	Audit Committee 20 March, 2013 **Report from the Deputy Director of Finance and Corporate Services**
For Information	Wards Affected: ALL

Treasury Management Strategy, 2013/14

1. Summary

This report attaches the Treasury Management Strategy for 2013/14, for the information of members. The attachment is an extract from the Budget report approved by the Council on 25 February.

2. Recommendations

The Audit Committee note the Strategy.

3. Detail

The Strategy sets the framework for Treasury Management activity in 2013/14.

4. Financial Implications

None

5. Legal Implications

None

6. Diversity Implications

None

7. Background Papers

1. Council Budget for 2013/14

8. Contact Officer Details

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SECTION 10

10. TREASURY MANAGEMENT STRATEGY

Introduction

10.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public Services and the Prudential Code require local authorities to determine its Treasury Management Strategy Statement (TMSS) and Prudential Indicators (PIs) on an annual basis. The TMSS also includes the Annual Investment Strategy (AIS) that is a requirement of the CLG's Investment Guidance.

10.2 As per the requirements of the Prudential Code, the Authority has adopted the CIPFA Treasury Management Code and reaffirmed its adoption at its annual Budget meeting, most recently on 27 February 2012.

10.3 The purpose of this TMSS is, therefore, to approve:

- Treasury Management Strategy for 2013/14
- Annual Investment Strategy for 2013/14
- Statement of Investment Policy
- Prudential Indicators for 2013/14 to 2016/17

The approved Strategy will be implemented from the date of approval by the Council.

10.4 The Authority has borrowed substantial sums of money and has a significant amount invested and therefore, has potentially large exposures to financial risks including the loss of invested funds and the effect of changing interest rates. The successful identification, monitoring and control of risk is, therefore, central to the Authority's Treasury Management Strategy.

Capital Financing Requirement

10.5 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). The CFR, together with usable reserves, are the core drivers of the Authority's Treasury Management activities. The expected movement of the CFR over the next three years is shown in Section 9.

10.6 At 31 December, 2012, the Authority's had £438m of debt and £80m of investments. These are set out in further detail below.

Existing Investment & Debt Portfolio Position

Table 1

	31/12/2012 Actual Portfolio £m	31/12/2012 Average Rate %
External Borrowing:		
PWLB – Maturity	49	2.54
PWLB – EIP	288	5.01
Local Authorities	5	0.27
LOBO Loans	96	4.81
Total Gross External Debt	438	4.64
Investments:		
Market Deposits	59	0.37
Money Market Funds	21	0.39
Total Investments	80	0.37
Net Debt	358	

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

Interest Rate Forecast

10.8 Interest rates are forecast to continue the trend of the last few years, that is, that interest rates will remain low for even longer. Indeed, the forecast is for official UK interest rates to remain at 0.5% until 2016 given the outlook for limited economic growth and the continued austerity measures described in the Chancellor's Autumn Statement. Until the Eurozone reaches a situation where there is a reasonable prospect of reducing debt and re-establishing growth, then the UK's safe haven status will continue and increases in official interest rates and long term borrowing rates are unlikely to become an immediate prospect. The Authority will reappraise its strategies from time to time in response to evolving economic, political and financial events.

Borrowing Strategy

10.9 Treasury management and borrowing strategies in particular continue to be influenced not only by the absolute level of borrowing rates but also the relationship between short and long term interest rates. This difference creates a "cost of carry" for any new longer term borrowing where the proceeds are temporarily held as investments because of the difference between what is paid on the borrowing and what is earned on the investment. The cost of carry is likely to be an issue until 2016 or beyond. As borrowing is often for longer dated periods (anything up to 60 years) the cost of carry needs to be considered against a backdrop of uncertainty and affordability constraints in the Authority's wider financial position.

10.10 The Authority has a borrowing requirement in 2013/14 and there is expected to be a long term requirement to fully finance the Authority's capital expenditure. Borrowing will be undertaken to reach this situation when the expected course of interest rates justifies further long term borrowing. The Authority will adopt a flexible approach to this borrowing in consultation with its treasury management advisers, Arlingclose Ltd. The following issues will be considered prior to undertaking any external borrowing:

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

Sources of Borrowing and Portfolio Implications

10.11 In conjunction with advice from Arlingclose, the Authority will keep under review the following borrowing sources:

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

10.12 The cost of carry has resulted in an increased use of shorter dated borrowing and repayment by equal instalments of principal. This type of borrowing injects volatility into the debt portfolio in terms of interest rate risk but is counterbalanced by its affordability and alignment of borrowing costs with investment returns. It also maintains an element of flexibility to respond to possible future changes in the requirement to borrow. The Authority's exposure to shorter dated and variable rate borrowing is kept under regular review.

10.13 The Authority has £95.5m exposure to LOBO loans (Lender's Option Borrower's Option) of which £25m of these can be "called" within 2013/14. A LOBO is called when the Lender exercises its right to amend the interest rate on the loan, at which point the Borrower can accept the revised terms or reject them and repay the loan without penalty. LOBO loans present a potential refinancing risk to the Authority since the decision to call a LOBO is entirely at the lender's discretion.

Any LOBOs called will be discussed with Arlingclose prior to acceptance of any revised terms. The default position will be the repayment of the LOBO without penalty i.e. the revised terms will not be accepted.

Debt Rescheduling

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

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

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

10.16 Borrowing and rescheduling activity will be reported to the Executive and Council in the Annual Treasury Management Report and the mid year report.

Annual Investment Strategy

10.17 In accordance with Investment Guidance issued by the CLG, and best practice, this Authority's primary objective in relation to the investment of public funds remains the security of capital. The liquidity or accessibility of the Authority's investments is secondary, followed by the yield earned on investments.

10.18. The Authority and its advisors remain on a heightened state of alert for signs of credit or market distress that might adversely affect the Authority.

10.19 Investments are categorised as "Specified" or "Non-Specified" within the investment guidance issued by the CLG.

Specified investments are sterling denominated investments with a maximum maturity of one year. They also meet the "high credit quality" as determined by the Authority and are not deemed capital expenditure investments under Statute. Non-specified investments are, effectively, everything else. Investments for more than a year remain non-specified until they mature.

10.20 The types of investments that will be used by the Authority and whether they are specified or non-specified are as follows:

Table 2: Specified and Non-Specified Investments

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

Further details can be found in Appendices L (i) and (ii).

10.21 Registered Providers (RPs) have been included within specified and non-specified investments for 2013/14. Investments with RPs will be analysed on an individual basis and discussed with Arlingclose prior to investing. RPs are Housing Associations and other Registered Social Landlords.

10.22 The minimum credit rating for non-UK sovereigns is AA+ (or equivalent). For specified investments the minimum long term rating for counterparties is A- (or equivalent). Within these criteria, the Chief Financial Officer (CFO) will have discretion to accept or reject individual institutions as counterparties on the basis of any information which may become available. This may include adding institutions not, at present, eligible should they become so, after having due regard to prudence. As detailed in non-specified investments in Appendix L (ii), the CFO will have discretion to make investments with counterparties that do not meet the specified criteria on advice from Arlingclose.

The other credit characteristics, in addition to credit ratings, that the Authority monitors are listed in the Prudential Indicator on Credit Risk (PI 12).

Any institution will be suspended or removed should any of the factors identified above give rise to concern, and caution will be paramount in reaching any deal regardless of the counterparty or the circumstances. Credit ratings are monitored continually by the Authority, using the advice of Arlingclose on ratings changes, and appropriate action to be taken.

The CFO will have the discretion to adopt a limit on lending to an individual country's institutions as seems prudent.

The countries and institutions that currently meet the criteria for investments are included in Appendix L (i).

10.23 Authority's Banker – The Authority banks with National Westminster and, at the current time, it meets the Authority's minimum credit criteria. NatWest is part of the RBS group and, should the credit rating fall below the Authority's minimum criteria, the RBS group will continue to be used for short term liquidity requirements (overnight and weekend investments) and business continuity arrangements.

Investment Strategy

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

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

10.26 Money market funds (MMFs) will be utilised but good treasury management practice prevails, and whilst MMFs provide good diversification, the Authority will also seek to mitigate operational risk by utilising at least two MMFs where practical. The Authority will also restrict its exposure to MMFs with lower levels of funds under management and will not exceed 0.5% of the net asset value of the MMF. In addition, each Fund will be limited to a maximum deposit of £10m and no more than half the Council's deposits will be placed with MMFs.

10.27 The investment strategy will provide flexibility to invest cash for periods of up to 370 days in order to access higher investment returns, although lending to UK local authorities can be for up to 5 years. The upper limit for lending beyond a year is £20m. In practice lending for more than one year will be only to institutions of the highest credit quality and at rates which justify the liquidity risk involved.

10.28 Collective Investment Schemes (Pooled Funds):
The Authority has evaluated the use of Pooled Funds and determined the appropriateness of their use within the investment portfolio. Pooled funds enable the Authority to diversify the assets and the underlying risk in the investment portfolio and provide the potential for enhanced returns. Investments in pooled funds will be undertaken with advice from Arlingclose Ltd. The Authority currently has no investments in Pooled Funds.

10.29 Investment Policy:
The Treasury Management in the Public Services: Code of Practice (the Code) produced by the Chartered Institute of Public Finance and Accountancy (CIPFA) was updated in November 2011, with a greater focus on risk management and significance of capital security as the Council's primary objective in relation to investments.

The Council will create and maintain, as the cornerstones for effective treasury management:-

- A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities
- Suitable treasury management practices (TMPs), setting out the manner in which the Council will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.
- The Policy Statement is set out in Appendix L (iii). It will continue to apply until specific changes are required.

Policy on Use of Financial Derivatives

10.30 The Authority will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Authority is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

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

10.32 The Authority will only use derivatives after seeking expertise, receiving a legal opinion and ensuring officers have the appropriate training for their use.

Housing Revenue Account Self-Financing

10.33 Central Government completed its reform of the Housing Revenue Account (HRA) Subsidy system at the end of 2011/12. Local authorities are required to recharge interest expenditure and income attributable to the HRA in a way which is fair to the HRA without detriment to the General Fund. The guidance is very general, so the Council is required to adopt a policy that will set out how interest charges attributable to the HRA will be determined. The CIPFA Code recommends that authorities present this policy in their TMSS.

10.34 As of 1st April 2012, the Council notionally split each of its existing long-term loans into General Fund and HRA pools. Individual loans or parts of loans have been allocated to the HRA, on the basis of achieving the same long term rate as that which applied to the General Fund at the self financing date. In the future, new long-term borrowing will be assigned in its entirety to one pool or the other, allocating the costs and benefits to each accordingly.

10.35 Differences between the value of the HRA loans pool and the HRA's underlying need to borrow will result in a notional element of internal borrowing which may be positive. This balance will be assessed over the year and interest charged to the HRA at an appropriate rate for short term borrowing. The HRA will also hold reserves and balances which will be invested with the Council, and interest will be paid on identified balances at a rate which recognises that any investment risk is borne by the General Fund

Monitoring and Reporting on the Treasury Outturn and Prudential Indicators

10.36 The CFO will report to the Executive on treasury management as follows:

- Annually, against the strategy approved for the year. The Authority will produce an outturn report on its treasury activity and the Prudential Indicators no later than 30th September after the financial year end.
- After the middle of the year on the implementation of strategy and main features of the year's activity to date
- The Executive and the Audit Committee will be responsible for the scrutiny of treasury management activity and practices.

Other Items

10.37 **Training**

CIPFA's Code of Practice requires the CFO to ensure that all members with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities.

10.38 **Treasury Management Advisors**

The Authority uses Arlingclose as Treasury Management Advisors and receives the following services:

– Credit advice
– Investment advice

- Technical advice
- Economic & interest rate forecasts
- Workshops and training events
- HRA support
- Other matters as required

The Authority maintains the quality of the service with its advisors by holding quarterly meetings and tendering periodically.

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List of institutions which meet the Council’s credit criteria

Country /Domicile	Counterparty	Maximum Group Limit £m	Maximum Maturity Limit
UK	Santander UK	15	370 days
UK	Lloyds TSB/Bank of Scotland	15	370 days
UK	Barclays Bank	15	370 days
UK	HSBC Bank	15	370 days
UK	Nationwide Building Society	15	370 days
UK	NatWest/RBS	15	370 days
UK	Standard Chartered Bank	15	370 days
Australia	Australia and NZ Banking Group	10	370 days
Australia	Commonwealth Bank of Australia	10	370 days
Australia	National Australia Bank	10	370 days
Australia	Westpac Banking Corp	10	370 days
Canada	Bank of Montreal	10	370 days
Canada	Bank of Nova Scotia	10	370 days
Canada	Canadian Imperial Bank of Commerce	10	370 days
Canada	Royal Bank of Canada	10	370 days
Canada	Toronto-Dominion Bank	10	370 days
Finland	Nordea Bank Finland	10	370 days
France	BNP Paribas	10	370 days
France	Credit Agricole CIB/SA	10	370 days
France	Société Générale	10	370 days
Germany	Deutsche Bank AG	10	370 days
Netherlands	ING Bank NV	10	370 days
Netherlands	Rabobank	10	370 days
Netherlands	Bank Nederlandse Gemeenten	10	370 days
Sweden	Svenska Handelsbanken	10	370 days
Switzerland	Credit Suisse	10	370 days
US	JP Morgan	10	370 days

The list above represents the institutions which meet the criteria at the time of preparation of the strategy. The CFO may introduce new names which meet the criteria from time to time and may adopt more restrictive limits on maturity or value as seems prudent

An operational list of institutions which are approved to take deposits from the Council will be prepared and circulated to dealing and approving Officers from time to time

Group Limits - for institutions within a banking group, the authority may lend the full limit to a single bank within that group, but may not exceed the limit for all group members.

Non-Specified Investments

Instrument

Call accounts, term deposits & CDs with banks, building societies & local authorities which do not meet the specified investment criteria (on advice from Arlingclose)

Deposits with registered providers

Gilts

Bonds issued by multilateral development banks

Sterling denominated bonds by non-UK sovereign governments

Money Market Funds and Collective Investment Schemes

Corporate and debt instruments issued by corporate bodies purchased from 01/04/12 onwards

Collective Investment Schemes (pooled funds) which do not meet the definition of collective investment schemes in SI 2004 No 534 or SI 2007 No 573. These would be capital expenditure.

The Authority will hold up to a maximum of £30m in each category, subject to a maximum of £30m in all non specified investments at any time.

Policies and Objectives of Treasury Management Activities

The Council 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."

This Council regards the successful 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 management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

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

The Council's borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk and refinancing risk. The source from which the borrowing is taken and the type of borrowing should allow the Council transparency and control over its debt.

The Council's primary objective in relation to investments remains the security of capital. The liquidity or accessibility of the Council's investments followed by the yield earned on investments remain important but are secondary considerations.

The Council delegates the execution and administration of treasury management decisions to the County Treasurer who will act in accordance with the organisation's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.

The Council nominates its Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.