PAPER NO. 5

REPORT TO THE EXECUTIVE MEETING OF 25 MARCH 2013

Meeting:	**Executive**
Date:	**25 March 2013**
Subject:	**Prudential Indicators and Treasury Management Strategy 2013/14**
Report of:	**Jim Holden, Section 151 Officer and Kirsty Cowell, Finance Services Manager**
Portfolio Holder:	**Councillor Graham Spendlove-Mason**
Status:	**Recommendation**

1 Purpose of the Report

This report details the Council's proposed prudential indicators for the period 2013/14 to 2015/16 and sets out the forecast treasury activities over the same period.

1.1 It also fulfils four key requirements of local government legislation as follows :-

- The reporting of the prudential indicators as required by the Chartered Institute of Public Finance and Accountancy's (CIPFA) Prudential Code for Capital Finance in Local Authorities;
- The Council's Minimum Revenue Provision (MRP) Policy, which sets out how the Council will pay for capital assets through revenue each year;
- The Treasury Management Strategy, in accordance with the CIPFA Code of Practice on Treasury Management in the public services; and
- The Annual Investment Strategy in accordance with the Department of Communities and Local Government (CLG) investment guidance.

R 2 Recommendations to Council:

It is recommended that:

2.1 The capital prudential indicators and limits for 2013/14 to 2015/16 contained within Section 5.2 are approved.

2.2 The Minimum Revenue Provision (MRP) Statement, contained within paragraph 5.2.4, which sets out the Council's policy on MRP, is approved.

2.3 The Treasury Management Strategy 2013/14 and the treasury prudential indicators contained in Section 5.3 are approved.

2.4 The Annual Investment Strategy 2013/14 contained in paragraph 5.3.9 and the detailed criteria included in Appendix A, are approved.

3 Summary of Reasons for the Recommendations

3.1 The Local Government Act 2003, as amended, and supporting regulations requires the Council to "have regard to" the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable

3.2 The Council is also required by the Local Government Act 2003 to undertake an annual review of its policy for calculating the minimum revenue provision (MRP) for repayment of external debt.

3.3 The Act requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy. This sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

4 Impact on Communities

4.1 An appropriate Treasury Management Strategy is required to maximise the cash flow of the Council to enable investment income to be generated, which in turn will enable any impact to the community via Council Tax levels to be minimised.

5 Key Facts

5.1 Introduction

5.1.1 Background

The Council is required to operate a balanced budget, which broadly means that there will be adequate funds in place, including the use of reserves, where appropriate, to meet the Council's annual expenditure plans. Part of the treasury management operation is to ensure that this cash flow is planned in such a way as to ensure the cash is available when it is needed. Surplus monies are invested in approved counterparties (financial institutions) or instruments, e.g. government bonds, commensurate with the Council's risk appetite, until such time as they are needed. The overarching requirement being to providing adequate liquidity ahead of investment returns.

The second main function of the treasury management service is the funding of the Council's capital expenditure plans. These capital plans provide a guide to the borrowing need of the Council. Cash flow planning is essential to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using underlying cash flow surpluses as an alternative to borrowing. Debt re-structuring can also be undertaken from time to time to ensure the Council is minimising its debt servicing costs.

CIPFA defines treasury management as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

5.1.2 Reporting Requirements

The Council is required to receive and approve three main reports in respect of each financial year, which incorporate a range of policies, estimates and actuals. These three reports, as set out below, are required to be considered and recommended to the Council.

A – Treasury Management Strategy and Prudential Indicators

The first, and most important, report covers:

- the capital plans (including prudential indicators);
- a Minimum Revenue Provision (MRP) Policy (how residual capital expenditure is charged to revenue over time);
- the Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

Details in respect of this requirement are set out at 5.13 below.

B - Mid Year Treasury Management Report

This will update Members with the progress of the capital position, amending prudential indicators as necessary, and identifying whether the treasury strategy is meeting its objectives.

C - Annual Treasury Report

This is an end of year report which provides details of a selection of actual prudential and treasury indicators and actual treasury operations as compared to the estimates set out in the strategy.

The remainder of this report meets the requirement of A above.

5.1.3 Treasury Management Strategy and Prudential Indicators for 2013/14

The proposed Treasury Management Strategy for 2013/14 is set out below.

The strategy covers two main areas:

Capital Issues (at 5.2)

- The capital plans and the prudential indictors;
- The minimum revenue provision (MRP) policy.

Treasury Management Issues (at 5.3)

- The current treasury position;
- Treasury indicators which limit the treasury risk and activities of the Council;
- Prospects for interest rates;
- The borrowing strategy;
- Policy on borrowing in advance of need;
- Debt rescheduling;
- The investment strategy;
- Creditworthiness policy; and
- Policy on the use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, CLG Minimum Revenue Provision (MRP) Guidance, the CIPFA Treasury Management Code and CLG Investment Guidance.

5.1.4 Training

The CIPFA Code of Practice requires that the Section 151 Officer ensures that Members with responsibility for treasury management receive adequate training in relevant aspects of this function. A training session for Members is planned for 2013/14 financial year. The training needs of treasury management officers are also periodically reviewed.

5.1.5 Treasury Management Consultants

The Council uses a company called Sector as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

It is also recognised however that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. It is important to have arrangements in place to ensure that the terms of their appointment are properly agreed and documented, and subjected to regular review.

5.2 The Capital Prudential Indicators 2013/14 to 2015/16

5.2.1 The Council's capital expenditure plans are one of the key drivers of treasury management activity. The output of the capital expenditure plans is reflected in prudential indicators, which are designed to assist Members to have an oversight of the implications of the Council's capital expenditure plans.

5.2.2 Capital Expenditure (Indicator 1)

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the estimated capital expenditure and resources in the table overleaf. Any shortfall in resources results in a need to borrow.

	2011/12 Actual £000	2012/13 Revised £000	2013/14 Estimate £000	2014/15 Estimate £000	2015/16 Estimate £000
Capital Expenditure	**691**	**9,357**	**937**	**356**	**356**
Capital Receipts	0	11	0	0	0
Capital Grants & Contributions	496	2,758	130	0	0
Capital Reserves	0	0	0	0	0
Revenue Contributions	195	2,656	285	0	0
Net financing need for the year	**691**	**3,932**	**522**	**356**	**356**

5.2.3 Capital Financing Requirement (CFR) (Indicator 2)

The second prudential indicator is the Council's Capital Financing Requirements (CFR). The CFR is the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying need to borrow. Any capital expenditure above, which has not immediately been paid for, will increase the CFR. The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each assets life. The MRP Statement for 2013/14 is outlined in paragraph 5.9.

The CFR includes any other long term liabilities such as finance leases which have been brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has no finance lease liabilities within the CFR.

The Council is asked to approve the CFR projections below:

	2011/12 Actual £000	2012/13 Revised £000	2013/14 Estimate £000	2014/15 Estimate £000	2015/16 Estimate £000
Total CFR	2,211	5,785	5,924	5,897	5,870

Movement in CFR	100	3,574	139	(27)	(27)

Movement in CFR Represented By:					
Net financing need for the year (above)	366	3,932	522	356	356
MRP and other financing movements	(266)	(358)	(383)	(383)	(383)
Movement in CFR	100	3,574	139	(27)	(27)

5.2.4 Minimum Revenue Provision (MRP) Policy Statement

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the minimum revenue provision – MRP), although it is also allowed to undertake additional voluntary payments if it wishes to (voluntary revenue provision – VRP).

CLG regulations have been issued which require the Council to approve an MRP Policy Statement in respect of each financial year. A number of options are available to Councils with the overriding requirement being to demonstrate a prudent provision. The Council is recommended to approve the following MRP Statement:

“For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the policy will be that MRP will continue to be charged at the rate of 4%, in accordance with option 1 of the guidance (the Regulatory Method).

The remaining expenditure reflected within the debt liability will be subject to MRP under option 3 of the guidance (Asset Life Method), which will be charged over a period which is reasonably commensurate with the estimated useful life applicable to the nature of the expenditure, using the equal instalment method. For example, capital expenditure on a new building, or on the refurbishment or enhancement of a building, will be related to the estimated life of that building.

Estimated life periods will be determined under delegated powers. To that 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, there 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.

As some types of capital expenditure incurred by the Council are not capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from such 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.

The following table gives an indication of the useful asset lives of different categories of assets/capital expenditure type, and hence the period over which MRP will be charged.

Capital Expenditure incurred on:	Estimated Asset Life for MRP purposes
Construction of new buildings	50 years
Disabled Facilities Grants – Stairlifts	5 years
Disabled Facilities Grants – Bathrooms/Major Adaptations	25 years
Enhancement and refurbishment of land and buildings	10 / 25 years
Other vehicles, plant and equipment	5 – 10 years
Other capital grants	5 years
IT Systems	5 years

MRP in respect of assets which may be acquired under finance leases will be charged at a rate equal to the principal element of the annual lease rental for the year in question."

Core Funds and Expected Investment Balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end balances for each resource.

	2011/12 Actual £000	2012/13 Revised £000	2013/14 Estimate £000	2014/15 Estimate £000	2015/16 Estimate £000
Fund Balances & Reserves	2,100	1,900	1,600	1,300	1,000
Capital Receipts	0	0	0	0	0
Provisions	4,500	4,500	4,100	4,100	4,100
Other					
Total Core Funds	**6,600**	**6,400**	**5,700**	**5,400**	**5,100**
Working Capital*	2,900	2,500	2,200	2,000	1,700
Unsupported Borrowing#	(700)	(3,900)	(500)	(400)	(400)
Expected Investments	**3,000**	**3,000**	**3,000**	**3,000**	**3,000**

* Working capital balances shown are estimated year end; these may be higher mid year.
# Unsupported borrowing can involve the use of internal revenue cash resources, external loans or a combination of both

5.2.5 Affordability Prudential Indicators (Indicators 3 and 4)

The previous sections cover the overall capital expenditure and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall financial position. The Council is asked to approve the following indicators:

Ratio of Financing Costs to Net Revenue Stream (3) – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. The estimates of financing costs include current commitments and the proposals in the budget report.

	2011/12 Actual %	2012/13 Revised %	2013/14 Estimate %	2014/15 Estimate %	2015/16 Estimate %
General Fund	3.38	3.68	3.76	3.76	3.76

Incremental Impact of Capital Investment Decisions on Council Tax (4) – This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in the 2013/14 budget report and proposed capital programme, compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of external government grant support, which are not published over a three year period.

	Proposed Budget 2013/14 £	Forward Projection 2014/15 £	Forward Projection 2015/16 £
Council Tax – Band D	2.10	2.43	2.76

5.3 Treasury Management Strategy and Indicators

5.3.1 The capital expenditure plans set out in paragraph 5.2.2 provide details of the levels of investment. The treasury management function ensures that the Council's cash is organised in accordance with the relevant codes of practice, so that sufficient cash is available to meet the capital investment plans. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. This strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

5.3.2 The Current Treasury Portfolio Position (Indicator 5)

The Council's treasury portfolio position at 31 March 2012, together with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement – CFR), highlighting any over or under borrowing.

	2011/12 Actual £000	2012/13 Revised £000	2013/14 Estimate £000	2014/15 Estimate £000	2015/16 Estimate £000
External Debt					
Debt at 1 April	1,490	1,490	1,490	4,840	4,840
Expected change in debt	0	0	3,350	0	0
Other long term liabilities (OLTL)	0	0	0	0	0
Expected change in OLTL					
Actual Debt at 31 March	**1,490**	**1,490**	**4,840**	**4,840**	**4,840**
Capital Financing Requirement	**2,211**	**5,785**	**5,924**	**5,897**	**5,870**
Under/(over) borrowing	**721**	**4,295**	**1,084**	**1,057**	**1,030**
Total Investments at 31 March	**4,000**	**3,000**	**5,000**	**3,000**	**3,000**

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for the current year and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Section 151 Officer reports that the Council complied with this prudential indicator in the current year and expects to comply going forward. This view takes into account current commitments, existing plans, and the proposals in this budget report.

5.3.3 Treasury Indicators – Limits to Borrowing Activities (Indicators 6 and 7)

The Operational Boundary (6) – This is the limit which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

Operational boundary for external debt	2012/13 Revised £000	2013/14 Estimate £000	2014/15 Estimate £000	2015/16 Estimate £000
Borrowing	6,500	7,000	7,000	7,000
Other long-term liabilities	0	500	500	500
Total	7,000	7,500	7,500	7,500

The Authorised Limit for External Debt (7) - A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

- This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all local authorities plans, or those of a specific Council, although this power has not been exercised to date.

- The Council is asked to approve the following Authorised Limits:

Authorised limit for external debt	**2012/13 Revised £000**	**2013/14 Estimate £000**	**2014/15 Estimate £000**	**2015/16 Estimate £000**
Borrowing	7,500	8,000	8,000	8,000
Other long-term liabilities	0	1,000	1,000	1,000
Total	7,500	9,000	9,000	9,000

5.3.4 Prospects for Interest Rates

The treasury advisors assist the Council to formulate a view on interest rates. The following table shows Sector's latest interest rate forecast.

Annual Average %	Bank Rate	PWLB Borrowing Rates (including certainty rate adjustment)		
		5 year	25 year	50 year
March 2013	0.50	1.50	3.80	4.00
June 2013	0.50	1.50	3.80	4.00
September 2013	0.50	1.60	3.80	4.00
December 2013	0.50	1.60	3.80	4.00
March 2014	0.50	1.70	3.90	4.10
June 2014	0.50	1.70	3.90	4.10
September 2014	0.50	1.80	4.00	4.20
December 2014	0.50	2.00	4.10	4.30
March 2015	0.50	2.20	4.30	4.50
June 2015	0.50	2.30	4.40	4.60
September 2015	0.50	2.50	4.60	4.80
December 2015	0.50	2.70	4.80	5.00
March 2016	0.50	2.90	5.00	5.20

The economic recovery in the UK since 2008 has been the worst and slowest recovery in recent history, although the economy returned to positive growth in the third quarter of 2012. Growth prospects are weak and consumer spending, the usual driving force of recovery, is likely to remain under pressure due to consumers focusing on repayment of personal debt, inflation eroding disposable income, general malaise about the economy and employment fears.

The primary drivers of the UK economy are likely to remain external. 40% of UK exports go to the Eurozone so the difficulties in this area are likely to continue to hinder UK growth. The US, the main world economy, faces similar debt problems to the UK, but urgently needs to resolve the fiscal cliff now that the presidential elections are out of the way. The resulting US fiscal tightening and continuing Eurozone problems are likely to depress UK growth and see the UK deficit reduction plans slip. Further analysis is set out at Appendix C.

5.3.5 Borrowing Strategy

The Council's estimated longer term debt portfolio will stand at £1.49m at 1 April 2013. The estimated average rate of interest payable on long-term debt during 2013/14 is forecast at 5.01% compared with 5.01% for 2012/13.

The total debt portfolio is funded by the Public Works Loans Board (PWLB. The details of the portfolio are set out in **Appendix D**. During 2012/13 annuity principal to the value of £0m will have been repaid, as all of the current loans are repayable at maturity. The average maturity profile of the loan portfolio is 38 years.

Council during 2012/13 had approved borrowing to fund 3 projects, including the refurbishment of the Council offices. Any borrowing relating to these projects will be carefully considered, in relation to timing, the rates available and the cash flow.

The Council is currently maintaining an under borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is relatively high.

Against this background and the risks within the economic forecast, caution will be adopted with the 2013/14 treasury operations. The Section 151 Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances, for example :-

- *if it was felt that there was a significant risk of a sharp fall in long and short term rates* (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

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

The Council is however in a relatively strong position to respond to market changes.

5.3.6 <u>Treasury Management Limits on Activity</u>

There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs and/or improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments;

- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;

- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

The Council is asked to approve the following treasury indicators and limits:

Limits in Interest Rate Exposure (Indicator 8)

	2013/14 Upper	2014/15 Upper	2015/16 Upper
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	50%	50%	50%

Maturity Structure of Fixed Interest Rate Borrowing (Indicator 9)

Maturity Structure of fixed interest rate borrowing	2013/14		2014/15		2015/16	
	Lower %	Upper %	Lower %	Upper %	Lower %	Upper %
Under 12 months	0	0	0	10	0	10
12 months to 2 years	0	10	0	10	0	10
2 years to 5 years	0	20	0	10	0	10
5 years to 10 years	0	30	0	30	0	30
10 years and above	0	100	0	100	0	100

5.3.7 **Policy on Borrowing in Advance of Need**

The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

5.3.8 **Debt Rescheduling**

As short term borrowing rates will be considerably cheaper than long term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

The reasons for any rescheduling to take place will include:-

- the generation of cash savings and/or discounted cash flow savings
- helping to fulfil the treasury strategy

- amending the maturity profile and/or the balance of volatility in the portfolio

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investment are likely to be lower than rates paid on current debt.

All rescheduling will be reported to the Executive at the earliest meeting following its action.

5.3.9 **Investment Policy and Strategy**

The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, and then return.

In accordance with guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology, used to create the counterparty list, fully accounts for the ratings, watches and outlooks published by all three rating agencies with a full understanding of what these reflect in the eyes of each agency. The Sector ratings service monitors potential counterparty ratings on a real time basis with knowledge of any changes issued electronically to the Council as the agencies notify modifications.

Furthermore, the Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets.

Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoid undue concentration of risk.

The intention of the strategy is to provide security of investment and minimisation of risk.

Investment instruments identified for use in the financial year are listed in Appendix A under the ‘Specified’ and ‘Non-Specified’ Investments categories. Counterparty limits will be as set out at Appendix E

5.3.10 **Creditworthiness Policy**

This Council applies the creditworthiness service provided by Sector. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies – Fitch, Moody’s, and Standard and Poor’s. The credit ratings of counterparties are supplemented with the following overlays:

- Credit watches and credit outlooks from credit rating agencies;
- Credit Default Swap (CDS) spreads to give early warning of likely changes in credit ranges;
- Sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands:

- Yellow 5 years
- Purple 2 years
- Blue 1 year (nationalised/or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 3 months
- No Colour not to be used (NB: except Building Societies)

In respect of building societies, the Council will use those societies that have assets in excess of £1 billion, subject to them having a minimum credit rating of P-2 (Moody’s) . In addition the Council will continue to use the locally based Market Harborough Building Society

The Council will use nationalised or part nationalised institutions such as RBS and Lloyds, subject to a monetary limit of £8m.

The Sector creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not place undue emphasis on just one agency’s ratings.

Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1, a Long Term rating of A-, Viability ratings of A-, and a Support rating of 1. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored on an ongoing basis. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service.

- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- In addition to the use of Credit Ratings the Council will be advised of information regarding movements in CDS against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Councils lending list.

Sole reliance will not be placed on the use of this external service. In addition the Council will also use market data and market information, information on government support for banks and the credit ratings of that government support.

5.3.11 <u>Country and Sector Limits</u>

The Council has considered the use of non-UK based banks, but given the current economic situation, has discounted their use for the foreseeable future, in the interests of prudence. Due care will be taken to consider the group and sector exposure of the Council's investments. The limits referred to above will apply to group companies, and sector limits will be monitored regularly for appropriateness.

Whilst the UK currently has recently been downgraded (by one agency - Moody's) to an Aa1 sovereign rating it unlikely this rating will be further downgraded in the near future. It is therefore proposed that the Council no longer sets a minimum sovereign rating of AAA in order to ensure continuity of being able to invest in UK banks.

5.3.12 <u>Investment Strategy</u>

The Council's in-house managed funds are principally derived from cash flow. However it is proposed as part of this strategy that the underlying core investments, which are derived from existing reserves, capital receipts and the Vat shelter receipts are utilised as follows:

- To be invested over a longer term (one to three years) to secure a competitive / enhanced rate of interest that may not be available in a year's time; and / or
- To mitigate the need for additional future long term borrowing (where long term borrowing rates are in excess of prevailing investment rates).

This represents a strategic departure from the existing strategy which applies lower monetary limits per counterparty and a maximum 12 month time limit. The rationale being to improve returns by investing larger sums for longer periods where there is no short term requirement for the underlying core funds.

Investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for short term interest rates (i.e. rates for investments up to 12 months). The criteria to be used in determining whether the Council may invest with a counterparty is set out in **Appendix A**.

The internally managed funds are now budgeted to realise net investment interest of £92k during 2012/13 against an original estimate of £72k. If investment rates continue to fall below long term borrowing rates consideration will be given to postponing any further borrowing and instead using investment balances to fund the Council's future capital spending plans.

The Council's proposed Approved Counterparty List appears at **Appendix E**.

The Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 4 of 2014. The Bank Rate forecasts for the next four financial year ends are:

- 2012/13 0.50%
- 2013/14 0.50%
- 2014/15 0.75%
- 2015/16 1.75%

There are downside risks to these forecasts (i.e. the start of increases in the Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if Bank of England inflation forecasts for two years ahead exceed the 2% target rate.

Investment Treasury Indicator and Limit (Indicator 10) - Total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of investments after each year-end.

Maximum principal sums invested for more than 364 days	**2013/14**	**2014/15**	**2015/16**
	£'m	£'m	£'m
Principal sums invested > 364 days	6,000	6,000	6,000

For its cash flow generated balances, the Council will seek to utilise business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

5.3.13 Performance Indicators

The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the Prudential Indicators, which are predominantly forward looking. The Council's performance indicator is as follows:-

- Investments – to achieve a return on external investments at least ¼% in excess of the London Interbank Bid Rate (LIBID) 7 day rate, which is currently 0.4%

The results of this indicator will be reported in the Annual Treasury Outturn report after the end of the financial year.

5.3.14 Policy on the use of External Service Providers

The Council uses Sector Treasury Services as its external treasury management advisers.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

The Council has entered into a letter of engagement with Sector and receives the company's full range of treasury services. It is proposed to extend the current agreement for a further year to 31st March 2014.

5.3.15 Treasury Management Scheme of Delegation

The treasury management scheme of delegation which forms part of the Treasury Management Practices appears at **Appendix F**.

5.3.16 Role of the Section 151 Officer

Treasury Management Practices also sets out the responsibilities of the Section 151 Officer in relation to treasury management activities, and an extract is shown at **Appendix G**.

6 Legal Issues

6.1 This report covers the requirement for capital financing and treasury management as set out in the Local Government Act 2003 and subsequent Regulations.

7 Resource Issues

7.1 These are covered in detail in this report.

8 Equality Impact Assessment Implications/Outcomes

8.1 There are no equality and diversity issues relating to this strategy.

9 Impact on the Organisation

9.1 The Prudential Code has had wide reaching implications for local authorities, providing greater flexibility for capital investment where spending plans can be demonstrated to be affordable, prudent and sustainable. The Council's capital resources have reduced in recent years and without the introduction of the Code the Council would have only been able to set a limited Capital Programme.

9.2 The Treasury Management function is an important element of the Council's overall financial affairs. It is inextricably linked to any financial decision which the Council may take, both in revenue and capital terms, and has taken on an even greater importance with the introduction of the Prudential Code.

10 Community Safety Implications

10.1 There are no community safety implications arising from this report.

11. Carbon Management Implications

11.1 There are no carbon management implications arising directly from this report.

12. Risk Management Implications

12.1 Management of the Council's financial resources is key to achieving targets set out in the budget. Security of the Council's money in the current banking market is paramount..

13 Consultation

13.1 The Prudential Indicators contained within this report have been compiled to take account of the borrowing requirements and available resources determined as part of the Council's capital programme and overall budget setting process. Members and officers have been involved in the budget process from the outset.

14 Options Considered

14.1 None

15 Background Papers

15.1 None

Previous report(s):

Information Issued Under Sensitive Issue Procedure: No

Ward Members Notified: Not Applicable

Appendices:

A	Detailed Criteria for Investment of Surplus Funds
B	Interest Rate Forecasts 2013 - 2016
C	Economic Background
D	External Debt Analysis (s/sheet)
E	Approved Counterparty List
F	Treasury Management Scheme of Delegation
G	Role of the Section 151 Officer