Chorley Council

APPENDIX D

Report of	Meeting	Date
Statutory Finance Officer	Special Council	3 March 2015

TREASURY STRATEGIES AND PRUDENTIAL INDICATORS (2015/16 TO 2017/18)

PURPOSE OF REPORT

1. To present for approval the Treasury Strategy and Prudential Indicators for the years 2015/16 to 2017/18. Submission of these reports is a requirement of the Codes of Treasury Practice with which the Council must comply.

RECOMMENDATION(S)

2. That Council approve
   - The Prudential Indicators for 2015/15 to 2017/18, as set out in this report
   - The Treasury Management Strategy for 2015/16 and Treasury Indicators
   - The Annual Investment Strategy 2015/16
   - The Annual Statement of MRP Policy 2015/16

EXECUTIVE SUMMARY OF REPORT

3. The report presents Prudential Indicators relating to capital expenditure and financing, and the level of external borrowing. Table 1 includes £1.1m capital expenditure in 2015/16 on Croston Flood Prevention being financed by Prudential Borrowing over fifty years. In addition, £2m New Homes Bonus is to be applied from 2016/17 to 2020/21 to repay temporary Prudential Borrowing incurred from 2015/16 to 2017/18; and to finance capital expenditure instead of borrowing in 2016/17 and 2017/18.

4. The proposed MRP Policy for 2015/16 is unchanged from that for 2014/15. It permits an “MRP Holiday” in respect of capital projects that take more than one financial year before completion.

5. No changes are proposed to the Investment Strategy for 2015/16, but a review of counterparties should be presented to Governance Committee during 2015/16. The following limits remain in force:
   - The maximum that can be invested with the part-nationalised banks remains at £5m, and with other institutions £2m. Up to £3m can be deposited in funds affording instant access (Money Market Funds and Call Accounts).
   - Funds can be deposited for up to one year in the part-nationalised banks and with local authorities, and for a maximum of 3 months with other institutions.
   - Investments are restricted to United Kingdom-registered financial institutions.
   - Deposits with the Debt Management office are permitted up to the DMO limit of six months. There is no limit on the amount.

Confidential report Please bold as appropriate	Yes	**No**
Key Decision? Please bold as appropriate	Yes	**No**
Reason Please bold as appropriate	1, a change in service provision that impacts upon the service revenue budget by £100,000 or more	2, a contract worth £100,000 or more
	3, a new or unprogrammed capital scheme of £100,000 or more	4, Significant impact in environmental, social or physical terms in two or more wards

REASONS FOR RECOMMENDATION(S)

(If the recommendations are accepted)

6. With security of investments being the paramount objective no change in the current narrow range of UK-registered counterparty institutions is proposed. However a review of investment counterparties (financial institutions and investment criteria) should be presented to Governance Committee during 2015/16.

7. Approval of the Prudential Indicators, Treasury Management Strategy, Treasury Indicators, and Annual Investment Strategy is necessary to comply with statutory requirements.

ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

8. None

CORPORATE PRIORITIES

9. This report relates to the following Strategic Objectives:

Involving residents in improving their local area and equality of access for all	✓	A strong local economy	✓
Clean, safe and healthy communities	✓	An ambitious council that does more to meet the needs of residents and the local area	✓

BACKGROUND

10. The Local Government Act 2003 gave authorities greater discretion over capital expenditure by allowing prudential borrowing. It also sought to strengthen governance by making compliance with the Chartered Institute of Public Finance and Accountancy (CIPFA)'s Prudential Code and CIPFA's Treasury Management Guidance, statutory requirements. The former requires the production of Indicators showing that expenditure is affordable; the latter requires the approval of an annual Treasury Management Strategy incorporating Treasury Indicators and limits.

11. Consequential to the Prudential Borrowing powers is a requirement that authorities should make prudential provision for the repayment of borrowing (MRP). This is to be the subject of an annual policy statement to be made to the full Council prior to the start of each year.

12. Finally Authorities have, through the Local Government Act 2003, also been given greater discretion in investing surplus cash. They are required however, by guidance issued by the

Department for Communities and Local Government (DCLG), to prepare an annual Investment Strategy to identify how that discretion should be applied.

13. This report therefore brings together these related requirements. The Governance Committee's role is to scrutinise these policies and practices, while the Council is required to approve them.

PRUDENTIAL INDICATORS 2015/16 to 2017/18

14. Local authorities have discretion to incur capital expenditure in excess of the capital resources provided by government, or those resources resulting from the sale of assets or the receipt of contributions from other parties. To do this however increases a Council's indebtedness and ultimately leads to a charge to the General Fund revenue budget.

15. To manage that process, Councils must set certain Indicators. These are designed to indicate that the expenditure is prudent and affordable. The following are the relevant indicators for Chorley.

Prudential Indicator 1 - Capital Expenditure

16. The following statement summarises the latest estimates of capital expenditure and the methods of financing the programme.

Table 1 - Capital Expenditure	**2014/15 Revised £'000**	**2015/16 Estimate £'000**	**2016/17 Estimate £'000**	**2017/18 Estimate £'000**
Capital expenditure incurred directly by the Council	5,368	9,214	3,991	2,232
Less Capital resources				
Capital receipts	211	649	0	0
Grants & contributions	3,368	1,869	0	0
Revenue and reserves	955	2,617	422	419
Unfinanced amount (affects the CFR: see Prudential Indicator 2 below)	**834**	**4,079**	**3,569**	**1,813**
Of which:				
General capital expenditure	834	1,220	51	54
Croston Flood Prevention	0	1,100	0	0
Chorley East Health Centre	0	1,759	3,518	1,759

17. Capital expenditure in respect of the Chorley East Health Centre on Friday Street is estimated to be spread over three financial years, and will be financed with Prudential Borrowing. The revenue consequences will be reflected in the revenue budget from 2018/19 onwards.

18. Of the unfinanced amount in 2015/16, £1.1m is in respect of Croston Flood Prevention, being financed by Prudential Borrowing over fifty years. The Prudential Borrowing to finance general capital expenditure from 2015/16 to 2017/18 is in effect short-term, because New Homes Bonus grant will be applied each year from 2016/17 to 2020/21 to finance the MRP and as voluntary set aside to reduce the CFR balance. In total £2m New Homes Bonus grant would be applied, part of which would be to used finance capital expenditure in 2016/17 and 2017/18 as an alternative to incurring additional borrowing.

Prudential Indicator 2 – Capital Financing Requirement (CFR)

19. The CFR is a measure of the Council's indebtedness resulting from its capital programme. It increases when, as above, the Council incurs unfinanced capital expenditure or leases liabilities. Its importance lies in the fact that it results in a charge to the revenue account, to make provision to finance the expenditure (the Minimum Revenue Provision - MRP).

20. It should be noted that this indebtedness does not necessarily result in the Council having an immediate need to take out additional external borrowings. This is because the Council has various reserves, and the cash which supports those reserves can be used temporarily instead of borrowing.

21. The CFR is important therefore because it creates a charge to the Council's General Fund, which therefore has an impact on Council Tax. The following table shows how the CFR is changing over the next few years.

Table 2 - CFR	2014/15 Revised £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Estimated CFR at year-end	33,239	36,819	39,787	40,990
Reasons for the annual change in the CFR				
Unfinanced capital expenditure (see Table 1)		4,079	3,569	1,813
Annual revenue charge (MRP)		(499)	(601)	(610)
Of which:				
General capital expenditure	10,033	10,896	10,515	10,135
Croston Flood Prevention	0	1,100	1,078	1,056
Market Walk Shopping Centre	23,206	23,064	22,917	22,763
Chorley East Health Centre	0	1,759	5,277	7,036

22. The CFR will be reduced by voluntary set aside from 2018/19 onwards, being the use of New Homes Bonus grant estimated to be available in future years. This would be applied to eliminate the CFR relating to general capital expenditure to be financed by Prudential Borrowing from 2015/16 to 2017/18. This part of the total CFR will be reduced to nil by the end of 2020/21.

23. There will be an "MRP Holiday" in respect of the Chorley East Health Centre on Friday Street, as permitted by the proposed MRP policy. The CFR will be eliminated over 25 years from 2018/19 onwards.

Prudential Indicator 3 – Ratio of financing costs to the net revenue stream

24. This indicator shows the proportion of the receipts from government grants and local taxation that is required to meet the costs associated with capital financing (interest and principal, net of interest received). The ratio shows an increase from 2015/16 onwards, which reflects the reduction in the revenue stream in respect of government funding. Financing costs increase as a result of additional prudential borrowing.

Table 3 - Ratio of financing costs	2014/15 Estimate %	2015/16 Estimate %	2016/17 Estimate %	2017/18 Estimate %
Ratio	9.19	7.33	11.56	11.37

Prudential Indicator 4 – Incremental impact of capital investment decisions on the band D Council Tax

Table 4 - Impact of capital investment decisions	2014/15 Estimate £	2015/16 Estimate £	2016/17 Estimate £	2017/18 Estimate £
Increase/(decrease) in Band D charge	(0.69)	0.93	9.27	14.43

25. This table shows the cumulative effect on council tax levels of the changes between the capital programme reported in this strategy and that submitted a year ago. It has to be stressed that the complexity, and notional nature, of the calculations mean that the figures should only be treated as being indicative, being based on very broad assumptions, for example, about interest rates over the long-term. They do not represent forecast changes to levels of Council Tax.

TREASURY MANAGEMENT STRATEGY 2015/16 to 2017/18

Background

26. The treasury management service fulfils an important role in the overall financial management of the Council's affairs. It deals with "*the management of the 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"* (CIPFA).

<u>Prudential Indicators 5 and 6</u>

27. The Council has a statutory obligation to have regard to the CIPFA Code of Practice, and is required to adopt both the Code and the Treasury Management Policy Statement therein. Both of these were adopted by Council on 2 March 2010 (Financial Procedure Rule 4 refers). The Policy Statement is repeated at Appendix D(2).

Reporting

28. This strategy statement has been prepared in accordance with the revised Code. As a minimum, a mid-year monitoring report, and a final report on actual activity after the year-end, will be submitted to the Council. Additional reports will be made to the Governance Committee during the year as required.

Borrowing and Investment Projections

29. The Council's borrowings and investment are inter-related. The following table details the estimated changes in borrowings and cash balances available for investment, consistent with the capital and revenue budgets. The table is prepared on the assumption that additional PWLB loans will be taken before the end of 2014/15 and 2015/16 to replace the use of internal borrowing, and to achieve long-term savings by borrowing before the interest rate rises forecast by our advisors take effect. In addition, borrowing repayable during 2015/16 will be repaid, and it is assumed that most Prudential Borrowing incurred for capital financing will be external rather than internal cash balances.

30. The table presents the estimated maximum borrowing in each financial year, in order to calculate the Operational Boundary and Authorised Limit in Tables 6 and 7 below. Setting those Prudential Indicators at the highest estimated level would mean that the option of taking further PWLB loans would be available without the need to amend the limits first. However, the effect of taking additional external loans would be to increase cash balances available for investment. There would be a "carrying cost" in the short-term of doing this, because the rate of return on the additional cash would be lower than the interest payable on the borrowing. However, there would be longer-term savings if loans are taken before interest rate rises are implemented. In addition, our advisors are forecasting increased rates of return on cash invested within the current budget cycle.

Table 5 - Borrowing and Investments	2014/15 Revised £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Borrowing at period start	20,264	24,042	32,659	34,383
Borrowing repaid in year	(1,222)	(6,442)	(3,294)	(3,756)
Borrowing in year	5,000	15,059	5,018	3,659
Borrowing at period end	**24,042**	**32,659**	**34,383**	**34,286**
Surplus cash for investment at year end	(8,000)	(13,000)	(13,000)	(13,000)
Net borrowing/(investments)	**16,042**	**19,659**	**21,383**	**21,286**

The issues affecting the timing of any borrowing are discussed in below.

Prudential Indicator 7

31. The Prudential Code requires authorities to make comparison between net borrowing and the CFR. At its greatest net borrowing should not exceed the current years CFR plus the estimated increases in CFR for the following two years. The figures reported above meet this requirement

Prudential Indicator 8 The Operational Boundary for External Debt

32. The Council is required to set two limits on its borrowings. The first is the Operational Boundary. This should reflect the most likely, but not worst case scenario consistent with the Council's budget proposals. As discussed above, this table assumes that additional external borrowing will be taken from 2014/15 onwards to replace the use of internal cash balances.

Table 6 - Operational Boundary	31/3/15 Estimate £'000	31/3/16 Estimate £'000	31/3/17 Estimate £'000	31/3/18 Estimate £'000
Borrowings	24,042	32,659	34,383	34,383
Other long-term liabilities	15	15	15	15
Operational boundary	**24,057**	**32,674**	**34,398**	**34,398**

Prudential Indicator 9 The Authorised Limit

33. This is the second limit. It should allow headroom above the Operational Boundary to accommodate the fluctuations that can occur in cash flows. The following is proposed:

Table 7 - Authorised Limit	31/3/15 Estimate £'000	31/3/16 Estimate £'000	31/3/17 Estimate £'000	31/3/18 Estimate £'000
Borrowings	26,042	34,659	36,383	36,383
Other long-term liabilities	15	15	15	15
Authorised Limit	**26,057**	**34,674**	**36,398**	**36,398**

Economic outlook and expected movement in interest rates

34. The report of the Council's consultants, Capital Asset Services, is attached at Appendix D(1).

35. Capita indicate that investment returns are likely to remain relatively low during 2015/16. Bank Rate is now expected to increase in the March quarter of 2016/17, which is a little earlier than previously expected.

Borrowing strategy

36. Prudential Indicators presented in this report reflect the assumption that before the end of the 2014/15 financial year, the use of internal cash balances for capital financing purposes would be replaced in part with further PWLB loans. This reflects Council approval in November 2013 of the financing of the purchase of Market Walk by external borrowing, and gives the flexibility to take further PWLB loans should interest rates be attractive and longer-term interest savings are achievable. The timing of any additional borrowing and estimated changes in interest rates would be discussed with the Council's treasury advisors, Capital Asset Services.

37. There is still some likelihood that actual borrowing may be lower than presented in Tables 5, 6 and 7. While internal cash balances are available, the greatest benefit to the revenue budget is to avoid borrowing at say 3% than to invest them at say 0.5%. Adopting this strategy would mean that cash balances available for investment would be lower than presented in Table 5, but this would be worthwhile if the effect is a net saving for the Council's revenue budget. However, as PWLB interest rates are forecast to increase within this budget cycle, long-term savings could be achieved by borrowing sooner rather than later, even though there would be a short-term "carrying cost".

Treasury Management Limits on Activity

38. The Authority is required to set the following Treasury Indicators. The purpose of these is to minimise the risk resulting from movements in interest rates.

Treasury Indicator 1 – Upper limit on Variable rate exposure

39. The Council is exposed to interest rate movements on its invested cash. The amount varies significantly over the course of the year, and during each month. Potentially balances can peak at around £25m for short periods, especially if PWLB loans replace the use of internal cash balances for capital financing. This amount will therefore form the limit.

Table 8 - Variable rate upper limit	2014/15 Revised £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Upper limit on variable rate exposure	20	25	25	25

Treasury Indicator 2 – Upper limit on fixed rate exposure

40. The Council is exposed to fixed rate interest on any long term liabilities and PWLB borrowings. It is proposed that up to 100% of the debt be at fixed rates.

Table 9 - Fixed rate upper limit	2014/15 Revised	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Upper limit on fixed rate exposure	100%	100%	100%	100%

Treasury Indicator 3 - Maturity structure of borrowing

41. The Council is required to determine upper and lower limits for the maturity structure of its debt. This Treasury Indicator is calculated as at 31 March 2016, and the upper limit assumes that there would be further PWLB borrowing during 2014/15 and 2015/16 to replace the use of internal cash balances, and to replace loans repayable in those years.

Table 10 - Maturity structure of borrowing	As at 31/3/16	
	Lower Limit	Upper Limit
Under 12 months	10%	13%
12 months to 2 years	10%	13%
2 to 5 years	27%	34%
5 to 10 years	12%	13%
10 years and above	28%	40%

Treasury Indicator 4 – Total principal sums invested for greater than 364 days

42. It is not planned to make any investments for periods over 364 days. Such investments would be "non-specified", as explained in the Investment Strategy below. This policy should be reviewed by Governance Committee during 2015/16, when the list of investment counterparties is reconsidered in the light of changes to credit rating criteria.

Use of Treasury Advisors

43. The Council recognises that responsibility for treasury decisions cannot be delegated to its advisors (Capita Asset Services) but remains its responsibility at all times.

Performance Indicators

44. Investments – the generally accepted indicator is 7-day LIBID (The London Interbank Bid rate). This is the rate that could be obtained by the “passive” deposit of money onto the money market. Active investment, in normal times, should outperform this. Average 7-day LIBID plus 10% has been set as a performance indicator for Shared Financial Services. This means, for example, that if average 7-day LIBID were 0.35%, the target would be to achieve 0.39%. Actual investment returns have exceeded this target during 2014/15, but it is likely that the margin above the target will reduce.

INVESTMENT STRATEGY 2015/16

Introduction

45. Under the Power in Section (15) (1) of the Local Government Act 2003 the DCLG has issued Guidance on Local Government Investments. This was updated with effect from 1 April 2010. Each Authority is recommended to produce an annual strategy that sets out its policies to manage investments, giving priority to security and liquidity. This strategy follows the guidance.

46. The major element in the guidance is that authorities should distinguish between lower risk (specified investments), and other investments (non-specified). These terms are explained in more detail below.

47. The specific issues to be addressed in the Investment Strategy are as follows:

- How “high” credit quality is to be determined
- How credit ratings are to be monitored
- To what extent risk assessment is based upon credit ratings and what other sources of information on credit risk are used
- The procedures for determining which non specified investments might prudently be used
- Which categories of non-specified investments the Council may use
- The upper limits for the amounts which may be held in each category of non- specified investment and the overall total.
- The procedures to determine the maximum periods for which funds may be committed.
- What process is adopted for reviewing and addressing the needs of members and treasury management staff for training in investment management.
- The Authority’s policies on investing money borrowed in advance of spending needs. The statement should identify measures to minimise such investments including limits on (a) amounts borrowed and (b) periods between borrowing and expenditure

Chorley Strategy 2015/16

Objectives

48. The Council’s investment priorities are:
    - The security of capital and
    - The liquidity of its investments.

49. The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

50. The borrowing of monies purely to invest or on-lend and to make a return is unlawful, and this Council will not engage in such activity. The Council will restrict borrowing in excess of its immediate need, to the additional amount envisaged to be required in the following eighteen months.

Use of Specified and Non-Specified Investments

51. Specified investments are those made:
    - with high “quality” institutions, the UK Government or a local authority,
    - for periods of less than one year and
    - denominated in sterling.

52. Other investments are “non-specified”. These could include investments in gilts, bond issues by other sovereign bodies and those issued by multilateral development banks, commercial paper, and any deposits for a period exceeding one year.

53. The Council policy has been to only make specified investments. It normally uses only the simplest instruments such as money market deposits or deposits in call accounts and Money Market Funds. It does also have a facility to purchase Treasury Bills (issued by the Government) and Certificates of Deposit (issued by the major financial institutions).

Counterparty Selection Criteria

54. In determining which institutions are “High Quality” the Council uses the creditworthiness service provided by Capital Asset Services. This combines the credit ratings from all three rating agencies (Fitch, Moody, Standard and Poor) in a sophisticated modelling process. It does not however rely solely on these ratings, but also uses

- Credit watches and credit outlooks from the agencies
- Credit Default Spreads (CDS) to give early warning of likely changes in ratings
- Sovereign ratings to select counterparties from only the most credit worthy countries

55. These factors are combined in a scoring system, and results in counterparties being colour coded:

- Purple – recommended maximum duration 2 years
- Blue (used for nationalised and part nationalised UK Banks)– 1 year
- Orange – 1 year
- Red – 6 months
- Green – 3 months
- No colour – not to be used

The Council only lends to UK financial institutions. This strategy does not therefore specify a minimum sovereign rating.

The Council may use AAA rated Money Market Funds.

The Council may lend to the UK Government (which includes the Debt Management Office)

The Council may lend to other Local Authorities.

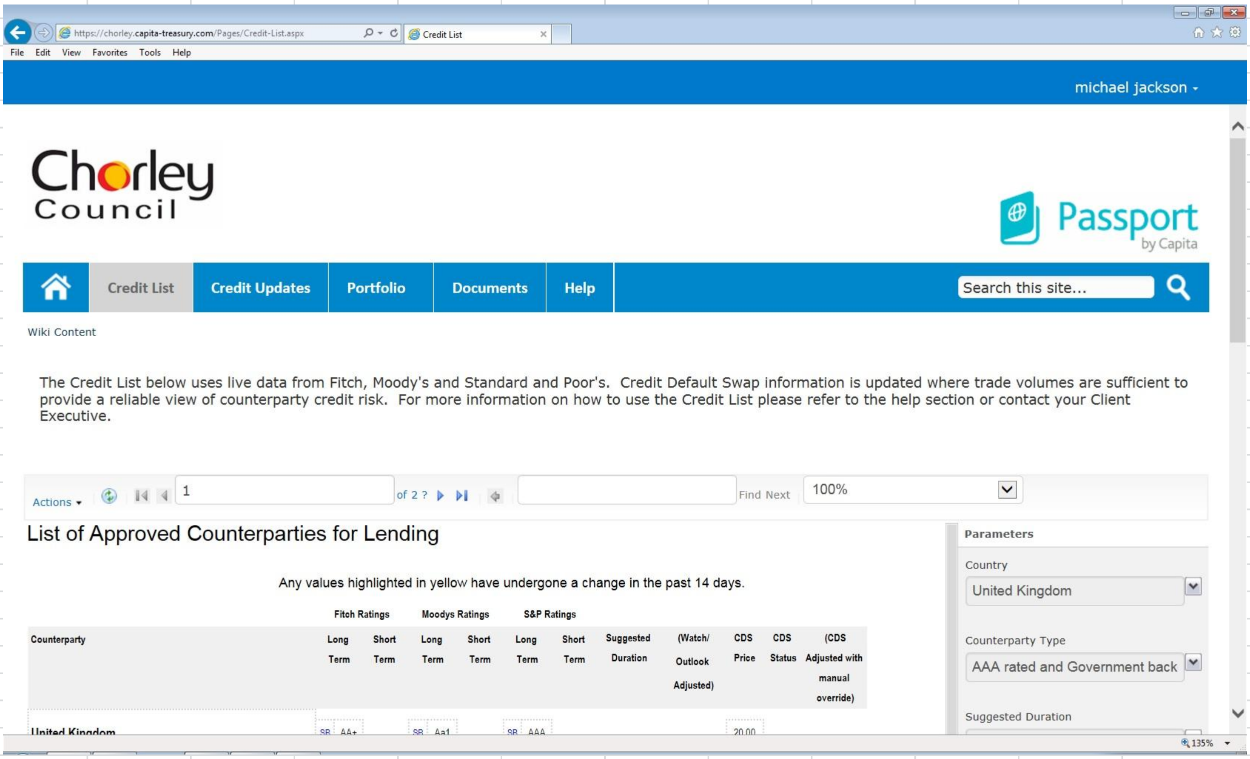
Currently all deposits except those with the part-nationalised banks are restricted to three months
There are dozens of banks and building societies registered in the UK, but only a small minority are of “High Quality” and therefore suitable for placing investments. Governance Committee should consider whether any additional UK counterparties should be added to the list, in order to minimise the occasions when funds are deposited with the DMO, which pays a low rate of interest (currently 0.25%). Though deposits with the DMO are secure, the low rate of interest offered brings down the average rate of interest earned.

Advice from Capita Asset Services about changes to credit rating methodology and the implications for the Council’s Investment Policy is presented in Appendix D(1).

Monitoring of Credit ratings

56. Capital Asset Services supply rating warnings and changes by e-mail immediately following their issuance by the rating agencies. The colour-coded counterparty lists are reissued weekly, updated by such changes. The information is also available at any time via Capita's Passport web site (see Table 11 below). Members of the Shared Financial Services' Financial Accountancy team are also registered with the three credit rating agencies so that ratings can be checked online independently of Capita.

Table 11 - Passport by Capita: online monitoring of approved counterparties for investments



Time and money Limits

57. No changes to the present limits are proposed. The limits applying to each category of institution are specified in the attachment to this report.

Member Training

58. There are no plans to provide additional training in 2015/16.

Financial Institutions and Investment Criteria (2015/16 Treasury Strategy)

Category	Institutions	CAS colour code	Sovereign rating	Max period	Limit per Institution
Sovereign or Sovereign "type"	DMADF Local Authority			6 months 1 year	No limit £3m
UK Partly nationalised institutions	RBS group (inc Nat West) Lloyds Group (inc HBoS & Lloyds)	Blue Blue	AAA	1 year 1 year	£5m per group £5m per group
Independent UK Institutions	HSBC Barclays, Nationwide	Orange Green Green	AAA	Restricted to 3 months	£2m £2m £2m
Money Market Funds	Standard Life Global liquidity MM Fund Prime Rate MMF	Aaa/MR1+		instant access	£3m £3m
Deposit/Call Accounts	Barclays Bank of Scotland Nat West Lancs CC		AAA	Call accounts with instant access	£3m less value of term deposits

Note – Deposits with any one institution shall not exceed £3m

ANNUAL STATEMENT OF MRP POLICY 2015/16

The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 require a local authority to determine each year an amount of Minimum Revenue Provision (MRP) which it considers to be prudent. This should be by reference to the calculated Capital Financing Requirement (CFR). Linked to this regulation, the Department for Communities and Local Government (DCLG) produced statutory guidance (updated in February 2012), which sets out what may constitute prudent provision.

In accordance with the DCLG guidance, this statement sets out the Council's MRP policy for the forthcoming financial year, 2015/16.

The aim of the policy is to ensure that MRP is charged over a period that is reasonably commensurate with the period over which the capital expenditure which gave rise to the debt provides benefits.

MRP shall commence in the financial year following that in which the capital expenditure is incurred, or in the year following that in which the relevant asset becomes operational (1).

In respect of the proportion of the Capital Financing Requirement which relates to debt incurred prior to 2008/9, MRP shall be charged on this at the rate of 4% in accordance with option 1 of the guidance, otherwise known as the Regulatory Method.

The MRP liability on debt incurred from 2008/09 onwards shall be based on the estimated useful life of the asset, (option 3 of the guidance, known as the Asset Life Method). The MRP shall be calculated using the following methods, as appropriate for specific capital expenditure:

- Equal instalments: where the principal repayments made are the same in each year
- Annuity: where the principal repayments increase over the life of the asset

Estimated life periods shall be determined under delegated powers, with reference to the guidance, in the year that MRP commences and shall not be revised. As some types of capital expenditure are not capable of being related to an individual asset, the MRP shall be assessed on a basis which most reasonably reflects the anticipated period of benefit arising from the expenditure.

Note:

(1) This is referred to in the report as an "MRP Holiday".

IMPLICATIONS OF REPORT

This report has implications in the following areas and the relevant Directors' comments are included:

Finance	✓	Customer Services	
Human Resources		Equality and Diversity	
Legal	✓	Integrated Impact Assessment required?	
No significant implications in this area		Policy and Communications	

COMMENTS OF THE STATUTORY FINANCE OFFICER

These are contained in the report

COMMENTS OF THE MONITORING OFFICER

The recommendations are appropriate as explained in the body of the report.

Background Papers			
Document	**Date**	**File**	**Place of Inspection**
CIPFA Treasury Management in the Public Services: Code of Practice & Guidance Notes			Town Hall
CIPFA Prudential Code for Capital Finance in Local Authorities			Town Hall
DCLG Guidance on Local Government Investments			Town Hall
DCLG Guidance on Minimum Revenue Provision			Town Hall

Report Author	Ext	Date	Doc ID
Michael L Jackson	5490	6 February 2015	Treasury Strategy 2015-16 Onwards.doc

APPENDIX D(1)

The following is the advice of the Council's treasury management consultants Capita Asset Services

Prospects for interest rates

The Council has appointed Capita Asset Services (CAS) 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 CAS central view.

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Mar 2015	0.50	2.10	3.30	3.30
Jun 2015	0.50	2.20	3.40	3.40
Sep 2015	0.50	2.30	3.60	3.60
Dec 2015	0.50	2.50	3.80	3.80
Mar 2016	0.75	2.60	3.90	3.90
Jun 2016	0.75	2.70	4.00	4.00
Sep 2016	1.00	2.80	4.20	4.20
Dec 2016	1.25	3.00	4.30	4.30
Mar 2017	1.25	3.10	4.40	4.40
Jun 2017	1.50	3.20	4.50	4.50
Sep 2017	1.50	3.30	4.60	4.60
Dec 2017	1.75	3.40	4.60	4.60
Mar 2018	2.00	3.50	4.70	4.70

UK GDP growth surged during 2013 and 2014 but cooled somewhat towards the end of 2014. However, growth is expected to regain stronger momentum during 2015 and 2016 under the stimulative effect of the sharp fall in oil prices and inflation potentially falling into negative territory, but anyway being near to zero until towards the end of 2015. Combined with a significant rise in average wage rates, this is expected to lead to consumer disposable income rising by around 3.5% in 2015. This would therefore strengthen consumer expenditure without much downside to the savings ratio. However, there still needs to be a significant rebalancing of the economy away from consumer spending to manufacturing, business investment and exporting in order for this recovery to become more firmly established. The Bank of England February Inflation Report drew attention to the falling level of unemployment and the reduction of spare capacity or slack in the economy. This is expected to feed through into an increase in pressure for wage increases and together with the sharp fall in the price of oil starting to fall out of the twelve month calculation of CPI inflation in quarter 4 of 2015, is expected to result in a sharp rise in inflation from near zero in that quarter and also onward into 2016.

The US, the biggest world economy, has generated stunning growth rates of 4.6% (annualised) in Q2 2014 and 5.0% in Q3, followed by a cooler 2.6% in Q4 (overall 2.4% for 2014 as a whole). This is hugely promising for the outlook for strong growth going forwards and it very much looks as if the US is now firmly on the path to full recovery from the financial crisis of 2008. Consequently, it is now confidently expected that the US will be the first major western economy to start on central rate increases by the end of 2015.

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

- Greece: the general election on 25 January 2015 brought to power a coalition which is strongly anti EU imposed austerity. However, if this should eventually result in Greece leaving the

Euro, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect effects of the likely strenthening of anti EU and anti-austerity political parties throughout the EU is much more difficult to gauge;

- As for the Eurozone in general, concerns in respect of a major crisis subsided considerably in 2013. However, the downturn in growth and inflation during the second half of 2014, and worries over the Ukraine situation and the Middle East, have led to a resurgence of those concerns as risks increase that it could be heading into a prolonged period of deflation and very weak growth. Sovereign debt difficulties have not gone away and major concerns could return in respect of individual countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;

- Investment returns are likely to remain relatively low during 2015/16 and beyond;

- Borrowing interest rates have been highly volatile during 2014 and early 2015 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. The opening weeks of 2015 saw gilt yields dip to historically phenominally low levels after inflation plunged, a flight to quality as a result of the Greek situation and the start of a huge programme of quantitative easing, (purchase of EZ government debt), by the ECB in January 2015. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt;

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

Investment returns expectations

Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 1 of 2016. Bank Rate forecasts for financial year ends (March) are:

- 2015/16 0.75%
- 2016/17 1.25%
- 2017/18 2.00%

There are downside risks to these forecasts (i.e. start of increases in Bank Rate occurs later) if economic growth weakens. However, should the pace of growth quicken, there could be an upside risk.

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

2015/16 0.60%
2016/17 1.10%
2017/18 1.75%
2018/19 2.25%
2019/20 2.75%
2020/21 3.00%

2021/22 3.25%
2022/23 3.25%
Later years 3.50%

Economic Background

UK. After strong UK GDP growth in 2013 at an annual rate of 2.7%, and then growth in 2014 of 0.6% in Q1, 0.8% Q2, 0.7% Q3 and 0.5% Q4 (annual rate for 2014 of 2.6%), growth is expected to gain increased momentum during 2015 and 2016 to annual rates of 2.9%, (2017 2.7%). This will be a response to two developments; firstly, the stimulative effect of the sharp fall in oil prices in quarter 4 of 2014 and then inflation potentially falling into negative territory during 2015, but anyway being near to zero until towards the end of the year. Secondly, due to an expected return to a significant rise in average wage rates due to the continuing fall in unemployment to about 5.5% by mid 2015, (the long run equilibrium level is 5.0%), and the further erosion of spare capacity, (slack), to about 0.5% of GDP. This is expected to lead to total consumer disposable income rising by no less than around 3.5% during quarter 3 2015. This would therefore strengthen consumer expenditure, but without much downside to the savings ratio.

However, for this recovery to become more balanced and sustainable in the longer term, the recovery still needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. In addition, there has been a need for a major improvement in labour productivity, which has languished at dismal levels since 2008, to support longer term increases in pay rates and economic growth after the positive effect of the fall in oil prices dissipates. The February Inflation Report contained good news on that score that productivity was forecast to increase by just under 0.75% in the first three quarters of 2015.

The February Inflation Report also explained that the initial fall in the price of oil of over 50% would cause an overall reduction in CPI of about 0.8% in quarter 2 2015 and boost UK GDP by around 0.5% during the MPC's three year forecast period. It also forecast that the sharp fall in the price of oil and its knock on effects, would start falling out of the twelve month calculation of CPI inflation in quarter 4 of 2015. This is expected to result in a sharp rise in inflation from near zero in that quarter and also onward into 2016. The report also mentioned a potential risk of deflation becoming embedded, which could then require remedial action by the MPC such as a cut in Bank Rate and / or further quantitative easing, This is viewed as being a small risk given the above expected sharp increase in inflationary pressures. However, while inflation is at or near 0% for much of 2015, it is unlikely that the MPC would make a start on increasing Bank Rate. Market expectations for the first increase in Bank Rate have therefore moved from quarter 3 2015 after the November 2014 report, to around mid year 2016 during February 2015. However, the MPC is focused on where inflation will be over a 2 – 3 year time horizon so too much emphasis should not be placed on the short term inflation outlook, especially when the February report identified a slight increase in inflationary pressures on that time horizon to just above the 2% target. This treasury management report is therefore based on a forecast of a first increase in Bank Rate in quarter 1 of 2016, though it would be quite possible for it to be in quarter 4 of 2015 if events were to turn out favourably in Greece, the EZ as a whole and elsewhere.

The return to strong growth has helped lower forecasts for the increase in Government debt over the last year but monthly public sector deficit figures during 2014 have disappointed, being only a fraction lower than the previous year through to December 2014. The autumn statement, therefore, had to revise the speed with which the deficit is forecast to be eliminated. The flight to quality in January 2015 has seen gilt yields fall to incredibly low levels, which will reduce interest costs on new and replacement government debt.

Eurozone (EZ). The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In January 2015, the inflation rate fell further, to reach a low of -0.6%. However, this is an average for all EZ countries and includes some countries with even higher negative rates of inflation. Initially, the ECB took some rather limited action in June and September 2014 to loosen monetary policy in order to promote growth. As this failed to have much of a discernible effect, the ECB launched a massive €1.1 trillion programme of quantitative easing in January 2015 to buy up high credit quality government debt of selected EZ countries. This programme will run to September 2016.

Concern in financial markets for the Eurozone had subsided considerably after the prolonged crisis during 2011-2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. The ECB's pledge in 2012 to buy unlimited amounts of bonds of countries which ask for a bailout has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the degree of recession. However, debt to GDP ratios (2013 figures) of Greece 180%, Italy 133%, Portugal 129%, Ireland 124% and Cyprus 112%, remain a cause for concern, especially as some of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are likely to continue to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US.

Greece: the general election on 25 January 2015 has brought to power a coalition which is anti EU imposed austerity. Although it is not certain that Greece will leave the Euro, the recent intractability of the troika (the EU, ECB and IMF), to finding a negotiated compromise with the new Greek government leaves this as a real possibility. However, if Greece was to leave the EZ, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. Nevertheless, the indirect effects of the likely strengthening of anti-EU and anti-austerity political parties throughout the EU are much more difficult to gauge. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries which have high unemployment rates. Of particular concern is the fact that Spain and Portugal have general elections coming up in late 2015. This will give ample opportunity for anti-austerity parties to make a big impact.

There are also major concerns as to whether the governments of France and Italy will effectively implement austerity programmes and undertake overdue reforms to improve national competitiveness. These countries already have political parties with major electoral support for anti EU and anti-austerity policies. Any loss of market confidence in either of the two largest Eurozone economies, after Germany, would present a huge challenge to the resources of the ECB to defend their debt.

USA. The U.S. Federal Reserve ended its monthly asset purchases in October 2014. GDP growth rates (annualised) for Q2 of 4.6%, Q3 of 5.0% and Q4 of 2.6%, (overall 2.4% during 2014 as a whole), provides great promise for strong growth going forward. It is confidently forecast that the first increase in the Fed. rate will occur by the end of 2015.

China. Government action in 2014 to stimulate the economy almost succeeded in achieving the target of 7.5% growth but recent government statements have emphasised that growth going forward will slow marginally as this becomes the new normal for China. There are concerns that the Chinese leadership has only just started to address an unbalanced economy, which is heavily over dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

Japan. Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth to the extent that it has slipped back into recession. The Japanese government already has the highest debt to GDP ratio in the world.

Forward View

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

There has been exceptionally high volatility in gilt yields and PWLB rates during January and February 2015. It is likely that this trend could continue through 2015 and that there could be swings of 50 basis points, (0.50%), during even one quarter.

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis. There is an increased risk that Greece could end up leaving the Euro but if this happens, the EZ now has sufficient fire walls in place that a Greek exit would have little immediate direct impact on the rest of the EZ and the Euro. It is therefore expected that there will be an overall managed, albeit painful and tortuous, resolution of any EZ debt crisis that may occur where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be weak at best for the next couple of years with some EZ countries experiencing low or negative growth, which will, over that time period, see an increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries, especially if growth disappoints and / or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a sharp resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK strong economic growth is weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.

- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- An adverse reaction by financial markets to the result of the UK general election in May 2015 and the EU, economic and debt management policies adopted by the new government.
- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.
- The commencement by the US Federal Reserve of increases in the Fed. funds rate in 2015, causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities. There could also be a sharp fundamental reassessment of investments in the debt and equities of emerging countries which have chased higher yields during a prolonged period when yields and returns in western countries have been heavily suppressed; countries such as Brazil and Russia are already in recession and facing major economic and political challenges.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Changes to credit rating methodology

The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. More recently, in response to the evolving regulatory regime, the agencies have indicated they may remove these "uplifts". This process may commence during 2014/15 and / or 2015/16. The actual timing of the changes is still subject to discussion, but this does mean immediate changes to the credit methodology are required.

It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of sovereign support that has been built into ratings through the financial crisis. The eventual removal of implied sovereign support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

Both Fitch and Moody's provide "standalone" credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody's has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments, both agencies have suggested going forward that these will be in line with their respective Long Term ratings. As such, there is no point monitoring both Long Term and these "standalone" ratings.

Furthermore, Fitch has already begun assessing its Support ratings, with a clear expectation that these will be lowered to 5, which is defined as "A bank for which there is a possibility of external support, but it cannot be relied upon." With all institutions likely to drop to these levels, there is little to no differentiation to be had by assessing Support ratings.

As a result of these rating agency changes, the credit element of our future methodology will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor's that we have always taken, but a change to the use of Fitch and Moody's ratings. Furthermore, we will continue to utilise CDS prices as an overlay to ratings in our new methodology.

Implications for Investment Policy

Continuing regulatory changes in the banking sector are designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key ratings used to monitor counterparties being the Short Term and Long Term ratings only. Viability, Financial Strength and Support Ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes.

As with previous practice, ratings will 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 should 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.

The CAS creditworthiness service employs a sophisticated modelling approach utilising credit ratings from the 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.

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.

APPENDIX D(2)

Treasury Management Policy Statement (adopted 2nd March 2010)

1. This organisation defines its treasury management activities as: *The management of the organisation'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.*

2. This organisations regards the succesful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury managementa ctivities will focus on their risk implications for the organisation.

3. This organisation acknowledges that effective treasury management will provide support towards the achieevement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance management techniques, within the context of effective risk management.