DECISION-MAKER:		GOVERNANCE COMMITTEE COUNCIL		
SUBJECT:		TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL LIMITS 2013/14 to 2015/16		
DATE OF DECISION:		5 FEBRUARY 2013 13 FEBRUARY 2013		
REPORT OF:		HEAD OF FINANCE AND IT (CHIEF FINANCIAL OFFICER)		
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STATEMENT OF CONFIDENTIALITY
NOT APPLICABLE

BRIEF SUMMARY

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

The core elements of the 2013/14 strategy are :

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

With overall annual expenditure in excess of £600M and an extensive capital programme, the Council is required to actively manage its cash-flows on a daily basis. The requirement to invest or to borrow monies to finance capital programmes, and to cover daily operational needs, is an integral part of daily cash and investment portfolio management.

As at 31 March 2013 the Council's gross external debt is expected to be £410M and the total value of investments is forecast at £53M. The Balance Sheet position as at 31 March 2012 showed the value of debt as £372M and the value of investments as £68M.

The Council's Capital Financing Requirement (CFR), which measures the Council's underlying need to borrow for capital purposes and represents the cumulative capital expenditure that has not yet been financed, is a key driver of borrowing strategy. The projected CFR for 31 March 2013 is £437M, of which £268M is attributed to the General Fund and the remaining £169M to the Housing Revenue Account (HRA).

The Council's current strategy is to minimise borrowing to below its CFR, the difference representing balances, reserves, provisions and working capital. This approach lowers interest costs, reduces credit risk and relieves pressure on the Council's counterparty list. Borrowing is restricted to a few highly secure sources which include the Public Works Loan Board (PWLB), commercial banks, the European Investment Bank, structured finance, and products associated with other local authorities. Additionally, borrowing is restricted by two limits, the Authorised Limit, (a statutory limit that sets the maximum level of external borrowing on a gross basis), and the Operational Boundary, (which is determined by both the estimated CFR and day to day cash flow movements). For 2013/14 the proposed Authorised Limit is £898M and proposed Operational Boundary is £857M. These are substantially higher than our anticipated actual level of debt but they allow for a full debt restructure to be undertaken if an appropriate opportunity arises, which may require taking new borrowing in advance of paying off existing loans.

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

In order to service the Council's day to day cash needs, the Council maintains a portfolio of short term investments. The Council's investment priorities are: the security of invested capital, the liquidity of invested capital, and the optimum yield that is commensurate with security and liquidity, in that order. The report details the Council's investment strategy, explains the institutions (counterparties) with whom the Council is permitted to invest, the limits related to the size of individual investments and the overall holding with institutions.

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

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

RECOMMENDATIONS:

GOVERNANCE COMMITTEE

It is recommended that Governance Committee:

i) Endorse the Treasury Management (TM) Strategy for 2013/14 as outlined in the report.

ii) Note that the indicators as reported have been set on the assumption that the recommendations in the Capital Update report will be approved by Council on 13 February 2013. Should the recommendations change, the Prudential Indicators may have to be recalculated.

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

COUNCIL

It is recommended that Council:

i) Approve the Council's Treasury Management (TM) Strategy and Prudential Indicators for 2013/14, 2014/15 and 2015/16, as detailed within the report.

ii) Approve the 2013 Minimum Revenue Provision (MRP) Statement as detailed in paragraphs 53 to 57.

iii) Approve the Annual Investment Strategy as detailed in paragraphs 26 to 43.

iv) Note that at the time of writing this report the recommendations in the Capital Programme Update report, submitted to Council on the 13 February 2013, have not yet been approved. The indicators in the report are based on the assumption that they will be approved, but should the recommendations change, the Prudential Indicators may have to be recalculated.

v) Continue to delegate authority to the Chief Financial Officer (CFO), following consultation with the Cabinet Member for Resources to approve any changes to the Prudential Indicators or borrowing limits that will aid good treasury management. For example, agreeing an increase in the percentage for variable rate borrowing to take advantage of the depressed market for short term rates. Any amendments will be reported as part of quarterly financial and performance monitoring and in revisions to the TM Strategy.

REASONS FOR REPORT RECOMMENDATIONS

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

- Treasury Management Strategy for 2013/14:
  - Borrowing – Paragraphs 17 to 22,
  - Debt Rescheduling – Paragraphs 23 to 25
  - Investments – Paragraphs 26 to 43.
- MRP Statement – Paragraphs 53 to 57.

- Prudential Indicators – Paragraphs 62 to 85.
- Use of Specified and Non-Specified Investments – Paragraphs 26 to 35.

ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

2. Alternative options for borrowing would depend on decisions taken on the review of the capital programme, which are being taken at Full Council on 13 February 2013.

DETAIL (Including consultation carried out)

CONSULTATION

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

BACKGROUND

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

5. The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public Services, (the "CIPFA TM Code"), and the Prudential Code require local authorities to determine a Treasury Management Strategy Statement (TMSS) and Prudential Indicators (PIs) on an annual basis. The TMSS also incorporates the Annual Investment Strategy (AIS), that is a requirement of the Department for Communities and Local Government's (CLG) Investment Guidance.

6. As per the requirements of the Prudential code, the Authority has adopted the CIPFA Treasury Management Code at a meeting of its Council meeting on 19 February 2003 and all subsequent updates.

7. The Authority has borrowed and invested substantial sums of money and therefore has potential large exposures to financial risks including the loss of invested funds and the effect of changing interest rates. The successful identification, monitoring and control of risk is the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the Council. The main risks to the Council's treasury activities are:

   - Liquidity Risk (Inadequate cash resources)
   - Market or Interest Rate Risk (Fluctuations in interest rate levels and thereby in the value of investments).
   - Inflation Risks (Exposure to inflation)
   - Credit and Counterparty Risk (Security of Investments)
   - Refinancing Risks (Impact of debt maturing in future years)
   - Legal & Regulatory Risk (i.e. non-compliance with statutory and regulatory requirements, risk of fraud)

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

- Treasury Management Strategy for 2013/14
- Annual Investment Strategy 2013/14
- Prudential Indicators for 2013/14, 2014/15 and 2015/16
- 2013 MRP Statement

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

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

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

BALANCE SHEET AND TREASURY POSITION

12. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). The CFR, together with balances and useable reserves, are the core drivers of TM Activity.

13. As at the 31 December 2012 the Authority's had £371M of debt and £70M investments which is set out in further detail in Appendix 1.

14. The Authority is able to borrow funds in excess of the current level of its CFR up to the projected level in 2015/16. The Authority is likely to only borrow in advance of need if it felt the benefits of borrowing at interest rates now compared to where they are expected to be in the future, outweighs the current cost and risks associated with investing the proceeds until the borrowing was actually required.

15. The forecast movement in the CFR in coming years is one of the Prudential Indicators (PIs). The movement in actual external debt and usable reserves combine to identify the Authority's borrowing requirement and potential investment strategy in the current and future years is shown below.

	2012/13 Estimate £M	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M
General Fund CFR	**268**	**261**	**259**	**251**
Housing CFR	**169**	**176**	**179**	**179**
Total CFR	**437**	**437**	**438**	**430**
Less: Existing Profile of Long Term Borrowing and Other Long Term Liabilities	385	394	395	384
Cumulative Maximum External Borrowing Requirement	**52**	**43**	**43**	**46**
Balances & Reserves	34	28	24	22
Cumulative Net Borrowing Requirement / (Investments)	**18**	**15**	**19**	**24**

OUTLOOK FOR INTEREST RATES

16. The economic interest rate outlook provided by the Council's treasury advisor, Arlingclose, is attached at Appendix 2. This indicates that rates are likely to remain lower for longer with the forecast for the UK base rate to remain at 0.5% until 2016, given the outlook for economic growth and the extension of austerity measures announced in the Chancellor's Autumn Statement. The Council also monitors other sources of market information and will reappraise its strategy from time to time and, if required, realign it with evolving market conditions and expectations for future interest rates.

BORROWING STRATEGY

17. Treasury management and borrowing strategies in particular, continue to be influenced not only by the absolute level of borrowing rates but also the relationship between short and long term interest rates. This difference creates a "cost of carry" for any new longer term borrowing where the proceeds are temporarily held as investments because of the difference between what is paid on the borrowing and what is earned on the investment. The interest rate forecast provided in Appendix 2 indicates that the cost of carry is likely to be an issue until 2016 or beyond. As borrowing is often for longer dated periods, (anything up to 50 years), the cost of carry needs to be considered against a backdrop of uncertainty and affordability constraints in the Authority's wider financial position.

18. As indicated in the table in paragraph 15, the Authority has a gross borrowing requirement in 2012/13 which may be deferred to 2013/14 or beyond, providing balances can support this. The Authority will adopt a flexible approach to this borrowing in consultation with its TM advisers.

    The following issues will be considered prior to undertaking any external borrowing:

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

Sources of Borrowing and Portfolio implications

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

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

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

21. The Council has exposed itself to interest rate risk by taking out variable debt. This was and continues to be very financially favourable in current markets but does mean that the Council must monitor markets to ensure it is not caught out. During 2013/14 the Council will continue to review and take action as necessary to lessen this risk through a balanced combination of:

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

In order to mitigate these risks further, the Council approved the creation of an

Interest Equalisation Reserve in 2009.

At that point a major debt restructuring exercise was undertaken in order to take advantage of market conditions and produce net revenue savings. In achieving this, the Council has exposed itself to short term variable interest rate risk and whilst in the current climate of low interest rates this remains a sound strategy, at some point when the market starts to move, the Council will need to act quickly to lock into fixed long term rates which may be at similar levels to the debt it restructured. Furthermore, the volatility in the financial markets means that interest costs and investment income will continue to fluctuate for some time. It was therefore recommended that an Interest Equalisation Reserve be created to help to manage volatility in the future and ensure that there was minimal impact on annual budget decisions or council tax in any single year. The Reserve will be maintained at an appropriate level to protect the Council from future increase in debt charges where it is prudent to do so. The level of the reserve will be reviewed over the next twelve months.

22. The Authority has £9M exposure to LOBO loans all of which can be “called” within 2013/14. A LOBO is called when the Lender exercises their right to amend the interest rate on the loan at which point the Borrower can accept the revised terms or reject them and repay the loan. LOBO loans present a potential refinancing risk to the Authority since the decision to call a LOBO is entirely at the lender’s discretion. Any LOBOs called will be discussed with the treasury advisers prior to acceptance of any revised terms. The default position will be the repayment of the LOBO without penalty i.e. the revised terms will not be accepted.

DEBT RESCHEDULING

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

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

- Reduce investment balances and credit exposure via debt repayment
- Align long-term cash flow projections and debt levels
- Savings in risk adjusted interest costs
- Rebalancing the interest rate structure of the debt portfolio
- Changing the maturity profile of the debt portfolio

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

INVESTMENT POLICY AND STRATEGY

26. In accordance with Investment Guidance issued by the CLG and best practice the Authority's primary objective in relation to the investment of public funds remains the security of capital. The liquidity or accessibility of the Authority's investments is secondary, followed by the yield earned on investments which is a tertiary consideration. The Authority and its advisors remain on alert for signs of credit or market distress which might adversely affect the Authority.

27. Investments are categorised as 'Specified' or 'Non Specified' investments based on the criteria in the CLG Guidance. Specified investments are sterling denominated investments with a maximum maturity of one year. They also meet the "high credit quality" as determined by the Authority and are not deemed capital expenditure investments under Statute. Non specified investments are, effectively, everything else. Potential instruments for the Council's use within its investment strategy are detailed below.

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

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

29. Investments with other organisations have been included as a non-specified investment category for 2013/14. This would include investment opportunities with small and medium sized enterprises (SMEs) and other businesses across the UK. Because of the higher perceived credit risk of SMEs, such investments may provide considerably higher rates of return. An external credit assessment will be undertaken and advice from the Council's TM adviser will be sought (where available) before any investment decision is made. No investment would be undertaken unless security on the asset could be obtained.

30. The minimum credit rating for non-UK sovereigns is AA+ (or equivalent). For specified investments the minimum long term rating for counterparties is A- (or equivalent). As detailed in non-specified investments in Appendix 4, the CFO will have discretion to make investments with counterparties that do not meet the specified criteria on advice from Arlingclose.

31. The other credit characteristics, in addition to credit ratings, that the Authority monitors are listed in the Prudential Indicator on Credit Risk, paragraphs 81 to 83.

32. Any institution will be suspended or removed should any of the factors identified give rise to concern. Specifically credit ratings are monitored by the Authority on a daily basis. Arlingclose advises the Authority on ratings changes and appropriate action to be taken.

33. The countries and institutions that currently meet the criteria for investments are included in Appendix 3.

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

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

Investment Strategy

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

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

38. Money market funds (MMFs) will be utilised, but good TM practice prevails and whilst MMFs provide good diversification the Authority will also seek to diversify any exposure by utilising more than one MMF. The Authority will also restrict its exposure to MMFs with lower levels of funds under management and will not exceed 0.5% of the net asset value of the MMF. In the case of Government MMFs, the Council will ensure exposure to each Fund does not exceed 2% of the net asset value of the Fund. Where MMF's participate, the Council utilises the facilities of a MMF portal to make subscriptions and redemptions. The portal procedure involves the use of a clearing agent however the Council's funds are ring fenced throughout the process.

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

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

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

42. The UK Bank Rate has been maintained at 0.5% since March 2009, and is anticipated to remain at low levels throughout 2013/14. Short term money market rates are likely to remain at very low levels for an extended period, which will have a significant impact on investment income and which has been reflected in the budget forecast.

Collective Investment Schemes (Pooled Funds)

43. The Council has evaluated the use of Pooled Funds and determined the appropriateness of their use within the investment portfolio. Pooled funds enable the Council to diversify the assets and the underlying risk in the investment portfolio and provide the potential for enhanced returns. Any investment in pooled funds will be undertaken with advice from our advisors. Pooled Funds available to the Authority are listed in Appendix 4; their performance and continued suitability in meeting the Authority's investment objectives are regularly monitored.

Policy on Use of Financial Derivates

44. Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). The CIPFA Code requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

45. The Authority will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce

the overall level of the financial risks that the Authority is exposed to.

Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

46. Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

47. The local authority will only use derivatives after seeking expertise, a legal opinion and ensuring officers have the appropriate training for their use.

Housing Revenue Account Self-Financing

48. Central Government completed its reform of the Housing Revenue Account Subsidy system at the end of 2011/12. Local authorities are required to recharge interest expenditure and income attributable to the HRA in accordance with Determinations issued by the CLG.

49. The Determinations do not set out a methodology for calculating the interest rate to use in each instance. The Council is therefore required to adopt a policy that will set out how interest charges attributable to the HRA will be determined. The CIPFA Code recommends that authorities present this policy in their TMSS.

50. On 1 April 2012, the Council notionally split each of its existing long-term loans into General Fund and HRA pools. In the future, new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs / income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged / credited to the respective revenue account.

51. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance. This balance will be measured and interest transferred between the General Fund and HRA at an agreed rate. Housing Legislation does not allow impairment losses to be charged to the HRA and consequently any credit related losses on the authority's investments will be borne by the General Fund alone. It is therefore appropriate that the General Fund is compensated for bearing this risk, and all interest transferred to the HRA should be adjusted downwards. The rate will be based on the average return of Government Treasury Bills as interest rate received on investments with commercial organisations (e.g. banks) includes a credit risk margin, i.e. an element to compensate the lender for the risk that the borrower is unable to repay the investment. The rate of return on comparable investments with the government is lower and often referred to as the risk-free rate.

BALANCED BUDGET REQUIREMENT

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

<u>2013/14 MINIMUM REVENUE PROVISION (MRP) STATEMENT</u>

53. The Council is required to set an annual policy on the way it calculates the prudent provision for the repayment of borrowing (MRP) and to submit this to Council before the start of the 2013/14 financial year. If it is ever proposed to vary the terms of the original MRP Statement during the year, a revised statement should be put forward for approval by the Authority at that time.

54. CLG's Guidance on Minimum Revenue Provision (issued in 2010) places a duty on local authorities to make a prudent provision for debt redemption. Guidance on Minimum Revenue Provision has been issued by the Secretary of State and local authorities are required to "have regard" to such Guidance under section 21(1A) of the Local Government Act 2003. The four MRP options available are:

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

    NB *This does not preclude other prudent methods to provide for the repayment of debt principal.*

    <u>MRP in 2013/14</u>: Option 1 and 2 will be used for the majority of General Fund historic debt particularly that deemed to be supported through the Revenue Support Grant. For major projects where capital expenditure is funded from prudential borrowing Option 3 will be used to provide MRP over the life of the asset to which the borrowing was applied.

55. Following the HRA self-financing settlement, HRA debt increased from £100M to £174M with a borrowing cap of £200M. There is no requirement for the HRA to make debt repayments but it has opted to make voluntary repayments relating to debt inherited at the split and provision has been made within its business plan to show that it can pay down the remaining debt over the life of the 30 year business plan.

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

57. Guidance relating to the regulatory method (option 1), which is used to calculate borrowing prior to the prudential regime, allows for debt transferred from Hampshire County Council (HCC) when we became a Unitary Authority in 1997 to be excluded from the MRP calculation as we are already repaying the principal element to HCC. The guidance states that the adjustment should be based on the value of the debt as at the 1 April 2004, however in order to be prudent we reduced the adjustment each year in line with the actual debt outstanding, thus increasing the amount of MRP we needed to pay in year. We are now seeking advice on whether this technical 'overpayment' can be reversed which could result in a one off credit in MRP to the General Fund.

MONITORING AND REPORTING ON THE ANNUAL TREASURY OUTTURN AND PRUDENTIAL INDICATORS

58. The Chief Financial Officer will report to the Governance Committee on TM activity / performance as follows:

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

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

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

TRAINING

60. CIPFA's Code of Practice requires the CFO to ensure that all Members tasked with TM responsibilities, including scrutiny of the TM function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities. Member training was undertaken on the 12 January 2012 and a further session has been arranged for the 30 January 2013. The Council adopts a continuous performance and development programme to ensure staff are regularly appraised and any training needs addressed. Treasury staff also attend regular training sessions, seminars and workshops which ensure their knowledge is up to date and relevant. Details of training received are maintained as part of the performance and development process.

TREASURY MANAGEMENT ADVISORS

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

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

    The Council has a contract in place with Arlingclose, to the 31 January 2014, to provide a treasury advisory service and receives the following services:

    - Credit advice
    - Investment advice
    - Technical advice
    - Economic & interest rate forecasts
    - Workshops and training events
    - HRA support
    - Ad hoc advice

    The Authority maintains the quality of the service with its advisors by holding quarterly meetings and tendering periodically. It should also be noted that decisions are taken independently by the CFO taking into account this advice and other internal and external factors.

PRUDENTIAL INDICATORS

Background

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

Gross Debt and the Capital Financing Requirement

63. This is a key indicator of prudence. In order to ensure that over the medium term debt will only be for a capital purpose, the local authority should ensure that debt does not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. If in any of these years there is a reduction in the CFR, this reduction is ignored in estimating the cumulative increase in the capital financing requirement which is used for comparison with gross external debt. The CFO reports that the Authority had no difficulty meeting this requirement in 2012/13, nor are there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

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

Estimates of Capital Expenditure

65. This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council Tax and in the case of the HRA, housing rent levels.

Capital Expenditure	2012/13 Approved £000's	2012/13 Revised £000's	2013/14 Estimate £000's	2014/15 Estimate £000's	2015/16 Estimate £000's
General Fund	65,677	63,558	47,034	23,666	4,282
HRA	33,894	31,196	37,202	35,622	34,609
Total	**99,571**	**94,754**	**84,236**	**59,288**	**38,891**

66. The table below details how capital expenditure is expected to be financed and shows that the Authority cannot finance this without the need for external borrowing.

Capital Financing	2012/13 Approved £000's	2012/13 Revised £000's	2013/14 Estimate £000's	2014/15 Estimate £000's	2015/16 Estimate £000's
Capital receipts	17,914	18,107	15,402	11,079	1,049
Government Grants	36,715	36,978	30,946	10,762	2,100
Contributions	5,328	5,103	2,624	2,586	2,832
Major Repairs Allowance	17,172	17,172	16,117	16,843	16,841
Revenue	11,537	11,025	11,354	9,677	11,169
Total Financing	**88,666**	**88,385**	**76,443**	**50,947**	**33,991**
Temporary Financing	0	(6,100)	(5,860)	0	0
Unsupported borrowing	10,905	12,469	13,653	8,341	4,900
Total Funding	**10,905**	**6,369**	**7,793**	**8,341**	**4,900**
Total Financing & Funding	**99,571**	**94,754**	**84,236**	**59,288**	**38,891**

Ratio of Financing Costs to Net Revenue Stream

67. This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet borrowing costs. The ratio is based on costs net of investment income. The upper limit for this ratio is currently set at 10% and will remain so for the General Fund to allow for known borrowing decision in the next two years and to allow for additional borrowing affecting major schemes. The table below shows the likely position based on the proposed capital programme. It should be noted that the budget requirement for the year is used to calculate this indicator and that the basis for this has changed from 2013/14 resulting in an increase, thus lowering the ratio. If the original basis had remained, the ratio for 2013/14 would have been around 7.5%.

68. This indicator is not so relevant for the HRA, especially since the introduction of self financing, as financing costs have been built into their 30 year business plan, including the voluntary payment of MRP. No problem is seen with the affordability but if problems were to arise then the HRA would have the option not to make principle repayments in the early years.

Ratio of Financing Costs to Net Revenue Stream	2012/13 Approved %	2012/13 Estimate %	2013/14 Estimate %	2014/15 Estimate %	2015/16 Estimate %
General Fund	6.84%	6.26%	6.78%	6.97%	7.24%
HRA	10.92%	24.96%	17.51%	16.18%	15.57%
Total	8.84%	12.15%	10.43%	10.20%	10.54%

Capital Financing Requirement (CFR)

69. The CFR measures the Council's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet

relating to capital expenditure and its' financing.

Capital Financing Requirement	2012/13 Approved £M	2012/13 Revised £M	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M
General Fund	265	268	261	259	251
HRA	176	169	176	179	179
Total CFR	**441**	**437**	**437**	**438**	**430**

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

Capital Financing Requirement	2012/13 Approved £M	2012/13 Forecast £M	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M
Balance B/F	**444**	**445**	**437**	**437**	**438**
Capital expenditure financed from borrowing (inc PFI schemes)	15	13	14	12	3
Temporary Funding (Repayment)	0	(6)	(6)	0	0
HRA Debt	(8)	5	7	3	3
Revenue provision for debt Redemption.	(8)	(18)	(13)	(12)	(12)
Movement in Other Long Term Liabilities	(2)	(2)	(2)	(2)	(2)
Cumulative Maximum External Borrowing Requirement	**441**	**437**	**437**	**438**	**430**

Incremental Impact of Capital Investment Decisions

70. This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax and Housing Rent levels. The incremental impact is calculated by comparing the total revenue budget requirement (i.e. Interest and MRP) of the current approved capital programme with an equivalent calculation arising from the proposed programme. The incremental impact of capital investments decisions are estimated to be:

Incremental Impact of Capital Investment Decisions	2012/13 Approved £	2013/14 Estimate £	2014/15 Estimate £	2015/16 Estimate £
Increase / (decrease) in Band D Council Tax	2.94	(10.11)	(5.20)	0.13
Increase /(decrease) in Average Weekly Housing Rents	(2.41)	14.02	7.22	5.28

71. The decision to restrict the capital programme and to use capital receipts to repay temporary financing results in an incremental decrease in the Band D Council Tax for 2013/14 and 2014/15. For the HRA, the reality is that the rent levels are set under the Government's rent restructuring formula, which is independent of the level of capital investment and borrowing. The calculation of the indicator ignores this factor.

Authorised Limit and Operational Boundary for External Debt

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

73. The ***Authorised Limit*** sets the maximum level of external borrowing on a gross basis (i.e. excluding investments) for the Council. It is measured on a daily basis against all external borrowing items on the Balance Sheet (i.e. long and short term borrowing, overdrawn bank balances and long term liabilities). This Prudential Indicator separately identifies borrowing from other long term liabilities such as finance leases. It is consistent with the Council's existing commitments, its proposals for capital expenditure and financing and its approved treasury management policy statement and practices.

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

Authorised Limit for External Debt	**2012/13 Approved £M**	**2012/13 Revised £M**	**2013/14 Estimate £M**	**2014/15 Estimate £M**	**2015/16 Estimate £M**
Borrowing	832	809	817	814	799
Other Long-term Liabilities	79	79	81	86	91
Total	**911**	**888**	**898**	**900**	**890**

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

Operational Boundary for External Debt	2012/13 Approved £M	2012/13 Revised £M	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M
Borrowing	794	772	779	777	763
Other Long-term Liabilities	75	75	78	82	87
Total	**869**	**847**	**857**	**859**	**850**

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

Adoption of the CIPFA Treasury Management Code

76. This indicator demonstrates that the Council has adopted the principles of best practice and all subsequent updates.

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

Upper Limits for Fixed and Variable Interest Rate Exposure

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

	Existing level at 31/12/2012 %	2011/12 Approved %	2013/14 Estimate %	2014/15 Estimate %	2015/16 Estimate %
Upper Limit for Fixed Interest Rate Exposure	85	100	100	100	100
Upper Limit for Variable Interest Rate Exposure	15	50	50	50	50

78. The Council will also limit and monitor large concentrations of fixed rate debt needing to be replaced. The limits provide the necessary flexibility within which decisions will be made for drawing down new loans on a fixed or variable rate basis; the decisions will ultimately be determined by expectations of anticipated interest rate movements as set out in the Council’s TM strategy.

As all LOBO are now in their call options they have been included as under 12 months within this indicator.

Maturity Structure of Fixed Rate borrowing

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

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

	Lower Limit %	Upper Limit %	Actual Fixed Debt as at 31/12/2012 £M	Average Fixed Rate as at 31/12/2012 %	% of Fixed Rate as at 31/12/2012	Compliance with set Limits?
Under 12 months	0	45	12	1.84	5.03	Yes
12 months and within 24 months	0	45	0	0.00	0.00	Yes
24 months and within 5 years	0	50	0	0.00	0.00	Yes
5 years and within 10 years	0	75	95	3.23	38.70	Yes
10 years and within 15 years	0	75	0	0.00	0.00	Yes
15 years and within 20 years	0	75	0	0.00	0.00	Yes
20 years and within 25 years	0	75	0	0.00	0.00	Yes
25 years and within 30 years	0	75	10	4.68	4.05	Yes
30 years and within 35 years	0	75	5	4.60	2.03	Yes
35 years and within 40 years	0	75	25	4.62	10.13	Yes
40 years and within 45 years	0	75	53	3.61	21.44	Yes
45 years and within 50 years	0	75	46	3.54	18.62	Yes
50 years and above	0	100	0	0.00	0.00	Yes
			247	**3.54**	**100.00**	

Credit Risk

81. The Council considers security, liquidity and yield, in that order, when making investment decisions. Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Council's assessment of counterparty credit risk.

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

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

83. The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

Upper Limit for total principal sums invested over 364 days

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

Upper Limit for total principal sums invested over 364 days	2011/12 Approved £M	2012/13 Revised £M	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M
	50	50	50	50	50

HRA Limit on Indebtedness

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

HRA Summary of Borrowing	2012/13 Estimate £M	2012/13 Revised £M	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M
Brought Forward	174.2	174.2	168.8	175.7	178.8
Maturing Debt	(8.6)	(10.4)	(5.6)	(5.1)	(5.1)
New borrowing	4.8	5.0	12.5	8.2	4.9
Carried forward	**170.4**	**168.8**	**175.7**	**178.8**	**178.6**
HRA Debt Cap (as prescribed by CLG)	201.3	199.6	199.6	199.6	199.6
Headroom	**30.9**	**30.8**	**23.9**	**20.8**	**21.0**

RESOURCE IMPLICATIONS

Capital

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

Revenue

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

Property/Other

88. None

LEGAL IMPLICATIONS

Statutory power to undertake proposals in the report:

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

Other Legal Implications:

90. None

POLICY FRAMEWORK IMPLICATIONS

91. This report has been prepared in accordance with CIPFA's Code of Practice on TM.

KEY DECISION? Yes/No

WARDS/COMMUNITIES AFFECTED:	

SUPPORTING DOCUMENTATION

Appendices

1.	Existing Investment & Debt Portfolio Position and Projections
2.	Economic and Interest Outlook

3.	Recommended Sovereign and Counterpart List
4.	Non- Specified Investments
5.	Treasury Management Policy Statement
6.	Glossary of Treasury Terms

Documents In Members' Rooms

1.	
2.	

Equality Impact Assessment

Do the implications/subject of the report require an Equality Impact Assessment (EIA) to be carried out.	No

Other Background Documents

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

Title of Background Paper(s)		Relevant Paragraph of the Access to Information Procedure Rules / Schedule 12A allowing document to be Exempt/Confidential (if applicable)
1.	ANNUAL TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL LIMITS 2012/13 TO 2014/15 – Council 15 February 2012	