

**Cabinet**

**14 February 2012**

Report of the Cabinet Member for Corporate Services

## **Treasury Management Strategy Statement and Prudential Indicators for 2012/13 to 2016/17**

### **Purpose**

1. The purpose of this report is to ask the Cabinet to recommend that Council approve the:
  - Integrated treasury management strategy statement including the annual investment strategy and the minimum revenue provision policy statement;
  - Prudential indicators for 2012/13 to 2016/17
  - Revised treasury management policy statement
  - Specified and non-specified investments schedule
  - Treasury management scheme of delegation and role of the section 151 officer

### **Background**

2. The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. The first function 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.
  3. The second main function of the treasury management service is the funding of the Council's capital programme. The capital programme provides 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
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occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

4. CIPFA (Chartered Institute of Public Finance and Accountancy) 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.”*

### **Reporting requirements**

5. The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals. These reports are required to be adequately scrutinised by committee before being recommended to the Council. This role is undertaken by the Audit & Governance Committee. The three reports are:
    - a) **Treasury management strategy statement and prudential indicators report** (this report) – which covers the treasury management strategy, minimum revenue provision policy, annual investment strategy and prudential indicators;
    - b) **A Mid Year Treasury Management Report** –will update members with whether the treasury activities are meeting the strategy, whether any policies require revision, if amending prudential indicators need amending;
    - c) **An Annual Treasury Report** – updates on treasury activity for the year and compares actual prudential indicators with estimates in the strategy.
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## **Treasury Management Strategy for 2012/13**

6. The treasury management strategy for 2012/13 covers two main areas – Capital issues and treasury issues which are listed below. These areas cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the Communities and Local Government (CLG) Minimum Revenue Provision (MRP) Guidance, the CIPFA Treasury Management Code and the CLG Investment Guidance:

a) Capital Issues – Capital Prudential Indicators 2012/13-2014/15

- Prudential Indicators relating to the Capital Programme;
- Prudential Indicators to assess affordability of the Capital programme
- Minimum Revenue Provision (MRP) Policy Statement .

b) Treasury management Issues – Treasury Management Strategy

- Prudential Indicators which will limit the treasury management risk and activities of the Council;
- the current treasury position;
- Economic background and prospects for interest rates;
- the borrowing strategy;
- Prudential indicators;
- policy on borrowing in advance of need;
- debt rescheduling;
- investment policy;
- creditworthiness policy;
- investment strategy;
- policy on use of external service providers;
- Scheme of delegation and the role of the S151 officer

## **The Capital Prudential Indicators 2012/13 – 2014/15**

7. The Council's capital expenditure plans are the key driver of treasury management activity. The Council's Capital expenditure plans are the subject of a separate report the Capital programme 2012/13 to 2016/17. The output of the capital programme is reflected in this report in the capital

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prudential indicators. The prudential indicators are designed to assist member's overview of the council's capital programme to ensure that the capital expenditure plans are affordable, sustainable and prudent.

8. The capital prudential indicators (PI) along with the treasury management prudential indicators (PI) are attached at Annex A and are also explained throughout the report:

- PI 1: Capital Expenditure
- PI 2: Capital financing requirement
- PI 3: Ratio of financing cost to Net revenue stream
- PI4&5: Incremental impact of capital investment decisions on council tax and housing rent
- PI6A: Affordable borrowing limit
- PI 6B: Operational boundary
- PI 6C: HRA debt Limit
- PI 7: Interest rate exposure for fixed and variable rated debt
- PI 8: Maturity structure of debt
- PI 9: Surplus funds invested >3654 days

9. HRA Self Financing Reform - A key issue facing the Council in 2012/13 is the impact of planned HRA self financing reform. This essentially ends the impact of the housing subsidy system and will see the HRA as a stand alone business. The Treasury Management Monitor 2 Mid Year Review and prudential Indicator report included information on the HRA Self-financing Reforms and revised the council's prudential Indicators for 2011/12. This report will also cover the HRA Self Financing reform and the further changes following the Government White paper in November 2011. The Council will need to approve these revised prudential indicator limits in advance of the reform being put into operation.
  10. The Council currently pays into the HRA housing subsidy system, and in order to stop future payments from 1 April 2012 the Council is required to pay the CLG £121.550m. This payment is effectively HRA debt, and so the prudential indicators in this treasury management report have been adjusted to reflect this change. The actual payment will be made on the 28 March 2012 and so the indicators will take immediate effect from the approval of these limits by Council. The changes under the HRA reform are expected to be beneficial to the Council.
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11. **Prudential Indicator 1 - Capital Expenditure.** This prudential Indicator is a summary of the Council's capital expenditure plans forming part of this budget cycle, where detail is provided in the Capital programme 12/13 to 16/17 report:

Capital Expenditure £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Non-HRA	48.2	67.6	32.0	23.3	12.7	10.7
HRA existing	10.2	7.8	7.6	7.3	6.4	8.4
HRA settlement	121.6					
<b>Total</b>	<b>180.0</b>	<b>75.5</b>	<b>39.6</b>	<b>30.6</b>	<b>19.1</b>	<b>19.1</b>

Table 1: Capital Expenditure

12. Table 1 details the capital expenditure of the Council excluding other long term liabilities, such as PFI and leasing arrangements which already include borrowing instruments.

13. **Prudential Indicator 2 - The Capital Financing Requirement (CFR) (Council's Borrowing Need);** 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. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

14. Following accounting changes under International Financial Reporting Standards introduced in the Statement of Accounts in 2010/11, the CFR includes any other long term liabilities (e.g. PFI schemes, finance leases) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's overall borrowing requirement, these types of scheme include a borrowing facility of their own and so the Council is not required to separately borrow for these schemes. The Council currently has a limit to cover such schemes of £20m included within the CFR. Table 2 shows the Capital Financing Requirement, excluding other long term liabilities, below:

Capital Financing Requirement £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
<b>Non-HRA CFR</b>	<b>150.8</b>	<b>168.6</b>	<b>166.8</b>	<b>167.6</b>	<b>168.2</b>	<b>167.3</b>
HRA existing	18.8	18.8	18.8	18.8	18.8	18.8
HRA settlement	121.6	121.6	121.6	121.6	121.6	121.6
<b>HRA CFR</b>	<b>140.4</b>	<b>140.4</b>	<b>140.4</b>	<b>140.4</b>	<b>140.4</b>	<b>140.4</b>
<b>Total CFR</b>	<b>291.1</b>	<b>309.0</b>	<b>307.2</b>	<b>308.0</b>	<b>308.6</b>	<b>307.7</b>

Table 2: Capital Financing Requirement (CFR)

15. **Affordability Prudential Indicators** - The prudential indicators mentioned so far in the report cover the overall capital programme and the control of borrowing through the capital financing requirement. In addition, it is necessary to assess the affordability of the Council's capital investment plans. These prudential indicators provide an indication of the impact of the capital programme investment plans on the Council's overall finances.

16. **Prudential Indicator 3 - 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) and compares it to the Council's net revenue stream.

%	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
<b>Non-HRA</b>	7.7%	9.2%	9.2%	8.8%	8.4%	8.2%
<b>HRA (inclusive of Settlement)</b>	2.4%	2.3%	2.1%	2.0%	1.7%	1.7%

Table 3: Ratio of financing costs to net revenue stream

17. **Prudential Indicator 4 - Incremental impact of capital investment decisions on council tax.** This indicator identifies the revenue costs associated with proposed changes to the five-year capital programme recommended in the Capital programme 2012/13 to 2016/17 budget report and compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget.

£	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
<b>Council tax - band D</b>	£19.81	£23.89	£18.04	£0.62	£0.98	£0.97

Table 4: - Incremental impact of capital investment decisions on the band D council tax

18. **Prudential Indicator 5 - 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 the capital programme budget report compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels. This indicator is zero as the housing rent levels are set by

Government and is not directly impacted by the Council's capital plans.

£	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Weekly housing rent levels	£0.00	£0.00	£0.00	£0.00	£0.00	£0.00

Table 5 - Incremental impact of capital investment decisions on housing rent levels

## MRP Policy Statement

19. The Council is required to pay off an element of the non-HRA (General Fund) capital expenditure each year which has accumulated as the Capital Financing Requirement (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).
20. CLG Regulations (statutory Instrument (SI) 2008 no.414 s4) have been issued which require full Council to approve an MRP Statement in advance of each year. The guidance offers four main options under which MRP could be made, with an overriding recommendation that the Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits. The four options are:
  - a) The regulatory method (which complies with regulation 28 in SI 2003 no.3146) – 4% of the borrowing outstanding;
  - b) The Capital Financing Method – 4% of the Council's Capital Financing Requirement;
  - c) The Depreciation Method – repayment of the debt over its depreciation life;
  - d) The Asset Life Method – repayment over the life of the asset to which the borrowing has been taken to fund.
21. The Council is recommended to approve the following MRP Statement. 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 A);  
or

22. These options provide for an approximate 4% reduction in the borrowing need (CFR) each year.
23. 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) (option D);
24. These options provide for a reduction in the borrowing need over approximately the asset's life. The asset life is an absolute maximum and wherever possible the debt should be repaid over a shorter period. Estimated asset life periods will be determined under delegated powers. It should be noted that with all debts, the longer the repayment period the more is paid in interest over the period of the loan. It is therefore deemed as prudent to reduce the period over which the repayments are made.
25. No revenue charge is currently required for the HRA under the HRA self-financing reform in the next 5 years. Under the HRA reform the HRA will be required to charge depreciation on its assets, which will have an increased revenue cost effect. In order to address any possible adverse impact in the next 5 years, regulations allow the Major Repairs Allowance to be used as a proxy for depreciation and for the depreciation charge to be reversed therefore, having no revenue impact on council tax. Further guidance is currently under discussion between the CLG and CIPFA.
26. Repayments included in annual PFI or finance leases are also applied as MRP.

### **Treasury Management Strategy**

27. The capital prudential indicators set out above ensure that the Council's capital programme / expenditure plans are affordable, sustainable and prudent. The treasury management function ensures that the Council's cash is available to meet the Council's capital programme requirements and also revenue activity needs in accordance with the Local Government Act 2003 and relevant professional codes
  28. The treasury management function involves both the forecasting of the cash flow and, where capital plans are
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require, the organisation of appropriate borrowing facilities. The strategy covers the / prudential / treasury indicators, the current and projected debt positions and the annual investment strategy.

### Current Portfolio Position

29. The Council's treasury portfolio position at 31 December 2011 is detailed below in table 6:

Institution Type	Principal	Average Rate
<u>Public Works Loan Board (PWLB)</u> – Money borrowed from the Debt Mgt Office (Treasury Agency)	£120.1m	4.23%
<u>Market Loans</u>		
Club Loan – A loan taken in conjunction with 2 other Authorities	£10.0m	7.155%
LOBO Loan – Lender Option Borrower Option	£10.0m	3.74%
<b>Total Gross Borrowing</b>	<b>£140.1</b>	<b>4.283%</b>
<b>Total Investments</b>	<b>£ 53.3</b>	<b>1.29%</b>
Net Debt	£ 86.8	

Table 6: Current position at 31 December 2012

30. The Council currently has £140.1m of fixed interest rate debt and £53.3m of investments. It appears that the level of investments is high in the current low investment interest rate environment, however at the end of the financial year the level of investments is estimated to reduce from cash flow movements and as the capital programme continues to spend, to £25m.

31. In addition, even though investment interest rates are currently low, in future borrowing rates are predicted to rise. It has therefore been important during 2011/12 to take a long term view on borrowing and £7m new loans have been taken. It is sensible to take some borrowing now to prevent (in future) a large amount of borrowing having to occur in a specific year. This reduces the risk of exposure to interest rates in a single year and gives some stability to the overall Council revenue budget.

32. The total borrowing requirement in 2011/12 is £17.1m and to date only £7m of borrowing has been taken. This is 41% of the borrowing requirement in 2011/12. The markets continue to be monitored to take advantage of favourable rates.

33. The £140.1m of borrowing has an average life of 17.7 years and average cost of debt of 4.283%. The Council currently has no variable rate borrowing. The Council is only permitted to borrow to invest in capital projects, unless permitted to do otherwise by the Government. Therefore the majority of the Councils existing debt is secured against its asset base.
34. Figure 1 shows the Councils current debt maturity structure as at 31 December 2011:

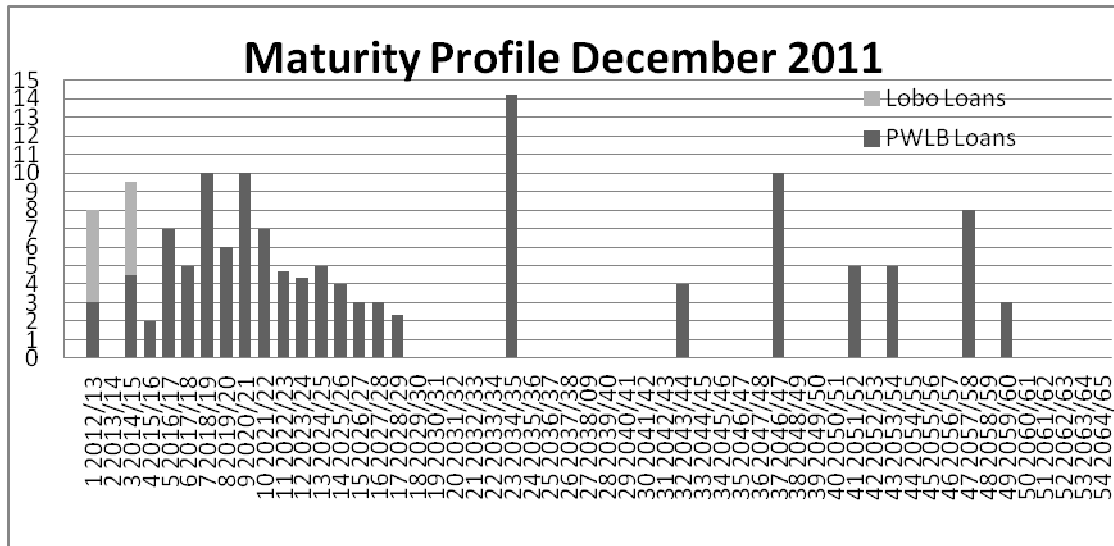


Figure 1 – Debt Maturity Profile as at 31 December 2011

35. The Council's total investments at 31 December 2011 was £53.3m of which £12.0m were held in instant access call accounts, £7.3m in instant access money market funds and £34.0m invested in fixed term deposits on the UK money market
36. Further to the current treasury management position above, it is key that the council operates its treasury management activities within defined prudential indicator limits. One of these is that the Council needs to ensure that its total debt, net of any investments, does not, except in the short term, exceed the total of the CFR in the preceding year 2011/12 plus the estimates of any additional CFR for 2012/13 and the following two financial years. This allows the flexibility to borrow in advance of need and ensures that borrowing is for a capital purpose and that borrowing is not undertaken for revenue purposes.
37. Table 7 shows that the net debt position of the Council does not exceed the underlying capital borrowing need (the Capital Financing Requirement - CFR). The Director of Customer Business & Support Services (S151 Officer) confirms that the

Council complied with this prudential indicator and does not envisage difficulties for the future.

£m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
External Debt	261.7	278.5	278.1	278.6	278.4	277.5
Investment	(25)	(20)	(20)	(20)	(20)	(20)
<b>Net Debt</b>	<b>241.7</b>	<b>258.5</b>	<b>258.1</b>	<b>258.6</b>	<b>258.4</b>	<b>257.5</b>
Total CFR	291.1	309.0	307.2	308.0	308.6	307.7
<b>NET &lt; CFR</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>

Table 7: Net Debt < Capital Financing Requirement

### Prudential Indicators: Limits on Authority to Borrow

**38. Prudential Indicator 6A – Authorised Borrowing Limit** - It is a statutory duty under Section 3 (1) of the Local Government Act 2003 and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the “Authorised Borrowing Limit”, and represents a control on the maximum level of debt. This is 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.

Authorised Limit £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Borrowing	215.4	216.3	216.9	216.0	216.0	216.0
HRA settlement	121.6	121.6	121.6	121.6	121.6	121.6
Other Long term liabilities	10	20	20	20	20	20
<b>Total</b>	<b>347.0</b>	<b>357.9</b>	<b>358.5</b>	<b>357.6</b>	<b>357.6</b>	<b>357.6</b>

Table 8: Authorised Borrowing Limit

**39. Prudential Indicator 6B – Operational Boundary.** In addition to the “authorised Borrowing Limit”, there is a limit which is the maximum level of debt allowed for, on an ongoing operational purpose. This is the Operational Boundary. The Operational Boundary in reality would only be breached because of in year cash flow movements. 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

Operational Boundary £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Borrowing	195.4	196.3	196.9	196.0	196.0	196.0
HRA settlement	121.6	121.6	121.6	121.6	121.6	121.6
Other Long term liabilities	10	20	20	20	20	20
<b>Total</b>	<b>327</b>	<b>327.9</b>	<b>328.5</b>	<b>327.6</b>	<b>327.6</b>	<b>327.6</b>

Table 9: Operational Boundary

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

HRA Debt Limit £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
<b>Total HRA</b>	<b>145.97</b>	<b>145.97</b>	<b>145.97</b>	<b>145.97</b>	<b>145.97</b>	<b>145.97</b>

Table 10: HRA Debt Limit

### Economic Background

41. The economic situations is the background to which all treasury management activities operate. It assists in the formation of the treasury management strategy as it details the current economic and market environment. Further information on the current economic environment is available on request.

### Prospects for Interest Rates

42. Current interest rates and the future direction of both long term and short term interest rates have a major influence on the overall treasury management strategy and affects both investment and borrowing decisions. To facilitate treasury management officers in making informed investment and borrowing decisions the Council contracts Sector as its treasury adviser. Part of their service is to assist the Council in formulating a view on interest rates. Annex B draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interests rates. Table 11 gives Sector's central view:

Annual Average %	Bank Rate	Investment Rates		Borrowing Rates		
		3 month	1 year	5 year	25 year	50 year
March 2012	0.50	0.70	1.50	2.30	4.20	4.30
June 2012	0.50	0.70	1.50	2.30	4.20	4.30
Sept 2012	0.50	0.70	1.50	2.30	4.30	4.40
Dec2012	0.50	0.70	1.60	2.40	4.30	4.40
March 2013	0.50	0.75	1.70	2.50	4.40	4.50
June 2013	0.50	0.80	1.80	2.60	4.50	4.60
Sept 2013	0.75	0.90	1.90	2.70	4.60	4.70
Dec 2013	1.00	1.20	2.20	2.80	4.70	4.80
March 2014	1.25	1.40	2.40	2.90	4.80	4.90
June 2014	1.50	1.60	2.60	3.10	4.90	5.00

Table 11 – Sector's Bank Rate forecast for financial year ends

43. Sector Treasury services view of fixed long term borrowing rates (PWLB) and the base rate are also shown in graphical format below in Figure 2.

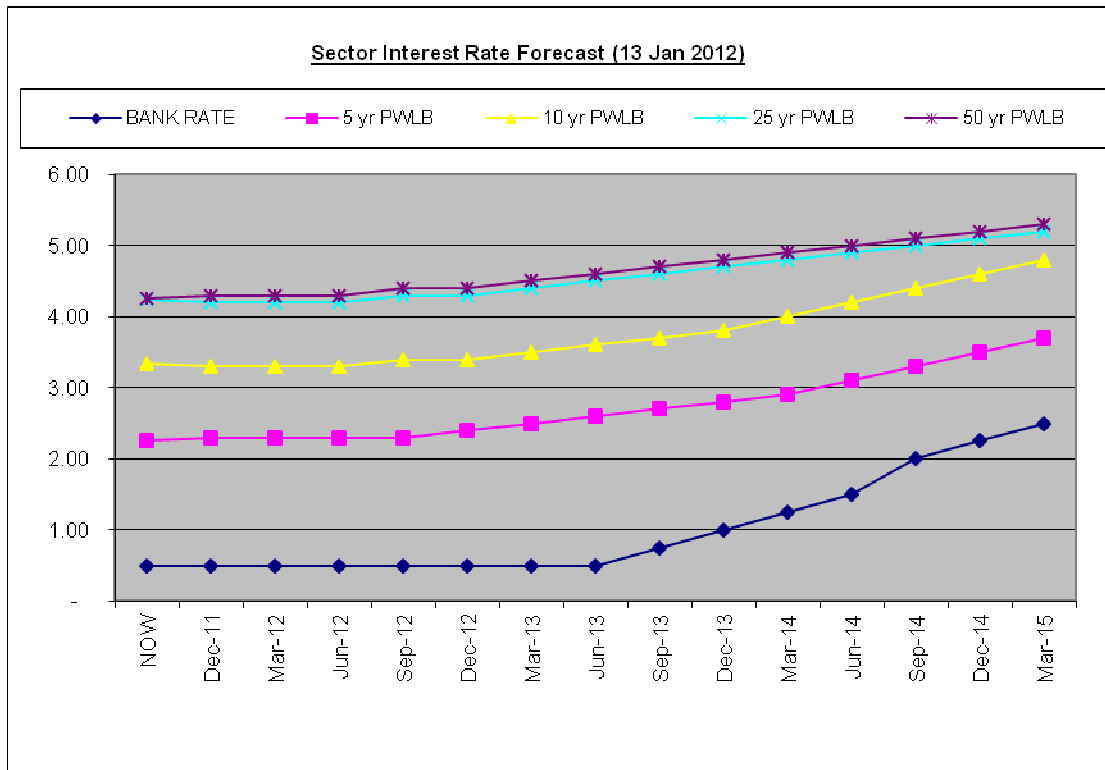


Figure 2 – Sector interest rate forecast

44. The graph clearly shows that the base rate and the range of PWLB borrowing rates are forecast to remain relatively flat until March 2013 where rates are seen to gradually rise.

45. Growth in the UK economy is expected to be weak in the next two years and there is a risk of a technical recession (i.e. two quarters of negative growth). Bank Rate, currently 0.5%, underpins investment returns and is not expected to start increasing until quarter 3 of 2013 despite inflation currently being well above the Monetary Policy Committee inflation target. Hopes for an export led recovery appear likely to be disappointed due to the Eurozone sovereign debt crisis depressing growth in the UK's biggest export market. The Comprehensive Spending Review, which seeks to reduce the UK's annual fiscal deficit, will also depress growth during the next few years.

46. Fixed interest borrowing rates are based on UK gilt yields. The outlook for borrowing rates is currently much more difficult to predict. The UK total national debt is forecast to continue rising until 2015/16; the consequent increase in gilt issuance is therefore expected to be reflected in an increase in gilt yields over this

period. However, gilt yields are currently at historically low levels due to investor concerns over Eurozone sovereign debt and have been subject to exceptionally high levels of volatility as events in the Eurozone debt crisis have evolved.

47. This challenging and uncertain economic outlook has a several key treasury management implications:

- The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2012/13;
- Borrowing interest rates are currently attractive, but may remain low for some time. The timing of any borrowing will need to be monitored carefully;
- There will remain a cost of capital – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

### **Borrowing Strategy**

48. The Council undertakes long term borrowing in accordance with the capital expenditure requirements of the capital programme. As a result of the capital programme 2012/13 to 2016/17 the borrowing requirement is projected to increase significantly from its current level of £141.6m in 2011/12 to a high of £309.0m over the next 5 years.

49. The increase in the borrowing requirement is as a result of the general requirements of the capital programme expenditure and specifically, borrowing rises due to:

- (i) £14.211m Administrative accommodation project
- (ii) £20m Economic Infrastructure Fund
- (iii) £121.550m HRA reform

50. The borrowing requirement for the administrative accommodation project of £14.2m is the funding needed to support the move to the new West Office building in 2012/13. The total capital expenditure of the project approved by Members remains at £43.804m and results in a saving over 25 years of £17m. Total borrowing requirement of the project is £29.628m, with the remainder of the funding being provided from a revenue

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contribution of £1.092m and earmarked capital receipts of £13.084m

51. The borrowing requirement for the Economic Infrastructure Fund will deliver major economic benefits for the City of York covering strategic themes/priorities – further information is available in the capital programme budget 2012/13 to 2016/17 report.
  52. The £121.6m borrowing requirement for the HRA reform is detailed in the additional HRA borrowing strategy below.
  53. The borrowing strategy takes into account the borrowing requirement, the current economic and market environments and is also influenced by the above interest rate forecast. Therefore, the borrowing strategy will be to lock into some long-term borrowing in 2012/13 whilst interest rates are lower than in the coming years, but also give consideration not to undertake external borrowing but rather use cash balances.
  54. The use of the Council's cash balances means that the capital borrowing need (the Capital Financing Requirement quoted above), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as consideration has to be given to the investment rate of return that is currently being received on Council's cash balances. Investment returns are low due to the continued historical low interest rates and counterparty risk is high.
  55. It is therefore beneficial to have a borrowing strategy where consideration is given to taking some longer term borrowing and also use some cash reserves.
  56. External borrowing will be taken throughout the financial year when interest rates seem most favourable. A target interest rate in light of table 11 above is 4.5%. This will enable borrowing to be taken through the year at different time periods. Consideration will also be given to the maturity profile of the debt portfolio so the Council is not exposed to the concentration of debt being in any one year.
  57. Against this background and the risks within the economic forecast, caution will be adopted with the 2012/13 treasury operations. The Director of Customer Business and Support Services 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
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risks around relapse into recession or of 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.

58. For the first time in 2012/13 a borrowing strategy needs to be identified for the HRA as a result of the HRA Reform. Under the HRA Self-financing reform, on 28 March 2012, there is a requirements for the Council to make a one-off payment to Communities and Local Government for £121.550m which will remove the Council from the current HRA subsidy system. This one off payment will ensure that the HRA will no longer make future annual payments to the CLG and it is expected that the overall impact will be beneficial to the Council.
  59. The Council will need to have the cash settlement amount of £121.550m available by the 28 March 2012, so separate borrowing solely for this purpose is anticipated. The Public Works Loan Board (PWLb) - the Governments public sector loans facility - are providing loans at interest rates 0.85% lower than the usual PWLB interest rates. These lower rates are solely for the HRA settlement requirements specifically on 28 March 2012 and this provides a compelling reason to utilise this borrowing availability.
  60. The exact structure of debt to be drawn is currently being considered by officers to ensure it meets the requirements of the HRA business plan and the overall requirements of the Council. Whilst the debt can be drawn earlier than needed, this may incur additional revenue costs that potentially would not occur if debt is taken on 28 March 2012 or it could incur a revenue saving that would not occur if debt is taken on 28 March 2012. This will be considered when a review of the structure of actual prevailing borrowing and investment interest rates is undertaken nearer to the time.
  61. Part of the HRA borrowing strategy is therefore to have funds available for the cash settlement to CLG of £121.550m on 28 March 2012. The exact structure of borrowing, the rate of interest
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and whether surplus cash balances will be used as an alternative to borrowing will be considered by officers. In addition, the HRA strategy in 2012/13 for borrowing will be the same as the borrowing strategy described above for the whole Council. However, it is not expected that the HRA will take any further borrowing in the foreseeable future.

62. All decisions will be reported to the appropriate decision making body – Cabinet - at the next available opportunity.

### **Prudential Indicators – Limits on Borrowing Activity**

63. There are three debt / borrowing related prudential indicators. The purpose of these are to constrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any 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. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- Maturity structure of borrowing. This gross limit is set to reduce the Council's exposure to large fixed rate sums falling due for refinancing in a confined number of years.

64. These three debt/borrowing related prudential indicators are calculated to include the debt undertaken for the HRA as well as the remaining borrowing debt portfolio.

£m	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
<b>Interest rate Exposure</b>					
	<b>Upper</b>	<b>Upper</b>	<b>Upper</b>	<b>Upper</b>	<b>Upper</b>
<b>Limits on fixed interest rates based on net debt</b>	<b>104%</b>	<b>104%</b>	<b>104%</b>	<b>104%</b>	<b>104%</b>
<b>Limits on variable interest rates based on net debt</b>	<b>-4%</b>	<b>-4%</b>	<b>-4%</b>	<b>-4%</b>	<b>-4%</b>

<b>Maturity Structure of borrowing 2012/13</b>		
	<b>Lower</b>	<b>Upper</b>
Under 12 months	0%	30%
12 months to 2 years	0%	30%
2 years to 5 years	0%	40%
5 years to 10 years	0%	40%
10 years and above	30%	90%

Table 12: Limits on Interest rate exposure and the Maturity Structure of Borrowing

### **Policy on Borrowing in Advance of Need**

65. 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.
66. Under regulation, the Council can borrow in advance of need in line with its future borrowing requirements in accordance with the Capital Financing Requirement. Any borrowing decision in advance of need will be considered carefully to ensure that value for money can be demonstrated, it is affordable, sustainable & prudent, that the treasury management revenue budget can support the borrowing finance costs in the longer term and that the Council can ensure the security of such funds if invested.
67. Borrowing in advance will be made within the constraints of the CIPFA Prudential Code that ensures that total debt, net of any investments, does not, except in the short term, exceed the total of the CFR in the preceding year 2011/12 plus the estimates of any additional CFR for 2012/13 and the following two financial years.
68. Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

### **Debt Rescheduling**

69. It is forecast that short term borrowing rates will be considerably cheaper than longer term fixed interest rates in the foreseeable future. Therefore, 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 management position, the short term nature of the loans, the costs of premiums involved in premature repayment for existing debt
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and the likely cost of refinancing those short-term loans, once they mature.

70. Debt rescheduling will also be considered for the HRA and the costs and benefits assessed to ensure value for money.
71. The reasons for any rescheduling to take place will include:
  - a) the generation of cash savings and / or discounted cash flow savings;
  - b) helping to fulfil the strategy outlined above, and
  - c) enhancing the balance of the portfolio (amend the maturity profile and/or the balance of volatility).
72. Consideration will also be given to identify if there is any residual potential left 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.
73. Any rescheduling will be reported in accordance with the usual monitoring cycle.

## **Annual Investment Strategy**

### **Investment Policy**

74. The Council will have regard to the department of Communities and Local Government's (CLG) Guidance on Local Government Investments ("the Guidance") and the 2009 CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code").
  75. The Council's investment priorities are the security of capital and the liquidity of its investments. The Council also aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments, see later in the section of the Creditworthiness Policy.
  76. The borrowing of monies specifically to invest or lend on and make a return is unlawful and the Council will not engage in such activity.
  77. In accordance with "the Guidance" it is necessary in the strategy to determine investment instruments, which are identified, for use in the financial year. The investment
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instruments are classed under “specified” and “non-Specified” investments categories and are detailed in Annex C. It is also a requirement to set limits for the institutions in which the Council will invest their surplus funds - Counterparties limits. These are set out in the later section - the Investment Strategy.

78. Consideration will be given throughout the year, and approval requested where necessary, to the alteration of the “specified” and “non-specified” investment categories to allow the continued effective management of the Councils treasury management operations. The Council continues to take a prudent approach to investing funds as set out in the Creditworthiness Policy below.

### **Creditworthiness Policy**

79. This Council uses the creditworthiness service provided by Sector Treasury Services. This service has been progressively enhanced over the last year and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys and Standard and Poors, which forms the core element. It does not rely solely on the current credit ratings of counterparties but also uses the following as overlays:

- credit watches and credit outlooks from credit rating agencies
- CDS spreads to give early warning of likely changes in credit ratings
- sovereign ratings to select counterparties from only the most creditworthy countries

80. This modelling approach combines credit ratings, credit watches, credit outlooks and CDS (Credit Default Swap) spreads in a weighted scoring system for which the end product is a series of colour code bands, which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to determine the duration for investments and are therefore referred to as durational bands. The Council is satisfied that this service now gives a much-improved level of security for its investments. It is also a service which the Council would not be able to replicate using in house resources.

81. The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions

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down to a minimum durational band within Sector's weekly credit list of worldwide potential counterparties. The Council will therefore use counterparties within the following durational bands:

Yellow	5 years*
Purple	2 years
Blue	1 year (only applies to nationalised or semi nationalised UK Banks)
Orange	1 year
Red	6 months
Green	3 months
No colour	not to be used

*\*This category is for AAA rated Government debt or its equivalent;*

82. The Sector creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings

83. Typically the minimum credit ratings criteria the Council use will be a short term rating (Fitch or equivalents) of Short Term rating F1, Long Term rating A-, Viability ratings of BB+, and a Support rating of 3. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

84. All credit ratings will be monitored on an ongoing basis as information is provided weekly basis and also adhoc. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service:

- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
  - In addition to the use of Credit Ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in
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downgrade of an institution or removal from the Councils lending list.

85. The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch Ratings (or equivalent from other agencies if Fitch does not provide). The list of countries that qualify using this credit criteria as at the date of this report are shown in Annex D. This list will be added to or deducted from by officers should ratings change in accordance with this policy.

### **Investment Strategy**

86. 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). The Council uses matrices that stipulate both time and financial limits in order to spread counterparty (credit) risk when investing money with approved counterparties. The matrices are based on the projected average balance for the year. Therefore for 2011/12 (as for 2010/11) with the average balance forecast to be circa £60m, the matrix stipulates a limit for £8m for counterparties with a durational band of 3 months and £15m longer than 3 months.

87. For 2012/13, in the current economic environment, the Council has budgeted for an investment return target of 1% on investments placed during the financial year. The budgeted investment earnings rates for returns on investments placed for periods up to three months during each financial year for the next five years are as follows:

2012/13	0.70%
2013/14	1.00%
2014/15	1.60%
2015/16	3.30%
2016/17	4.10%

88. There are downside risks to these forecasts (i.e. start of increases in Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if Bank of England inflation forecasts for two years ahead exceed the Bank of England's 2% target rate.

89. For its cash flow generated balances, the Council will seek to utilise, business reserve accounts (call accounts), 15 to 30 day
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notice accounts, short dated fixed term deposits and money market funds. The Council will avoid locking into longer term deals while investment rates are down at historically low levels unless attractive rates are available with counterparties of particularly high creditworthiness, which make longer-term deals worthwhile, and within the risk parameters set by this council.

90. **Prudential Indicator 9** - total principal investment funds invested for greater than 364 days. This limit is set with regards to the Council's liquidity requirements and are based on the availability of funds after each year-end. A maximum principal sum to be invested for greater than 364 days is £10m
91. At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report. It should be noted that the Investment policy, creditworthiness policy and investment strategy are applicable to the council's overall surplus funds and are also pertinent to the HRA.

#### **Policy on the use of external service providers**

92. The Council uses Sector as its external treasury management advisors.
93. The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.
94. It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

#### **Scheme of Delegation and the Role of the Section 151 Officer**

95. Those charged with governance are responsible for the treasury management activities and these need to be clearly defined within the organisation. Attached at Annex E are the Treasury Management Scheme of Delegation and also the Treasury Management role of the section 151 officer (Director of Customer & Business Support Services).
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## **Consultation and Options**

96. The treasury management function of any business is a highly technical area, where decisions are often taken at very short notice in reaction to the financial markets. Therefore, to enable effective treasury management, all operational decisions are delegated by the Council to the Director of Customer & Business Support Services, who operates within the framework set out in this strategy and through the Treasury Management Policies and Practices. In order to inform sound treasury management operations the Council works with its Treasury Management advisers, Sector Treasury Services. Sector Treasury Services offer the Council a comprehensive information and advisory service to enable the Council to maximise its investment returns and minimise the costs of its debts.
97. Treasury Management strategy and activity is influenced by the capital investment and revenue spending decisions made by the Council. Both the revenue and capital budgets have been through a corporate process of consultation and consideration by the elected politicians. The revenue budget and capital budget proposals are included within this agenda.
98. At a strategic level, there are a number of treasury management options available which depend on the Council's stance on interest rate movements. The report sets out the Council's stance and recommends the setting of key trigger points for borrowing and investing over the forthcoming financial year.

## **Council Plan**

99. The Treasury Management Strategy Statement and Prudential Indicators are aimed at ensuring the Council maximises its return on investments and minimises the cost of its debts. This will allow more resources to be freed up to invest in the Council's priorities, values and imperatives, as set out in the Council's Plan.

## **Implications**

100. Implications of the report are as follows:
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- **Financial** – The revenue implications of the treasury strategy are set out in the Revenue Budget report also on this agenda.
- **Human Resources (HR)** – None
- **Equalities** – None
- **Legal** – Treasury Management activities have to conform to the Local Government Act 2003, the Local Authorities (Capital; Finance and Accounting) (England) Regulations 2003 (SI 2003/3146), which specifies that the Council is required to have regard to the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice and also the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI 2008/414), which clarifies the requirements of the Minimum Revenue Provision guidance.
- **Crime and Disorder** – None
- **Information Technology (IT)** – None
- **Property** – None

### **Risk Management**

101. The treasury management function is a high-risk area because of the volume and level of large money transactions. As a result of this the Local Government Act 2003 (as amended), supporting regulations, the CIPFA Prudential Code and the CIPFA Treasury Management in the Public Services Code of Practice (the code) are all adhered to as required.

### **Recommendations**

102. The Cabinet are asked to recommend that Council approve:
- a. The proposed Treasury Management Strategy for 2012/13 including the annual investment strategy and the minimum revenue provision policy statement;
  - b. The Prudential Indicators for 2012/13 to 2016/17 in the main body of the report;
  - c. The Specified and Non-specified investments schedule (Annex C)
  - d. The Scheme of Delegation and the Role of the Section 151 Officer (Annex E)

Reason: To enable the continued effective operation of the Treasury Management function and ensure that all Council borrowing is prudent, affordable and sustainable.

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## **Contact Details**

### **Author:**

Louise Branford-White  
Technical Finance Manager  
Corporate Accountancy  
Tel No. 551187

Ross Brown  
Principal Accountant  
Corporate Accountancy  
Tel No. 551207

### **Chief Officer Responsible for the report:**

Ian Floyd  
Director of Customer and Business  
Support Services

Keith Best  
Assistant Director CBSS (Finance)

**Report**  **Date** 15/02/11  
**Approved**

Ian Floyd - Director of Customer Business  
and Support Services

**Report**  **Date** 14/02/12  
**Approved**

### **Specialist Implications Officer(s)**

N/a

### **Wards Affected:**

All

**For further information please contact the author of the report**

### **Background Papers**

Prudential indicator workings 2011/12 to 15/16

Treasury management budget 2011/12

Capital programme 2012/13 to 2016/17 report

Capital budget control 2011/11 to 2016/17.

Sector -treasury management advisers commentary.

### **Annexes**

Annex A – Prudential and Treasury Indicators 2011/12– 2016/17

Annex B – Interest Rate Forecast

Annex C – Specified and Non-Specified Investments categories  
Schedule

Annex D – Approved countries for investments

Annex E – Scheme of Delegation and the Role of the Section 151  
Officer