Report to:

Audit & Governance Committee
Cabinet
Council

Report of Head of Finance

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Wards affected: all

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To:	AUDIT & GOVERNANCE COMMITTEE on	30 January 2013
	CABINET on	8 February 2013
	COUNCIL on	20 February 2013

Treasury management and investment strategy 2013/14

Recommendations

The committee recommends to cabinet and council:

1. To approve the treasury management strategy 2013/14 ;

2. To approve the prudential indicators and limits for 2013/14 to 2015/16 as set out in table 2, appendix A;

3. To approve annual investment strategy 2013/14 set out in appendix A and the lending criteria detailed in table 5.

That cabinet:

Considers any comments from committee and make any necessary amendments before recommending Council to approve the report.

Purpose of report

1. This report presents the council's Treasury Management Strategy (TMS) for 2013/14 to 2015/16 and sets out the expected treasury operations for this period. It comprises of four elements required by legislation as follows:

   - The prudential indicators required by the CIPFA Prudential Code for Capital Finance in Local Authorities (paragraph 8, table 2);
   - The treasury management strategy in accordance with the CIPFA Code of Practice on Treasury Management. This sets out how the council's treasury service will support capital investment decisions, and how the treasury management operates day to day. Its sets out the limitations on treasury management activity through prudential indicators, within which the council's treasury function must operate. The strategy is included as appendix A to the report (paragraphs 1-49);
   - The annual investment strategy. This sets out the council's criteria for selecting counterparties and limiting exposure to the risk of loss on its investments. This strategy is in accordance with the DCLG investment guidance and forms part of the treasury management strategy. (appendix A, paragraphs 20 – 49);
   - A statutory duty to approve a minimum revenue provision policy for 2013/14 (paragraphs 44-45).

   It is a requirement of the CIPFA 2011 Treasury Management Code that this report is approved by Full Council on an annual basis.

Strategic objectives

2. Effective treasury management is required in order to meet our strategic objective of managing our business effectively. Managing the finances of the authority in accordance with the treasury management strategy will help to ensure that resources are available to deliver its services and meet the council's other strategic objectives.

Background

3. Treasury management is the management of the council's 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.

4. The funding of the council's capital expenditure is also a function of treasury management. The capital programme provides a guide to the funding needs of the council and the long term cash flow plans to ensure that the council can meet its capital spending obligations.

5. The treasury management and annual investment strategy set out the council's policies for managing investments and confirms the council gives priority to the security and liquidity of those investments. It also includes the prudential indicators for the next three years; these demonstrate that the council's capital investment plans are affordable, prudent and sustainable.

6. The council's treasury management strategy 2013/14 to 2015/16 is attached in appendix A. Whilst every attempt has been made to minimise the technical content of this report, by its very nature and the need for compliance with associated guidance the report is technical in parts. A glossary of terms in annexe 6 should aid members understanding of some technical terms used in the report.

Recommended changes to the treasury management strategy

7. Council approved the 2012/13 treasury management strategy on 22 February 2012. The proposed strategy for 2013/14 includes the changes detailed below, which cabinet is asked to recommend to council:

   a) To raise the limit that can be invested in UK government backed institutions to £15 million.

   This change is proposed due to the limited number of counterparties available to the council as a result of so many credit rating down grades over the last year. The council had restricted lending to registered UK banks at an operational level whilst uncertainties continue in Europe. UK part nationalised banks have significant UK government ownership which provides assurance to investors of security.

   b) To extend the investment period with the council's own 'house bank the Co-operative Bank plc to three months duration and set a limit of £5 million.

   This change is proposed to allow greater flexibility in the management of short term investments. Current market conditions have produced a flat investment rate between one month and six months. There is no added value to be gain in investing in short term periods between three and six months. However, allowing investments to be made short term up to three months with the council's own bank will allow the flexibility to invest at the right time for periods from six months to one year.

   c) To provide the facility to invest £3 million in a pooled property fund.

   This change is proposed so that the council has the option to expand the current investments that are linked to property in the council's portfolio. This gives flexibility to improve investment spread across sectors and the option to reduce the amount or core cash invested directly in fixed cash deposits. The advantage of a pooled property fund is that it can be sold quickly for liquidity if required. Any such investment would only be made after a review of options available, in comparison with direct property investment options and after taking expert advice.

   d) To add a limit of £5 million for the investment in corporate bonds with a minimum AA- credit rating or equivalent.

   e) To add a limit of £3 million for investment in equities via a pooled fund.

   f) To provide a limit of £15 million for investment in managed bond funds.

   All of the changes proposed in (d) to (f) are to provide a facility for the council to use these types of investment category subject to the counter limits in the report in table 5 of appendix A. All of these categories have previously been set out within the specified and non specified criteria, however the changes now specify more detailed limits for each investment type. This will provide flexibility to spread investments over types and sectors. Any such investment would only be made after an assessment of risk and seeking advice from the council's treasury advisors.

g) To change the counterparty limits and maturity periods for investments with building societies as set out in table 5 of appendix A.

This change is proposed in order to improve the selection of building societies available for investing in the short term periods under one year. Security risk is managed in relation to the size of assets held by the building society and a reducing maturity period.

Financial implications and risk assessment

8. This report and all associated policies and strategies set out clearly the parameters the council must work within. It is important that the council follows the approved treasury management strategy which is designed to protect the council's finances by managing its risk exposure.

9. In the last few years investment income has fallen due to lower interest rates. In the medium term interest rates are expected to rise. The table below gives an estimate of the amounts available for investment, and the investment income achievable for the next four years.

Table 1: Medium term investment income forecast.

	2012/13	2013/14	2014/15	2015/16	2016/17
	£000's	£000's	£000's	£000's	£000's
Original budget 2012/13	417	669	993	1213	1213
Revised budget 2013/14 onwards	410	418	537	743	1129
Revised forecast for 2012/13	536	356	376	659	952
Forecast average interest rate	2.55%	1.50%	1.50%	2.25%	3.25%
Estimate of average investments	21,000	23,735	25,035	29,284	29,284

10. The 2013/14 budget setting report will take into account the latest projections of anticipated investment income.

Legal implications

11. There are no significant legal implications as a result of the recommendations in this report. Compliance with the CIPFA Code of Practice for Treasury Management in the Public Services, the ODPM Local Government Investment Guidance provides assurance that the council's investments are, and will continue to be, within its legal powers.

12. The council must approve any amendment to the treasury management strategy and annual investment strategy in accordance with the Local Government Act 2003 (the Act), the CIPFA Code of Practice for Treasury Management in the Public Services and the ODPM Local Government Investment Guidance under Section 15(1) (a) Local Government Act 2003 and CIPFA Prudential Code for Capital Finance.

Conclusion

13. This report provides details of the proposed changes to the treasury management strategy and the annual investment strategy for 2013/14 which are appended to this report, together with the prudential indicators for approval to council. These documents provide the parameters within which officers will operate the council's treasury management function.

Background papers

- CIPFA Treasury Management in the Public Services Code of Practice and Cross Sectoral Guidance Notes (revised 2011)
- ODPM Local Government Investment Guidance under Section 15(1)(a) Local Government Act 2003 and CIPFA Prudential Code for Capital Finance.
- Treasury Management Investment Strategy 2012/13 (cabinet 10 February 2012, council 22 February 2012)
- Amendments to the Treasury Management Strategy (Audit and Governance committee 11 July 2012)

Appendices

Appendix A	Treasury Management Strategy 2013/14 – 2015/16	
	Annex 1 economic condition	
	Annex 2	Prospects for interest rates
	Annex 3	Risk and performance benchmarking
	Annex 4	Property Investment policy
	Annex 5	Explanation of prudential indicators
	Annex 6	Glossary of terms

Appendix A

Treasury Management Strategy 2013/14- 2015/16

Introduction

1. The Local Government Act 2003 and supporting regulations require the council to 'have regard to' the CIPFA Prudential Code and to set Prudential Indicators for the next three years to ensure that the council's capital investment plans are affordable, prudent and sustainable.
2. The Act requires the council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance issued subsequent to the Act). This sets out the council's policies for managing its investments and for giving priority to the security and liquidity of those investments.
3. The strategy in respect of the following aspects of the treasury management function is based on treasury officers' views on interest rates, supplemented with market forecasts provided by the council's treasury advisor, Sector Treasury Services. The strategy covers:
    - Prudential and treasury indicators in force that will limit the treasury risk and activities of the council;
    - Current treasury position
    - Prospects for interest rates;
    - Borrowing strategy
    - Policy on borrowing in advance of need;
    - Investment strategy;
    - Counterparty selection and limits;
    - Policy on use of external service providers;
    - Minimum revenue Provision (MRP) statement;
    - Treasury management scheme of delegation and Section 151 role.

4. It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each year to include the revenue costs that flow from capital financing decisions. This means that increases in capital expenditure must be limited to a level where any increases in charges to revenue are from:
    - Increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
    - Any increases in running costs from new capital projects are identified and limited to a level which is affordable.

   A key requirement of this report is to explain the risks, and the management of those risks, associated with providing the treasury service. Legislation requires that as a minimum two further treasury reports are provided: a mid-year monitoring report and an outturn report after the year-end that reports on actual activity for the year.

Treasury Limits for 2013/14 to 2015/16

5. It is a statutory duty, under Section 3 of the Act and supporting regulations for the council to determine and keep under review how much it can afford to borrow. The amount so determined is called the “Affordable Borrowing Limit”. The Authorised Limit is the legislative limit specified in the Act.

6. The council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital expenditure remains within sustainable limits and in particular, that the impact upon its future council tax and council rent levels is ‘acceptable’.

7. The Authorised Limit is set on a rolling basis, for the forthcoming financial year and two successive financial years.

8. The following indicators set the parameters within which we manage the overall capital investment and treasury management functions. There are specific treasury activity limits, which aim to contain the activity of the treasury function in order to manage risk and reduce the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The limits are set out in table 2 below.

Cabinet is asked to recommend council to approve the limits:

Table 2: Prudential indicators

	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Debt	**£m**	**£m**	**£m**	**£m**
Authorised limit for external debt				
Borrowing	5	10	10	10
Other long term liabilities	0	5	5	5
	5	**15**	**15**	**15**
Operational boundary for external debt				
Borrowing	2	5	5	5
Other long term liabilities	.	.	.	.
	2	**5**	**5**	**5**
Interest rate exposures				
Maximum fixed rate borrowing	nil	100%	100%	100%
Maximum variable rate borrowing	nil	100%	100%	100%
Investments				
Interest rate exposures				
Limits on fixed interest rates	50	40	40	40
Limits on variable interest rates	10	30	30	30
Principal sums invested > 364 days				
Upper limit for principal sums invested >364 days	20	30	30	30

Current position

9. The council's investments at 31 December 2012 were as follows (excluding Landsbanki):

Table 3: maturity structure of investments at 31 December:	Total £000's	% holding
Call	9,200	26%
Money market fund	700	2%
Up to 4 months	12,000	34%
5-6 months	2,500	7%
6 months to 1 year	10,500	30%
Total investments	**34,900**	**100%**

10. The council currently holds all of its investments in the form of cash deposits, the majority of which have been placed for fixed terms with a fixed investment return.

Icelandic banks – Landsbanki

11. The council has now received £473,786 in respect of the claim for £1 million (plus interest due of £4,890) from the investment made with the failed Icelandic bank Landsbanki Islands hf. There have been three repayments to date. The Icelandic Supreme Court found in favour of UK local authorities to be paid before non-priority creditors and the council now expects to get back 100 per cent of the money deposited in Landsbanki.

Investment performance for the year to 31 December 2012.

12. The council's budgeted investment return for 2012/13 is £0.417 million, and the actual interest earned to date is shown as follows:

Table 4: Investment interest earned by investment type				
		Interest Earned		
Investment type	Annual Budget £000's	Actual to date £000's	Annual Forecast £000's	Forecast Variation £000's
Call accounts	177	36	41	(136)
Cash deposits	0	321	433	433
MMFs	0	6	6	6
Investec - Fund Mgmt	240	47	47	(193)
Total interest	**417**	**411**	**527**	**110**

Borrowing Strategy 2013/14 – 2015/16

13. The council has to provide details of its borrowing requirement, any maturing debt which will need to be re-financed, and the effect this will have on the treasury position over the next three years. This council has no external debt and does not expect to borrow long term to finance the current capital programme. The council will continue to take a prudent approach to its debt strategy. In general, the council will borrow for one of two purposes:

- To finance cash flow in the short-term;

- To fund capital investment over the medium to long term.

14. The prudential indicators and limits for debt are set out in table 2 and provide the scope and flexibility for the council to borrow in the short-term up to a maximum of £10 million, if such a need arose within the cash flow management activities of the authority, for the achievement of its service objectives. The council's capital investment plans do not currently demonstrate a need to borrow, as all projects are fully funded.

15. The bank rate is expected to remain at a historically low level for another year. This does provide a window of opportunity to review the strategy of undertaking external borrowing for new projects.

16. The treasury management strategy for the forthcoming year aims to efficiently manage the investment portfolio by reducing the amount of funds held extremely short-term for cash flow purposes and operating with an adequate but not excessive level of working capital. This optimum level is dictated by the accuracy of cash flow forecasts and, although unlikely, it is prudent to set a minimum level for the use of short-term borrowing arrangements or overdraft facilities if the cash flow forecasts prove inaccurate at any point in the year.

17. The head of finance, would in such instances take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above.

Policy on borrowing in advance of need

18. 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 value for money can be demonstrated and that the council can ensure the security of such funds. In determining if any borrowing will be undertaken in advance of need, the council will:

    - Consider the impact of borrowing in advance on investment cash balances and the exposure to counterparty risk. Any risk associated with any borrowing in advance of activity will be subject to prior appraisal and subsequent reporting through the mid year or annual reporting process.

Annual investment strategy

19. The main aim of the council's investment strategy is to maintain the security and liquidity of its investments, although the yield or return on the investment will be a consideration, subject to adequate security and liquidity. The council will ensure:

    - It has sufficient liquidity in its investments to cover cash flow. For this purpose it has set out parameters for determining the maximum periods for which funds may prudently be committed.

    - It maintains a policy covering the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security.

20. The strategy aims to provide a high degree of flexibility to take appropriate lending decisions, with a view to producing a portfolio with an even spread of maturity periods as and when institutional security and market confidence returns. This aim is to provide a more even and predictable investment return in the medium term.

21. The council's chief finance officer will ensure a counterparty list (a list of named institutions) is maintained in compliance with the recommended credit rating criteria (table 6) and will revise the criteria and submit any changes to the credit rating criteria to council for approval as necessary.

Investment types

22. The types of investment that the council can use are summarised below. These are split under the headings of specified and non-specified in accordance with the statutory guidance.

Specified investment instruments (maximum period 1 year)

- Deposits with banks and building societies
- Deposits with UK local authorities
- UK Government – treasury stock (Gilts) with less than one year to maturity
- Debt Management Agency Deposit Facility (DMADF)
- Money Market Funds (MMF) (AAA rated)
- Pooled Bond funds (AAAf rated)
- Certificates of deposits issued by banks and building societies

Non-specified investment instruments (maturities over one year)

- Bank and building society cash deposits up to 5 years
- Deposits with UK local authorities up to 5 years
- Corporate bonds
- Pooled property, bond funds and UK pooled equity funds
- UK treasury stock (Gilts) up to 10 years
- Supranational bonds up to 10 years
- Direct property investment

Other Non-specified investment instruments

- Fixed term deposits with variable rate and variable maturities
- Local Authority Mortgage Scheme (LAMS)

Approach to investing

23. The council holds approximately £15 million core cash balances which are available to invest for more than one year. This is expected to reduce over the medium term as the approved capital expenditure is carried out. In addition the council has funds which are available on a temporary basis to invest. These are held pending payment over to another body such as precept payments and council tax. The amount can vary between £8 million and £15 million throughout the year and can only be invested short term (under one year). Investments will be made primarily with reference to known cash flow requirements.

24. Whilst the current market uncertainties remain the council will aim to keep investments relatively short term, but where possible will continue to look for opportunities to fix lending in the medium term with highly rated institutions when possible for core cash balances. The aim is to increase the weighted average maturity of the portfolio in order to reduce maturity risk.

25. Officers will continue to implement an operational strategy which provides tight controls on the investments placed. As a result of a sharp decline in the number of acceptable counterparties, limits have been increased for higher rated counterparties. Where possible opportunities to spread the investment risk over different types of instruments will be considered.

26. Should market conditions deteriorate suddenly to the extent that the council is unable to place money with institutions with the necessary credit rating, it will make use of the UK Government deposit account (DMADF).

27. The property investment holdings will be kept under review to identify if further investments should be placed in these categories. Property funds will also be looked at in more detail for consideration. Further details on the property investment policy are contained in annex 4.

28. Money market funds are used for security and liquidity and to spread portfolio risk. The council will monitor our exposure to these funds in order to manage our security risk.

29. There will be no further investment using a fund manager at this time. However, this will be kept under review.

30. Bond funds can be used to diversify the portfolio, whilst maintaining liquidity and security. These will be considered and reviewed as an investment possibility to spread portfolio risk.

Counterparty selection

31. Treasury management risk is the risk of loss of capital to the council. To minimise this risk, the council uses credit rating information when considering who to lend to. Sector provides the council with credit rating updates from all three ratings agencies – Standard & Poors, Fitch and Moodys.

32. The council is also required to supplement the credit rating data with operational market information such as credit default swaps (CDS), negative watches and outlooks, which are considered when assessing the security of counterparties. This additional information is used so that the council does not rely solely on the current credit ratings of counterparties.

33. The council will not use the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine the creditworthy counterparties. This is because Moodys have become far more aggressive in allocating low ratings than the other two agencies. If followed, this approach would leave the council with so few institutions on its approved lending list it would be unworkable. The information provided by Sector uses a wider array of information than just primary ratings and does not give undue weight to any one agency's ratings. Credit information is updated and monitored weekly, supplemented by daily emails, which are consulted prior to making an investment decision. The council is alerted to any changes from all three agencies

through the use of data provided by Sector. If a downgrade results in the counterparty no longer meeting the council's minimum criteria, it will not be used for future investments. Movements in CDS and other market data is also reviewed on a weekly basis. Extreme market movements may result in a downgrade of an institution or removal from the council's lending list.

34. Where it is felt the council would benefit from utilising government guarantees provided by countries with an AAA rating, the council may lend to institutions covered by such guarantees. Any decision to lend in this way will be subject to consultation with and the agreement of the cabinet member responsible for finance.

Country and sector considerations

35. The council has determined that it will only use approved counterparties outside the UK from countries with a minimum sovereign credit rating of AAA from Fitch Ratings.

Counterparty limits

36. In the normal course of the council's cash flow operations it is expected that both specified and non-specified investments will be used for the control of liquidity as both categories allow for short term investments. The use of longer term instruments (greater than one year from inception to repayment) will fall in the non-specified investment category. These instruments will be used where the council's liquidity requirements are safeguarded. The council will lend to institutions that meet the following criteria:

Table 5: Counterparty Limits

Counterparty	Minimum Fitch Long term Rating (or equivalent)	Counterparty Limit £m	Max. maturity period	Maximum % of total investments
Institutions with a minimum rating:	F1+ / AA-	£10.0m	5 years	100%
Institutions with a minimum rating:	F1 / A-	£7.5m	1 year	80%
Institutions with a minimum rating:	F2/BBB	£5.0m	1 year	70%
Banks - part nationalised UK		£15.0m	3 years	100%
Banks - Eligible institutions	n/a	£5.0m	2 years	100%
Banks - house bank*	n/a	£5.0m	3 months	20%
Bank subsidiary - unconditional guarantee	as parent	as parent	as parent	n/a
Building societies - assets > £5000m	n/a	£5.0m	12 months	70%
Building societies - assets > £1000m	n/a	£3.5m	10 months	60%
Building societies - assets > £500m	n/a	£2.5m	9 months	50%
Building societies - assets > £250m	n/a	£2.0m	6 months	40%
Corporate Bonds	AA-	£5.0m	variable	40%
Money Market funds	AAA	£20.0m	liquid	100%
UK Government - gilts	UK sovereign	Unlimited	25 years	20%
UK Governmemt - DMADF	UK sovereign	Unlimited	6 months	100%
Local authorities , parish councils	n/a	£20.0m	25 years	20%
Supranationals	AAA	£10.0m	10 years	50%
Pooled property funds - CCLA	n/a	£3.0m	variable	10%
Share capital / Equities	n/a	£3.0m	variable	20%
Direct property investment	n/a	n/a	unlimited	80%
Managed Bond Funds	n/a	£15.0m	variable	70%

37. The criteria proposed for choosing counterparties provides a sound approach to investment in “normal” market circumstances. Whilst members are asked to approve the criteria in table 5, under the exceptional current market conditions the head of finance may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval. These restrictions will remain in place until the banking system returns to “normal” conditions.

Fund managers

38. The treasury management strategy allows for a total of up to £15.0 million portfolio to be invested with a fund manager. Fund managers can invest in a variety of investment types such as cash deposits, gilts and certificates of deposits. These types of funds can extend the spread of investment portfolio, access highly rated institutions and capitalise upon opportunities to improve returns, whilst maintaining liquidity. This is reviewed regularly, and at present it is not evident that the council can currently benefit from the service of a fund manager due to the market conditions. However, the situation will continue to be reviewed.

Risk and performance benchmarks

39. A requirement of the code is that security and liquidity benchmarks are considered and approved. This is in addition to yield benchmarks which are used to assess performance. The benchmarks are guidelines (not limits) so may be breached depending on the movement in interest rates and counterparty criteria. Their purpose is to allow officers to monitor the current trend position and amend the operational strategy depending on any changes. Any breach of the benchmarks will be reported, with an explanation in the mid year or annual report to audit and corporate governance committee. Detailed information for the assessment of risk is shown in annexe 3.

40. Performance indicators are set to assess the adequacy of the treasury function over the year. These are distinct historic performance indicators, as opposed to the predominantly forward looking prudential indicators. The indicators used to assess the performance of the treasury function are:

    - Investment returns above the 3 month LIBID rate.
    - Maximum investment of daily balances (in-house).
    - Maintenance of a balanced portfolio.

    The results of these indicators will be reported in both the annual mid-year and year-end treasury reports.

Policy on the use of treasury management advisers

41. The council has a joint contract for treasury management advisors with South Oxfordshire District Council. A three year contract was awarded to Sector Treasury Services Limited, a subsidiary of the Capita Group Plc in October 2011. The company provides a range of services which include:

    - technical support on treasury matters, capital finance issues member reports;
    - economic forecasts and interest rate analysis;
    - credit ratings / market information service involving the three main credit rating agencies;

- provision of credit rating information, strategic advice including a review of the investment and borrowing strategies and policy documents.

42. Following the collapse of the Icelandic banks, and the subsequent local authority exposure to these defaults, the revised CLG investment guidance notes and the CIPFA Treasury Code of Practice requires the council to recognise that responsibility for treasury management decisions remains with the council at all times and to ensure that undue reliance is not placed upon 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. .

Minimum revenue provision (MRP) statement 2013/14

43. The council is required to assess its MRP requirement for the year in accordance with the guidance of section 21 of the Act. MRP is only chargeable on outstanding capital liabilities. The council's MRP liability for 2013/14 is nil.

44. This will remain the case unless new capital expenditure is financed by borrowing.

Member and officer training

45. The requirement for increased member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for members and officers. In compliance with the revised code, the council has provided treasury management training to members on the 17th January 2012.

Treasury management scheme of delegation and the role of the section 151 officer

46.

I. **Council**
- Receiving and approval of reports on treasury management policies, practices and activities;
- Approval of annual strategy

II. **Audit and governance Committee / Cabinet**
- Approval of /amendments to the organisations adopted clauses, treasury management policy statements and treasury management practices;
- Receiving and reviewing monitoring reports and acting on recommendations;

III. **Section 151 Officer / Head of Finance**
- Recommending clauses, treasury management policies/practices for approval, review and monitoring compliance;
- Submitting regular treasury management information reports;
- Submitting budgets and budget variations;
- Reviewing the performance of the treasury management function;
- Ensuring adequacy of treasury management resources and skills and the effective division of responsibilities within the treasury management function;
- Ensuring the adequacy of internal audit and liaising with external audit;
- Approving the selection of external service providers and agreeing terms of appointment.

Summary

47. Prior to the beginning of each financial year the council must approve the treasury management strategy. The strategy sets the parameters within which officers can invest the council's surplus fund.

48. This strategy provides a commentary on the current financial climate and sets out the council's lending strategy in response to this.

Economic conditions and interest rate forecasts

49. In order to put the investment strategy into context it is necessary to consider the external factors in the financial markets and their impact on interest rate forecasts.

    Global economy – the outlook for the Eurozone (EZ) economy dominates the financial markets and will remain until fundamental issues over the structure of the currency in the EZ are resolved. Weak growth will also continue to be a key factor as this determines how much income will be generated in relation to each counties debt repayments. Thos has affected the UK economy which is likely to affect growth in 2013. The recession is now the worst and slowest recovery of any of the five recessions since 1930.
    UK economy - the Bank of England lowered its expectations for the speed of recovery and rate of growth in August. The growth in the UK economy remains weak and forecasts for growth have been reduced for the next two years. The governments austerity measures aimed at getting the public sector deficit under control in the next four years, now look as if they may not meet the original timeframe. The UK economy is growing at a reasonable pace but recession in the Eurozone, the UK's biggest trading partner, has lower growth.
    Currently the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world, as the UK is seen as safe haven from Euro zone debt.
    Economic growth – Economic growth has basically, flat lined since the election in 2010, and the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation quarterly report for August 2102. Quantitative Easing (QE) was increased again by £50bn in July 2102 to a total of £375bn.
    Unemployment – The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years in August 2012 and the numbers of unemployment benefit claimants have also been falling slightly.

    Inflation and Bank rate – Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. Inflation is expected to fall further to the 2% target level within the two year horizon.

    AAA rating – the UK's sovereign rating was recently reaffirmed, but warnings to review the position have been made if the government were to change the deficit reduction programme, or if the desired outcome was not being achieved. The status has provided a safe haven for investors.

    Sector's forward view

Economic forecasting remains difficult with so many influences affecting the UK. There does appear to be consensus among analysts that the economy remains fragile. Key areas of uncertainty include:

- The second Greek bailout package could cuase greater problems in EZ debt and a higher risk of breakdown of the EZ or even the currency itself;

- Intergovernment agreement on how to deal with the Eurozone crisis could fragment; the impact of the Eurozone crisis on financial markets and the banking sector;

- The impact of the UK governments austerity plan on confidence and growth and the need to rebalance the economy from services to exporting manufactured goods;

- The economic performance of the UK's trading partners in particular the EU and US as some analysts suggest that recession may return to both;

The overall balance of risks remains weighted to the downside. Many consumers, corporates and banks are still focused on reducing their borrowings rather than spending so will continue to actas a major headwind to a return to robust growth.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to high volumes of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes before the end of 2014 as very limited. There is potential for the start of the Bank Rate increases to be delayed further if growth disappoints.

The uncertain economic outlook has several key implications for treasury management:

- The sovereign debt issues provide a clear indication of higher counterparty risk.
- Investment returns are likely to remain low for 2013/14.
- Borrowing rates are attractive and may remain low for some time.

Prospects for interest rates

50. The bank base rate is forecast to remain unchanged at 0.5%, rising in Q4 in 2014. Sector's central view for bank rate forecasts is shown below:

	Bank of England base rate	PWLB borrowing rates (adjusted for certainty rate)		
		5 yr	25 yr	50 yr
Dec 2012	0.50%	1.50%	3.70%	3.90%
Dec 2013	0.50%	1.60%	3.80%	4.00%
Dec 2014	0.75%	2.00%	4.10%	4.30%

51. There are downside risks to these forecasts for example if economic growth remains weaker for longer than expected. However, there is also a risk that the pace of growth could pick up more quickly than expected if inflation exceeds the Bank of England's target rate of two per cent.

Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service.

These benchmarks are targets and so may be exceeded from time to time. Any variation will be reported, along with supporting reasons, in the Annual Treasury Report.

Yield. The local benchmark currently used to assess the performance of investments for the in-house team and the fund manager is the level of returns contrasted against the London Interbank Bid (LIBID) 3 month rate. This is the interest rate a bank would be willing to pay to borrow from another bank for seven days.

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Previously, however, they have not been set out separately and explicitly for member consideration. Proposed benchmarks for the cash investments are below and these will form the basis for future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

Much of the CLG and CIPFA guidance is aimed at a relatively large authority with both borrowing and investments spread over a number of years. As an indication of this, worked examples from Sector assume investments of £50 million spread over 5 years.

Liquidity. Liquidity is defined as the council "having adequate, though not excessive, cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). The in-house team keeps a daily cash-flow forecast and would only have an unseen requirement if (for example) a large receipt was received later than expected. In such a scenario, short term borrowing would be considered to cover the period of delay. In respect of this area the Council seeks to maintain:

- Bank overdraft – there is no routine overdraft facility but in an emergency we could overdraw with our transactional bankers for a short period.
- Liquid short term deposits of at least £500,000 available on instant access.

The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the weighted average life (WAL) of the portfolio – a shorter WAL would generally embody less risk. In this respect the proposed benchmark is to be used:

- WAL benchmark is expected to be **150** days, with a maximum of **360** days**.**

Security of the investments. In the context of benchmarking, assessing security is very much more a subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard and Poor's). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy. The table beneath shows average defaults for differing periods of investment grade products for each Fitch long term rating category over the period 1990 to 2007.

Average defaults for differing periods of investment

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.00%	0.00%	0.00%	0.00%	0.00%
AA	0.00%	0.00%	0.00%	0.03%	0.06%

A	0.03%	0.15%	0.30%	0.44%	0.65%
BBB	0.24%	0.78%	1.48%	2.24%	3.11%

The council's minimum long term rating criteria is currently "A-" meaning the average expectation of default for a one year investment in a counterparty with an "A" long term rating would be 0.03% of the total investment (e.g. for a £1m investment the average loss would be £300). This is only an average - any specific counterparty loss is likely to be higher - but these figures do act as a proxy benchmark for risk across the portfolio. As mentioned above, the in-house team rarely make an investment in excess of 1 year and most are considerably shorter. Further development of this approach is required to see if this methodology is suitable for a portfolio of mostly short-term investments.

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

- **0.03%** historic risk of default when compared to the whole portfolio. (i.e. equivalent to £300 on £1 million)

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to members in the both the Investment Mid-Year report and the Investment Annual report. As this data is collated, trends and analysis will be collected and reported. Where a counterparty is not credit rated a proxy rating will be applied.

Annex 4

Property Investment Policy

1.0 The case for property

1.1 The Council is restricted in the different investment vehicles it is legally allowed to invest in notwithstanding the over-riding need for prudence mentioned earlier. Of the few avenues open one is property and the returns from investing in property have generally been, and currently are, greater than the limited opportunities in the money markets.

1.2 In broad terms the returns are greater because the risks are greater. Factors to be taken into account when deciding the principle of investing in property include:

- investment will be for the long term since it may not be possible, or wise, to sell quickly,
- the costs of acquisition and disposal are higher,
- there are management costs, risk of rent default and failure to honour maintenance agreements,
- different types of property and different areas carry different risks,
- generally property tends to appreciate in value, although this will vary by type and area; however, in some cases the value may go down,
- property can become functionally obsolete necessitating major refurbishment,
- without regular repair and maintenance the condition will deteriorate and the responsibility for repairs/maintenance may not always rest with the tenant,
- certain types of property may become less desirable as time goes by; this can make re-letting difficult or attract a lower calibre of tenant.

2.0 How much to invest?

2.1 The in-house cash holdings are currently adequate for cash-flow management purposes (operational capital). £34 million is invested in property and £30 million is invested in treasury investments. The investment in property currently represents 53% of the total figure.

Policy 1. The maximum percentage of the investment portfolio in property should be 80% of the total, and the cash funds invested (i.e. not held for cash-flow purposes) should not fall below £10 million.

3.0 What type of property?

3.1 There are different types of property investment with assessment of prospects as follows:

i)	shops and offices	good - although may be subject to changing fashions and working practices
ii)	industrial	good but condition can be variable
iii)	leisure	good but may be best avoided since too close to our “core” business

iv)	agricultural	moderate but too risky now
v)	woodland	poor – some is owned for environmental/leisure purposes

3.2 Average Yield Levels (%). In general, property can be categorised as prime, secondary or tertiary in terms of its desirability. 'Rack-rented' means that the maximum market rental achievable is being received. Yield derives from both capital and rent. Lower yields can indicate that the investment attracts a lower degree of risk due to the ratio of rent to capital and other factors such as location, security and regularity of income.

Policy 2. In general, properties for investment will be from the categories: retail, offices, industrial land and buildings.

4.0 Where should it be located?

4.1 There are compelling legal, cultural and financial reasons for not investing in the European mainland at the moment. Within the UK the location will influence the return and the type of property and may make management more or less difficult depending on distance from the Council offices.

Policy 3. **Only property located in the UK will be considered.**

5.0 What level of financial return?

5.1 As mentioned above, generally the greater the return, the greater the risk inherent in the investment. There are so many variables involving area, management, condition, leases and the varying return on other investments that it is difficult to draw up hard and fast rules about them and their relationship with the rate of return.

Policy 4. With regard to the rate of return, each proposal will be considered on its merits.

6.0 Review

6.1 The Policy to be reviewed annually (along with the Treasury Management Strategy).

Explanation of Prudential Indicators

Central government control of borrowing was ended and replaced with Prudential borrowing by the Local Government Act 2003. Prudential borrowing permitted local government organisations to borrow to fund capital spending plans provided they could demonstrate their affordability. Prudential indicators are the means to demonstrate affordability.

Capital expenditure – shows last year's spending, this year's projected spending and the approved programme until 2014/15.

Ratio of financing costs to net revenue stream – because the council has no net debt investment interest on reserves and balances makes a positive contribution to the council's finances.

Net borrowing requirement – this demonstrates that no borrowing is planned to fund the capital programme.

In year capital financing requirement – this shows the council has no borrowing.

Capital financing requirement (CFR) as at 31 March – the CFR shows the underlying need of the council to borrow for capital purposes as determined from the balance sheet. The overall CFR of £93.018m shows that there is no need to borrow.

Incremental impact of capital investment decisions – increase in Council Tax (band D) per annum – this indicator shows the affect of the latest capital programme report on annual council tax. This indicator is based on the estimated decrease or increase in interest payable to the General Fund each year due to the changed funding of the capital programme in the latest capital report to December 2011 cabinet.

Incremental impact of capital investment decisions – This indicator shows the affect of the latest capital programme report on revenue. This indicator is based on the estimated decrease or increase in interest payable to the funding of the capital programme. As the council has no debt this indicator is not relevant.

Authorised limit for external debt – this is the maximum limit for external borrowing. This is the statutory limit determined under section 3(1) of the Local Government Act 2003. This limit is set to allow sufficient headroom for day to day operational management of cash flows.

Operational boundary for external debt – this is set as the more likely amount that may be required for day to day cash flow. This has an amount included to allow for cash flow borrowing associated with the canal project.

Upper limit for fixed and variable interest rate exposure – these limits allow the council flexibility in its investment and borrowing options.

Upper limit for total principal sums invested for over 364 days – the amount it is considered can be prudently invested for periods in excess of a year.

GLOSSARY OF TERMS

Basis Point (BP)	1/100th of 1%, i.e. 0.01%
Base Rate	Minimum lending rate of a bank or financial institution in the UK.
Benchmark	A measure against which the investment policy or performance of a fund manager can be compared.
Bill of Exchange	A financial instrument financing trade.
Callable Deposit	A deposit placed with a bank or building society at a set rate for a set amount of time. However, the borrower has the right to repay the funds on pre agreed dates, before maturity. This decision is based on how market rates have moved since the deal was agreed. If rates have fallen the likelihood of the deposit being repaid rises, as cheaper money can be found by the borrower.
Cash Fund Management	Fund management is the management of an investment portfolio of cash on behalf of a private client or an institution, the receipts and distribution of dividends and interest, and all other administrative work in connection with the portfolio.
Certificate of Deposit (CD)	Evidence of a deposit with a specified bank or building society repayable on a fixed date. They are negotiable instruments and have a secondary market; therefore the holder of a CD is able to sell it to a third party before the maturity of the CD.
Commercial Paper	Short-term obligations with maturities ranging from 2 to 270 days issued by banks, corporations and other borrowers. Such instruments are unsecured and usually discounted, although some may be interest bearing.
Corporate Bond	Strictly speaking, corporate bonds are those issued by companies. However, the term is used to cover all bonds other than those issued by governments in their own currencies and includes issues by companies, supranational organisations and government agencies.
Counterparty	Another (or the other) party to an agreement or other market contract (e.g. lender/borrower/writer of a swap/etc.)
CDS	Credit Default Swap – a swap designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.
CFR	Capital Financing Requirement.
CIPFA	Chartered Institute of Public Finance and Accountancy.
CLG	Department for Communities and Local Government.
Derivative	A contract whose value is based on the performance of an underlying financial asset, index or other investment, e.g. an option is a derivative because its value changes in relation to the performance of an underlying stock.
DMADF	Deposit Account offered by the Debt Management Office, guaranteed by the UK government.
ECB	European Central Bank – sets the central interest rates in the EMU area. The ECB determines the targets itself for its interest rate setting policy; this is the keep inflation within a band of 0 to 2%. It does not accept that monetary policy is to be used to manage

	fluctuations in unemployment and growth caused by the business cycle.
Equity	A share in a company with limited liability. It generally enables the holder to share in the profitability of the company through dividend payments and capital gain.
Forward Deal	The act of agreeing today to deposit funds with an institution for an agreed time limit, on an agreed future date, at an agreed rate.
Forward Deposits	Same as forward dealing (above).
Fiscal Policy	The government policy on taxation and welfare payments.
GDP	Gross Domestic Product.
Gilt	Registered British government securities giving the investor an absolute commitment from the government to honour the debt that those securities represent.
Money Market Fund	A well rated, highly diversified pooled investment vehicle whose assets mainly comprise of short-term instruments. It is very similar to a unit trust, however in a MMF.
Monetary Policy Committee (MPC)	Government body that sets the bank rate (commonly referred to as being base rate). Their primary target is to keep inflation within plus or minus 1% of a central target of 2.5% in two years time from the date of the monthly meeting of the committee. Their secondary target is to support the government in maintaining high and stable levels of growth and employment.
Other Bond Funds	Pooled funds investing in a wide range of bonds.
PWLB	Public Works Loan Board.
QE	Quantitative Easing.
Retail Price Index	Measurement of the monthly change in the average level of prices at the retail level weighted by the average expenditure pattern of the average person.
Sovereign Issues (Ex UK Gilts)	Bonds issued or guaranteed by nation states, but excluding UK government bonds.
Supranational Bonds	Bonds issued by supranational bodies, e.g. European Investment Bank. The bonds – also known as Multilateral Development Bank bonds – are generally AAA rated and behave similarly to gilts, but pay a higher yield (“spread”) given their relative illiquidity when compared with gilts.
Treasury Bill	Treasury bills are short-term debt instruments issued by the UK or other governments. They provide a return to the investor by virtue of being issued at a discount to their final redemption value.