Appendix 10: Treasury Management Strategy and Prudential Indicators 2016/17 to 2018/19

The Council is recommended to:
- **approve the Treasury Management Strategy for 2016/17**
- **approve the Treasury Management Indicators for 2016/17**
- **approve the Prudential Indicators 2016/17 to 2018/19**
- **approve the Treasury Management Policy Statement (Annex 1)**

1. Executive Summary

1.1. This appendix sets out the Council's Treasury Management Strategy for 2016/17 and Prudential Indicators for 2016/17 and 2018/19.

1.2. The Treasury Management Strategy incorporates a debt management strategy that reflects the Council's potential need to borrow to finance its capital expenditure plans as set out in Appendices 6 through to 8.

1.3. In formulating the Prudential Indicators in this report it has been assumed that no new long-term borrowing will be undertaken over the next 3 years. However £4.6m of PWLB debt is maturing in 2017/18. As it is likely that the interest rate environment will be favourable it is expected that the Council will replace this debt at the time. The Capital Investment Programme will be funded from capital receipts, grants, other contributions and HRA borrowing approved by government in previous years. The borrowing requirement for the HRA will be sourced from cash balances rather than external debt. Should the need to borrow arise as a result of unforeseen circumstances, an appropriate report will be presented to Members at a later date in the year.

2. Context

2.1 Introduction

2.1.1 On the 23rd February 2010 the Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year.

2.1.2 In addition, the Department for Communities and Local Government (CLG) issued revised guidance on local authority investments in March 2010 that requires the Council to approve an investment strategy before the start of each financial year.

2.1.3 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Guidance.

2.2 Economic context: Treasury Management Adviser's Assessment

2.2.1 UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y). Growth is expected to weaken marginally to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation of Sterling against the Euro and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme, although the pace of reductions was eased in the May Budget. However, the Purchasing Manager's Index, (PMI), for services issued on 5 October would indicate an even lower growth rate of around +0.3%, in quarter 4, which would be the lowest growth rate since the end of 2012.

2.2.2 Despite these headwinds, the Bank of England August Inflation Report had included a forecast for growth to remain around 2.4 – 2.8% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth. Since then, worldwide economic statistics have been distinctly weak so it would not be a surprise if the next Inflation Report in November were to cut those forecasts.

2.2.3 The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on 17 September, or if not by the end of 2015, the recent downbeat news about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from making that start. The nonfarm payrolls figures for September and revised August, issued on 2 October, were disappointingly weak and confirmed concerns that US growth is likely to weaken. This has pushed back expectations of a first rate increase from 2015 to 2016. However, there are increasing concerns, both in the US and UK, that the growth rates currently being achieved are only being achieved with monetary policy being highly aggressive with central rates at near zero and huge QE in place. This is causing an increasing debate as to how realistic it will be for central banks to start on reversing such aggressive monetary policy until such time as strong growth rates are more firmly established and confidence increases that inflation is going to get back to around 2% within a 2-3 year time horizon. In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

2.3 **Credit outlook:**

2.3.1 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 that:

- 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; and,
- 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.

Bail-in Risk: Part of the Bank Recovery and Resolution Directive contains provisions relating to recovery and resolution planning, intragroup financial support, early intervention, resolution tools and powers, cross-border group resolution, relations with third countries and financing arrangements. These are part of a widely evolving regulatory background that not only deals with recapitalisation or resolution of failing / failed institutions, but more importantly, making them more resistant to problems in future crises. As part of the resolution mechanisms, uninsured depositors are expected to be included within "bail-in" measures that would take place at a time of failure. This could include Local Authority depositors and would mean all or part of the Council's deposit could be used to support the bank's failure, in effect the deposit would not be returned (a default).

This is, in effect, what could already happen, although in practice the Government has stepped in to rescue banks with importance to the banking system and the economy (RBS, Lloyds/HBOS etc.), thereby ensuring market confidence (a bail-out – too big to fail).

The key issue is that bail-in is likely to come into effect in 2016, later internationally, so it is not an immediate issue. It may be later for the UK, but the changes in the run up to this date may impact on the Council's operations.

There is likely to be some counterbalancing, as bail-in risk increases, so banks financial positions should be improving. The final impact may therefore be neutral.

In summary, the Council needs to be prepared, although there should be no immediate need to change, subject to the criteria for selecting counterparties already in place. As the Council only uses long term ratings there should be no need to change the counterparty selection criteria within the treasury management strategy.

2.4 Interest rate forecasts

2.4.1 The Council has appointed Capita Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives their central view.

Table 1: Capita Central Interest rate Forecast – November 2015				
	Bank Rate	3 month LIBID	12 month LIBID	25-year gilt yield*

Q4 2015	0.50	0.60	1.10	2.80
Q1 2016	0.50	0.70	1.20	3.00
Q2 2016	0.75	0.80	1.30	3.10
Q3 2016	0.75	0.90	1.40	3.20
Q4 2016	1.00	1.10	1.60	3.30
H1 2017	1.25	1.40	1.90	3.50
H2 2017	1.50	1.80	2.30	3.70
H1 2018	1.75	1.90	2.40	3.80

* The Council can currently borrow from the PWLB at 0.80% above gilt yields

The table below shows the lowest, average and highest annual medium-term forecasts for the official Bank rate by independent forecasters compiled by HM Treasury.

Table 2:	**HM Treasury Survey of Forecasts – November 2015**				
	Average annual Bank Rate %				
	2015	2016	2017	2018	2019
Highest	0.6	1.2	1.8	2.5	3.1
Average	0.5	0.8	1.4	2.1	2.6
Lowest	0.4	0.6	1.2	1.4	1.6

2.4.2 For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.5%, and the base assumption is that there will be no new borrowing in 2016/17 and funding will be raised internally and we will review opportunities in the long term.

3. Current and Expected Treasury Portfolios

3.1. Current portfolio

The Council's treasury portfolio as at 31 December 2015 was as follows.

Table 3: **Current Portfolio**	**Principal amount £m**	**Interest rate %**
Call accounts	33.8	0.26
Money market funds	40.0	0.46
Short-term deposits	180.0	0.95
Long-term deposits	0.00	0.00
Total Investments	**253.8**	**0.78**
Short-term loans	0.00	0.00
Long-term PWLB loans	(412.7)	5.57
Long-term market loans (LOBOs)	-	
Total Borrowing	**(412.7)**	**5.57**
Net Borrowing	**(158.9)**	

3.2. Expected changes in portfolio

According to current cash flow forecasts, net borrowing of £158.9 million is expected to increase as at 31 March 2016 as a result of financing capital expenditure using cash balances. This forecast in net borrowing will be achieved by reducing investment balances, as discussed in the borrowing strategy below.

3.3. **Budget implications**

The budget for investment income in 2016/17 is £0.75 million, based on an average investment portfolio of £150 million at an estimated average interest rate of 0.50%. The budget for debt interest paid in 2016/17 is £23.0 million, based on an average debt portfolio of £412.7 million at an average interest rate of 5.57%. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will vary and will be reported through the Council's regular revenue monitoring process.

3.4. **Investment Strategy**

The Council holds surplus funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £167.5 million and £256.5 million, and average balances are expected to be at considerably below the lower end of this range in the forthcoming year. Both the CIPFA Code and the CLG Guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield.

3.4.1 Investment criteria and limits

The Council defines the following as being of "high credit quality" (as per the CLG Guidance), subject to the monetary and time limits shown.

<table>
<tr><th colspan="2">Table 4: Investment Criteria and Limits</th><th>Cash limit</th><th>Time limit</th></tr>
<tr><td rowspan="7">Banks and other organisations whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:</td><td>AAA</td><td rowspan="5">£25m each of which no more than £15m over 1 year</td><td>10 years</td></tr>
<tr><td>AA+</td><td>5 years</td></tr>
<tr><td>AA</td><td>4 years</td></tr>
<tr><td>AA-</td><td>3 years</td></tr>
<tr><td>A+</td><td>2 years</td></tr>
<tr><td>A</td><td rowspan="2">£20m each</td><td rowspan="2">1 year 6 months</td></tr>
<tr><td>A-</td></tr>
<tr><td></td><td>BBB+</td><td>£10m each</td><td>1 year</td></tr>
<tr><td colspan="2">The Council's current account bank (RBS/NatWest plc) if it fails to meet the above criteria</td><td>£50m</td><td>next day</td></tr>
<tr><td colspan="2">UK building societies whose lowest published long term credit rating is BBB and societies without credit ratings with assets greater than £500m</td><td>£10m</td><td>1 year 6 months</td></tr>
<tr><td colspan="2">UK building societies whose lowest published long term credit rating is below BBB and/or societies without credit ratings with assets less than £500m but greater than £250m</td><td>£5m</td><td>1 year</td></tr>
</table>

Money market funds and similar pooled vehicles whose lowest published credit rating is AAA	0.5% of the Funds size	Instant Access
Other non-credit rated pooled investment vehicles such as bond funds up to £1 million and property funds up to £3 million	£1-3 m	notice period
UK Local Authorities (irrespective of credit rating)	£20m each	25 years
UK Registered Providers of Social Housing whose lowest published long-term credit rating is [**A-**] or higher	£20m each	10 years
UK Registered Providers of Social Housing whose lowest published long-term credit rating is [**BBB-**] or higher and those without credit ratings	£10m each	5 years
UK Central government and its agencies (irrespective of credit rating)	unlimited	unlimited
Organisations and pooled funds which do not meet the above criteria, subject to an external credit assessment and a specific recommendation from the Council’s treasury management adviser	£5m each	3 months
	£1m each	1 year
	£100,000 each	5 years
Organisations funded through the Funding Circle Targeted at local businesses within the Council area.	£100,000	5 years
Council's current bank account with the Cooperative Bank	Receipts only	swept to RBS monthly or ASAP

3.4.2 There is no intention to restrict investments to banks and building society deposits, and investments may be made with any public or private sector organisation that meets the credit rating criteria above. This reflects a lower likelihood that central government will support failing banks following the Independent Commission on Banking report, as well as the removal of restrictions on local authority purchases of corporate bonds in April 2012.

3.4.3 The majority of the Council’s investments will be made for relatively short periods and in highly credit rated investments, giving priority to security and liquidity ahead of yield. However, where the Council has identified a core cash balance that is not required for any current or planned cash outflow, these funds will be considered suitable for a wider range of investments, with a more moderate focus on security and liquidity and a greater focus on achieving a level of investment income that can support Council services. These may include long-term investments with registered providers of social housing, small businesses or corporate bond funds where an enhanced return is paid to cover the additional risks presented. Standard risk mitigation techniques, such as wide diversification and external credit assessments, will be employed, and no such investment will be made without a specific recommendation from the Council’s treasury management adviser.

3.4.4 The Council's revenue reserves available to cover investment losses are forecast to be £90 million on 31st March 2016. In order that no more than 20%-30% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government and the Council's Bankers - RBS) will be £27 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

3.4.5 Current account bank

The Council's current accounts are held with RBS/National Westminster Bank & The Cooperative bank. The Council will treat RBS as "high credit quality" for the purpose of making investments that can be withdrawn on the next working day, subject to the bank maintaining a credit rating no lower than BBB. The Council will not look to make long term investments with the Co-op. Any amounts that are deposited by customers of the Council with the Co-op will be moved out the next day or as soon as practicable.

The Council's tendering of its banking services resulted in the re-appointment of RBS (NatWest) as a provider. It is deemed to meet the Councils minimum criteria in terms of its investment strategy i.e. "high credit quality" for the purpose of making investments that can be withdrawn on the next working day, subject to the bank maintaining a credit rating no lower than BBB.

3.5. **Building societies**

3.5.1 UK building societies without credit ratings will be considered to be of "high credit quality", but subject to a lower cash limit and shorter time limit than rated societies. The Council takes additional comfort from the building societies' regulatory framework and insolvency regime where, in the unlikely event of a building society liquidation, the Council's deposits would be paid out in preference to retail depositors. The Government has announced plans to amend the building society insolvency regime alongside its plans for wide ranging banking reform, and investments in lower rated and unrated building societies will therefore be kept under continuous review.

3.5.2 However, no investments will be made with building societies with assets less than £250 million or equivalent credit rating due to the increased likelihood of default implied by this rating.

3.6. **Money market funds**

3.6.1 Money market funds are pooled investment vehicles consisting of instruments similar to those used by the Council. They have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Council. As part of its shadow banking regulatory proposals, the European Commission has proposed a new European framework for Money Market Funds ("MMFs"). As and when these regulations come into force and depending on their likely impact on the current nature and characteristics of the MMF's, the Council will take a view as to whether or not to continue using MMF's within its investment portfolio.

3.6.2 Funds that offer same-day liquidity and a constant net asset value will be used as an alternative to instant access call accounts, while funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

3.7 Other Pooled Funds:

The Council will also consider using other pooled funds such as pooled property and bond funds that offer enhanced returns over the longer term, but are potentially more volatile in the shorter term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date and not credit rated, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.

3.8 Collateralised investments

Where the Council makes an investment with an organisation that is secured on collateral in a third party (e.g. a reverse repo or a collateralised deposit), the time limit may be extended to match the limit given above for that third party. However, the investment will still count against the cash limit of the organisation receiving the funds.

3.9 Funding Circle

As part of the 2016/17 investment criteria a small amount of funds will be invested with local companies through the peer to peer lending scheme, The Funding Circle. The inclusion of this option is part treasury management, to test whether investment returns can be boosted, and part policy to support local businesses. The initial investment pool is small to assess the performance of this option. The Council's finance staff will mainly undertake appropriate due diligence on the Funding Circle counterparties commensurate with the size of any loan but may seek the assistance of the Council's external treasury advisors. As with any loans of this nature there is a possibility of partial or full loss of some of the investments, although overall the Council would expect a better performance than cash investments. The performance of this option will be reported to Members in the annual treasury management report to assess whether to continue or expand the scheme.

3.10 Foreign countries

3.10.1 Investments in foreign countries will be limited to those that hold an AAA, AA+ or AA sovereign credit rating from all three major credit rating agencies, and to a maximum of £20 million per foreign country. Investments in countries whose lowest sovereign rating is not AAA will be limited to one year's duration. No country limit will apply to investments in the UK, irrespective of the sovereign credit rating.

3.10.2 Overseas subsidiaries of foreign banking groups will normally be assessed according to the country of domicile of the parent organisation. However, Santander UK plc (a subsidiary of Spain's Banco Santander) and Clydesdale Bank plc (a subsidiary of National Australia Bank) will be classed as UK banks due to their substantial UK franchises and the arms-length nature of the parent-subsidiary relationships.

3.10.3 Sovereign credit rating criteria and foreign country limits will not apply to investments in multilateral development banks (e.g. the European Investment Bank and the World Bank) or other supranational organisations (e.g. the European Union).

3.11 Risk assessment and credit ratings

3.11.1 The Council uses long-term credit ratings from the three main rating agencies Fitch Ratings Ltd, Moody's Investors Service Inc and Standard & Poor's Financial Services LLC to assess the risk of investment default. The lowest available credit rating will be used to determine credit quality.

3.11.2 Long-term ratings are expressed on a scale from AAA (the highest quality) through to D (indicating default). Ratings of BBB- and above are described as investment grade, while ratings of BB+ and below are described as speculative grade. The Council will not hold speculative grade investments.

3.11.3 Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then: no new investments will be made, any existing investments that can be recalled or sold at no cost will be, and full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

3.11.4 Where a credit rating agency announces that a rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it is likely to fall below the above criteria, then no further investments will be made in that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks.

3.11.5 The Council's investments are normally senior unsecured liabilities of the borrower, and the credit rating of the investment is therefore normally identical to the credit rating of the counterparty. However, where a credit rating agency awards a different rating to a particular class of investment instruments, the Council will base its investment decisions on the instrument credit rating rather than the counterparty credit rating.

3.12 Other information on the security of investments

3.12.1 The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the above criteria.

3.12.2 When deteriorating financial market conditions affect the creditworthiness of all organisations, as in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions.

3.12.3 If these restrictions mean that insufficient commercial organisations of "high credit quality" are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

3.13 Non-specified investments

3.13.1 The CLG Guidance defines specified investments as those:

- denominated in pound sterling;
- due to be repaid within 12 months of arrangement;
- not defined as capital expenditure by legislation; and,
- invested with one of:
  - the UK Government;
  - a UK local authority, parish council or community council; or,
  - a body or investment scheme of "high credit quality".

3.13.2 Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any investments denominated in foreign currencies, nor any with low credit quality bodies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement. Limits on non-specified investments are shown on Table 5 below:

Table 5

	Cash Limit
Total Long-Term Investments	£50m
Total Investments with Building Societies without credit rating or rated below [A-]	£180m
Total investments in MMF*	£50m
Total of other non-credit rated Pooled Funds	£3m
Total of Funding Circle Loans (non-credit rated)	£0.1m
Total non-specified investments	**£283.1m**

* as and when the MiFIDII regulations come into force the Council will review its use of these funds – see also section 3.6 above

3.13.3 The total cash limit on Money Market Funds has been increased to £50m to diversify away from Debt Management Account Deposit Facility (DMADF) and other local authorities owing to the fixed nature of investments with these institutions which limits the Council's ability to respond to unexpected cash out-flow requirements.

4. Liquidity management

4.1. The Council uses purpose-built cash flow forecasting software (Logotech) to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a pessimistic basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments.

4.2. Limits on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast.

4.3. In addition to the above, a new Daily Cash Flow excel workbook is in place. This cash flow is updated, line by line, on a daily basis and compared to the forecast and this is providing further comfort to the Council's cash position.

5. Planned investment strategy for 2016/17

5.1. The cash flow forecast will be used to divide surplus funds into three categories:

- Short-term – cash required to meet known cash outflows in the next month, plus a contingency to cover unexpected cash flows over the same period.
- Medium-term – cash required to manage the annual seasonal cash flow cycle, including amounts to cover forecast shortages, planned uses of reserves, and a longer-term contingency.
- Long-term – cash not required to meet cash flows, and used primarily to generate investment income.

5.2. Short-term funds are required to meet cash flows occurring in the next month or so, and the preservation of capital and liquidity is therefore of paramount importance. Generating investment returns is of limited concern here, although it should not be ignored. Instant access money market funds and bank deposit accounts will be the main methods used to manage short-term cash.

5.3. Medium-term funds which may be required in the next one to twelve months will be managed concentrating on security, with less importance attached to liquidity but a slightly higher emphasis on yield. The majority of investments in this period will be in the form of fixed term deposits with banks and building societies. A wide spread of counterparties and maturity dates will be maintained to maximise the diversification of credit and interest rate risks; this may be achieved by the use of suitable medium-term money market funds. Deposits with lower credit quality names will be made for shorter periods only, while deposits with higher quality names can be made for longer durations.

5.4. Cash that is not required to meet any liquidity need can be invested for the longer term with a greater emphasis on achieving returns that will support spending on local authority services. Security remains important, as any losses from defaults will impact on the total return, but fluctuations in price and even occasional losses can be managed over the long term within a diversified portfolio. Liquidity is of lesser concern, although it should still be possible to sell investments, with due notice, if large spending commitments arise unexpectedly. A wider range of instruments, including structured deposits, certificates of deposit, gilts and corporate bonds will be used to diversify the portfolio. The Council will consider employing external fund managers that have the skills and resources to manage the risks inherent in a portfolio of long-term investments.

5.5. With short-term interest rates currently much lower than long-term rates, due consideration will also be given to using surplus funds to make early repayments of long-term borrowing. In addition to the savings on the interest rate differential, this strategy will also reduce the Council's exposure to credit risk and interest rate risk.

6. Borrowing Strategy

6.1. The Council currently holds £412.7 million of long-term loans, with no movement from the previous year. The Council's capital financing requirement (CFR, or underlying need to borrow for capital purposes) as at 31st March 2016 is expected to be £720.1 million, and is forecast to go up to £134.4 million by March 2017 as capital expenditure is incurred. This will be funded from the current cash balances held.

6.2. The maximum expected long-term borrowing requirement for 2016/17 is:

Table 6: Maximum Expected Long-Term borrowing Requirement for 2016/17	£m
Change in underlying need to borrow	139.1
Less: Minimum Revenue Provision (MRP)	(4.7)
Equals: Forecast increase in Capital Financing Requirement (CFR)	**134.4**
Plus: Loans maturing in 2015/16	0
Equals: Total long term borrowing requirement	**134.4**

6.3. However, depending on the pattern of interest rates during the year, it may be more cost effective to defer borrowing until later years, and to temporarily reduce the size of the Council's investment balance instead.

6.4. In addition, the Council may borrow for short periods of time (normally for up to two weeks) to cover unexpected cash flow shortages.

6.5. **Sources of borrowing**

The approved sources of long-term and short-term borrowing will be:

- Public Works Loan Board
- any institution approved for investments above
- any other bank or building society approved by the Financial Services Authority
- capital market bond investors
- Special purpose companies created to enable joint local authority bond issues.

6.6. **Planned borrowing strategy for 2016/17**

6.6.1 The base assumption is that the Council will not enter into any new borrowing except for specific major capital projects. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either borrow short-term loans, variable rate loans or to not borrow and reduce the level of investments held instead. However, with long-term rates forecast to rise in the coming years, any such short-term savings will need to be balanced against the potential longer-term costs.

6.6.2 Loans that present additional risk to the authority, such as lender's option borrower's option (LOBO) loans will be limited to £10m. Variable rate loans will be subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

6.6.3 The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. The Council may take advantage of this and replace some higher rate loans with new loans at lower interest rates, or repay loans without replacement, where this is expected to lead to an overall saving or reduction in risk. However, debt rescheduling opportunities have been limited in the current economic climate and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010.

6.7 Policy on Use of Financial Derivatives

6.7.1 Local authorities (including this Council) have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). The CIPFA Code requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

6.7.2 The Council 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 Council 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.

6.8 Derivative counterparties

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 the relevant foreign country limit.

7. Treasury Management Indicators

7.1 The Council measures and manages its exposures to treasury management risks using the following indicators. The Council is asked to approve the following indicators:

7.1.1 <u>Security: average credit rating</u>

The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the weighted average credit rating of its investment portfolio.

	Target
Portfolio average credit rating	A-

For the purpose of this indicator, unrated building societies are assigned an indicative rating of BBB, and unrated local authorities are assumed to hold a AA+ rating.

7.1.2 <u>Liquidity: cash available within three months</u>

The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period.

	Target
Total cash available without borrowing	£10m
Total cash available including borrowing	£20m

7.1.3 <u>Interest rate exposures</u>

This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as an amount of net principal borrowed will be:

	2016/17 £m	**2017/18 £m**	**2018/19 £m**
Upper limit on fixed interest rate exposures	450	450	450
Upper limit on variable interest rate exposures	50	50	50

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

7.1.4 <u>Maturity structure of borrowing</u>

This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper	**Lower**
Under 12 months	10%	0%
12 months and within 24 months	10%	0%
24 months and within five years	10%	0%
Five years and within 10 years	10%	0%
10 years and within 20 years	30%	0%
20 years and within 30 years	50%	0%
30 years and above	70%	0%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

7.1.5 <u>Principal sums invested for periods longer than 364 days</u>

The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2016/17	2017/18	2018/19
Limit on principal invested beyond year end	£50m	£40m	£30m

8. Prudential Indicators 2016/17 to 2018/19

8.1 CIPFA's Prudential Code for Capital Finance in Local Authorities requires Council to use a set of indicators and limits to provide a control framework for capital investment and treasury management decisions. The Council is being asked to approve these Prudential Indicators as part of the Revenue & Capital Budget report.

8.2 Borrowing limits

The Council is being asked to approve these Prudential Indicators as part of the Capital Programme report.

8.3 Setting the Borrowing Limits.

8.3.1 The Council is required to set the Operational Boundary and the Authorised Limit to its external debt. External debt refers to borrowing and other long-term liabilities e.g. Leasing arrangements.

8.3.2 Both the limits need to be consistent with the Council's plans for capital expenditure and financing and with its treasury management policy statement and practices.

8.3.3 The operational boundary is to directly link into the Council's plans for capital expenditure, the estimates of the capital financing requirement and the estimate of the cash flow requirements for all other purposes, including revenue.

8.3.4 Table 7 below sets out the Borrowing Limits for the years 2016/17 to 2018/19.

Table 7: Borrowing Limits	2016/17	2017/18	2018/19
Operational boundary – borrowing	£450m	£450m	£450m
Operational boundary – other long-term liabilities	£110m	£105m	£100m
Operational boundary – TOTAL	£560m	£555m	£550m
Authorised limit – borrowing	£600m	£600m	£600m
Authorised limit – other long-term liabilities	£110m	£105m	£100m
Authorised limit – TOTAL	£710m	£705m	£700m

8.4 Capital Expenditure and Affordability

8.4.1 The purpose of the affordability indicators is to show whether capital investment decisions are affordable and sustainable in the medium term. The key information that indicates both the affordability and sustainability of the programme is shown in the table below:

Table 8: General Fund Prudential Indicators	2015/16	2016/17	2017/18	2018/19
Affordability	£'000	£'000	£'000	£'000
	(Forecast)	(Budget)	(Budget)	(Budget)
Estimates of capital expenditure	85,163	67,386	91,298	22,936
Estimates of capital financing requirement ("CFR")	225,589	225,073	227,090	230,185
GF ratio of financing costs to revenue (%)	4.96%	5.18%	5.47%	5.68%
Incremental impact on band D council tax levels (£)	0.00	0.00	0.00	0.00

Table 9: HRA Prudential Indicators	2015/16	2016/17	2017/18	2018/19
Affordability	**£'000**	**£'000**	**£'000**	**£'000**
	(Forecast)	**(Budget)**	**(Budget)**	**(Budget)**
Estimates of capital expenditure	138,584	196,955	42,088	41,912
Estimates of capital financing requirement (“CFR”)	350,417	431,671	572,575	569,705
HRA ratio of financing costs to revenue (%)	14.53%	14.85%	15.10%	15.34%
Incremental impact on housing rents (£)	0.00	0.00	0.00	0.00

8.4.2 The table above sets out the following indicators for capital expenditure and affordability:

- Actual and estimated capital expenditure;
- Actual and estimated capital financing requirement;
- Actual and estimated ratio of financing costs to net revenue stream; and,
- Estimated incremental impact on council tax and housing rents.

8.4.3 The estimates of capital expenditure indicator reflects the capital expenditure and funding plans set out in Appendices 5 and 6, plus the capitalised value and funding of relevant long term liabilities (such as PFI arrangements).

8.4.4 Estimates of Capital Financing Requirement (“CFR”): the General Fund CFR remains broadly unchanged over the period 2016/17 to 2018/19. The HRA indicator Estimates of Capital Financing Requirement increase over the period as the HRA implements its capital investment plans following recommendations set out by the Lambeth Housing Commission

8.4.5 It should be noted that the CFR does not reflect the actual level of external debt. Neither does it reflect the actual capital expenditure to be incurred in these years. They are indications of the level of capital expenditure the authority plans to finance from borrowing (that is, its underlying need to borrow). The Strategic Director of Enabling, as Chief Finance officer, determines how capital expenditure is actually financed once a year, after year-end.

8.4.6 The authority has a number of significant capital investment schemes in the early stages of development. It is not possible at this point to incorporate the potential borrowing requirements of these schemes within the CFR. However, it will be an essential viability test for any such scheme that any associated borrowing is affordable against the requirements of the council’s Treasury Management strategy. In the event that the Council does need to borrow in order to progress the schemes an updated Treasury Management Strategy will be submitted to Council for approval.

8.4.7 **Ratio of Financing Costs to Net Revenue %:** The estimated General Fund and HRA ratios are forecast to increase as the council implements its ambitious Capital Investment plans.

8.4.8 **Incremental Impact on Council tax/Housing rents:** this is a key indicator of affordability since any decision to borrow to finance capital expenditure creates incremental costs to the authority, which may impact on council tax and/or housing rents. The indicators express the cost of proposed changes in the three year capital programme recommended in this budget report, in comparison with the council's existing commitments and current plans. It is essential to note that this indicator is not a projection of increases in council tax/housing rents over the three years. It is simply an additional tool to aid medium term financial planning.

8.5 Prudence

8.5.1 Gross Debt and the CFR indicator is a key control over the council's borrowing activity in relation to its capital expenditure and ensures that over the medium term net borrowing is only for capital purposes.

8.5.2 No difficulty is anticipated in meeting this requirement for the current or future years having taken into account current commitments, existing plans, and the proposals in the budget report. However no borrowing is anticipated for now.

Gross Debt and the CFR Indicator	2016/17 (£m)
Borrowing	412.7
Finance Leases	111.1
Gross Debt	**523.8**
CFR March 2016	**720.8**

9. Other Matters

9.1 The CLG Investment Guidance requires the Council to note the following matters each year as part of the investment strategy:

9.2 Treasury management advisers

9.2.1 The Council tendered its contract for treasury management advisory services and Capita Treasury Services were successful and started as the Council's advisors on 10 May 2014.

The Council also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources.

Capita now therefore provides advice and information on the Council's investment and borrowing activities, although responsibility for final decision making remains with the Council and its officers. The services received include:

- advice and guidance on relevant policies, strategies and reports;
- advice on investment decisions;
- notification of credit ratings and changes;
- other information on credit quality;
- advice on debt management decisions;

- accounting advice;
- reports on treasury performance;
- forecasts of interest rates; and,
- training courses.

9.2.2 The quality of this service is controlled by monitoring its relevance to the requirements of the authority, the speed at which requests for information are responded to and how accurate the advice is when evaluated against other independent but similar institutions.

9.3 Investment training

9.3.1 The needs of the Council's treasury management staff for training in investment management are assessed quarterly as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

9.3.2 Staff regularly attend training courses, seminars and conferences provided by Capita and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations. The Council has therefore made a commitment to support staff in their pursuit to obtaining and maintaining the relevant skills, qualifications and membership needed as recommended by the CIPFA code TMP10 "*The Council recognises the importance of ensuring that all staff involved in the Treasury Management function are fully equipped to undertake the duties and responsibilities allocated to them. It will therefore seek to appoint individuals who are both capable and experienced and will provide training for staff to enable them to acquire and maintain an appropriate level of expertise, knowledge and skills."*

9.4 Investment of money borrowed in advance of need

9.4.1 The Council may, from time to time, borrow in advance of spending need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

9.4.2 The total amount borrowed will not exceed the authorised borrowing limit of £600 million. The maximum period between borrowing and expenditure is expected to be two years, although the Council does not link particular loans with particular items of expenditure.

9.5 Policy on charging interest to the Housing Revenue Account

9.5.1 Following the reform of housing finance as set out in the report to Cabinet on 12th September 2011 the Council is free to adopt its own policy on sharing interest costs and income between the General Fund and Housing Revenue Account (HRA). The CIPFA Code recommends that authorities state their policy on this matter each year in their treasury management strategy.

9.5.2 The report agreed the separation of its external loans into GF and HRA pools and the mechanism for charging interest to each revenue account based on the weighted average cost of those loans. Following ratification of the localism bill on the 28 March

2012 the remaining loans were split into a GF pool (£169.6m) and an HRA pool (£243.1m).

9.5.3 Interest costs chargeable to the HRA per 2015/16 will be determined once the financing of the Capital Investment Programme has been completed at year end.

9.5.4 Under self-financing the government has set a cap for each local authority. The Housing Commission recommended that the council should borrow up to this amount to fund capital expenditure for the Housing Revenue Account over a 3 to 5 year period starting in 2012/13.

	2016/17	2017/18	2018/19
HRA Limit on indebtedness	**£m**	**£m**	**£m**
HRA Borrowing Limit	**408.078**	**408.078**	**408.078**
HRA Capital Financing Requirement	517.086	663.197	665.455
Less Myatt's Field North PFI	(85.415)	(90.662)	(95.750)
HCFR	**431.671**	**572.535**	**569.705**
Additional HRA borrowing allowable	**23.593**	**164.457**	**128.627**

9.6 Other Options Considered

The CLG Investment Guidance and the CIPFA Code of Practice do not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer, having consulted the Deputy Leader (Finance & Investment), believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Adopt a narrower definition of "high credit quality" and/or shorter time limits	Interest income will be lower	Reduced risk of losses from credit related defaults
Adopt a wider definition of "high credit quality" and/or longer time limits	Interest income will be higher	Increased risk of losses from credit related defaults
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest

		costs will be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long term costs will be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income in the short/medium term depending on changes in interest rate. Repaying debt would currently include significant premium costs, which make it unattractive.	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs will be less certain

Annex 1: Treasury Management Policy Statement

The Council's financial regulations require it to create and maintain a treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury activities, as a cornerstone for effective treasury management.

Definition
The Council defines its treasury management activities as: the management of the Council'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.

Risk management
The 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.

Value for money
The 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 comprehensive performance measurement techniques, within the context of effective risk management.

Borrowing policy
The Council greatly values revenue budget stability and will therefore borrow the majority of its long-term funding needs at long-term fixed rates of interest. Short-term and variable rate loans will only be borrowed to the extent that they either offset short-term and variable rate investments or can be shown to produce revenue savings.

The Council will set an affordable borrowing limit each year in compliance with the *Local Government Act 2003*, and will have regard to the *CIPFA Prudential Code for Capital Finance in Local Authorities* when setting that limit. It will also set limits on its exposure to changes in interest rates and limits on the maturity structure of its borrowing in the treasury management strategy report each year.

Investment policy
The Council's primary objectives for the investment of its surplus funds are to protect the principal sums invested from loss, and to ensure adequate liquidity so that funds are available for expenditure when needed. The generation of investment income to support the provision of local authority services is an important, but secondary, objective.

The Council will have regard to the Communities and Local Government Guidance on Local Government Investments and will approve an investment strategy each year as part of the treasury management strategy. The strategy will set criteria to determine suitable organisations with which cash may be invested, limits on the maximum duration of such investments and limits on the amount of cash that may be invested with any one organisation.