ITEM NO. 11.1

Report of:	**Head of Finance**
Contact Officer:	**S Campbell**
Telephone No:	**464389**
Portfolio Leader:	**Leader of the Council**
Key Decision:	**No**
Report Track:	**Cabinet 31/01/13** **Council 13/02/13**

CABINET

31 JANUARY 2013

TREASURY MANAGEMENT STRATEGY STATEMENT 2013-14

1 Purpose of Report

1.1 To submit for Members' approval a Treasury Management Strategy Statement, Minimum Revenue Provision Policy (MRP) policy statement and Annual Investment Strategy for 2013-14.

2 Recommendations

2.1 That members approve the Treasury Management Strategy Statement, Minimum Revenue Provision Policy (MRP) and Annual Investment Strategy for 2013-14 and recommend the following control framework to Council :-

(a) That the Council will maintain for effective treasury management:-

- A Treasury Management Policy Statement (TMPS) which sets out the policies and objectives of its Treasury Management activities.
- Suitable Treasury Management Practices (TMP) setting out the manner in which the organisation will seek to achieve those policies and objectives.

(b) The Council will receive as a minimum an annual Treasury Management Strategy Statement – including the Annual Investment Strategy and Minimum Revenue Provision Policy – for the year ahead, a mid-year review report and an annual report covering activities during the previous year.

(c) The Council delegates responsibility for the implementation and monitoring of its Treasury Management Policies and Practices to the Cabinet and for the execution and administration of Treasury Management decisions to the Head of Finance.

2.2 That members note that the Treasury and Prudential limits under Section 3 of the Local Government Act 2003 to apply in 2013-14 will be determined at Council in setting its budget and subject to that adopt the revised Treasury Management Policy statement.

3 Key Issues and Reasons for Recommendation

3.1 That the recommendations above be approved. The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury management 2011 was adopted by this Council on 29th February 2012.

3.2 The primary requirements of the code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

- Receipt by the full Council of an annual Treasury Management Strategy Statement – including the Annual Investment Strategy and Minimum Revenue Provision Policy – for the year ahead, A Mid-year Review Report and an Annual Report covering activities during the previous year.

- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Audit and Governance committee.

4 Relationship to Corporate Priorities

4.1 This report supports the Council's Corporate Priorities as follows:
Treasury Management is an important function of the authority and provides part of the setting of an approved budget for 2013-14 and future years. The approved budget represents the agreed priorities of the Council as determined by the Delivering Change process and hence have directly contributed to the Corporate Priorities as part of a medium term financial strategy.

5 Report Detail

Background

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

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

5.3 CIPFA defines treasury management as:

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

Reporting requirements

5.4 The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and accruals.

5.5 **Prudential and treasury indicators and treasury strategy** (this report) – The first, and most important report covers:

- The capital plans (including prudential indicators);
- A minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
- The treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- An investment strategy (the parameters on how investments are to be managed).

A mid year treasury report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether the treasury strategy is meeting the strategy or whether any policies require revision.

An annual treasury report – This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.
Scrutiny – the above reports are required to be adequately scrutinised before being recommended to the Council.

Treasury Management Strategy for 2013-14

5.6 The strategy for 2013-14 covers two main areas:

Capital Issues
- The capital plans and the prudential indicators;
- The minimum revenue provision (MRP) strategy.

Treasury management issues
- The current treasury position
- Treasury indicators which limit the treasury risk and activities of the Council;
- Prospects for interest rates;
- The borrowing strategy
- Policy on borrowing in advance of need;
- Debt rescheduling;
- The investment strategy;
- Creditworthiness policy; and

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential code, CLG MRP guidance, the CIPFA Treasury Management Code and CLG Investment guidance.

Training

5.7 The CIPFA code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny and training will be arranged as required. The training needs of treasury management officers are periodically reviewed.

Treasury management consultants

5.8 The Council uses Sector as its external treasury management advisors. 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.

5.9 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.

The Capital Prudential Indicators 2013-14 to 2015-16

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

5.11 **Capital expenditure** – This prudential indicator is a summary of the Council's capital expenditure plans, including items contained in the Consultation Budget, both those agreed previously, and those forming part of this budget cycle. The expenditure includes at this stage the Section 106 capital programme. Members are asked to approve the capital expenditure forecasts, subject to any amendments arising from Councils determination of Capital Budgets as part of the formal process for setting the budget.

Capital Expenditure £m	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
Culture and Sport	4.796	1.780	0.238	1.149	1.149
Housing GF	2.860	0.455	1.355	0.887	0.875
Economic Development	0.007	0.981	1,240	2.641	
Environment	0.085	0.035	1.850	0.036	0.036
Non HRA	**7.748**	**3.251**	**4.683**	**4.713**	**2.060**
HRA	**5.800**	**7.421**	**12.160**	**12.235**	**10.212**
Total	**13.548**	**10.672**	**16.843**	**16.948**	**12.272**

5.12 The table below summarises the above capital expenditure plans , including consultation options,and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need:

Capital Expenditure £m	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
Non HRA	**7.748**	**3.251**	**4.683**	**4.713**	**2.060**
HRA	**5.800**	**7.421**	**12.160**	**12.235**	**10.212**
Total	**13.548**	**10.672**	**16.843**	**16.948**	**12.272**
Financed by:					
Capital Receipts	0.974	1.648	2.009	0.923	0.911
Capital Grants	2.608	0.884	2.301	2.752	1.374
Growing Places			0.880	2.641	
MRA	0.283	3.131	3.642	3.432	5.671
RCCO	2.552	2.405	6.391	4.178	4.316
Net financing need for the year	**7.131**	**2.604**	**1.619**	**3.022**	**0.000**

5.13 **The Council's borrowing need (the Capital Financing Requirement)** – 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.

5.14 The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each assets life.

5.15 The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £0.797m of such schemes within the CFR.

5.16 The Council is asked to approve the CFR projections below:

Capital Financing Requirement £m	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
CFR – non housing	12.762	16.622	17.786	17.289	16.812
CFR – housing	82.007	82.007	82.007	85.029	85.029
Total CFR	**94.769**	**98.629**	**99.793**	**102.318**	**101.841**
Movement in CFR	**65.397**	**3.860**	**1.164**	**2.525**	**(0.477**

Movement in CFR represented by					
Net financing need for the year (above)	65.649	2.604	1.619	3.022	0
LAMS		2.000			
Less MRP and other financing movements	0.252	0.744	0.455	0.497	0.477
Movement in CFR	**65.397**	**3.860**	**1.164**	**2.525**	**(0.477)**

5.17 **Minimum Revenue Provision (MRP) policy statement** – The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the minimum revenue provision – MRP), although it is allowed to undertake additional voluntary payments if required (voluntary revenue provision – VRP).

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

5.19 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. This provides for an approximate 4% reduction in the borrowing need (CFR) each year.

5.20 From 1 April 2008 for all unsupported borrowing (including PFI and finance leases) the MRP policy will be the 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). This option provides for a reduction in the borrowing need over approximately the asset's life.

5.21 There is no requirement on the HRA to make a minimum revenue provision but there is a legal requirement for a charge for depreciation to be made.

5.22 The Council on 16th January approved the Council's participation in the Local Authority Mortgage Scheme (LAMS). For authorities who participate in LAMS using the cash backed option, the mortgage lenders require a five year deposit from the local authority to match the five year life of the indemnity. The deposit placed with the mortgage lender provides an integral part of the mortgage lending, and is treated as capital expenditure and a loan to a third party. The Capital Financing Requirement (CFR) will increase by the amount of the total indemnity. The deposit is due to be returned in full at maturity, with interest paid either annually or on maturity. Once the deposit matures and funds are returned to the local authority, the returned funds are classed as a capital receipt, and the CFR will reduce accordingly. As this is a temporary (five years) arrangement and the funds will be returned in full, there is no need to set aside prudent provision to repay the debt liability in the interim period, so there is no MRP application.

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

Year End Resources £m	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
Core Funds	18.156	12.350	9.035	7.516	6.191
Working Capital	11.294	10.350	8.035	7.016	5.691
Expected Investments	**6.862**	**2.000**	**1.000**	**0.500**	**0.500**

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

Ratio of financing costs to net revenue stream.
This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

%	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
Non HRA	1.56	4.67	4.41	5.51	5.51
HRA	8.36	18.34	18.05	18.57	18.14

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

£	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
Council Tax Band D	0.00	0.00	0.00	0.00	0.00

5.26 **Estimates of the incremental impact of capital investment decisions on housing rent levels.** Similar to the council tax calculation, this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels. This indicator shows the revenue impact on any newly proposed changes, although any discrete impact will be constrained by rent controls.

£	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
Weekly Housing Rent levels	0.00	0.00	0.00	0.00	0.00

Borrowing

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

5.28 **Current portfolio positions**- The Council's treasury position at 31 March 2012, with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement – CFR), highlighting any over or under borrowing.

£m	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
External Debt					
Debt at 1 April	21.487	83.546	90.881	92.377	95.396
Expected change in debt	62.059	7.335	1.497	3.019	(0.838)
Other Long-term liabilities (OLTL)					
Expected change in OLTL					
Actual gross debt at 31 March	83.546	90.881	92.378	95.396	94.558
The CFR	94.769	98.629	99.793	102.318	101.002
Under / (Over) borrowing	11.223	7.748	7.415	6.922	6.444

5.29 Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2013-14 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

5.30 The Head of Finance reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

Treasury Indicators: limits to borrowing activity

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

Operational Boundary £m	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
Debt	87.600	94.930	96.427	99.446	98.604

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

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

2 The Council is asked to approve the following authorised limit:

Authorised Limit £m	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
Debt	94.443	101.773	103.270	106.289	105.447

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

HRA Debt Limit £m	2011-12 Actual	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate	2015-16 Estimate
	85.029	85.029	85.029	85.029	85.029

5.34 **Prospects for interest rates.** The Council has appointed Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives the Sector central view.

Annual Average %	Bank Rate	PWLB Borrowing Rates (including certainty rate adjustment)		
		5 year	25 year	50 year
Dec 2012	0.50	1.50	3.70	3.90
March 2013	0.50	1.50	3.80	4.00
June 2013	0.50	1.50	3.80	4.00
Sept 2013	0.50	1.60	3.80	4.00
Dec 2013	0.50	1.60	3.80	4.00
March 2014	0.50	1.70	3.90	4.10
June 2014	0.50	1.70	3.90	4.10
Sept 2014	0.50	1.80	4.00	4.20
Dec 2014	0.50	2.00	4.10	4.30
March 2015	0.75	2.20	4.30	4.50
June 2015	1.00	2.30	4.40	4.60
Sept 2015	1.25	2.50	4.60	4.80
Dec 2015	1.50	2.70	4.80	5.00
March 2016	1.75	2.90	5.00	5.20

5.35 The economic recovery in the UK since 2008 has been the worst and slowest recovery in recent history, although the economy returned to positive growth in the third quarter of 2012. Growth prospects are weak and consumer spending, the usual driving force of recovery, is likely to remain under pressure due to consumers focusing on repayment of personal debt, inflation eroding disposable income, general malaise about the economy and employment fears.

5.36 The primary drivers of the UK economy are likely to remain external. 40% of UK exports go to the Eurozone so the difficulties in this area are likely to continue to hinder UK growth. The US, the main world economy, faces similar debt problems to the UK, but urgently needs to resolve the fiscal cliff now that the presidential elections are out of the way. The resulting US fiscal tightening and the continuing Eurozone problems will depress UK growth and is likely to see the UK deficit reduction plans slip.

5.37 This challenging and uncertain economic outlook has several key treasury management implications:

- The Eurozone sovereign debt difficulties provide a clear indication of high 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 2013-14 and beyond;
- Borrowing interest rates continue to be attractive and may remain relatively low for some time. The timing of any borrowing will need to be monitored carefully;
- There will remain a cost of carry – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

5.38 **Borrowing Strategy**. The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is relatively high.

5.39 Against this background and the risks within the economic forecast, caution will be adopted with the 2013-14 treasury operations. The Head of Finance will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- If it was felt that there was a significant risk of a sharp FALL in long and short term rates (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), the 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.

Any decisions will be reported to the appropriate decision making body at the next available opportunity.

5.40 **Treasury management limits on activity** There are no direct financial implications for the Council as a result of this report three debt related treasury activity limits. The purpose of these are to restrain 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. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

The Council is asked to approve the following treasury indicators and limits:

£m	2013-14	2014-15	2015-16
Interest rate exposures	Upper	Upper	Upper
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	50%	50%	50%
Limits on fixed interest rates: - Debt Only - Investments only	 100% 50%	 100% 50%	 100% 50%
Limits on variable interest rates: - Debt Only Investments only	 10% 100%	 10% 100%	 10% 100%

Maturity structure of fixed interest rate borrowing	
Under 12 months	0.0%
12 months to 2 years	3.4%
2 years to 5 years	3.9%
5 years to 10 years	0.0%
10 years and above	92.7%

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

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

The reasons for any rescheduling to take place will include:

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

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt. All rescheduling will be reported to Cabinet, at the earliest meeting following its action.

Annual Investment Strategy

5.43 **Investment policy.** The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second and then return.

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

5.45 Furthermore, the Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings. This is fully integrated into the credit methodology provided by the advisors, Sector in producing its colour codings which show the varying degrees of suggested creditworthiness.

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

5.47 The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk. The intention of the strategy is to provide security of investment and minimisation of risk.

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

5.49 **Creditworthiness policy**. This council applies the creditworthiness service provided by Sector. This service employs a sophisticated modelling approach utilising credit ratings from he three main credit rating agencies – Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following 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.

5.50 This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands.

- Yellow 5 years AAA rated Government debt
- Purple 2 years
- Blue 1 year Nationalised or semi-nationalised UK banks
- Orange 1 year
- Red 6 months
- Green 3 months
- No colour not to be used

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

5.52 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 rating of A-, and a support rating of 1. 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.

5.53 All credit ratings will be monitored weekly. 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 swaps spreads against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

5.54 Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on government support for banks and the credit ratings of that supporting government.

5.55 **Local Authority Mortgage Scheme (LAMS)** The Council is currently progressing participating in the cash backed mortgage scheme which requires the Council to place a matching five year deposit to the life of the indemnity. This investment is an integral part of the policy initiative and is outside the criteria above.

5.56 **Country Limits**. The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch. The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 4. This list will be added to, or deducted from; by officers should ratings change in accordance with this policy.

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

5.58 **Investment returns expectations –** Bank Rate is forecast to remain unchanged at 0.5% before staring to rise from quarter 4 of 2014. Bank rate forecasts for financial year ends (March) are :

- 2012-13 0.50%
- 2013-14 0.50%
- 2014-15 0.75%
- 2015-16 1.75%

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.

5.59 The suggested 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 0.50%
- 2013-14 0.50%
- 2014-15 0.60%
- 2015-16 1.50%

5.60 **Investment treasury indicator and limit** – total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after year-end. This Council is not expected to have any investments for greater than 364 days expect for the LAMS money.

5.61 For its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

5.62 **Investment risk benchmarking** – These benchmarks are simple guides to maximum risk, do they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or annual report. Security – The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:

0.001% historic risk of default when compared to the whole portfolio.

Liquidity – in respect of this area the Council seeks to maintain:

- Bank overdraft - £0.100m
- Liquid short term deposits of at least £1 available with a week's notice
- Weighted average life benchmark is expected to be 0.033 years.

Yield – local measures of yield benchmarks are

- Investments – internal returns above the 7 day LIBID rate.

5.63 **End of year investment report –** At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

6.1 **Financial**

The financial implications have been referred to throughout this report.

6.2 **Legal**

The legal implications are set out throughout the report.

6.3 **Human Resources**

None

6.4 **Section 17 (Crime Prevention)** –

None

6.5 **Human Rights Act**

None

6.6 **Data Protection**

None

6.7 **Risk Management**

Treasury Management is a high risk area due to the large amounts of money dealt with on a daily basis. However, the Council has a Treasury Policy and Strategy in place which is approved each year for the following 12 months. The Council also has advice on investment and lending from the leading company in the field and has instituted a strict control and delegation of duties regime which reduces all risks to a minimum.

6.8 **Equality & Diversity**

None

6.9 **Best Value**

None

7 Appendices to the Report

Appendix 1 - Interest rate forecasts
Appendix 2 – Economic background
Appendix 3 – Treasury management practice 1 – credit and counterparty risk management
Appendix 4 – Approved countries for investments
Appendix 5 – Treasury management scheme of delegation
Appendix 6 – The treasury management role of the section 151 officer.

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Previous Consideration

Background Papers

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APPENDIX 1

Interest Rate Forecast 2013-2016

U.K. Interest Rate Forecasts

Bank Rate	NOW	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yr PWLB Rate	**NOW**	**Dec-12**	**Mar-13**	**Jun-13**	**Sep-13**	**Dec-13**	**Mar-14**	**Jun-14**	**Sep-14**	**Dec-14**	**Mar-15**	**Jun-15**	**Sep-15**	**Dec-15**	**Mar-16**
Sector's View	1.75%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
UBS	1.75%	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	1.75%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.50%	1.60%	-	-	-	-	-
10yr PWLB Rate	**NOW**	**Dec-12**	**Mar-13**	**Jun-13**	**Sep-13**	**Dec-13**	**Mar-14**	**Jun-14**	**Sep-14**	**Dec-14**	**Mar-15**	**Jun-15**	**Sep-15**	**Dec-15**	**Mar-16**
Sector's View	2.72%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
UBS	2.72%	2.80%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	-	-	-	-	-
Capital Economics	2.72%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	-	-	-	-	-
25yr PWLB Rate	**NOW**	**Dec-12**	**Mar-13**	**Jun-13**	**Sep-13**	**Dec-13**	**Mar-14**	**Jun-14**	**Sep-14**	**Dec-14**	**Mar-15**	**Jun-15**	**Sep-15**	**Dec-15**	**Mar-16**
Sector's View	3.93%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
UBS	3.93%	4.00%	4.20%	4.30%	4.40%	4.50%	4.50%	4.50%	4.50%	4.50%	-	-	-	-	-
Capital Economics	3.93%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	-	-	-	-	-
50yr PWLB Rate	**NOW**	**Dec-12**	**Mar-13**	**Jun-13**	**Sep-13**	**Dec-13**	**Mar-14**	**Jun-14**	**Sep-14**	**Dec-14**	**Mar-15**	**Jun-15**	**Sep-15**	**Dec-15**	**Mar-16**
Sector's View	4.11%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
UBS	4.11%	4.10%	4.30%	4.40%	4.50%	4.60%	4.60%	4.60%	4.60%	4.60%	-	-	-	-	-
Capital Economics	4.11%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	-	-	-	-	-

Please note – The current PWLB rates and forecast shown above have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012

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APPENDIX 2

Economic Background

The Global economy

The Eurozone debt crisis has continued to cast a pall over the world economy and has depressed growth in most countries. This has impacted the UK economy which is unlikely to grow significantly in 2012 and is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy; this recession is the worst and slowest recovery of any of the five recessions since 1930. A return to growth @ 1% in quarter 3 in unlikely to prove anything more than a washing out of the dip in the previous quarter before a return to weak, or even negative, growth in quarter 4.

The **Eurozone sovereign debt crisis** has abated somewhat following the ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement was Spain which continues to prevaricate on making such a request and so surrendering its national sovereignty to IMF supervision. However, the situation in Greece is heading towards a crunch point as the Eurozone imminently faces up to having to relax the time frame for Greece reducing its total debt level below 120% of GDP and providing yet more financial support to enable it to do that. Many commentators still view a Greek exit from the Euro as inevitable as total debt now looks likely to reach 190% of GDP i.e. unsustainably high. The question remains as to how much damage a Greek exit would do and whether contagion would spread to cause Portugal and Ireland to also leave the Euro, though the longer a Greek exit is delayed, the less are likely to be the repercussions beyond Greece on other countries and on EU banks.

Sentiment in financial markets has improved considerably since this ECB action and recent Eurozone renewed commitment to support Greece and to keep the Eurozone intact. However, the foundations to this "solution" to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse.

The US economy has only been able to manage weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing (QE) combined with a commitment to a continuation of ultra low interest rates into 2015. Unemployment levels have been slowly reducing but against a background of a fall in the numbers of those available for work. The fiscal cliff facing the President at the start of 2013 has been a major dampener discouraging business from spending on investment and increasing employment more significantly in case there is a sharp contraction in the economy in the pipeline. However, the housing market does look as if it has, at long last, reached the bottom and house prices are now on the up.

Hopes for a broad based recovery have, therefore, focused on the **emerging markets**. However, there are increasing concerns over flashing warning signs in various parts of the Chinese economy that indicate it may be heading for a hard landing rather than a gradual slow down.

The UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order over the next four years, now look as if they will fail to achieve their objectives within the original planned timeframe. Achieving this target is dependent on the UK economy growing at a reasonable pace but recession in the Eurozone, our biggest trading partner, has depressed growth whilst tax receipts have not kept pace with additional welfare benefit payments. It will be important for the Government to retain investor confidence in UK gilts so there is little room for it to change course other than to move back the timeframe.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. There is, though, little evidence that consumer confidence levels are recovering nor that the manufacturing sector is picking up. On the positive side, growth in the services sector has rebounded in Q3 and banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lending scheme, which started in August 2012, has not yet had the time to make a significant impact. Finally, the housing market remains tepid and the outlook is for house prices to be little changed for a prolonged period.

Economic Growth. Economic growth has basically flat lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation quarterly report for August 2012 and were then further lowered in the November Report. Quantitative Easing (QE) was increased again by £50bn in July 2012 to a total of £375bn. Many forecasters are expecting the MPC to vote for a further round of QE to stimulate economic activity regardless of any near-term optimism. The announcement in November 2012 that £35bn will be transferred from the Bank of England's Asset Purchase Facility to the Treasury (representing coupon payments to the Bank by the Treasury on gilts held by the Bank) is also effectively a further addition of QE.

Unemployment. The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years as over one million jobs have been created in the private sector in the last two years.

Inflation and Bank Rate. Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. However, inflation increased back to 2.7% in October though it is expected to fall back to reach the 2% target level within the two year horizon.

AAA rating. The UK continues to enjoy an AAA sovereign rating. However, the credit rating agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years. Moody's has stated that it will review the UK's AAA rating at the start of 2013.

Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains relatively fragile and whilst there is still a broad range of views as to potential performance, expectations have all been downgraded during 2012. Key areas of uncertainty include:

- the potential for the Eurozone to withdraw support for Greece at some point if the costs of such support escalate were to become prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;

- inter government agreement on how to deal with the overall Eurozone debt crisis could fragment; the impact of the Eurozone crisis on financial markets and the banking sector;

- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to manufactured goods;

- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;

- the risk of the UK's main trading partners, in particular the EU and US, falling into recession ;

- stimulus packages failing to stimulate growth;

- elections due in Germany in 2013;

- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.

- the potential for action to curtail the Iranian nuclear programme

- the situation in Syria deteriorating and impacting other countries in the Middle East

The focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. The interest rate forecast in this report represents a balance of downside and upside risks. The downside risks have already been commented on. However, there are specific identifiable upside risks as follows to PWLB rates and gilt yields, and especially to longer term rates and yields: -

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields

- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held

- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Eurozone
- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth
- The possibility of a UK credit rating downgrade (Moody's has stated that it will review the UK's AAA rating at the start of 2013).

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APPENDIX 3

Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

SPECIFIED INVESTMENTS:_All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' quality criteria where applicable.

NON-SPECIFIED INVESTMENTS These are any investments which do not meet the Specified Investment criteria. A maximum of 50% will be held in aggregate in non-specified investments.

A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories.

The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

	*** Minimum Credit Criteria**	**Limit per institution £m**	**Max maturity period**
DMADF – UK Government	N/A	5	6 months
Money Market Funds	AA	5	Liquid
Bonds issued by multilateral development banks	AA	5	6 months
Gilt Funds	UK Sovereign rating	5	1 Year
CDs or corporate bonds with banks and building societies	Minimum Green Sector durational band.	5	3 months
UK Government Treasury Bills	UK Sovereign rating	5	1 year
UK Government Gilts	UK Sovereign rating	5	1 year
Local authorities	N/A	5	1 year
Term deposits – banks and building societies	Minimum Green Sector durational band.	5	3 months
UK part nationalised Banks	Minimum Blue Sector durational band.	5	1 year
Banks part nationalised by high credit rated (sovereign rating) countries non UK	Sovereign Rating AA	5	1 year
Enhanced cash funds			
Corporate bond funds			
Local Authority Mortgage Scheme Under this scheme the Council is required to place funds of £2m with the approved lender for a period of 5 years. This is classified as being a service investment, rather than a treasury management investment, and is therefore outside of the specified / non specified categories			

NON-SPECIFIED INVESTMENTS:
Maturities of ANY period

	* Minimum Credit Criteria	Use	Max % of total investments	Max. maturity period
Fixed term deposits with variable rate and variable maturities: -Structured deposits	Minimum Green Sector durational band.	In-house	50%	3 months
Commercial Paper issuance covered by a specific UK Government (explicit) guarantee	UK Sovereign rating	In-house	50%	1 year
Term Deposits – UK Government (with Maturities in excess of 1 year)	UK Sovereign rating	In-house	50%	1 year
Term Deposits – other LA's (with Maturities in excess of 1 year)	UK Sovereign rating	In-house	50%	1 year
Term Deposits – banks and building societies (with Maturities in excess of 1 year)	Minimum Orange Sector durational band.	In-house	50%	1 year
Commercial Paper other	Minimum Green Sector durational band.	In-house	50%	3 months
Certificates of deposits issued by banks and building societies covered by UK government banking support package	Minimum Green Sector durational band.	In-house	50%	3 months
Certificates of deposits issued by banks and building societies	Minimum Green Sector durational band.	In-house	50%	3 months
Corporate Bonds	Minimum Green Sector durational band.	In-house	50%	3 months
Other debt & commercial paper issuance by UK banks covered by UK Government (explicit) guarantee	Minimum Green Sector durational band.	In-house	50%	3 months
Bonds issued by multilateral development banks	Minimum Green Sector durational band.	In-house	50%	3 months

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APPENDIX 4

Approved Countries for Investments

AAA

- Australia
- Canada
- Denmark
- Finland
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- U.K.

AA+

- France
- Hong Kong
- U.S.A.

AA

- Abu Dhabi
- Qatar
- UAE

AA-

- Belgium
- Japan
- Saudi Arabia

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APPENDIX 5

Treasury Management Scheme of Delegation

(i) Full council

- receiving and reviewing reports on treasury management policies, practices and activities
- approval of annual strategy.

(ii) Audit and Governance Committee

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices
- budget consideration and approval
- approval of the division of responsibilities
- receiving and reviewing regular monitoring reports and referring to cabinet any recommendations
- approving the selection of external service providers and agreeing terms of appointment.

(iii) Cabinet

reviewing the treasury management policy and procedures and making recommendations to the responsible body.

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APPENDIX 6

The treasury management role of the section 151 officer

The S151 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance
- submitting regular treasury management policy reports
- submitting budgets and budget variations
- receiving and reviewing management information reports
- reviewing the performance of the treasury management function
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function
- ensuring the adequacy of internal audit, and liaising with external audit
- recommending the appointment of external service providers.