Treasury Management Strategy 2012/13 – 2014/15

1. The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators in **Appendix A** consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets balanced budget requirement under the Local Government Finance Act 1992.
2. The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management – revised November 2011). This Council has adopted the Code of Practice on Treasury Management, and has adopted the revised Code.
3. As a result of adopting the Code the Council, also adopted a Treasury Management Policy Statement. This adoption is the requirements of one of the prudential indicators.
4. The Constitution requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year, and a new requirement of the revision of the Code of Practice is that there is a mid-year monitoring report.
5. This strategy covers:
   - The Council's debt and investment projections;
   - The Council's estimates and limits on future debt levels;
   - The expected movement in interest rates;
   - The Council's borrowing and investment strategies;
   - Treasury performance indicators;
   - Specific limits on treasury activities;
   - Any local treasury issues

Debt and investment Projections 2012/13 to 2014/15

6. The borrowing requirement comprises the expected movement in the Capital Financing Requirement (CFR) and any maturing debt which will need to be re-financed. The table below shows this effect on the treasury position over the next three years. The expected maximum debt position during each year represents the Operational Boundary prudential indicator, and so may be different from the year end position. The table also highlights the expected change in investment balances.

	2011/12 Q2 Forecast £000	2012/13 Estimate £000	2013/14 Estimate £000	2014/15 Estimate £000
External Debt				
Debt at 1 April	21,386	21,386	21,386	21,386
Expected change in debt	0	0	0	0
Debt at 31 March	21,386	21,386	21,386	21,386
Operational boundary	22,000	22,000	22,000	22,000
The debt estimated at 31 March represents the Council's Operational Boundary				
Investments				
Total Investments at 31 March	15,000	10,000	10,000	10,000
Investment Change	-	(5,000)	-	-

7. The related impact of the above movements on the revenue budget are:

	2011/12 Q2 Forecast £000	2012/13 Estimate £000	2013/14 Estimate £000	2014/15 Estimate £000
Revenue Budgets				
Interest on borrowings	987	987	987	987
Investment Income	130	160	160	200
Less earmarked interest	-	-	-	-
Net general fund investment income	130	160	160	200

Limits to Borrowing Activity

8. Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well defined limits.
9. For the first of these the Council needs to ensure that its total borrowing net of any investments, 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 2012/13 and the following two financial years (the relevant comparative figures are highlighted). This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

	2011/12 Q2 Forecast £000	2012/13 Estimate £000	2013/14 Estimate £000	2014/15 Estimate £000
Gross Borrowing	21,386	21,386	21,386	21,386
Investments	(15,000)	(10,000)	(10,000)	(10,000)
Net Borrowing	**6,386**	**11,386**	**11,386**	**11,386**
CFR	26,324	22,380	21,280	20,180

10. The Strategic Director for Resources 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.

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

12. 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 no control has yet been exercised.

13. The Council is asked to approve the following Authorised Limit:

	2011/12 Revised £000	2012/13 Estimate £000	2013/14 Estimate £000	2014/15 Estimate £000
Borrowing	26,000	26,000	26,000	26,000
Other Long Term Liabilities	0	0	0	0
Total	26,000	26,000	26,000	26,000

14. Borrowing in advance of need – The Council has some flexibility to borrow funds for use in future years where a future need for borrowing has been identified. The Strategic Director for Resources may do this under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. Whilst the Strategic Director for Resources will adopt a cautious approach to any such borrowing, where there is a clear business case for doing so borrowing may be undertaken to fund the approved capital programme or to fund future debt maturities. Borrowing in advance will be made within the constraints that:

- It will be limited to no more than 50% of any expected increase in borrowing need (CFR) over the three year planning period; and

- Would not look to borrow more than 18 months in advance of need.

15. Risks associated with any advance borrowing activity will be subject to appraisal in advance and subsequent reporting through the mid-year or annual reporting mechanism. It is unlikely that the Council will require any borrowing in advance of need.

Expected Movement in Interest Rates (commentary provided by Sector)

Annual Average %	**Bank Rate**	**Money Rates**		**PWLB Borrowing Rates**		
		3 month	1 year	5 year	20 year	50 year
March 2012	0.50	0.70	1.50	2.30	4.20	4.30
June 2012	0.50	0.70	1.50	2.30	4.20	4.30
Sept 2012	0.50	0.70	1.50	2.30	4.30	4.40
Dec 2012	0.50	0.70	1.60	2.40	4.30	4.40
March 2013	0.50	0.75	1.70	2.50	4.40	4.50
June 2013	0.50	0.80	1.80	2.60	4.50	4.60
Sept 2013	0.75	0.90	1.90	2.70	4.60	4.70
Dec 2013	1.00	1.20	2.20	2.80	4.70	4.80
March 2014	1.25	1.40	2.40	2.90	4.80	4.90
June 2014	1.50	1.60	2.60	3.10	4.90	5.00

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

17. Fixed interest borrowing rates are based on UK gilt yields. The outlook for borrowing rates is currently much more difficult to predict. The UK total national debt is forecast to continue rising until 2015/16; the consequent increase in gilt issuance is therefore expected to be reflected in an increase in gilt yields over this period. However, gilt yields are currently at historically low levels due to investor concerns over Eurozone sovereign debt and have been subject to exceptionally high levels of volatility as events in the Eurozone debt crisis have evolved.

18. This challenging and uncertain economic outlook has a several key treasury mangement implications:

- The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2012/13;
- Borrowing interest rates are currently attractive, but may remain low for some time. The timing of any borrowing will need to be monitored carefully;

- There will remain a cost of capital – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

Borrowing Strategy 2012/13 – 2014/15

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 high.

Against this background and the risks within the economic forecast, caution will be adopted with the 2012/13 treasury operations. The Strategic Director for Resources 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, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

- *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

Any decisions will be reported to members at the next available opportunity.

Investment Strategy 2012/13 – 2014/15

19. **Key Objectives -** The Council's investment strategy primary objectives are safeguarding the re-payment of the principal and interest of its investments on time first and ensuring adequate liquidity second – the investment return being a third objective. Following the economic background above, the current investment climate has one over-riding risk consideration that of counterparty security risk. As a result of these underlying concerns officers are implementing an operational investment strategy which tightens the controls already in place in the approved investment strategy.

20. **Risk Benchmarking** – A development in the revised Codes and the CLG consultation paper is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are new requirements to the Member reporting, although the application of these is more subjective in nature. Additional background in the approach taken is attached at **Annex B2**.

21. These benchmarks are simple targets (not limits) and so 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 depending on any changes. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

22. Security - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:

- 0.1% historic risk of default when compared to the whole portfolio.

23. Liquidity – In respect of this area the Council seeks to maintain:

- Bank overdraft - £0m
- Liquid short term deposits of at least £1m available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.2 years, with a maximum of 0.75 years.

24. Yield - Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate

25. .**Investment Counterparty Selection Criteria -** The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:

  - It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.

  - It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

26. The Strategic Director for Resources will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. This criteria is separate to that which chooses Specified and Non-Specified investments as it provides an overall pool of counterparties considered high quality the Council may use rather than defining what its investments are.

27. The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with a CIPFA Treasury Management Panel recommendation in March 2009

28. Credit rating information is supplied by our treasury consultants on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to

officers almost immediately after they occur and this information is considered before dealing. For instance a negative rating watch applying to counterparty will be suspended from use, with all others being reviewed in light of market.

29. The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments) is:

- **Banks 1 - Good Credit Quality** – the Council will only use banks which:

    i. Are UK banks; and/or

    ii. Are non-UK and domiciled in a country which has a minimum Sovereign long term rating of AA+.

    And have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):

    i. **Short Term -** Fitch (or equivalent) rating of F1
    ii. **Long Term -** Fitch (or equivalent) rating of A-
    iii. **Individual Viability/ Financial Strength** – Fitch individual rating of at least BB+ (Fitch / Moody's only)

    iv. **Support** – Fitch rating of 3 (Fitch only)

- **Banks 2 – Guaranteed Banks with suitable Sovereign Support** – In addition, the Council will use banks whose ratings fall below the criteria specified above if all of the following conditions are met:

    i. wholesale deposits in the bank are covered by a government guarantee;

    ii. the government providing the guarantee is rated "AAA" by all three major rating agencies (Fitch, Moody's and Standard & Poors); and

    iii. the Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.

- **Banks 3 – Eligible Institutions** - the organisation is an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008, with the necessary short and long term ratings required in Banks 1 above. These institutions were subject to suitability checks before inclusion.

- **Banks 4** – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

- **Building Societies** – the Council will *use* all Societies which:

    meet the ratings for banks outlined above

    Or are both:

    iii. Eligible Institutions; and

    iv. Have assets in excess of £1bn.

- **Money Market Funds –** these offer safety, security, liquidity and yield. Whilst not a replacement for all other kinds of investments money market funds are suitable for managing short term funds. The Council is permitted to use these funds and only deals with Counterparties on the approved list. The Council limits the total investment to the amount on the approved counterparty list.
- **UK Government** (including gilts and the DMADF)
- **Local Authorities, Parish Councils etc**

A limit of 80% will be applied to the use of Non-Specified investments (*this will partially be driven by the long term investment limits*).

30. **Country and sector considerations** - Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part the country selection will be chosen by the credit rating of the Sovereign state in Banks 1 above. In addition:
    - no more than 10% will be placed with any non-UK country at any time;
    - limits in place above will apply to Group companies;
    - Sector limits will be monitored regularly for appropriateness.
31. **Use of additional information other than credit ratings** – Additional requirements under the Code of Practice now require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.
32. **Time and Monetary Limits applying to Investments** - The time and monetary limits for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch Rating	Moody's Rating	Standard & Poor's Rating	Money Limit	Time Limit
Upper limit category	F1+/ AA-	P-1/Aa3	A-1+/AA-	£5m	3 yrs
Middle Limit Category	F1/A-	P-1/A3	A-1/A-	£2m	364 days
Other Institution Limits (other Local Authorities, Money Market Funds, DMADF)				£5m	364 days
Guaranteed Organisations				Within the terms of the guarantee to a maximum of £1m up to 6 months	

33. The proposed criteria for Specified and Non-Specified investments are shown in **Annex B1** for approval.

34. In the normal course of the council's cash flow operations it is expected that both Specified and Non-specified investments will be utilised for the control of liquidity as both categories allow for short term investments.

35. The use of longer term instruments (greater than one year from inception to repayment) will fall in the Non-specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the longer term investment limits.

36. **Economic Investment Considerations** - Expectations on shorter-term interest rates, on which investment decisions are based, show likelihood of the current 0.5% Bank Rate remaining flat but with the possibility of a rise in quarter 3 of 2013. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts.

37. **The criteria for choosing counterparties set out above provide a sound approach to investment in "normal" market circumstances. Whilst Members are asked to approve this base criteria above, under the exceptional current market conditions the Strategic Director for Resources may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval. These restrictions will remain in place until the banking system returns to "normal" conditions. Similarly the time periods for investments will be restricted.**

38. Examples of these restrictions would be the greater use of the Debt Management Deposit Account Facility (DMADF – a Government body which accepts local authority deposits), Money Market Funds, guaranteed deposit facilities and strongly rated institutions offered support by the UK Government. The credit criteria have been amended to reflect these facilities.

Treasury Management Limits on Activity

39. There are four further treasury activity limits, which were previously prudential indicators. The purpose of these are to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an 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 – Similar to the previous indicator this covers a maximum limit on fixed interest rates.
- Maturity structures 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.

- 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 each year-end.

40. The Council is asked to approve the limits:

	2012/13	2013/14	2014/15
Interest rate exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates	£25.000m	£25.125m	£25.250m
Limits on variable interest rates	£7.500m	£7.538m	£7.575m
Maturity structure of fixed interest rate borrowing 2011/12			
		Upper	**Lower**
Under 12 months		25%	0%
12 months to 2 years		25%	0%
2 years to 5 years		20%	0%
5 years to 10 years		20%	0%
10 years and above		100%	0%
Maximum principal sums invested > 364 days		25%	

Performance Indicators

41. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

    - Debt – Borrowing - Average rate of borrowing for the year compared to average available
    - Debt – Average rate movement year on year
    - Investments – Internal returns above the 7 day LIBID rate
    - Investments – External fund managers – returns 110% above 7 day compounded LIBID

    The results of these will be reported in the Treasury Annual Report.

Treasury Management Advisers

42. The Council uses Sector as its treasury management consultants. The company provides a range of services which include:

- Technical support on treasury matters, capital finance and housing issues and the drafting of Member reports;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- Debt rescheduling advice surrounding the existing portfolio;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings/market information service comprising the three main credit rating agencies;

43. Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the Council. This service is subject to regular review.

Member and Officer Training

44. The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers. This Council has addressed this important issue by:

    a. Holding Member briefing sessions at appropriate times during each year. Regular updates on Treasury Management activity are also provided to Cabinet.

    b. Officers attend regular regional awareness seminars, provided by Sector and attend appropriate technical training courses that are provided by CIPFA. On the job coaching and supervision is an integral part of officer training.