Cabinet meeting on the 21 January 2015

Treasury Management, Annual Investment and Minimum Revenue Provision Strategies 2015/16

Report summary from Ian Parry, Deputy Leader and Cabinet Member for Strategy, Finance and Corporate Issues

Ian Parry said "In the face of an improving economic backdrop our sensible approach to treasury management activity continues. We are still investing carefully and continuing to save money by using cash instead of borrowing"

1. This report sets out how the council plans to manage its investment and borrowing activity in the coming year. This will take place in an improving environment but one that still contains considerable risks though and these are reflected in this treasury strategy.

2. The report explains that, where possible, we will continue to use our own cash instead of borrowing money whilst retaining the flexibility to take out loans if we need to. Using cash instead of borrowing means that we have less to invest which reduces our exposure to the risky financial environment which is still an important consideration.

3. When we do invest, we will continue to work on the prudent basis that the return of our money is more important than the return on our money.

4. Our treasury activities involve large sums of money and reflect the huge scale of the county council's operations. The amount of financing raised to fund capital investments, for example on schools and highways, is expected to be £548 million on the 31 March 2015.

5. Overall the report shows that the council's borrowing and investment activities are being undertaken prudently and sensibly against an improving but still challenging economic background.

Recommendation – I recommend that cabinet approve the detailed set of recommendations set out in the attached report.

Local Members Interest
N/A

Cabinet – 21 January 2015

Treasury Management, Annual Investment and Minimum Revenue Provision Strategies 2015/16

Recommendations of the Deputy Leader and Cabinet Member for Strategy, Finance and Corporate Issues

1. That, in accordance with regulations, the cabinet recommends to the county council, at its meeting on the 19 March 2015, the adoption of the Annual Investment Strategy (AIS) 2015/16 detailed in **paragraphs 24** to **70** and as detailed in **Appendix 2 and 4.**

2. That cabinet approve, as required by guidance, policies on:
   a) reviewing the strategy;
   b) the use of external advisors;
   c) training.
   As described in **paragraph 96** to **104.**

3. That the cabinet approve the proposed borrowing strategy for the 2015/16 financial year comprising:
   a) the use of cash in lieu of borrowing required in 2015/16;
   b) the use of cash to repay loans early, subject to market conditions;
   c) as a contingency, the ability to borrow new loans as a result of:
      - unexpected changes in the capital programme;
      - a reduction in the level of cash balances;
      - the repayment of LOBO's.
   d) a forward borrowing strategy that will not be used in 2015/16;
   e) a loan rescheduling strategy that is unlimited where this re-balances risk;
   f) the above to operate within the prudential limits set out in **Appendix 5** and in consultation with the Deputy Leader and Cabinet Member for Strategy, Finance and Corporate Issues with respect to early loan repayment, raising new loans and loan rescheduling.

4. That, in accordance with regulations, the cabinet also recommends to the county council the adoption of the Minimum Revenue Provision (MRP) policy 2015/16 as summarised in **paragraphs 105** to **107**; the full policy statement is shown at **Appendix 8.**

Report of the Director of Finance and Resources

Reasons for recommendations

5. The economic environment has improved in the UK during the past twelve months with higher than expected growth and lower inflation. However the financial environment remains risky.

6. One of these risks is related to the fact that the Government is changing how banks that fail are treated such that there is risk that depositors such as the county council could lose a proportion of their investments (known as “bail-in”). Whilst the recent Bank of England stress tests were passed by the majority of banks the Co-op bank failed the test and will need to do more to address their financial position.

7. Further there are other risks to the economic situation with falling oil prices, stagnation in Europe and a Chinese economy under pressure. As a result, the treasury strategy retains the low risk approach adopted in recent years based on prioritising security, liquidity and then yield.

Link to the Medium Term Financial Strategy (MTFS)

8 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992 for the council to produce a balanced budget. In particular, Section 32 requires the calculation of a budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. Capital expenditure must not exceed an amount which can be afforded, in terms of interest charges and running costs for the foreseeable future.

9. The Local Government Act 2003 requires a local authority to have regard to the Prudential Code and to set Prudential Indicators for the next three years to ensure that its capital investment plans are affordable, prudent and sustainable. The Prudential Indicators are approved as part of the Medium Term Financial Strategy (MTFS), but the treasury indicators are included in this report as they require consideration as part of the Treasury Management Strategy. **Appendix 5** lists these indicators for the next five financial years in order to provide a link to the MTFS. A brief narrative of the reason for each indicator is also shown.

10. The Treasury Management Strategy is a key element of the MTFS as the planned capital expenditure programme drives the borrowing required. This is explained further at **paragraph 71.**

Economic and financial background

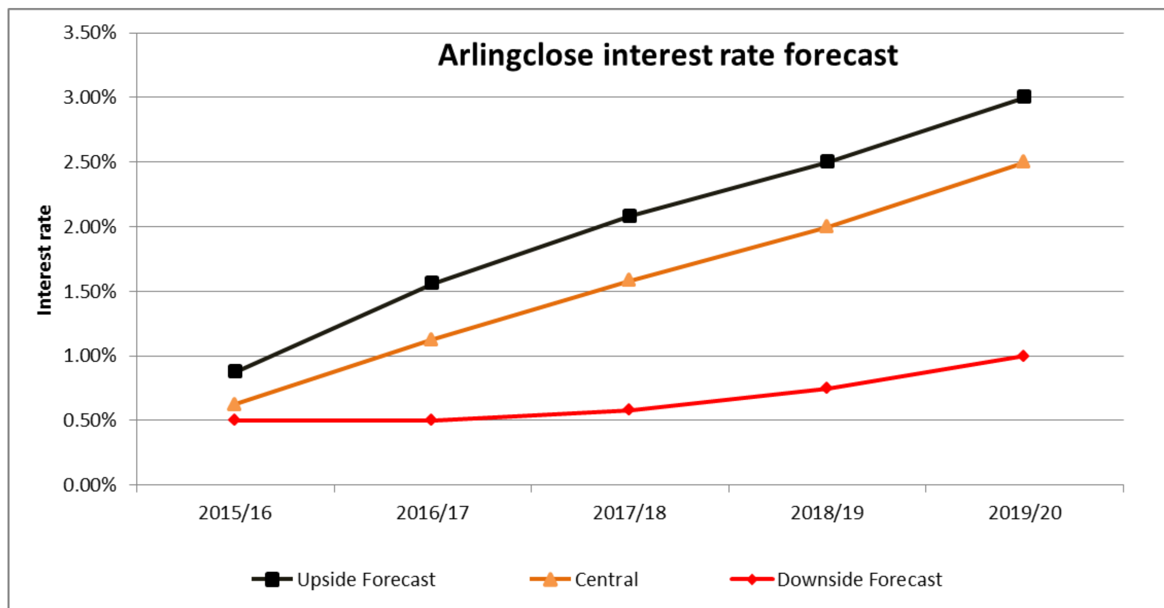
Interest rates

11. In considering the council's borrowing and investment strategies, it is important that account is taken of the likely economic and financial environment and the potential level of interest rates. At the time of writing there is much discussion about when the first rise in bank-rate will occur and two members of the Bank of England's Monetary Policy Committee (MPC) have voted for a rise recently.

12. Forecasting is always difficult in such a complex economic environment; in effect there is a tension between three separate issues:
    - Positive momentum in the UK economy that supports a rise, offset by;
    - External risks in the Eurozone and other countries around the world; and
    - Benign inflationary pressure that reduces pressure for a rise.

13. In terms of treasury management, the bank rate (the interest rate set by the Bank of England) is fundamental to the income received and it may also affect expenditure on loan interest where new loans are taken out or variable rate loans are held.

14. The following graph shows an interest rate forecast over the next five years as provided by the council's advisor, Arlingclose; three possibilities are shown, an upside forecast (the higher of the three), and a central and downside forecast.



15. The central forecast is as Arlingclose see it the most likely scenario for interest rates and is considered prudent for setting the budget. The forecast has been used in the MTFS and reflects the fact that short-term interest rates may start to rise in 2015 and then will rise slowly.

16. So whilst interest rates are expected to rise in 2015 and thereafter, they are not expected to reach pre-crisis levels for many years into the future.

<u>Credit outlook</u>

17. The credit outlook is in one sense positive and in one negative because of legislation to be introduced in 2015/16. This will change the way that failing banks are dealt with; instead of a Government "bail-out" being the default position a "bail-in" by investors will be forced upon a bank.

18. This is positive as it provides a way of dealing with a failing bank; in theory this means that there is less chance of wider contagion arising from a failure because a bank can experience difficulties without formally closing. Banks will also be forced to strengthen their balance sheets and in effect become more resilient to a downturn.

19. However, what this does mean is that some investors are more likely to lose money; in effect an investment may be "top-sliced" to contribute to losses at a bank. Those investors affected are public sector bodies (such as local authorities) and financial companies; others will be covered by the Financial Services Compensation Scheme (FSCS).

20. Although this risk has increased, the county council will continue to follow the advice of Arlingclose; the full creditworthiness approach is outlined at **paragraph 37**.

21. Stress tests conducted by the Bank of England's Prudential Regulatory Authority (the PRA) also give an indication of the health of the largest and most important UK banks. In mid-December 2014 the most recent results were announced and the majority of the banks "passed" which means that their balance sheets are strong enough to survive an extreme economic downturn. Lloyds Bank and the Royal Bank of Scotland Group did "pass" but are considered to be at risk in such a situation. Both will need to strengthen their balance sheet as a result. Finally, as expected the Co-op Bank "failed" the test and will be expected to reduce its risk profile; it will be monitored closely by the PRA. **Paragraph 48** details the progress in "on-boarding" Lloyds bank as the Council's banker and ending the contract with the Co-op Bank.

Policy framework

22. In order to assess the various options for borrowing and investment it is important to have a policy framework. The table that follows sets out three main elements:

    1. Objectives.
    2. Economic considerations.
    3. Relevant risks.

23. The table compares borrowing and investments side by side to highlight the similarities and differences. For example, some of the economic considerations (i.e. the yield curve) are similar, whilst some aspects are different.

	Borrowing strategy	Investment strategy
Objectives	• Reduce the average rate (cost) of debt ensuring debt is affordable • Maintain medium term budget stability • Be able to respond to changes in the external environment	• Ensure security (and to ensure bills are paid) • Provide liquidity (i.e. to pay the bills as they fall due) • Earn interest
Economic considerations	• The shape of the whole yield curve* (the level of interest rates for different lengths of time) • The steepness of the yield curve • Forecast changes in interest rates • The relative position of interest rates to the average cost of the debt • The direction of travel of overall debt in the future • Cash balances available to support the strategy	• The shape of the short-term yield curve* • Forecast changes in interest rates • Counterparty issues (credit worthiness) • Type of financial instrument • Risk in the financial environment
Relevant risks	• Security • Liquidity • Interest rate • Market risk • Refinancing • Regulatory and legal	• Security • Liquidity • Interest rate • Market risk • Refinancing • Regulatory and legal

**The yield curve is a fundamental concept; it represents the price paid by the council for its long-term loans or the price received for the money it invests.*

Annual Investment Strategy (AIS) 2015/16

24. The council manages a significant investment portfolio that can reach over £200m each year. Since the financial crisis in 2008, the council has taken a low risk approach and this AIS continues in this vein.

    Investment options

25. The main characteristics which determine an investment strategy are related to:
    - the credit risk of the counterparties that you invest with;
    - the length of the investment; and
    - the type of financial instrument that is used.

26. These issues have to be considered in the light of the regulatory framework provided by the Government.

27. Key parts of this framework are the Government Guidance on Local Government Investments issued in March 2010 and the CIPFA Code of

Practice for Treasury Management in the Public Services. These state that the two prime risk issues are:

- the security of capital; and
- the liquidity of investments.

28. In addition, Government regulations specify the type of financial instruments you can invest in and they divide them into what they term ‘specified’ investments and ‘non-specified’ investments.

a.) Specified investments

29. Specified investments are investments made in sterling for a period of less than a year that are not counted as capital expenditure and are invested with:
    - the UK Government;
    - a local authority;
    - a parish or community council; or
    - a body, or in an investment instrument, **that has ‘high credit quality’.**

30. The first three named investments will be used by the council by virtue of their inclusion within the guidance (referred to as regulation investments subsequently in this report). The assessment of the fourth aspect is dealt with in the paragraphs that follow.

31. Whilst it is difficult to define ‘high credit quality’, credit ratings are published by credit rating agencies (for example, Fitch, Standard and Poors, Moodys); this information is provided by the council’s treasury adviser, Arlingclose, where available.

Money Market Funds (MMF’s)

32. Money Market Funds are pooled investment vehicles consisting of money market deposits and similar instruments. Arlingclose recommend the use of MMF’s by their local government clients, and these have been used for some time by the council.

33. In the background there is the possibility of European Commission (EC) regulations that may affect how MMF’s operate and in the light of these, it is MMF’s that meet the criteria listed below which will be considered to have high credit quality and will be included on the lending list:
    - They are recommended to clients by the council’s treasury adviser, Arlingclose.
    - Diversified – MMF’s are diversified across many different investments, far more than the council could hope to achieve on its own account.
    - Same day liquidity – this means that funds can be accessed on a daily basis.
    - Ring-fenced assets – the investments are owned by the investors and not the fund management company.
    - Custodian – the investments are also managed by an independent bank known as a custodian, who operates at arms-length from the fund management company.

34. All treasury activity carries an element of risk and MMF’s are no different. In the event of a further financial crisis, the failure of one or more of an MMF’s

investments could lead to a run on the MMF as investors rush to redeem their investment. This could then spread to other MMF's as investors take flight from this asset class.

35. The very low interest rate environment also threatens the ongoing continuity of MMF's. Each MMF charges a fee and this could mean that interest earned became negative after its deduction. If this problem arose then it would be a matter of moving funds to an alternative class of investment.

36. All of these issues point towards the fundamental need for diversification across MMF's and also investment categories where possible. This issue is dealt with later in this report (**paragraph 54**).

The credit management strategy for 2015/16

37. Government guidance requires an explanation of how credit quality is monitored, what happens when it changes and what additional sources of information are used to assess credit quality.

38. The assessment of what is "high credit quality" for banks or building societies is set out in this section of the report.

39. Arlingclose are the council's treasury advisor and an important aspect of this service is credit advice. This is where the advisor provides information to the council about suitable investments in the context of the current economic risk environment and incorporates the views of credit rating agencies. What follows is an overview of how this operates, within which it is important to understand that the council is responsible for the decisions it takes with its investments.

40. Credit ratings provided by the three main credit rating agencies form an important, but not the only, aspect of how creditworthiness is assessed by Arlingclose. For 2015/16 minimum credit-rating thresholds are set at a long-term rating of "A-" where available. Counterparties that are rated below this level are excluded.

41. In addition the following are also considered:
    - Statements of potential government support;
    - Credit Default Swaps (CDS) (i.e. the cost of insuring against counterparty default);
    - Share prices;
    - Gross Domestic Product (GDP) in the country of incorporation;
    - Macro-economic factors;
    - Information in the press;
    - A subjective overlay, i.e. a judgement being made about whether the counterparty should be recommended or not.

42. In practical terms all of this information is considered by Arlingclose when they determine their recommendations. Any change in these criteria can result in a counterparty being removed from the lending list, not solely a change in credit rating.

43. In the recent past, the economic environment has been very volatile, so the advice provided by Arlingclose results in counterparties with high quality credit characteristics that are intended to insulate the council against further volatility. Of course, the future cannot be foreseen and in some situations changes may need to be made quickly, but this is considered a cautious approach.

44. The council remains responsible for its investment decisions. The Treasury Management Panel, chaired by the Director of Finance and Resources, meets monthly and a review of the lending list and any changes made by Arlingclose will take place at these meetings. In between meetings the Treasury Team will implement any recommendations made by Arlingclose. On the rare occasion that Arlingclose do not make a firm recommendation then this will be referred to the Panel for their review.

45. Under stressed market conditions, additional Panel meetings may take place at very short notice after which the Panel may decide to adjust the council's investment risk profile. The end result may involve moving investments to lower risk counterparties or instruments.

46. The proposed AIS would be based on the following definition of high credit quality:
    - Regulation investments as set out.
    - Diversified sterling Money Market Funds meeting the criteria set out.
    - A bank or building society that is recommended by Arlingclose for inclusion on the lending list.

Monitoring

47. As required, an overview of the monitoring process is outlined below:
    - Rating changes and significant changes in risk indicators will be communicated to the Treasury Team by Arlingclose together with any revisions to their recommendations.
    - Changes are sent by e-mail and in urgent situations followed up by a phone call as Arlingclose hold a record of the lending list of approved investment counterparties.

The Council's banker

48. At the time of writing this report the implementation of the new banker, Lloyds Bank is underway. This involves, over a period of several months, moving the council's banking arrangements away from the Co-op Bank.

49. When this process is complete the council will close all Co-op Bank accounts and end the contract. It is expected that this will be complete by the 31 March 2015.

50. Under the new arrangements funds will be retained with Lloyds bank each night earning interest at a market rate; the amount retained will be set in line with the diversification policy set out at **paragraph 54**.

51. Should the Lloyds credit rating fall below the minimum specified in this report then small balances may be retained with the bank for operational efficiency; this will be determined by the Treasury Management Panel chaired by the Director of Finance and Resources.

Investment duration for specified investments

52. In considering the financial instruments that meet the definition of a specified investment, there is the scope to consider the length of the investment period.

53. One of the important lessons of the banking crisis has been to exercise caution in the duration of investments with banks and building societies, this recognises that the factors that led to the investment being considered sound can change adversely over time. As such it is judged reasonable to limit fixed term deposits with banks or building societies to a maximum duration of 12 months, even if Arlingclose recommend a longer duration.

Investment diversification

54. Having determined the lending list of highly rated counterparties and the duration of investments the last piece of the process is to overlay the methodology for ensuring diversification. This is achieved by setting a maximum amount to be invested with each counterparty to limit risk and spread investments.

55. Ensuring diversification has never been more important; it protects the security of the investments by limiting the council's loss in the event of a counterparty default. However, diversification does not protect the council from a systemic failure of the banking sector, although as stated earlier the risk of this may diminish as a result of new banking regulations.

56. Investment balances rise and fall during the year, so diversification needs to take account of this. The limits shown are based upon percentages of investments and the Treasury Team will review and reset these limits at least once a month with reference to future balances. This action will then be ratified by the Treasury Panel at their next meeting. The interval between each review is very much a matter of balance between ensuring diversification and efficient processing as investment balances cannot practically be moved each day to accommodate shifting limits. It is judged that a monthly review strikes this balance.

57. Investment diversification is proposed at two levels; firstly at investment category level:

Investment category	**Maximum % of total investments**
Regulation Investments *	100%
MMF	50%
Banks and Building Societies	50%

**no limit is proposed (in certain circumstances these may be utilised for all of the council's investments)*

58. Secondly, diversification will also take place at investment level:

Banks and Building Societies Lower of:	
£m	Maximum investment as a proportion of the total
30	15%

MMF Lower of:	
Maximum investment as a proportion of total MMF size	Maximum investment as a proportion of the total
0.50%	10%

59. There is an exception to these rules, that where balances are low then the amount invested in MMFs may be as high as 100%. This recognises the fact that there may simply be no other available investment for small amounts where liquidity is needed.

60. It is proposed that both the application and amendment of the investment diversification policy are delegated to the Treasury Management Panel chaired by the Director of Finance and Resources with the results reported in the regular treasury management reports.

b.) Non-specified investments

61. The Government regulations define non-specified investments as all other types of investment that do not meet the definition of specified investments. In contrast to specified investments, government guidance indicates that the AIS should:
    - set out procedures for determining which categories of non-specified investments should be prudently used;
    - identify such investments;
    - state an upper limit for each category of non specified investment;
    - state upper limits for the total amount to be held in such investments.

62. In terms of ensuring future flexibility there are additional categories of investments that are also proposed for use within the AIS. None of the non-specified investments proposed present additional security risk to those investments within specified investments. Each are explained below:
    - Covered Bonds – these are bonds issues by banks that are “covered” in the sense that they are secured upon a basket of assets. In the case of failure the assets can be sold to cover the loss.
    - Repos (a repurchase agreement) – these investments involve investments being exchanged for assets, such as Government bonds. In a similar way to a covered bond these assets can be sold in the case of a loss.

- Certificates of Deposit – identical to a fixed term deposit excepting the fact that they can be sold if needs be. This additional liquidity makes these investments more attractive to the council.
- Government gilts / bonds – equivalent to the DMADF account and T-bills, simply a longer term investment with the UK Government that can also be sold.
- Multilateral development bank bonds – “AAA” rated, these are institutions created and backed by a group of countries which can be sold as needed.

63. Where investments are subject to market risk (this is the risk that the value of the investment can go down as well as up), the inclusion of these investment instruments is proposed only on the basis that if purchased they would be held until maturity under normal circumstances. At maturity the investment and expected interest would be paid in full.

64. In the case of Certificates of Deposit then these would only be sold early on the basis that there were concerns over the borrower defaulting. This liquidity is one of the attractions of this type of investment.

65. Investments that involve this judgement will only be taken after due consideration by the Treasury Management Panel chaired by the Director of Finance and Resources.

66. In addition it is also possible to invest in collective investment schemes. There are many types of these across different asset classes, with varying different risk and return profiles, but the category has been included here subject to a decision of the Treasury Management Panel.

67. It is proposed to cap the investment in these other categories of non-specified investments at £25m in total. When taken with the long-term local authority investment (£45m) the final total is £70m. This is reflected in **Appendix 5,** prudential indicators (point 5).

68. **Appendix 2** sets out the investment categories authorised for use in 2015/16 and **Appendix 4** list the actual counterparties recommended by Arlingclose at the time of writing this report.

<u>Risk assessment</u>

69. Although guidance sets out security and liquidity as being the main risks, they are not the only risks in investing faced by the council. **Appendix 3** sets out a high-level risk assessment of six of the key risks, these are summarised in the following table:

Risk	Assessment
Security	Low
Liquidity	Low
Interest rate	Low to Medium
Market	Low
Refinancing	Low to Medium
Regulatory and Legal	Low

70. The proposed AIS has been assessed against these risks and the judgement is that the most important risks have been reduced as far as possible, this is not to say that all risk has been eliminated which is not possible in treasury terms.

Borrowing strategy 2015/16

Link to the Medium Term Financial Strategy

71. The following table shows how the MTFS and the capital expenditure programme are related. How new borrowing is calculated, taking into account other sources of finance and an allowance for the Minimum Revenue Provision (MRP) is shown in the following table. Some of this MRP is not payable by the council, but the Treasury Team manage the entire position whether it relates to county council debt or not.

	2015/16 £m	2016/17 £m	2017/18 £m
capital expenditure programme	139	97	78
less funding from other sources of finance	125	94	78
= funding from borrowing	14	3	0
less gross MRP *	(22)	(22)	(21)
= net new borrowing for planned capital expenditure / (repayment) **	**(8)**	**(19)**	**(21)**
* county council MRP	(19)	(19)	(19)

*** excluding the borrowing needed to replace maturing loans*

Borrowing position

72. It can be seen from the table above that the council is a re-payer of debt in 2015/16 and beyond. This will reduce the difference between debt and the loan position funding it. This is summarised in the following table, assuming use of cash each year.

	2015/16 £m	2016/17 £m	2017/18 £m
forecast gross debt at 31 March	541	522	501
forecast loans position	488	488	483
difference funded from cash	53	34	18

73. The loans position includes £81.5m of what are known as LOBO (Lender Option Borrower Option) loans. In each case the lender has a loan call option which could amend the interest rate on a pre-determined date to a higher rate. Therefore the council's policy on LOBO calls will be to repay these in all cases and either:
    - take up a shorter term and cheaper loan, say with the Public Works Loan Board (PWLB); or
    - finance the balance from cash in line with this strategy.

74. LOBO calls are judged unlikely in the current interest rate environment but the financing stress that banks are under could lead to loan call options being exercised as banks attempts to repatriate loans. Whilst the loans have been arranged to stagger the potential impact of options being exercised, in 2015/16 £54m of loans are subject to a call option.

Borrowing options

75. The council has three main options available to it in a borrowing strategy:

    1. To use cash (i.e. do not borrow).
    2. To bring borrowing up to the amount needed to fully fund the capital programme at any point in time.
    3. To forward borrow up to two years in advance.

76. Overall, the economic environment continues to favour using cash for a sixth year:
    - There is a normal yield curve (i.e. it's cheaper to use cash than to borrow) and especially when this is very steep.
    - It remains important to minimise security (investment) risk (as using cash reduces investment balances).
    - Future debt levels are forecast to fall (i.e. new loans are not forecast to be needed).
    - Investments are yielding a low return and these are forecast not to recover to pre-crisis levels.

77. Maintaining the existing use of cash, or indeed maximising the use of cash within practical cash management limits would meet the policy outlined at **paragraph 23**.

78. As shown in the economic background and interest rate forecast (**paragraph 11**), bank rate is at a very low level and it is expected to remain well below the average debt rate for the next year and beyond. So following this strategy meets the objective of bringing down the average rate of interest for borrowing providing an opportunity to fund the capital programme at a low cost.

79. The latest forecasts show that the council is going to find this strategy difficult to continue to the extent it has done previously as it is not creating new debt in 2015/16 and beyond. This means the use of cash is reversing unless action is taken to maintain it. In the current low interest rate environment, increasing cash balances represent a lost opportunity to offset existing loans.

80. A key part of the CIPFA Code of Practice for Treasury Management is to assess the risk of the treasury management borrowing strategy. It sets out a

number of risks to be considered and this assessment for the six risks considered most relevant is shown at **Appendix 7**. These are listed in the following table together with the risk shown:

Risk	Assessment
Security	Low
Liquidity	Low
Interest rate	Low to Medium
Market	Medium
Refinancing	Medium
Regulatory and Legal	Medium

81. Other risks CIPFA set out have not been considered as they are less important when determining a borrowing strategy; these are inflation, operational and foreign exchange risks.

82. Overall the use of cash in lieu of borrowing is considered a relatively low risk strategy.

Proposed contingency arrangements and flexibility

83. To date, cash balances have been sufficient to allow the strategy of using cash to continue without taking out external loans. The possibility of cash balances being further unexpectedly reduced needs to be recognised though. This could be due to:
    - increases in the capital programme;
    - budget pressures;
    - changes in the council's cash funding as a result of structural changes;
    - LOBO loan call options being called.

84. Where additional liquidity is needed temporarily then the council can call upon short-term temporary loans raised from the money markets including from other local authorities with surplus cash to invest.

85. If these facilities are not available then new longer-term loans, for a year or more, must be raised to allow the council to continue to pay its day to day bills.

86. If new longer-term loans are needed it is necessary to consider their exact nature. The following observations are important:
    - The council's existing loan portfolio is very long-term as can be seen on the graph at **Appendix 6.** Taking shorter term loans rebalances the portfolio.
    - As stated already, the yield curve is normal. Shorter term loans are cheaper.
    - PWLB interest rates are much higher than they were historically although this has been reduced by the Government following the introduction of the certainty rate in November 2012 (a 0.20% reduction in the cost of loans).

87. It is clear that in the current economic climate loans should be short-term in nature. In terms of the choice of loans there are a number of possibilities:

- PWLB loans – a well known route for local authorities, still seen as the "lender of first resort" because of flexibility and ease of access. However the risk of this facility being discontinued or amended further should be noted.
- Local Authority loans – other authorities may have different cash flow positions which create cheap funding opportunities in the short to medium term.
- Market loans – these may come in various forms, such as LOBO's already referred to and may be cheaper than the PWLB.

88. Should it be needed, the decision to borrow long-term will be taken by the Director of Finance and Resources in consultation with the Deputy Leader and Cabinet Member for Strategy, Finance and Corporate Issues because the optimum timing cannot be foreseen and a decision often needs to be taken at short notice. Members will be kept informed via the outturn and half-year treasury management reports.

Policy on borrowing in advance of need

89. The Prudential Code allows borrowing to take place for the current year plus two future years. However, government regulations state that there should be a specific policy on borrowing in advance of need.

90. As the borrowing strategy set out for 2015/16 involves use of cash resources in the first instance, then the policy is not to borrow in advance this year. This will be reviewed each year as part of the overall borrowing strategy.

Loan restructuring

91. Movements in interest rates over time may provide opportunities to restructure the loan portfolio in one of two ways:
    - Replace existing loans with new loans at a lower rate (known as loan rescheduling).
    - Repay loans early, without replacing the loans. This would increase the use of cash.

92. The council's ability to adjust its loan portfolio in this way is only possible if:
    - the Government allow it; PWLB rules have been changed in the past with no notice;
    - market conditions allow economic repayment.

93. Currently loan restructuring would be very expensive and unattractive for the council, this is because:
    - Gilt yields are historically low. This would lead to large penalties to compensate the PWLB if loans were repaid early.
    - New loans are much more expensive than in the past even though Gilt yields are so low. Since 2010 the Government has increased the margin on top of Gilts at which it onward lends to local government via the PWLB (originally 1.00%, subsequently dropped to 0.80%).

94. The difficulty is that the council wishes to maintain its policy of using cash for the reasons outlined at **paragraph 76**. To do this, loans would need to be paid

early but, as explained, the cost of doing so is very high. These reasons were the key drivers behind the long-term investments with other local authorities discussed in previous reports.

95. Market conditions and regulations do change so the outcome cannot be foreseen. It is proposed to allow loan restructuring with the decision being delegated to the Director of Finance and Resources in conjunction with the Deputy Leader and Cabinet Member for Strategy, Finance and Corporate Issues.

Review of strategy

96. Regulations require that the circumstances under which a revised strategy would be prepared should be stated. These circumstances would be a change in:
- the economic environment;
- the financial risk environment;
- the budgetary position;
- the regulatory environment.

97. The responsibility for assessing these circumstances and proposing changes to the strategy is allocated to the Treasury Management Panel chaired by the Director of Finance and Resources.

Policy on the use of external service providers

98. Regulations require the council to disclose its policy on the use of external providers. The council appointed Arlingclose as its external treasury management adviser from 1 April 2013.

99. Arlingclose is contracted to pass information to the council, provide technical accounting assistance and an investment advice service. The council recognises that responsibility for treasury management decisions remains with the council at all times.

100. An annual review of service quality is carried out by senior officers on the Treasury Management Panel. Arlingclose attend the council offices bi-annually to discuss how well they are assisting the council to discharge its responsibilities.

Investment management training

101. The council is also required by regulations to disclose its processes for ensuring officers are well-trained in investment management.

102. Treasury management is a specialised area requiring high quality and well trained staff that have an up to date knowledge of current issues, legislation and treasury risk management techniques.

103. Officers who attend the Treasury Management Panel are senior qualified finance professionals. Treasury practitioners attend regular CIPFA and treasury consultant training seminars throughout the year and undertake a Performance Review each year through which training needs are identified.

104. Member training is also important to introduce treasury concepts. The need for training events will be kept under review with more sessions in the future if necessary.

MRP Strategy 2015/16

105. The council are also legally obliged to have regard to government guidance issued in February 2008 concerning the Minimum Revenue Provision (MRP) policy. MRP is where the council must make an annual revenue provision for the repayment of debt (also referred to as the Capital Financing Requirement or CFR). The MRP policy must be submitted to the full council for approval prior to the start of the financial year to which the provision will relate. The policy for 2015/16 is summarised below and shown in full at **Appendix 8**.

106. Following guidance issued in 2007/08 regarding the Minimum Revenue Provision (MRP), it is proposed to continue the agreed policy as follows:

- The major proportion of the MRP for 2015/16 will relate to the more historic debt liability that will continue to be charged at the rate of 4%, in accordance with the recommendations and intent of Option 1 of the guidance.

- Further amounts of new capital expenditure may continue to be charged at the rate of 4%, and added to the above mentioned base CFR amount, up to an amount equivalent to the council's annual Supported Capital Expenditure (Revenue) allocation.

- Certain expenditures reflected within the debt liability at 31 March 2015 will under delegated powers be subject to MRP under Option 3.

107. In practical terms, this approach means that capital expenditure funded from supported borrowing (that is, supported by government grant) will be repaid at 4%. However, expenditure funded from unsupported borrowing will be repaid at a rate which matches the useful lives of those assets funded. This will result in a saving for the authority as the debt can be spread over a longer period of time, for example 60 years where a building has been funded from unsupported borrowing (that is, supported by the council). The MRP Policy statement for 2015/16 is shown at **Appendix 8**.

Appendix 1

Equalities implications: There are no equalities implications.

Legal implications: Approval of Prudential Indicators and an Annual Investment Strategy is necessary in order to meet the requirements of the Local Government Act 2003.

Resource and value for money implications: All resource implications are covered in the body of this report which links to the council's MTFS.

Risk implications: Risk is inherent in treasury management and is dealt with throughout the report.

Climate change implications: There are no direct climate change implications arising from treasury and investment strategy decisions.

Health impact assessment screening: There are no health impact assessment implications arising from this report.

Author's name: Chris Gibbs – Senior Accountant (Treasury and Pension Fund)
Telephone no: (01785) 276331
Room no: Floor 2, Staffordshire Place 2

List of background papers

1. Treasury Management in the Public Services: Code of Practice (CIPFA) (2011)
2. Prudential Code for Capital Finance in Local Authorities (CIPFA) (2011)
3. Local Authorities (Capital Finance and Accounting) Regulations 2003
4. Local Government Investments - Guidance under Section 15(1) of the Local Government Act 2003 issued by the Secretary of State
5. Local Government Act 2003 - Guidance issued under section 21(1a) (re MRP policy)

Appendix 2

Cabinet – 21 January 2015 - Investment categories authorised for use 2015/16

Investment	Specified*	Non-Specified	Comments
UK Government - Debt Management Account Deposit Facility (DMADF) (regulation investment)	**unlimited**	**n/a**	6 months maximum available
UK Government - Treasury Bills (T-Bills) (regulation investment)	**unlimited**	**n/a**	6 months maximum available
UK local authorities term deposits (regulation investment)	**unlimited**	**£45m**	Up to 40 years in duration (non-specified)
Money Market Funds	✓	**n/a**	50% of total investments in this category Lower of 0.50% of MMF size or 10% of all investments per MMF
Term deposits with banks and building societies	✓	✗	50% of total investments in this category Lower of 15% of total investments or £30m per counterparty
Certificates of deposit (banks / building societies)	✓	✓	Maximum £25m across all of these categories in total
UK Government – Gilts	✓	✓	
Bonds issued by Multilateral Development Banks	✓	✓	
Collective Investment Schemes	✗	✓	
Covered Bonds	✗	✓	
Repos (repurchase agreement)	✗	✓	

** Up to 12 months*

Appendix 3

Cabinet – 21 January 2015

Risk Assessment – Investments

Risk Heading	Risk Description	Relevance to Investment	Key Control	Assessment	Approved Investment Strategy (AIS)
Security	A third party fails to meet its contractual obligations (counterparty risk).	Crucial that money invested is returned (principal and interest).	Relies on credit management policy including; credit risk, duration of investment and amount as well as an ongoing review of the credit environment. Prudential Limit on investment over 1 year as well as limits on non-specified investments.	**LOW**	Use of the instruments and banks identified within the AIS reduces this risk to a low level. In addition the long-term investments with other local authorities has reduced security risk further and the borrowing strategy keeps cash balances low. With the exception of regulation investments with the UK Government and local authorities counterparties have a maximum investment limit. Overall this remains a low risk strategy.
Liquidity	Cash is not readily available when it is needed.	Cash is invested daily so the availability of cash from investment is fundamental to providing liquidity.	Managed through detailed cash flow forecast and investment in highly liquid funds – but can also borrow temporarily (and Local Authorities are a good credit risk if lent money).	**LOW**	Fixed term deposits have a relatively short maximum duration of up to 12 months; this contributes to high liquidity. Same day access accounts are held as follows: • All MMF's • Lloyds Banking Group • Santander • Barclays Cash flow plans are completed annually and regularly updated. The long-term investments with other local authorities have reduced liquidity but these can be transferred if funds need to be raised. Overall liquidity risk is considered low.

Appendix 3 (continued)

Risk Heading	Risk Description	Relevance to Investment	Key Control	Assessment	Approved Investment Strategy
Interest Rate	Unexpected reduction in Interest rate.	Reduces the return on investment and reduces the level of reserves.	Can reduce risk by: A) netting off investment against borrowing to reduce net exposure B) investing for longer periods. Controlled through the overall strategy.	**LOW**	Investments will be mainly short-term, of up to 12 months maximum – this does not protect against an interest rate reduction or falls in the market generally. The long-term investments made with other local authorities reduce this risk as the rates are fixed for a long period of time.
Interest Rate	Unexpected increase in interest rates.	In order to take advantage of the unexpected return would need to keep investment short term and increase the amount of cash invested (e.g. by not using cash in lieu of borrowing).	Controlled through the overall strategy.	**MEDIUM**	Current policy allows upturns to be taken advantage of as investments are not fixed for very long periods. Upturns are possible in the medium term. The long–term investments made with other local authorities increase this risk as the rates are fixed for a long period of time. Using cash to fund borrowing (the proposed borrowing strategy) reduces this risk as the overall exposure to short term interest rates is less.
Market	Unexpected need to liquidate market instrument quickly and accept ‘price on the day’.	Only relevant if invest in market instruments (e.g. CD’s, Gilts).	Limit investment in market instruments or alternatively have capacity to borrow to avoid need to liquidate. Controlled by limits on non specified investments (excluding long-term local authority investments) to £25m in aggregate.	**LOW**	It is proposed to hold these type of investments to maturity to mitigate this risk.

Appendix 3 (continued)

Risk Heading	Risk Description	Relevance to Investment	Key Control	Assessment	Approved Investment Strategy
Refinancing risk	Maturing transactions cannot be renewed on similar terms.	Reflected in the term (duration) of investments if everything invested shorter term has a high refinancing risk.	Proportion of investments maturing in the future.	**LOW/ MEDIUM**	The current policy is to invest in the relatively short-term. There is an increased risk with this strategy due to frequent 'refinancing' but this is expected to be advantageous in a rising interest rate environment. The long–term investments made with other local authorities has reduced this risk as they are for an extended period of time reducing the need to refinance a proportion of the investment portfolio. Using cash to fund borrowing (the proposed borrowing strategy) reduces this risk as the overall exposure to short term interest rates is less.
Regulatory and legal risk	Rules governing local government investment powers are changed or amended without notice.	Investment powers are granted through statute and guidance.	None	**LOW**	The current policy of using cash in lieu of borrowing reduces the council's dependency on interest receipts. In the past these were generated by using the full range of powers granted to local authorities. This is not the case now; the AIS is low risk and uses liquid and conservative investment instruments. The long-term investments made with other local authorities have increased this risk as they are for an extended period of time. Within the contracts for these investments is the ability for the council to force an early repay or transfer which contributes to overall this risk still being considered low.

Appendix 4

Cabinet - 21 January 2015

County council lending list – December 2014	
	Time Limit
Regulation investments	
DMADF account	6 months
UK Government T-bills	6 months
UK local authority	12 months
Banks and building societies	
Barclays	100 days
HSBC	6 months
Lloyds / Bank of Scotland	6 months
Nationwide	6 months
RBS / NatWest	*suspended*
Santander	6 months
MMF	
Black Rock	same day
Insight	same day
Federated	same day
Ignis	same day
State Street (SSGA)	same day

Appendix 5

Cabinet – 21 January 2015

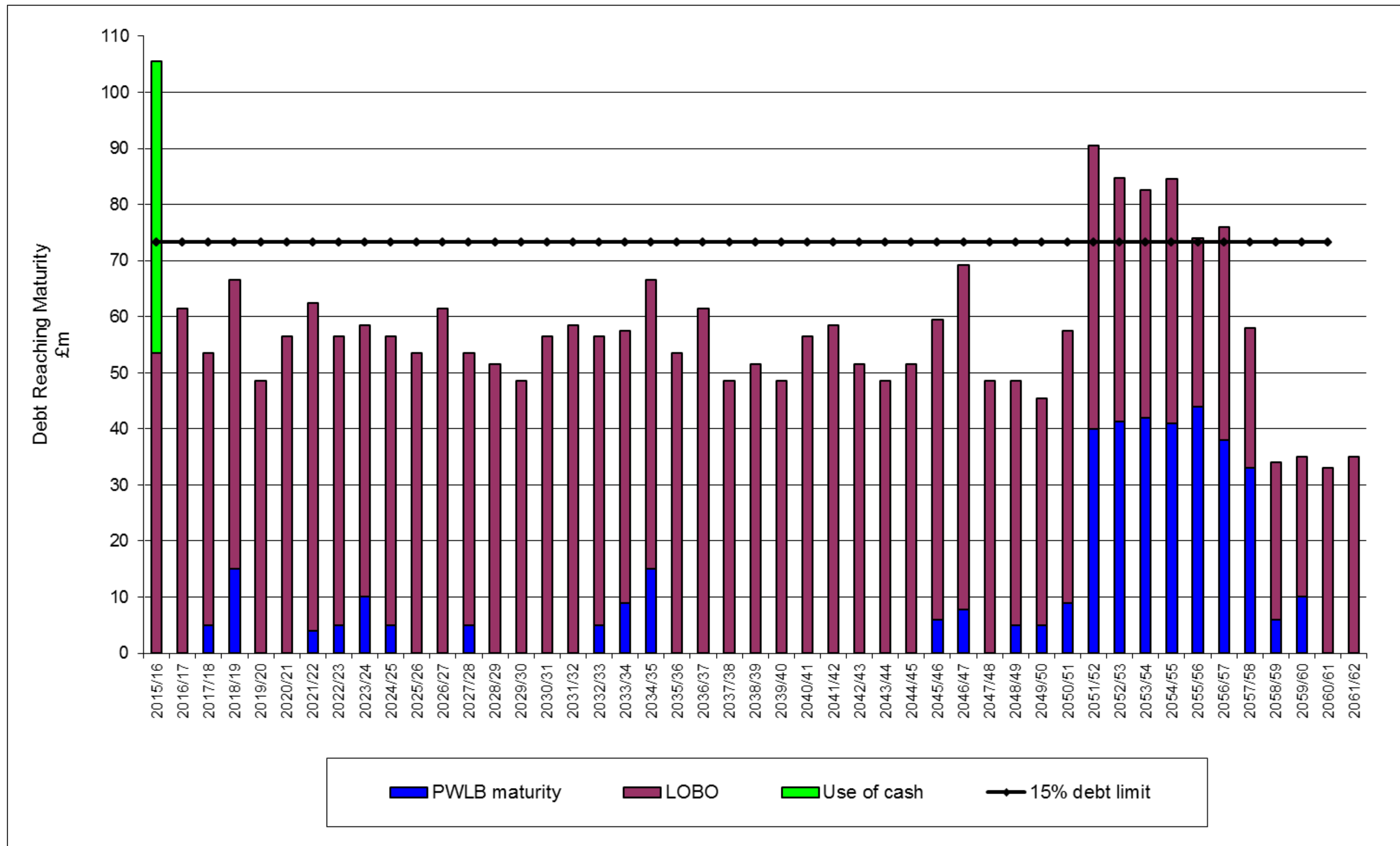
Prudential Indicators for Treasury Management

Indicator	Estimate 2015/16	Estimate 2016/17	Estimate 2017/18	Estimate 2018/19	Estimate 2019/20
1.CIPFA Code of Practice for Treasury Management in the Public Services	The council has adopted the CIPFA Code of Practice on Treasury Management (2011 version).				
This indicator identifies whether an authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services.					
2. External Debt	£m	£m	£m	£m	£m
Authorised Limit for borrowing	586	562	536	511	486
Authorised Limit for other liabilities	235	236	238	240	242
TOTAL	**821**	**798**	**774**	**751**	**728**
Operational Boundary for borrowing	537	537	531	515	502
Operational Boundary for other liabilities	235	236	238	240	242
TOTAL	**772**	**773**	**769**	**755**	**744**
External Loans	**488**	**488**	**483**	**468**	**468**
The Authorised Limit is the maximum level of external borrowing which should not be exceeded. It is linked to the estimated level of borrowing assumed in the capital programme. *The Operational Boundary represents the Director of Finance and Resources estimate of the day to day limit for treasury management borrowing activity based on the most likely i.e. prudent but not worst case scenario.* *"Other liabilities" relate to PFI schemes which are recorded in the council's accounts.*					
3.Interest Rate Exposures					
a. Upper Limit (Fixed)	£504m	£496m	£478m	£457m	£437m
b. Upper Limit (Variable)	(£210m)	(£226m)	(£245m)	(£260m)	(£275m)
Upper limits of fixed and variable borrowing and investments are required to be set. The effect of setting these upper limits is to provide ranges within which the council will manage its exposure to fixed and variable rates of interest. Negative figures are shown in brackets; these relate to the" high- point" of investments at a variable rate which are not offset by variable borrowings. The exposure to variable rate movements has been reduced by the use of cash in lieu of borrowing.					
4.Maturity Structure of Borrowing	Upper Limit	Lower Limit			
See **Appendix 6**					
This indicator relates to the amount of loans maturing in specified periods. The overarching principle is that steps should be taken from a risk management point of view to limit exposure to significant refinancing risk in any short period of time. The council currently applies the practice of ensuring that no more than 15% of its total gross fixed rate loans mature in any one financial year. *Because this is a complex situation for the council, involving PWLB loans, LOBO loans with uncertain call dates and the use of internal cash, specific indicators have not been set. Instead the council will manage its exposures within the limits shown on the graph at **Appendix 6**. This graph shows all LOBO call options on a cumulative basis; in fact the actual pattern of repayment, although uncertain, will not be of this magnitude.*					
5.Upper limit for total principal sums invested for over 364 days (from maturity)					
Any investments made for over 364 days will be in accordance with the council's limits on non-specified investments.	£70m	£70m	£70m	£70m	£70m
6. Borrowing in advance of need (Maximum debt)	100%	100%	100%	100%	100%
This indicator sets the maximum loans as a proportion of the borrowing need. In 2015/16 the strategy is not to borrow in advance, hence the indicator is set at 100%.					

Appendix 6

Cabinet – 21 January 2015

County council maturity structure of debt graph



Appendix 7

Cabinet – 21 January 2015

Risk Assessment – Borrowing Strategy

Risk Heading	Risk Description	Relevance to Borrowing	Key Control	Assessment	Borrowing strategy
Security	A third party fails to meet its contractual obligations (i.e. counter party risk).	Unlikely that there is a failure between the agreement to borrow and sums being received a few days later. However, if we borrow in advance we must invest until this is needed and this increases exposure to investment risk.	Usually borrow from the Government (PWLB) and maximum 2/3 day gap between agreement to borrow and receipt of money.	**LOW**	Use of cash to fund borrowing reduces this risk further i.e. less money is held with banks and third parties as a result (see investment risk assessment).
Liquidity	Cash is not readily available when it is needed.	Only borrow for capital – usually borrow from Government (PWLB) with no limits other than the council agrees the borrowing is affordable. See legal and regulatory risk below.	Prudential rules on borrowing and consideration of whether Government is secure.	**LOW**	Use of cash to fund borrowing increases this risk as liquidity is reduced when borrowing is avoided. However, the council is able to borrow money temporarily using the money markets should it need to, so the overall risk remains low.
Interest Rate	Unexpected reduction in short term Interest rates.	Depends on the mix between fixed rate borrowing and variable rate borrowing Higher exposure to variable rate borrowing helps the budget.	The control is set out below.	**LOW to MEDIUM**	Pursuing a strategy of using cash reduces the overall net exposure to sudden interest rate falls.
Interest Rate	Unexpected increase in short term interest rates.	Mix of variable and fixed rates – Lower exposure to variable rate borrowing helps the budget.	Limit variable rate borrowing to a relatively small proportion (e.g. 20%) excluding cash.		20% limit provides a suitable risk control.

Appendix 7 (continued)

Risk Heading	Risk Description	Relevance to Borrowing	Key Control	Assessment	Borrowing strategy
Market	The market value of a loan changes substantially (i.e. how much is the borrowing strategy exposed to long term interest rate change).	How much risk is built into the maturity profile of the loans structure. LOBO's (17% of all loans) are the only 'market instrument' in borrowing terms currently used.	See alternative methodology using graph in **Appendix 6.** This is inversely linked to refinancing risk below.	**MEDIUM**	Use of cash will shorten the duration of the loan portfolio and reduces this risk. Without the use of cash this risk assessment would probably be high.
Refinancing risk	Maturing transactions cannot be renewed on similar terms.	Need to avoid a high level of borrowing over a short period where you are exposed to high interest rates.	The council has a policy of limiting maturing loans to 15% of the portfolio (including LOBO's) See graph in **Appendix 6.** This is inversely linked to market risk above.	**MEDIUM**	Using cash to fund borrowing potentially increases the refinancing risk. LOBO's increase refinancing risk (as the option to exercise the repayment trigger is held by the borrower). Without the use of cash this risk assessment would probably be low.
Regulatory and legal risk	Rules governing local government borrowing are changed or amended without notice, this has happened in the recent past.	Local government heavily reliant upon PWLB; cost and ability to reschedule / manage loans are determined by the Government. The Government could close the PWLB and force local authorities to use market loans for all new borrowing.	Market loans will be evaluated and taken if these are good overall value and dilute reliance on the PWLB. This risk cannot be managed in any other way.	**MEDIUM**	LOBO's are held and these diversify loans away from the PWLB. Use of cash means that PWLB loans are not being taken. If the PWLB was closed to new business then market loans would be the only option However, debt levels are falling in 2015/16.

Appendix 8

Cabinet – 21 January 2015

Minimum Revenue Provision (MRP) Policy Statement

Introduction

Capital expenditure is expenditure on assets which have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. It would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred therefore such expenditure is spread over several years in order to try to match the years over which such assets benefit the local community through their useful life.

The manner of spreading these costs is through an annual Minimum Revenue Provision (MRP), which was previously determined under Regulation, and will in future be determined under Guidance.

The Government issued guidance which came into force on 31 March 2008 which requires that a Statement on the council's policy for its annual MRP should be submitted to the full council for approval before the start of the financial year to which the provision will relate.

The guidance offers four main options under which MRP could be made (for information these are detailed over the page), with an overriding recommendation that the Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits.

MRP Policy Statement 2015/16

The council implemented the new MRP guidance in 2009/10, and will assess their MRP for 2015/16 in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

The major proportion of the MRP for 2015/16 will relate to the more historic debt liability that will continue to be charged at the rate of 4%, in accordance with the recommendations and intent of Option 1 of the Guidance.

Further amounts of new capital expenditure may continue to be charged at the rate of 4%, and added to the above mentioned base Capital Financing Requirement (CFR) amount, up to an amount equivalent to the council's annual Supported Capital Expenditure (Revenue) allocation.

Certain expenditures reflected within the debt liability at 31 March 2015 will under delegated powers be subject to MRP under Option 3.

Estimated life periods will be determined under delegated powers. To the extent that expenditure is not on the creation of an asset and is of a type that is subject to estimated life periods that are referred to in the guidance, these periods will generally be adopted by the council. However, the council reserves the right to determine useful life periods and prudent MRP in exceptional circumstances where the recommendations of the guidance would not be appropriate.

Asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also, whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure and will only be divided up in cases where there are two or more major components with substantially different useful economic lives.

Option 1: Regulatory Method

Under the previous MRP regulations, MRP was set at a uniform rate of 4% of the adjusted CFR (i.e. adjusted for “Adjustment A”) on a reducing balance method (which in effect meant that MRP charges would stretch into infinity). This historic approach must continue for all capital expenditure incurred in years before the start of this new approach. It may also be used for new capital expenditure up to the amount which is deemed to be supported through the SCE annual allocation.

Option 2: Capital Financing Requirement Method

This is a variation on option 1 which is based upon a charge of 4% of the aggregate CFR without any adjustment for Adjustment A, or certain other factors which were brought into account under the previous statutory MRP calculation. The CFR is the measure of an authority’s outstanding debt liability as depicted by their balance sheet.

Option 3: Asset Life Method.

This method may be applied to most new capital expenditure, including where desired that which may alternatively continue to be treated under options 1 or 2.

Under this option, it is intended that MRP should be spread over the estimated useful life of either an asset created, or other purpose of the expenditure. There are two useful advantages of this option: -

- Longer life assets e.g. freehold land can be charged over a longer period than would arise under options 1 and 2.
- No MRP charges need to be made until the financial year after that in which an item of capital expenditure is fully incurred and, in the case of a new asset, comes into service use (this is often referred to as being an ‘MRP holiday’). This is not available under options 1 and 2.

There are two methods of calculating charges under option 3:

a. equal instalment method – equal annual instalments,
b. annuity method – annual payments gradually increase during the life of the asset.

Option 4: Depreciation Method

Under this option, MRP charges are to be linked to the useful life of each type of asset using the standard accounting rules for depreciation (but with some exceptions) i.e. this is a more complex approach than option 3.

The same conditions apply regarding the date of completion of the new expenditure as apply under option 3.