital resources such as capital receipts, capital grants etc., or revenue resources), but if these resources are insufficient any residual capital expenditure will add to the Council's borrowing need.

6. The key risks to the plans are that the level of Government support has been estimated and is therefore subject to change. Similarly some estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale. For instance anticipated asset sales may be postponed due to the poor condition of the property market.

7. The Council is asked to approve the summary capital expenditure projections below. This forms the first prudential indicator:

Table 1

Capital Expenditure £'000	Actual 2012/13	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Non-HRA	4,333	10,218	14,019	12,379	992
HRA	2,785	3,111	4,604	7,184	6,787
Total	7,118	13,329	18,624	19,563	7,779
Financed by:					
Capital receipts	1,341	1,982	2,900	100	100
Capital grants	1,471	7,205	6,356	414	326
Capital reserves	949	1,000	3,863	4,005	3,446
Revenue	2,841	2,778	3,134	3,168	3,273
Net financing need for the year	**516**	**364**	**2,371**	**11,876**	**634**

The Council's Borrowing Need (the Capital Financing Requirement)

8. The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. The capital expenditure above which has not immediately been paid for will increase the CFR.

9. The Council is asked to approve the CFR projections below:

Table 2

£'000	Actual 2012/13	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Capital Financing Requirement					
CFR - Non Housing	15,388	15,158	16,921	28,085	24,470
CFR - Housing	70,320	70,320	70,320	70,320	70,320
Total CFR	**85,708**	**85,478**	**87,241**	**98,450**	**94,745**
Movement in CFR	**515**	**-230**	**1,763**	**11,164**	**-3,615**

Movement in CFR represented by					
Net financing need for the year (above)	516	364	2,371	11,876	634
Less MRP/ VRP and other financing movements	1	594	608	712	4,259
Movement in CFR	**515**	**-230**	**1,763**	**11,164**	**-3615**

10. The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments if required (Voluntary Revenue Provision - VRP). No revenue charge is required for the HRA.

11. CLG Regulations have been issued which require full Council to approve **an MRP Statement** in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement.

Minimum Revenue Provision (MRP) Policy Statement.

12. For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP policy will be:

- **Existing practice** - MRP will follow the existing practice outlined in former CLG Regulations (Option 1);

These options provide for an approximate 4% reduction in the borrowing need (CFR) each year.

13. From 1 April 2008 for all unsupported borrowing (including PFI and Finance Leases) the MRP policy will be

- **Asset Life Method** – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction)

These options provide for a reduction in the borrowing need over approximately the asset's life.

The Use of the Council's Resources and the Investment Position

14. The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc). Detailed below are estimates of the year end balances for each resource and anticipated day to day cash flow balances.

Table 3

£'000	Actual 2012/13	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Fund balances	3,657	2,092	1,895	1,435	1,320
Capital receipts	554	268	562	912	62
Earmarked reserves	8,668	13,122	12,692	11,739	14,858
Provisions	0	0	0	0	0
Contributions unapplied	2,950	1,000	500	500	500
Total Core Funds	**15,829**	**16,482**	**15,649**	**14,586**	**16,740**
Working Capital*	1,000	1,000	1,000	1,000	1,000
Under borrowing	14,829	14,158	14,649	14,586	15,470
Expected Investments	**0**	**0**	**0**	**0**	**0**

*Working capital balances shown are estimated year end; these may be higher mid year

Affordability Prudential Indicators

15. The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

16. **Actual and Estimates of the ratio of financing costs to net revenue stream –** This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

Table 4

%	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Non-HRA	8.49	8.91	10.15	9.83
HRA	40.5	40.3	40.1	40.0

17. The estimates of financing costs include current commitments and the proposals in this budget report.

18. **Estimates of the incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the revenue costs associated with ***proposed changes*** to the three year capital programme recommended in this budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

19. **Incremental impact of capital investment decisions on the Band D Council Tax**

20. Table 5

£	Actual 2012/13	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Council Tax - Band D	1.38	0.98	0.42	3.04	10.10

21. **Estimates of the incremental impact of capital investment decisions on Housing Rent levels –** Similar to the Council tax calculation this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

22. **Incremental impact of capital investment decisions - Housing Rent levels.**

Table 6

£	Actual 2012/13	Proposed Budget 2013/14	Forward Projection 2014/15	Forward Projection 2015/16	Forward Projection 2016/17
Weekly Housing Rent levels	40.5	40.3	40.1	40.0	40.0

23. This indicator shows the revenue impact on any newly proposed changes, although any discrete impact will be constrained by rent controls.

C) Treasury Management Strategy 2013/14 - 2014/15

1. Treasury Management is an important part of the overall financial management of the Council's affairs. The prudential indicators in Appendix A consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992.

2. The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This Council adopted the Code of Practice on Treasury Management on 30 June 2003.

3. As a result of adopting the Code the Council also adopted a Treasury Management Policy Statement (30 June 2003). This adoption is the requirements of one of the prudential indicators.

4. The Constitution requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year, and a new requirement of the revision of the Code of Practice is that there is a mid-year monitoring report.

This strategy covers:

- The Council's debt and investment projections;
- The Council's estimates and limits on future debt levels;
- The expected movement in interest rates;
- The Council's borrowing and investment strategies;
- Treasury performance indicators;
- Specific limits on treasury activities;

Borrowing

5 The capital expenditure plans set out above provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy

The Council's treasury portfolio position at 31 March 2013, with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

Table 7

£'000	**2013/14 Revised**	**2014/15 Estimate**	**2015/16 Estimate**	**2016/17 Estimate**
External Debt				
Debt at 1 April	85,708	85,478	87,241	98,450
Expected change in debt	-230	1,763	11,164	-3,615
Debt at 31 March	85,478	87,241	98,405	94,790
Actual Gross Debt	70,952	70,952	70,952	70,952
Under Borrowed	14,526	16,289	27,453	23,838

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Deputy Chief Executive (Corporate Direction) reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

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Treasury Indicators: limits to borrowing activity

The operational boundary. This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

Table 8

Operational boundary £m	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Total	85,478	87,241	98,405	94,790

6 **The authorised limit for external debt.** A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

The Council is asked to approve the following authorised limit:

Table 9

Authorised limit £m	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
General Fund	15,878	17,641	28,850	25,190
HRA	72,000	72,000	72,000	72,000
Bus Station*	7,000	7,000	0	0
Total	94,878	96,641	100,850	97,190

* Possible maximum temporary borrowing for the Bus Station.

Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit is currently:

HRA Debt Limit £m	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
HRA debt cap	72.0	72.0	72.0	72.0
HRA CFR	70.3	70.3	70.3	70.3
HRA headroom	1.7	1.7	1.7	1.7

Expected Movement in Interest Rates

7 The Council has appointed Capita Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives our central view.

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Dec 2013	0.50	2.50	4.40	4.40
Mar 2014	0.50	2.50	4.40	4.40
Jun 2014	0.50	2.60	4.50	4.50
Sep 2014	0.50	2.70	4.50	4.50
Dec 2014	0.50	2.70	4.60	4.60
Mar 2015	0.50	2.80	4.60	4.70
Jun 2015	0.50	2.80	4.70	4.80
Sep 2015	0.50	2.90	4.80	4.90
Dec 2015	0.50	3.00	4.90	5.00
Mar 2016	0.50	3.10	5.00	5.10
Jun 2016	0.75	3.20	5.10	5.20
Sep 2016	1.00	3.30	5.10	5.20
Dec 2016	1.00	3.40	5.10	5.20
Mar 2017	1.25	3.40	5.10	5.20

Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth has rebounded during 2013 to surpass all expectations. Growth prospects remain strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. One downside is that wage inflation continues to remain significantly below CPI inflation so disposbale income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. A rebalancing of the economy towards exports has started but as 40% of UK exports go to the Eurozone, the difficulties in this area are likely to continue to dampen UK growth. There are, therefore, concerns that a UK recovery currently based mainly on consumer spending and the housing market, may not endure much beyond 2014. The US, the main world economy, faces similar debt problems to the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth.

The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

- Although Eurozone concerns have subsided in 2013, Eurozone sovereign debt difficulties have not gone away and there are major concerns as to how these will be managed over the next few years as levels of government debt to GDP ratios, in some countries, continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2014/15 and beyond;
- Borrowing interest rates have risen significantly during 2013 and are on a rising trend. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring even higher borrowing costs, which are now looming

ever closer, where authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt, in the near future;

- There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

Borrowing Strategy 2014/15 - 2016/17

8 The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow have been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is high and will be maintained for the borrowing, excluding the HRA reform settlement.

Against this background and the risks within the economic forecast, caution will be adopted with the 2014/15 treasury operations. The Deputy Chief Executive (Corporate Direction) will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- *if it was felt that there was a significant risk of a sharp FALL in long and short term rates,* e.g. due to a marked increase of risks around relapse into recession or risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

- *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

Borrowing In Advance

9. The Council will not borrow more than or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the current reporting mechanism.

Debt Restructuring

10 As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

Treasury Management Limits on Activity

11 There are four further treasury activity limits, which were previously prudential indicators. The purpose of these are to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The indicators are:

- Upper limits on variable interest rate exposure – This identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- Upper limits on fixed interest rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.
- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- Total principal funds invested for greater than 364 days - these limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

12 The Council is asked to approve the limits:

Table 10

£m	2014/15	2015/16	2016/17
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	16	16	16
Limits on variable interest rates based on net debt	4	4	4
Maturity Structure of fixed interest rate borrowing 2013/14			
		Lower	**Upper**
Under 12 months		0%	100%
12 months to 2 years		0%	100%
2 years to 5 years		0%	100%
5 years to 10 years		0%	100%
10 years and above		0%	100%
Maximum principal sums invested > 364 days			
Principal sums invested > 364 days	£5m	£5m	£5m

Annual Investment Strategy

Investment policy

13 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury

Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then return.

In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings, watches and outlooks published by all three ratings agencies with a full understanding of these reflect in the eyes of each agengy. Using our ratings service potential counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

Further, the Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.

Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable divesification and thus avoidance of concentration risk.

The intention of the strategy is to provide security of investment and minimisation of risk.

Investment instruments identified for use in the financial year are listed in appendix 5.4 under the 'specified' and 'non-specified' investments categories. Counterparty limits will be as set through the Council's treasury management practices – schedules

14 **Creditworthiness Policy** The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle, the Council will ensure that:

- **It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections below; and**
- **It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.**

The Deputy Chief Executive (Corporate Direction) will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

The minimum rating criteria uses the lowest common denominator method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. Credit rating information is supplied by Capita Asset Services our treasury consultants, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance, a negative rating watch applying to a counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions. Additional background in the approach taken is attached at Appendix 2

15 The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments) is:

- **Banks 1 - Good Credit Quality –** the Council will only use banks which:

  i) Are UK banks; and/or
  ii) Are non-UK and domiciled in a country which has a minimum Sovereign long term rating of AAA.

  And have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):

  i) **Short Term** – F1
  ii) **Long Term** – A
  iii) **Individual / Financial Strength** – C (Fitch / Moody's only)
  iv) **Support** – 3 (Fitch only)

- **Banks 2 – Part Nationalised UK Banks –** These banks will be included if they continue to be part nationalised or they meet the ratings criteria in Bank 1 above.

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- **Banks 3** - The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

- **Bank Subsidiary and Treasury Operations –** the Council will use these where the parent bank has the necessary ratings outlined above.

- **Building Societies –** the Council will use all Societies which:

  i) meet the ratings for banks outlined above
  Or are both:
  ii) Eligible Institutions; and
  iii) Have assets in excess of £500m.

- **Money Market Funds** - AAA
- **UK Government** (including gilts and the DMADF)
- **Local Authorities, Parish Councils etc**

- **Supranational institutions**

  A limit of 100% will be applied to the use of Non-Specified investments.

16. **Country and sector considerations** - Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part the country selection will be chosen by the credit rating of the Sovereign state in Banks 1 above. In addition:

- no more than 5% will be placed with any non-UK country at any time;
- limits in place above will apply to Group companies;
- Sector limits will be monitored regularly for appropriateness.

17 **Use of additional information other than credit ratings** – Additional requirements under the Code of Practice requires the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

18 **Time and Monetary Limits applying to Investments** - The time and monetary limits for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch (or equivalent)	Money Limit	Time Limit
Bank 1 Category	AAA	£5m	1yr
Bank 2 Category	AA	£5m	3yrs
Bank 3 Councils Own Bank	A	£3m	2yrs
Other Institution Limits	-	£2m	1yr
Local Authorities	N/A	£3m	1yr
Money Market Funds	AAA	£3m	liquid
DMADF	N/A	£5m	6 months

Annual Investment Strategy Approach 2013/14 – 2016/17

19 **In-house funds.** Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

20 **Investment returns expectations.** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2016. Bank Rate forecasts for financial year ends (March) are:

- 2013/14 0.50%
- 2014/15 0.50%
- 2015/16 0.50%
- 2016/17 1.25%

There are upside risks to these forecasts (i.e. start of increases in Bank Rate occurs sooner) if economic growth remains strong and unemployment falls faster than expected. However, should the pace of growth fall back, there could be downside risk, particularly if Bank of England inflation forecasts for the rate of fall of unemployment were to prove to be too optimistic.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next four years are as follows:

2014/15	0.50%
2015/16	0.50%
2016/17	1.00%
2017/18	2.00%

21 **Investment treasury indicator and limit** - total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Council is asked to approve the treasury indicator and limit: -

Maximum principal sums invested > 364 days			
£m	**2014/15**	**2015/16**	**2016/17**
Principal sums invested > 364 days	£0	£0	£0

Where appropriate , for its cash flow generated balances, the Council will seek to utilise its business "Call Account" in order minimise risk.

22 These benchmarks are simple guides to maximum risk and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

23 **Security** - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:

- 0.24% historic risk of default when compared to the whole portfolio.

24 **Liquidity –** In respect of this area the Council seeks to maintain:

- Bank overdraft - £0.250m
- Liquid short term deposits of at least £1m available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.5 years, with a maximum of 1 year.

25 **Yield** - Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate and in addition that the security benchmark for each individual year is:

Table 11

	1 year	**2 years**	**3 years**	**4 years**	**5 years**

Maximum	0.24%	0.78%	1.48%	2.24%	3.11%

Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

The proposed criteria for investments are shown in Appendix 1 for approval.

Table 12

£m	2014/15	2015/16	2016/17
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	16	16	16
Limits on variable interest rates based on net debt	4	4	4
Maturity Structure of fixed interest rate borrowing 2013/14			
		Lower	**Upper**
Under 12 months		0%	100%
12 months to 2 years		0%	100%
2 years to 5 years		0%	100%
5 years to 10 years		0%	100%
10 years and above		0%	100%
Maximum principal sums invested > 364 days			
Principal sums invested > 364 days	£5m	£5m	£5m

Performance Indicators

26 The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

- Debt - Borrowing - Average rate of borrowing for the year compared to average available
- Debt - Average rate movement year on year
- Investments - Internal returns above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report.

Treasury Management Advisers

27 The Council uses Sector as its treasury management advisers. The company provides a range of services which include:

- Technical support on treasury matters, capital finance issues and the drafting of Member reports;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- Debt rescheduling advice surrounding the existing portfolio;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings/market information service comprising the three main credit rating agencies;

28 Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the Council. This service is subject to regular review.

4. FINANCIAL IMPLICATIONS (IB)

These are contained in the body of the report.

5. LEGAL IMPLICATIONS (AB)

These are contained in the body of the report.

6. CORPORATE PLAN IMPLICATIONS

Delivery of the Prudential Indicators contributes to the achievement of Strategic Objective 3: "Deliver the Councils Medium Term Financial with a sustained focus on the Council's priorities whilst working to resolve the continuing pressure of service requirements in the context of available resources".

7. CONSULTATION

None.

8. RISK IMPLICATIONS

The following significant risks associated with this report/decision were identified from this assessment:

Management of Significant (Net Red) Risks		
Risk Description	Mitigating Actions	Owner
Failure to achieve planned level of capital expenditure on the Capital Programme	Monitor expenditure via Budget Monitoring process and Capital Forum	Ilyas Bham
Failure to generate sufficient Capital Receipts and/or grants and other external funding to support the proposed programme	Look to revise the programme to bring spend into line with available resources	Ilyas Bham

9. KNOWING YOUR COMMUNITY – EQUALITY AND RURAL IMPLICATIONS

Schemes in the Capital Programme cover all services and all areas of the Borough including rural areas.

10. CORPORATE IMPLICATIONS

By submitting this report, the report author has taken the following into account:

- Community Safety Implications
- Environmental Implications
- ICT Implications
- Asset Management Implications
- Human Resources Implications
- Voluntary Sector Implications

Background Papers
Capital Programme 2013/14 to 2016/17
The CIPFA Prudential Code
Treasury Management Policy
Revenue Budget 2013/14

Contact Officer: Ilyas Bham, Group Accountant ext 5924

Executive Member: Cllr KWP Lynch

Appendix 1

Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management

The CLG issued Investment Guidance in 2010, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which are under a different regulatory regime.

The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the Code on 30 June 2003 and will apply its principles to all investment activity. In accordance with the Code, the Deputy Chief Executive (Corporate Direction) has produced its treasury management practices (TMPs). This part, TMP 1(5), covering investment counterparty policy requires approval each year.

Annual Investment Strategy - The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

The investment policy proposed for the Council is:

Strategy Guidelines – The main strategy guidelines are contained in the body of the treasury strategy statement.

Specified Investments – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

1. The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity).
2. Supranational bonds of less than one year's duration.
3. A local authority, parish council or community council.
4. Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category 4 this covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.
5. A body that is considered of a high credit quality (such as a bank or building society). For category 5 this covers bodies with a minimum short term rating of F1 (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies.

Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investments would include any sterling investments with:

	Non Specified Investment Category	Limit (£)
a.	**Supranational Bonds greater than 1 year to maturity** **(a) Multilateral development bank bonds** - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.). **(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company {GEFCO}) The security of interest and principal on maturity is on a par with the Government and so very secure, and these bonds usually provide returns above equivalent gilt edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	AAA long term ratings £3m £3m
b.	**Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£3m
c.	**The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.**	£3m
d.	**Building societies not meeting the basic security requirements under the specified investments**. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. The Council may use such building societies which were originally considered Eligible Institutions and have a minimum asset size of £500m, but will restrict these type of investments to £2m	£2m
e.	Any **bank or building society** that has a minimum long term credit rating of A, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	£5m
f.	Any **non rated subsidiary** of a credit rated institution included in the specified investment category. These institutions will be included as an investment category subject to a limit of £2m for a period of 6 months	£2m

The Monitoring of Investment Counterparties - The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Sector as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Deputy Chief Executive (Corporate Direction), and if required new counterparties which meet the criteria will be added to the list.

Appendix 2

Security, Liquidity and Yield Benchmarking

Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service - A proposed development for Member reporting is the consideration and approval of security and liquidity benchmarks.

These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury Report.

Yield - These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments - Internal returns above the 7 day LIBID rate

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. However they have not previously been separately and explicitly set out for Member consideration. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

Liquidity - This is defined as "having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

- Bank overdraft - £0.250m
- Liquid short term deposits of at least £1m available with a week's notice.

The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect the proposed benchmark is to be used:

- WAL benchmark is expected to be 0.75 years, with a maximum of 1 year**.**

Security of the investments - In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard and Poors). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy. The table beneath shows average defaults for differing periods of investment grade products for each Fitch/Moody's Standard and Poors long term rating category over the last 20 years.

Years	**1**	**2**	**3**	**4**	**5**
AAA	0.00%	0.02%	0.06%	0.09%	0.13%
AA	0.02%	0.04%	0.14%	0.28%	0.36%
A	0.09%	0.25%	0.43%	0.60%	0.79%
BBB	0.23%	0.65%	1.13%	1.70%	222%
BB	0.93%	2.47%	4.21%	5.81%	7.05%
B	3.31%	7.89%	12.14%	15.50%	17.73%
CCC	23.15%	32.88%	39.50%	42.58%	45.48%

The Council's minimum long term rating criteria is currently "A", meaning the average expectation of default for a one year investment in a counterparty with a "A" long term rating would be 0.09% of the total investment (e.g. for a £1m investment the average loss would be £900). This is only an average - any specific counterparty loss is likely to be higher - but these figures do act as a proxy benchmark for risk across the portfolio.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

- 0.055% historic risk of default when compared to the whole portfolio.

And in addition that the security benchmark for each individual year is:

	1 year	2 years	3 years	4 years	5 years
Maximum	0.24%	0.68%	1.19%	1.79%	2.42%

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Investment Annual Report. As this data is collated, trends and analysis will be collected and reported. Where a counterparty is not credit rated a proxy rating will be applied.