# TREASURY MANAGEMENT STRATEGY STATEMENT, MINIMUM REVENUE PROVISION POLICY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2016/17

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| To: | **Governance & Audit Committee – 9th December 2015** |
| Main Portfolio Area: | **Financial Services and Estates** |
| By: | **Portfolio Holder for Financial Services and Estates** |
| Classification: | **Unrestricted** |


**Summary:** **This report is to provide the Governance & Audit Committee with the proposed Treasury Management Strategy Statement, Minimum Revenue Provision Policy Statement and Annual Investment Strategy for 2016/17 for approval.**


**<u>For Decision</u>**

## 1 INTRODUCTION

### 1.1 Background

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.

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.

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."

## 1.2 Reporting requirements

The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals.

**Prudential and treasury indicators and treasury strategy** (this report) - The first, and most important report covers:

- the capital plans (including prudential indicators);
- a minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
- the treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

**A mid year treasury management report –** This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision.

**An annual treasury report –** This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

**Scrutiny**
The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Governance and Audit Committee.

## 1.3 Treasury Management Strategy for 2016/17

The strategy for 2016/17 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.

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

### 1.4 Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. Training was last undertaken by members on 21 September 2015 and further training will be arranged as required.

The training needs of treasury management officers are periodically reviewed.

### 1.5 External service providers

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

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

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

The Council uses the ICD Portal to invest or redeem trades in its Money Market Funds (MMFs). The portal provides advanced reporting tools so that the authority can assess its exposure to certain banks or countries.

Some investments via the ICD portal are made via JP Morgan who act as a clearing house for six of the nine MMFs the Council currently uses. The clearing house allows the authority to make several investments in different MMFs but only requires one payment to the clearing house, therefore saving the authority costs in CHAPS fees.

## 2 THE CAPITAL PRUDENTIAL INDICATORS 2016/17 – 2018/19

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

### 2.1 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 £m | 2014/15 Actual | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|---|
| Non-HRA | 8.184 | 21.701 | 4.332 | 3.586 | 1.682 |
| HRA | 7.149 | 16.672 | 11.681 | 3.615 | 3.495 |
| **Total** | 15.333 | 38.373 | 16.013 | 7.201 | 5.177 |

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 £m | 2014/15 Actual | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|---|
| Non-HRA | 8.184 | 21.701 | 4.332 | 3.586 | 1.682 |
| HRA | 7.149 | 16.672 | 11.681 | 3.615 | 3.495 |
| **Total** | 15.333 | 38.373 | 16.013 | 7.201 | 5.177 |
| **Financed by:** | | | | | |
| Capital receipts | 0.199 | 4.103 | 1.995 | 0.332 | 0.155 |
| Capital grants | 5.324 | 13.651 | 2.012 | 2.268 | 1.277 |
| Capital reserves | 5.525 | 7.948 | 4.739 | 3.350 | 2.970 |
| Revenue | 1.940 | 2.346 | 1.753 | 0.525 | 0.525 |
| **Net financing need for the year** | **2.345** | **10.325** | **5.514** | **0.726** | **0.250** |

Other long term liabilities: The above financing need excludes other long term liabilities, such as PFI and leasing arrangements which already include borrowing instruments.

## 2.2 The Council's borrowing need (the Capital Financing Requirement)

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.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each assets life.

The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council had £4.259m of long term liabilities (excluding pensions) as at 31 March 2015.

The Council is asked to approve the CFR projections below:

| £m | 2014/15 Actual | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|---|
| **Capital Financing Requirement** | | | | | |
| CFR – non housing | 22.390 | 28.306 | 28.856 | 28.200 | 26.999 |
| CFR – housing | 20.874 | 23.607 | 27.282 | 27.282 | 26.454 |
| **Total CFR** | **43.264** | **51.913** | **56.138** | **55.482** | **53.453** |
| **Movement in CFR** | **1.492** | **8.649** | **4.225** | **(0.656)** | **(2.029)** |

| | | | | | |
|---|---|---|---|---|---|
| **Movement in CFR represented by** | | | | | |
| Net financing need for the year (above) | 2.345 | 10.325 | 5.514 | 0.726 | 0.250 |
| Less HRA – loan repayments and downward revaluations* | 0.000 | (0.828) | 0.000 | 0.000 | (0.828) |
| Less MRP/VRP and other financing movements | (0.853) | (0.848) | (1.289) | (1.382) | (1.451) |
| **Movement in CFR** | **1.492** | **8.649** | **4.225** | **(0.656)** | **(2.029)** |

**The CFR treatment of downward revaluations to HRA non-current assets is under review by the Department of Communities and Local Government (requiring both Ministerial and Treasury approval) and accordingly is subject to change.*

### 2.3 Minimum revenue provision (MRP) policy statement

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

CLG 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:

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.

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.

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).

Repayments included in annual PFI or finance leases are applied as MRP.

### 2.4 Core funds and expected investment balances

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

| Year End Resources £m | 2014/15 Actual | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|---|
| Fund balances / reserves | 2.011 | 2.011 | 2.011 | 2.011 | 2.011 |
| Capital receipts | 0.199 | 4.103 | 1.995 | 0.332 | 0.155 |
| Earmarked reserves | 9.511 | 3.770 | 3.242 | 3.242 | 3.242 |
| **Total core funds** | **11.721** | **9.884** | **7.248** | **5.585** | **5.408** |
| Balances incl working capital* | 37.781 | 32.284 | 31.957 | 31.608 | 31.144 |
| Under/over borrowing | 8.346 | 12.284 | 11.957 | 11.608 | 11.144 |
| **Expected investments** | **29.435** | **20.000** | **20.000** | **20.000** | **20.000** |

*Working capital balances shown are estimated year end; these may be different mid-year.

### 2.5 Affordability prudential indicators

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:

### 2.6 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.

| % | 2014/15 Actual | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|---|
| Non-HRA | 4.7% | 6.6% | 10.2% | 10.9% | 11.3% |
| HRA | 5.7% | 6.9% | 8.3% | 8.3% | 8.4% |

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

## 2.7 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.

**Incremental impact of capital investment decisions on the band D council tax**

| £ | 2014/15 Actual | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|---|
| **Council tax - band D *** | (4.45) | (4.53) | 5.07 | 9.23 | 38.79 |

**The 2018/19 estimate is higher than the other years because, being the final year estimate, there is no comparison shown in the Treasury Management Strategy Statement for last year. In other words, the incremental 2018/19 estimate reflects the full cost of the 2018/19 capital programme. The main element of the 2018/19 estimate is the Minimum Revenue Provision charge.*

## 2.8 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.

**Incremental impact of capital investment decisions on housing rent levels**

| £ | 2014/15 Actual | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|---|
| **Weekly housing rent levels *** | (0.18) | (0.05) | 0.00 | 0.02 | 0.47 |

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

**The 2018/19 estimate is higher than the other years because, being the final year estimate, there is no comparison shown in the Treasury Management Strategy Statement for last year. In other words, the incremental 2018/19 estimate reflects the full cost of the 2018/19 capital programme.*

### 2.9 HRA ratios

| £ | 2014/15 Actual | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|---|
| **HRA debt £m** | 20.869 | 23.602 | 27.277 | 27.276 | 26.448 |
| **HRA rents £m** | 12.941 | 13.294 | 13.259 | 13.134 | 13.014 |
| **Ratio of debt to rents %** | 161.3% | 177.5% | 205.7% | 207.7% | 203.2% |

| £ | 2014/15 Actual | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|---|
| **HRA debt £m** | 20.869 | 23.602 | 27.277 | 27.276 | 26.448 |
| **Number of HRA dwellings** | 3,034 | 3,051 | 3,063 | 3,075 | 3,087 |
| **Debt per dwelling £** | 6,878 | 7,736 | 8,905 | 8,870 | 8,568 |

## 3 BORROWING

The capital expenditure plans set out in Section 2 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 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 approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

### 3.1 Current portfolio position

The Council's treasury portfolio position at 1 April 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.

| £m | 2014/15 Actual | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|---|
| **External Debt** | | | | | |
| Debt at 1 April | 27.252 | 30.659 | 35.710 | 40.602 | 40.635 |
| Expected change in Debt | 3.407 | 5.051 | 4.892 | 0.033 | (1.225) |
| Other long-term liabilities (OLTL) at 1 April | 3.900 | 4.259 | 3.919 | 3.579 | 3.239 |
| Expected change in OLTL | 0.359 | (0.340) | (0.340) | (0.340) | (0.340) |
| **Actual gross debt at 31 March** | **34.918** | **39.629** | **44.181** | **43.874** | **42.309** |
| The Capital Financing Requirement | 43.264 | 51.913 | 56.138 | 55.482 | 53.453 |
| **Under / (over) borrowing** | **8.346** | **12.284** | **11.957** | **11.608** | **11.144** |

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 2016/17 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Section 151 Officer reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

### 3.2 Treasury Indicators: limits to borrowing activity

**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 £m | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|
| Debt | 42.000 | 46.000 | 46.000 | 46.000 |
| Other long term liabilities | 12.000 | 12.000 | 12.000 | 12.000 |
| Total | 54.000 | 58.000 | 58.000 | 58.000 |

**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.

1. 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.
2. The Council is asked to approve the following authorised limit:

| Authorised limit £m | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|
| Debt | 47.000 | 51.000 | 51.000 | 51.000 |
| Other long term liabilities | 15.000 | 15.000 | 15.000 | 15.000 |
| Total | 62.000 | 66.000 | 66.000 | 66.000 |

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

| HRA Debt Limit £m | 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|---|
| HRA debt cap* | 27.792 | 27.792 | 27.792 | 27.792 |
| HRA CFR | 23.607 | 27.282 | 27.282 | 26.454 |
| HRA headroom | 4.185 | 0.510 | 0.510 | 1.338 |

***It has been determined that the HRA debt cap can increase for capital expenditure incurred between 1 April 2016 and 31 March 2017 on certain HRA projects up to a limit of £1.115m.*

### 3.3 Capita's economic and interest rate forecast (issued by Capita on 11 November 2015)

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 the Capita central view.

| Capita Asset Services Interest Rate View | Dec-15 | Mar-16 | Jun-16 | Sep-16 | Dec-16 | Mar-17 | Jun-17 | Sep-17 | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Capita Asset Services View | 0.50% | 0.50% | 0.75% | 0.75% | 1.00% | 1.00% | 1.25% | 1.50% | 1.50% | 1.75% | 1.75% | 2.00% | 2.00% | 2.00% |
| 5yr PWLB Rate | 2.30% | 2.40% | 2.60% | 2.70% | 2.80% | 2.80% | 2.90% | 3.00% | 3.20% | 3.30% | 3.40% | 3.50% | 3.50% | 3.60% |
| 10yr PWLB View | 2.90% | 3.00% | 3.10% | 3.20% | 3.30% | 3.40% | 3.50% | 3.60% | 3.70% | 3.80% | 3.90% | 4.00% | 4.10% | 4.10% |
| 25yr PWLB View | 3.60% | 3.70% | 3.80% | 3.90% | 4.00% | 4.10% | 4.10% | 4.20% | 4.30% | 4.30% | 4.40% | 4.40% | 4.40% | 4.50% |
| 50yr PWLB Rate | 3.50% | 3.60% | 3.70% | 3.80% | 3.90% | 4.00% | 4.00% | 4.10% | 4.20% | 4.20% | 4.30% | 4.30% | 4.30% | 4.40% |

**UK:** UK Gross Domestic Product (GDP) growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any Group of 7 (G7) country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, probably being second to the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y) before weakening again to +0.5% (2.3% y/y) in quarter 3. The November Bank of England Inflation Report included a forecast for growth to remain around 2.5 – 2.7% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that Consumer Price Index (CPI) inflation has fallen to, or near to, zero since February 2015. Investment expenditure is also expected to support growth. However, since the August Inflation report was issued, worldwide economic statistics have distinctly weakened and the November Inflation Report flagged up particular concerns for the potential impact on the UK.

The Inflation Report was notably subdued in respect of the forecasts for inflation; this was expected to barely get back up to the 2% target within the 2-3 year time horizon. However, once the falls in oil, gas and food prices over recent months fall out of the 12 month calculation of CPI, there will be a sharp tick up from the current zero rate to around 1 percent in the second half of 2016. The increase in the forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon was the biggest since February 2013. There is considerable uncertainty around how quickly inflation will rise in the next few years and this makes it difficult to forecast when the Monetary Policy Committee (MPC) will decide to make a start on increasing Bank Rate.

**USA**: The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015, but then weakened again to 1.5% in quarter 3. The downbeat news in late August and in September about Chinese and

Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Federal Reserve's (Fed.) decision at its September meeting to pull back from a first rate increase. However, the nonfarm payrolls figure for growth in employment in October was very strong and, together with a likely perception by the Fed. that concerns on the international scene have subsided, has now firmly opened up the possibility of a first rate rise in December.

**Eurozone:** In the Eurozone, in January 2015 the European Central Bank (ECB) unleashed a massive €1.1 trillion programme of quantitative easing (QE) to buy up high credit quality government and other debt of selected Eurozone (EZ) countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

**Greece:** During July, Greece finally capitulated to EU demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.

- Investment returns are likely to remain relatively low during 2016/17 and beyond;
- Borrowing interest rates have been highly volatile during 2015 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. Gilt yields have continued to remain at historically phenominally low levels during 2015. The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt;
- 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.

### 3.4 Borrowing strategy

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

Against this background and the risks within the economic forecast, caution will be adopted with the 2016/17 treasury operations. The Section 151 Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

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

- *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from a greater than expected increase in the anticipated rate to US tapering of asset purchases, or in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are still lower than they will be in the next few years.

  Any decisions will be reported to the appropriate decision making body at the next available opportunity.

**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.

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

| £m | 2016/17 | 2017/18 | 2018/19 |
|---|---|---|---|
| **Interest rate exposures** | | | |
| | **Upper** | **Upper** | **Upper** |
| Limits on fixed interest rates:<br>• Debt only<br>• Investments only | <br><br>66.000<br>45.000 | <br><br>66.000<br>45.000 | <br><br>66.000<br>45.000 |
| Limits on variable interest rates<br>• Debt only<br>• Investments only | <br><br>66.000<br>45.000 | <br><br>66.000<br>45.000 | <br><br>66.000<br>45.000 |

| Maturity structure of fixed interest rate borrowing 2016/17 | | |
|---|---|---|
| | **Lower** | **Upper** |
| Under 12 months | 0% | 50% |
| 12 months to under 2 years | 0% | 50% |
| 2 years to under 5 years | 0% | 50% |
| 5 years to under 10 years | 0% | 55% |
| 10 years to under 20 years | 0% | 50% |
| 20 years to under 30 years | 0% | 50% |
| 30 years to under 40 years | 0% | 50% |
| 40 years to under 50 years | 0% | 50% |
| 50 years and above | 0% | 50% |

### 3.5 Policy on borrowing in advance of need

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

The Council has some flexibility to borrow funds this year for use in future years. The Section 151 Officer may do this under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed rates will be economically beneficial or meet budgetary constraints. Whilst the Section 151 Officer will adopt a cautious approach to any such borrowing, where there is a clear business case for doing so borrowing may be undertaken to fund the approved capital programme or to fund future debt maturities.

Borrowing in advance will be made within the constraints that:

- The authority would not look to borrow more than 18 months in advance of need.

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.

### 3.6 Debt rescheduling

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).

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).

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.

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

### 3.7 Municipal Bond Agency

It is likely that the Municipal Bond Agency, currently in the process of being set up, will be offering loans to local authorities in the near future. It is also hoped that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). This Authority intends to make use of this new source of borrowing as and when appropriate.

## 4 ANNUAL INVESTMENT STRATEGY

### 4.1 Changes in credit rating methodology

The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. Commencing in 2015, in response to the evolving regulatory regime, all three agencies have begun removing these "uplifts" with the timing of the process determined by regulatory progress at the national level. The process has been part of a wider reassessment of methodologies by each of the rating agencies. In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A consequence of these new methodologies is that they have also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

In keeping with the agencies' new methodologies, the credit element of Capita's own credit assessment process now focuses solely on the Short and Long Term ratings of an institution. While this is the same process that has always been used by Standard & Poor's, this has been a change to the use of Fitch and Moody's ratings. It is important to stress that the other key elements to Capita's process, namely the assessment of Rating Watch and Outlook information as well as the Credit Default Swap (CDS) overlay have not been changed.

The evolving regulatory environment, in tandem with the rating agencies' new methodologies also means that sovereign ratings are now of lesser importance in the assessment process. Where through the crisis, Capita clients typically assigned the highest sovereign rating to their criteria the new regulatory environment is attempting to break the link between sovereign support and domestic financial institutions. While this authority understands the changes that have taken place, it does specify a minimum sovereign rating of AA- for non-UK deposit counterparties. This is in relation to the fact that the underlying domestic and where appropriate, international, economic and wider political and social background will still have an influence on the ratings of a financial institution.

It is important to stress that these rating agency changes do not reflect any changes in the underlying status or credit quality of the institution, merely a reassessment of their methodologies in light of enacted and future expected changes to the regulatory environment in which financial institutions operate. While some banks have received lower credit ratings as a result of these changes, this does not mean that they are suddenly less credit worthy than they were formerly. Rather, in the majority of cases, this mainly reflects the fact that implied sovereign government support has effectively been withdrawn from banks. They are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In fact, in many cases, the balance sheets of banks are now much more robust than they were before the 2008 financial crisis when they had higher ratings than now. However, this is not universally applicable, leaving some entities with modestly lower ratings than they had through much of the “support” phase of the financial crisis.

## 4.2 Investment policy

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, then return.

In accordance with the above guidance from the CLG 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. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

Ratings will not be the sole determinant of the quality of an institution; 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.

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.

Investment instruments identified for use in the financial year are listed in section 5 under the ‘specified’ and ‘non-specified’ investments categories. Counterparty limits will be as set through the Council’s treasury management practices.

## 4.3 Creditworthiness policy

The primary principle governing the Council’s investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle, the Council will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections below; and

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

The Section 151 Officer will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

Credit rating information is supplied by Capita Asset Services our treasury consultants, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance, a negative rating watch applying to a counterparty at the minimum Council criteria may be suspended from use, with all others being reviewed in light of market conditions.

The criteria for providing a pool of high quality investment counterparties (both specified and non-specified investments) is:

- Banks 1 - good credit quality – the Council will only use banks which:
    i. are UK banks; and/or
    ii. are non-UK and domiciled in a country which has a minimum sovereign long term rating of AA-

  and have, as a minimum, the following credit rating from at least one of Fitch, Moody's and Standard and Poors (where rated):
    i. Short term – F1 (or equivalent)
    ii. Long term – A (or equivalent)
- Banks 2 – Part nationalised UK banks – Royal Bank of Scotland Group. This bank can be included if it continues to be part nationalised or it meets the above criteria.
- Banks 3 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- Bank subsidiary and treasury operations - The Council will use these where the parent bank has the necessary ratings outlined above.
- Building societies: The Council will use all societies which meet the ratings/criteria for banks outlined above.
- Money market funds (including enhanced money market funds) – AAA
- UK Government (including gilts and the DMADF)

- Local authorities, parish councils, community councils, companies controlled by the Council (either alone or with other Local Authorities) etc
- Supranational institutions

A limit of £5m will be applied to the use of investments with a maturity of over 364 days but not more than 370 days.

**Use of additional information other than credit ratings.** Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

**Time and monetary limits applying to investments.** The time and monetary limits for institutions on the Council's counterparty list are as follows (these will cover both specified and non-specified investments):

| | Fitch Long Term Rating (or equivalent)* | Money Limit | Time Limit |
|---|---|---|---|
| **Higher quality** | **AA-** | **£6m per institution** | **370 days** |
| **Medium quality** | **A** | **£5m per institution** | **370 days** |
| **Part nationalised** | **N/A** | **£7m per institution** | **370 days** |
| **Debt Management Account Deposit Facility** | **AAA** | **unlimited** | **6 months** |
| **Money market Funds (including enhanced money market funds)** | **AAA** | **£6m per fund** | **370 days** |
| **Local authorities, parish councils, community councils, companies controlled by the Council (either alone or with other Local Authorities), Supranational institutions etc** | **N/A** | **£4m per institution** | **370 days** |

**The institution must have this minimum credit rating from at least one of Fitch, Moody's, and Standard and Poors (where rated).*

The proposed criteria for specified and non-specified investments are shown in section 5 for approval.

## 4.4 Country and sector limits

Due care will be taken to consider the country, group and sector exposure of the Council's investments.

The Council has determined that it will only use approved counterparties from the UK (irrespective of the UK sovereign credit rating) or other countries with a minimum sovereign credit rating of AA- from Fitch (or equivalent). This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

In addition:

- no more than £5m will be placed with any non-UK country at any time (this limit applies to each non-UK country individually and not to non-UK countries in total);
- limits in place above will apply to a group of companies;
- sector limits will be monitored regularly for appropriateness.

The above country restrictions do not apply to money market funds (including enhanced money market funds). The Council only invests in sterling denominated money market funds (including enhanced money market funds).

## 4.5 Investment strategy

**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).

**Capita's Investment returns expectations (issued by Capita on 11 November 2015).** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2016. Bank Rate forecasts for financial year ends (March) are:

2016/17 1.00%
2017/18 1.75%
2018/19 2.00%

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:

2016/17 0.90%
2017/18 1.50%
2018/19 2.00%
2019/20 2.25%
2020/21 2.50%
2021/22 3.00%
2022/23 3.00%
Later years 3.00%

The overall balance of risks to these forecasts is currently to the downside (i.e. start of increases in Bank Rate occurs later). However, should the pace of growth quicken and / or forecasts for increases in inflation rise, there could be an upside risk.

**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** | **2016/17** | **2017/18** | **2018/19** |
| Principal sums invested > 364 days (but not more than 370 days) | £5m | £5m | £5m |

For its cash flow generated balances, the Council will seek to utilise its instant access and notice accounts, money market funds and deposits (overnight to 370 days) in order to benefit from the compounding of interest.

### 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.

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

- 0.05% historic risk of default when compared to the whole portfolio.

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

- Bank overdraft - £0.5m
- Liquid short term deposits of at least £10m available with a week's notice.
- Weighted average life benchmark is expected to be 0.5 years, with a maximum of 1.0 year.

Yield - local measures of yield benchmarks are:

- Investments – internal returns above the 7 day LIBID rate

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

| | 370 days | 2 years | 3 years | 4 years | 5 years |
|---|---|---|---|---|---|
| **Maximum** | **0.05%** | **0.00%** | **0.00%** | **0.00%** | **0.00%** |

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

### 4.7 End of year investment report

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

## 5 TREASURY MANAGEMENT PRACTICE (TMP1) – CREDIT AND COUNTERPARTY RISK MANAGEMENT

The CLG issued Investment Guidance in 2010, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which operate under a different regulatory regime.

The key intention of the Guidance is to maintain the current requirement for councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the Code and will apply its principles to all investment activity. In accordance with the Code, the Section 151 Officer has produced its treasury management practices (TMPs). This part, TMP 1(1), covering investment counterparty policy requires approval each year.

### 5.1 Annual investment strategy

The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of the annual treasury strategy for the following year, covering the identification and approval of the following:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments that the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

The investment policy proposed for the Council is:

**Strategy guidelines** – The main strategy guidelines are contained in the body of the treasury strategy statement.

### 5.2 Specified investments

These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

1. The UK Government (such as the Debt Management Account deposit facility, UK treasury bills or a gilt with less than one year to maturity).
2. Supranational bonds of less than one year's duration.
3. Local authorities, parish councils, community councils, companies controlled by the Council (either alone or with other Local Authorities).
4. Pooled investment vehicles (such as money market funds including enhanced money market funds) that have been awarded a high credit rating by a credit

rating agency. For category 4 this covers pooled investment vehicles, such as money market funds including enhanced money market funds, rated AAA by Standard and Poor's, Moody's and/or Fitch rating agencies.

5. A body that is considered of a high credit quality (such as a bank or building society). For category 5 this covers bodies with a minimum short term rating of F1 (or the equivalent) and minimum long term rating of A (or the equivalent) as rated by at least one of Standard and Poor's, Moody's and/or Fitch rating agencies.
6. Any part nationalised UK bank or building society.
7. Any subsidiary and treasury operations where the parent bank or building society has the necessary ratings outlined above.
8. The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies, as set out in this report.

### 5.3 Non-specified investments

Non-specified investments are any other type of investment (i.e. not defined as specified above). The Council may only use non-specified investments with a maturity of no more than 370 days and which otherwise meet the criteria for specified investments in section 5.2 above.

### 5.4 The monitoring of investment counterparties

The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Capita Asset Services as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Section 151 Officer, and if required new counterparties which meet the criteria will be added to the list.

### 5.5 Use of external fund managers

It is the Council's policy not to use external fund managers for any part of its investment portfolio.

## 6 OPTIONS

That the Governance and Audit Committee:

- Approve this report and recommend that it is approved by Cabinet and Council.
- Do not approve this report and do not recommend that it is approved by Cabinet and Council, thereby not complying with the Treasury Management Code of Practice.

## 7 CORPORATE IMPLICATIONS

### 7.1 Financial

The financial implications are highlighted within this report.

### 7.2 Legal

Section 151 of the 1972 Local Government Act requires a suitably qualified named officer to keep control of the Council's finances. For this Council, this is the Director of Corporate Resources, Tim Willis, and this report is helping to carry out that function.

### 7.3 Corporate

Failure to undertake this process will impact on the Council's compliance with the Treasury Management Code of Practice.

### 7.4 Equity and Equalities

There are no equity or equality issues arising from this report.

## 8 RECOMMENDATIONS

The Governance and Audit Committee is recommended to approve this report, including each of the key elements of this report listed below, and recommend them to Cabinet and Council:

- The Capital Plans, Prudential Indicators and Limits for 2016/17 to 2018/19, including the Authorised Limit Prudential Indicator.
- The Minimum Revenue Provision (MRP) Policy.
- The Treasury Management Strategy for 2016/17 to 2018/19 and the Treasury Indicators.
- The Investment Strategy for 2016/17 contained in the Treasury Management Strategy, including the detailed criteria.

## 9 DECISION MAKING PROCESS

Under the Treasury Management Code of Practice it is required that the Governance and Audit Committee approves this report before it is sent to Cabinet and Council for its approval.

Following the Governance and Audit Committee's approval, this report must go to Cabinet and Council as part of the Medium Term Financial Strategy.

## 10 DISCLAIMER

This report is a technical document focussing on public sector investments and borrowings and, as such, readers should not use the information contained within the report to inform personal investment or borrowing decisions. Neither Thanet District Council nor any of its officers or employees makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained herein (such information being subject to change without notice) and shall not be in any way responsible or liable for the contents hereof and no reliance should be placed on the accuracy, fairness or completeness of the information contained in this document. Any opinions, forecasts or estimates herein constitute a judgement and there can be no assurance that they will be consistent with future results or events. No person accepts any liability whatsoever for any loss howsoever arising from any use of this document or its contents or otherwise in connection therewith.

| | |
|---|---|
| Contact Officer: | Tim Willis, Section 151 Officer, extn 7617 |
| Reporting to: | Madeline Homer, Chief Executive |

**Corporate Consultation Undertaken**

| | |
|---|---|
| Finance | Technical Finance Team |
| Legal | N/A |