Crawley Borough Council

Report to Overview & Scrutiny Commission
9 February 2015

Report to Cabinet
11 February 2015

Treasury Management Strategy 2015/2016

Report of the Head of Finance, Revenues and Benefits – FIN/355

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1. Purpose

1.1 The strategy for 2015/16 covers two main areas:

Capital issues
- the capital plans and the prudential indicators;
- the minimum revenue provision (MRP) policy.

Treasury management issues
- 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 use of external service providers.

1.2 In respect of non-Housing Revenue Account activities, the Council's policy is to remain debt free and invest according to the principles of security, liquidity and yield.

1.3 There are no material changes to the investment strategy in section 7 and appendix 3 compared with the 2014/2015 strategy.

2. Recommendations

2.1 To the Overview and Scrutiny Commission:

That the Commission considers the report and decides what comments, if any, it wishes to submit to the Cabinet.

2.2 To the Cabinet

The Cabinet is requested to recommend to Council the approval of:-

a) the Treasury Prudential Indicators and the Minimum Revenue Provision (MRP) Statement contained within Section 5;
b) the Treasury Management Strategy contained within Section 6;
c) the Investment Strategy contained within Section 7, and the detailed criteria included in Appendix 3;

3. Reasons for the Recommendations

3.1 The Council's financial regulations, in accordance with the CIPFA Code of Practice for Treasury Management, requires a Treasury Management Strategy to be approved for the forthcoming financial year. This report complies with these requirements.

4. Background

4.1 The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

4.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning 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 longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

4.3 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. The Capital Prudential Indicators 2013/14 – 2017/18

5.1 The Capital Expenditure Plans

5.1.1 The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

5.1.2 **Capital expenditure.** 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 capital expenditure forecasts:

Capital Expenditure £'000	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Cabinet	127	824	3,719	3,600	0
Customer & Corporate	152	784	885	541	0
Environment	1,549	7,987	4,890	2,021	715
Planning & Economic Development	0	6,232	8,768	100	100
Housing Services	1,644	1,104	1,242	2,310	645
Leisure & Cultural	1,245	3,140	3,485	1,368	310
General Fund	**4,717**	**20,071**	**22,989**	**9,940**	**1,770**
HRA	**10,141**	**20,942**	**21,349**	**23,310**	**18,233**
Total	**14,858**	**41,013**	**44,338**	**33,250**	**20,003**

5.1.3 The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

Capital Expenditure £'000	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
General Fund	4,717	20,071	22,989	9,940	1,770
HRA	10,141	20,942	21,349	23,310	18,233
Total	14,858	41,013	44,338	33,250	20,003
Financed by:					
Capital receipts	2,802	12,649	17,303	13,209	1,392
Capital grants	2,125	4,431	2,624	1,021	378
Capital reserves	595	6,232	3,768	0	0
Revenue	9,336	17,701	20,643	19,020	18,233
Net financing need for the year	**0**	**0**	**0**	**0**	**0**

5.2 The Council's borrowing need (the Capital Financing Requirement).

5.2.1 The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply 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 borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

5.2.2 The Council is asked to approve the CFR projections below:

£’000	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Capital Financing Requirement					
CFR – General Fund	(330)	(330)	(330)	(330)	(330)
CFR - HRA	260,273	260,273	260,273	260,273	260,273
Total CFR	**259,943**	**259,943**	**259,943**	**259,943**	**259,943**
Movement in CFR	**0**	**0**	**0**	**0**	**0**

Movement in CFR represented by					
Net financing need for the year (above)	0	0	0	0	0
Less MRP/VRP and other financing movements	10	0	0	0	0
Movement in CFR	**10**	**0**	**0**	**0**	**0**

5.2.3 The large CFR on the HRA is due to the self-financing settlement in 2011/12.

5.3 Minimum revenue provision (MRP) policy statement

5.3.1 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 required (voluntary revenue provision - VRP).

5.3.2 Government regulations have been issued which require the full Council to approve **an MRP Statement** in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement:

5.3.3 For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP policy will be:

- **Existing practice** - MRP will follow the existing practice outlined in former CLG regulations (option 1)

This option provides for an approximate 4% reduction in the borrowing need (CFR) each year.

5.3.4 From 1 April 2008 for all unsupported borrowing (including PFI and finance leases) the MRP policy will be:

- **Asset life method** – MRP will be based on the estimated life of the assets, in accordance with the regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction) (option 3)

This option provides for a reduction in the borrowing need over approximately the asset’s life.

5.3.5 There is no requirement on the HRA to make a minimum revenue provision but there is a requirement for a charge for depreciation to be made (although there are transitional arrangements in place).

5.4 Core funds and expected investment balances

5.4.1 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 and anticipated day to day cash flow balances.

Year End Resources £'000	**2013/14 Actual**	**2014/15 Estimate**	**2015/16 Estimate**	**2016/17 Estimate**	**2017/18 Estimate**
Fund balances / reserves	56,629	50,615	52,702	57,355	58,797
Capital receipts	44,087	37,071	25,295	11,883	13,691
Total core funds	**100,716**	**87,686**	**77,997**	**69,238**	**72,488**
Working capital*	18,676	18,000	18,000	18,000	18,000
Under/over borrowing	382	382	382	382	382
Expected investments	**119,010**	**106,068**	**96,379**	**87,620**	**91,870**

5.5 Affordability prudential indicators

5.5.1 The previous sections cover the overall capital 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 finances. The Council is asked to approve the following indicators:

5.5.2 **Ratio of financing costs to net revenue stream.** 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.

%	**2015/16 Estimate**	**2016/17 Estimate**	**2017/18 Estimate**
General Fund	-7.68	-10.12	-14.25
HRA	17.31	17.22	16.96

The estimates of financing costs include current commitments and the proposals in this budget report.

5.5.3 **Incremental impact of capital investment decisions on council tax**. This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in this budget report 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 Government support, which are not published over a three year period.

£	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Council tax - band D	nil	nil	nil

5.5.4 **Estimates of the incremental impact of capital investment decisions on housing rent levels.** Similar to the council tax calculation, this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

£	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Weekly housing rent levels	nil	nil	nil

This indicator shows the revenue impact on any newly proposed changes, although any discrete impact will be constrained by rent controls.

5.5.5 **HRA ratios**

	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
HRA debt £'000	260,325	260,325	260,325	260,325	260,325
HRA revenues £'000	45,602	46,660	47,339	47,444	48,168
Ratio of debt to revenues %	571	558	550	549	540

	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
HRA debt £'000	260,325	260,325	260,325	260,325	260,325
Number of HRA dwellings	7,895	7,897	7,867	7,844	7,821
Debt per dwelling £	32,973	32,965	33,091	33,188	33,285

6. Borrowing

6.1 The capital expenditure plans set out in Section 5 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

6.2 Current portfolio position

6.2.1 The Council's treasury portfolio position at 31 March 2014, 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.

£'000	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
External Debt					
Debt at 1 April	260,325	260,325	260,325	260,325	260,325
Expected change in Debt	0	0	0	0	0
Other long-term liabilities (OLTL)	0	0	0	0	0
Expected change in OLTL	0	0	0	0	0
Actual debt at 31 March (A)	**260,325**	**260,325**	**260,325**	**260,325**	**260,325**
The Capital Financing Requirement	259,943	259,943	259,943	259,943	259,943
Under / (over) borrowing	(382)	(382)	(382)	(382)	(382)

6.2.2 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 2015/16 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.

6.2.3 The Head of Finance reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

6.3 Treasury Indicators: Limits to Borrowing Activity

6.3.1 **The Operational Boundary.** This is the limit beyond 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 £'000	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Debt	260,325	260,325	260,325	260,325
Other long term liabilities	0	0	0	0
Total	260,325	260,325	260,325	260,325

6.3.2 **The Authorised Limit for external debt.** 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.

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

6.3.4 The Council is asked to approve the following Authorised Limit:

Authorised limit £'000	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Debt	270,325	270,325	270,325	270,325
Other long term liabilities	0	0	0	0
Total	270,325	270,325	270,325	270,325

6.3.5 Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit is currently:

HRA Debt Limit £'000	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
HRA debt cap	263,902	263,902	263,902	263,902
HRA CFR	260,325	260,325	260,325	260,325
HRA headroom	3,577	3,577	3,577	3,577

6.4 Prospects for Interest Rates

6.4.1 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 Capita's central view.

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Mar 2015	0.50	2.20	3.40	3.40
Jun 2015	0.50	2.20	3.50	3.50
Sep 2015	0.50	2.30	3.70	3.70
Dec 2015	0.75	2.50	3.80	3.80
Mar 2016	0.75	2.60	4.00	4.00
Jun 2016	1.00	2.80	4.20	4.20
Sep 2016	1.00	2.90	4.30	4.30
Dec 2016	1.25	3.00	4.40	4.40
Mar 2017	1.25	3.20	4.50	4.50
Jun 2017	1.50	3.30	4.60	4.60
Sep 2017	1.75	3.40	4.70	4.70
Dec 2017	1.75	3.50	4.70	4.70
Mar 2018	2.00	3.60	4.80	4.80

6.4.2 UK GDP growth surged during 2013 and the first half of 2014. Since then it appears to have subsided somewhat but still remains strong by UK standards and is expected to continue likewise into 2015 and 2016. There needs to be a significant rebalancing of the economy away from consumer spending to manufacturing, business investment and exporting in order for this recovery to become more firmly established. One drag on the economy has been that wage inflation has only recently started to exceed CPI inflation, so enabling disposable income and living standards to start improving. The plunge in the price of oil brought CPI inflation down to a low of 1.0% in November, the lowest rate since September 2002. Inflation is expected to stay around or below 1.0% for the best part of a year; this will help improve consumer disposable income and so underpin economic growth during 2015. However, labour productivity needs to improve substantially to enable wage rates to increase and further support consumer disposable income and economic growth. In addition, the encouraging rate at which unemployment has been falling must eventually feed through into pressure for wage increases, though current views on the amount of hidden slack in the labour market probably means that this is unlikely to happen early in 2015.

6.4.3 There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

6.5 Borrowing Strategy

6.5.1 The Council borrowed £260.325m in 2011/12 for the HRA self-financing settlement. The General Fund remains debt free, and this position is not expected to change during 2015/16.

6.5.2 **Treasury management limits on activity**
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 / 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.

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

£'000	**2015/16**	**2016/17**	**2017/18**
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates: • **Debt only** • **Investments only**	 270,325 140,000	 270,325 140,000	 270,325 140,000
Limits on variable interest rates • **Debt only**	 10,000	 10,000	 10,000

• **Investments only**	40,000	40,000	40,000
Maturity Structure of fixed interest rate borrowing 2015/16			
		Lower	**Upper**
Under 12 months		0%	10%
12 months to 2 years		0%	10%
2 years to 5 years		0%	10%
5 years to 10 years		0%	20%
10 years to 20 years		0%	80%
20 years to 30 years		0%	25%
30 years to 40 years		0%	10%
40 years to 50 years		0%	10%

6.6 Policy on borrowing in advance of need

6.6.1 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.

6.6.2 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.

6.7 Debt rescheduling

6.7.1 As short term borrowing rates will be considerably cheaper than longer 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).

6.7.2 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;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

6.7.3 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 investments are likely to be lower than rates paid on current debt.

6.7.4 All rescheduling will be reported to the Cabinet, at the earliest meeting following its action

7. Annual Investment Strategy

7.1 Investment Policy

7.1.1 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 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.

7.1.2 In accordance with the above guidance from the Government and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk.

7.1.3 Continuing regulatory changes in the banking sector are designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key ratings used to monitor counterparties being the Short Term and Long Term ratings only. Viability, Financial Strength and Support Ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes.

7.1.4 As with previous practice, ratings will 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. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.

7.1.5 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.

7.1.6 Investment instruments identified for use in the financial year are listed in Appendix 3 under the 'specified' and 'non-specified' investments categories. Counterparty limits will be as set through the Council's treasury management practices – schedules.

7.2 Creditworthiness policy

7.2.1 This Council applies the creditworthiness service provided by Capita Asset Services. 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;
- CDS spreads to give early warning of likely changes in credit ratings;
- sovereign ratings to select counterparties from only the most creditworthy countries.

7.2.2 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 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 *
- Dark pink 5 years for Enhanced money market funds (EMMFs) with a credit score of 1.25
- Light pink 5 years for Enhanced money market funds (EMMFs) with a credit score of 1.5
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days
- No colour not to be used

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour

	Colour (and long term rating where applicable)	Money Limit	Time Limit
Banks *	yellow	unlimited	5 yrs
Banks	purple	£15m	2 yrs
Banks – part nationalised	blue	£15m	1 yr
Banks	orange	£10m	1 yr
Banks	red	£10m	6 mths
Banks	green	£10m	100 days
Banks	No colour	Not to be used	
Limit 3 category – Council's banker (not meeting Banks 1)	n/a	£1m	1 day
Corporate Bonds	AA- A-	£5m £2m	2 yrs 1 yr
DMADF	AAA	unlimited	6 months
Local authorities	n/a	£15m	5 yrs

Money market funds	AAA	£15m	liquid
Enhanced money market funds with a credit score of 1.25	Dark pink / AAA	£10m	liquid
Enhanced money market funds with a credit score of 1.5	Light pink / AAA	£10m	liquid

** Please note: the yellow colour category is for UK Government debt, or its equivalent, constant NAV money market funds and collateralised deposits where the collateral is UK Government debt.*

7.2.3 Capita's creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

7.2.4 Typically the minimum credit ratings criteria the Council use will be a short term rating (Fitch or equivalents) of short term rating F1, long term rating A-, viability rating 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.

7.2.5 All credit ratings will be monitored daily. The Council is alerted to changes to ratings of all three agencies through its use of Capita's 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 in movements in credit default swap spreads 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 Council's lending list.

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

7.3 Country limits

7.3.1 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch (or equivalent). The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 4. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

7.4 Investment strategy

7.4.1 **In-house funds.** Investments will 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).

7.4.2 **Investment returns expectations.** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2015. Bank Rate forecasts for financial year ends (March) are:

- 2015/16 0.75%
- 2016/17 1.25%
- 2017/18 2.00%

7.4.3 There are downsize risks to these forecasts (i.e. start of increases in Bank Rate occurs later) if economic growth weakens. However, should the pace of growth quicken, there could be upside risk.

7.4.4 The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next eight years are as follows:

2015/16	0.60%
2016/17	1.25%
2017/18	1.75%
2018/19	2.25%
2019/20	2.75%
2020/21	3.00%
2021/22	3.25%
2022/23	3.25%
Later years	3.50%

7.4.5 **Investment treasury indicator and limit** - total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Council is asked to approve the treasury indicator and limit: -

Maximum principal sums invested > 364 days			
£m	**2015/16**	**2016/17**	**2017/18**
Principal sums invested > 364 days	£50m	£50m	£50m

7.4.6 **Investment Risk Benchmarking**. These benchmarks are simple guides to maximum risk, so they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

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

- **0.15% historic risk of default when compared to the whole portfolio.**

7.4.8 Liquidity – in respect of this area the Council seeks to maintain:

- Bank overdraft - £0.1m

- Liquid short term deposits of at least £2m available with a week's notice.
- Weighted Average Life benchmark is expected to be 1.20 years, with a maximum of 1.50 years.

7.4.9 Yield - local measures of yield benchmarks are:

- Investments – internal returns 0.2% above the 7 day LIBID rate

7.4.10 And in addition that the security benchmark for each individual year is:

	1 year	2 years	3 years	4 years	5 years
Maximum	**0.03%**	**0.22%**	**0.40%**	**0.56%**	**0.74%**

Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

7.4.11 A the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

7.5 Treasury management consultants

7.5.1 The Council uses Capita Asset Services, Treasury solutions as its external treasury management advisors.

7.5.2 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 external service providers.

7.5.3 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.

8. Background Papers

Treasury Management Strategy for 2014/2015 – Cabinet, 12 February 2014 [report FIN/323 refers].
2015/2016 Budget and Council Tax – Cabinet, 11 February 2015 [report FIN/356 refers].
"Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes", 2011 Edition – Chartered Institute of Public Finance and Accountancy.
"The Prudential Code for Capital Finance in Local Authorities", 2011 Edition – Chartered Institute of Public Finance and Accountancy.

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ENDS

Capita Asset Services Interest Rate View													
	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank Rate View	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
3 Month LIBID	0.50%	0.50%	0.60%	0.80%	0.90%	1.10%	1.10%	1.30%	1.40%	1.50%	1.80%	1.90%	2.10%
6 Month LIBID	0.70%	0.70%	0.80%	1.00%	1.10%	1.20%	1.30%	1.50%	1.60%	1.70%	2.00%	2.10%	2.30%
12 Month LIBID	0.90%	1.00%	1.10%	1.30%	1.40%	1.50%	1.60%	1.80%	1.90%	2.00%	2.30%	2.40%	2.60%
5yr PWLB Rate	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
10yr PWLB Rate	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB Rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
50yr PWLB Rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
Bank Rate													
Capita Asset Services	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
Capital Economics	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	-	-	-	-	-
5yr PWLB Rate													
Capita Asset Services	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
Capital Economics	2.20%	2.50%	2.70%	3.00%	3.10%	3.20%	3.30%	3.40%	-	-	-	-	-
10yr PWLB Rate													
Capita Asset Services	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
Capital Economics	2.80%	3.05%	3.30%	3.55%	3.60%	3.65%	3.70%	3.80%	-	-	-	-	-
25yr PWLB Rate													
Capita Asset Services	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
Capital Economics	3.25%	3.45%	3.65%	3.85%	3.95%	4.05%	4.15%	4.25%	-	-	-	-	-
50yr PWLB Rate													
Capita Asset Services	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
Capital Economics	3.30%	3.50%	3.70%	3.90%	4.00%	4.10%	4.20%	4.30%	-	-	-	-	-

Please note – The current PWLB rates and forecast shown above have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012

APPENDIX 2: Economic Background

UK. After strong UK GDP growth in 2013 at an annual rate of 2.7%, and then in 2014 0.7% in Q1, 0.9% in Q2 2014 (annual rate 3.2% in Q2), Q3 has seen growth fall back to 0.7% in the quarter and to an annual rate of 2.6%. It therefore appears that growth has eased since the surge in the first half of 2014 leading to a downward revision of forecasts for 2015 and 2016, albeit that growth will still remain strong by UK standards. For this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster than expected. The MPC is now focusing on how quickly slack in the economy is being used up. It is also particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back significantly above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Unemployment is expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in wage growth at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.0% in November 2014, the lowest rate since September 2002. Forward indications are that inflation is likely to remain around or under 1% for the best part of a year. The return to strong growth has helped lower forecasts for the increase in Government debt over the last year but monthly public sector deficit figures during 2014 have disappointed until November. The autumn statement, therefore, had to revise the speed with which the deficit is forecast to be eliminated.

Eurozone (EZ). The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In November 2014, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB took some rather limited action in June and September 2014 to loosen monetary policy in order to promote growth. It now appears likely that the ECB will embark on full quantitative easing (purchase of EZ country sovereign debt) in early 2015.

Concern in financial markets for the Eurozone subsided considerably after the prolonged crisis during 2011-2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. The ECB's pledge in 2012 to buy unlimited amounts of bonds of countries which ask for a bailout has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the degree of recession. However, debt to GDP ratios (2013 figures) of Greece 180%, Italy 133%, Portugal 129%, Ireland 124% and Cyprus 112%, remain a cause of concern, especially as some of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are likely to continue to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US.

Greece: the general election due to take place on 25 January 2015 is likely to bring a political party to power which is anti EU and anti austerity. However, if this eventually results in Greece leaving the Euro, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect effects of the likely strengthening of anti EU and anti austerity political parties throughout the EU is much more difficult to quantify. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries which have high unemployment rates. There are also major concerns as to whether the governments of France and Italy will effectively implement austerity programmes and undertake overdue reforms to improve national competitiveness. These countries already have political parties with major electoral support for anti EU and anti austerity policies. Any loss of market confidence in either of the two largest Eurozone economies after Germany would present a huge challenge to the resources of the ECB to defend their debt.

USA. The U.S. Federal Reserve ended its monthly asset purchases in October 2014. GDP growth rates (annualised) for Q2 and Q3 of 4.6% and 5.0% have been stunning and hold great promise for strong growth going forward. It is therefore confidently forecast that the first increase in the Fed. rate will occur by the middle of 2015.

China. Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has indicated a marginally lower outturn for 2014, which would be the lowest rate of growth for many years. There are also concerns that the Chinese leadership has only started to address an unbalanced economy which is heavily over dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

Japan. Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth to the extent that it has slipped back into recession in Q2 and Q3. The Japanese government already has the highest debt to GDP ratio in the world.

CAPITA ASSET SERVICES FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis. There is an increased risk that Greece could end up leaving the Euro but if this happens, the EZ now has sufficient fire walls in place that a Greek exit would have little immediate direct impact on the rest of the EZ and the Euro. It is therefore expected that there will be an overall managed, albeit painful and tortuous, resolution of any EZ debt crisis that may occur where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be weak at best for the next couple of years with some EZ countries experiencing low or negative growth, which will, over that time period, see an increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries, especially if growth disappoints and / or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a sharp resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK strong economic growth is weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- An adverse reaction by financial markets to the result of the UK general election in May 2015 and the economic and debt management policies adopted by the new government
- ECB either failing to carry through on recent statements that it will soon start quantitative easing (purchase of government debt) or severely disappointing financial markets with embarking on only a token programme of minimal purchases which are unlikely to have much impact, if any, on stimulating growth in the EZ.
- The commencement by the US Federal Reserve of increases in the central rate in 2015 causing a fundamental reassessment by investors of the relative risks of

holding bonds as opposed to equities, leading to a sudden flight from bonds to equities.

- A surge in investor confidence that a return to robust world economic growth is imminent, causing a flow of funds out of bonds into equities.

- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

APPENDIX 3: Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

SPECIFIED INVESTMENTS: All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' quality criteria where applicable.

NON-SPECIFIED INVESTMENTS: These are any investments which do not meet the specified investment criteria. A maximum of 70% will be held in aggregate in non-specified investment

A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories.

The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

Specified investments	**Minimum credit criteria / colour band**	**£ limit per institution**	**Max. maturity period**
DMADF – UK Government	N/A	unlimited	6 months
UK Government gilts	UK sovereign rating	unlimited	1 year
UK Government Treasury bills	UK sovereign rating	unlimited	1 year
Bonds issued by multilateral development banks	UK sovereign rating	unlimited	1 year
Money market funds	AAA	£15m	Liquid
Enhanced money market funds with a credit score of 1.25	AAA	£10m	Liquid
Enhanced money market funds with a credit score of 1.5	AAA	£10m	Liquid
Local authorities	N/A	£15m	1 year
CDs or term deposits with banks and building societies	Yellow Purple Blue Orange	£15m £15m £15m £10m	1 year

Non-specified investments	Minimum credit criteria / colour band	£ limit per institution	Max. maturity period
UK Government gilts	UK sovereign rating	unlimited	5 years
Bonds issued by multilateral development banks	UK sovereign rating	unlimited	5 years
Money market funds	AAA	£15m	Liquid
Enhanced money market funds with a credit score of 1.25	AAA	£10m	Liquid
Enhanced money market funds with a credit score of 1.5	AAA	£10m	Liquid
Local authorities	N/A	£15m	5 years
CDs or Term deposits with banks and building societies	Yellow Purple Blue Orange Red Green No Colour	unlimited £15m £15m £10m £10m £10m	Up to 5 years Up to 2 years Up to 1 year Up to 1 year Up to 6 Months Up to 100 days Not for use
Corporate bonds	AA- A-	£5m £2m	1 year

APPENDIX 4: Approved countries for investments

Based on lowest available rating

AAA

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Finland
- Hong Kong
- Netherlands
- U.K.
- U.S.A.

AA

- Abu Dhabi (UAE)
- France
- Qatar

AA-

- Belgium
- Saudi Arabia