

CABINET

18 February 2014

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| Title: Treasury Management Strategy Statement 2014/15 | |
| Report of the Cabinet Member for Finance | |
| Open Report | For Decision |
| Wards Affected: None | Key Decision: Yes |
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| Accountable Director: Jonathan Bunt, Chief Finance Officer | |
| Summary <p>This report deals with the Treasury Management Annual Strategy Statement, Treasury and Prudential Indicators, Annual Investment Strategy and borrowing limits, in compliance with Section 15(1)(a) of the Local Government Act 2003.</p> <p>The production and approval of a Treasury Management Annual Strategy Statement and Annual Investment Strategy are requirements of the Council under Section 15(1) of the Local Government Act 2003. It is also a requirement of the Act to set an authorised borrowing limit for the forthcoming financial year.</p> <p>The Local Government Act 2003 also requires the Council to have regard to the Prudential Code, and to set prudential indicators which take into account the Council's capital investment plans for the next three years.</p> | |
| Recommendation(s) <p>The Cabinet is asked to recommended the Assembly to:</p> <ul style="list-style-type: none">(i) Adopt the Treasury Management Strategy Statement for 2014/15 attached as Appendix 1 to the report and, in doing so, to:<ul style="list-style-type: none">(a) Note the current treasury position for 2013/14 and prospects for interest rates, as referred to in sections 6 and 7 of Appendix 1;(b) Approve the Council's Borrowing Strategy, Debt Rescheduling Strategy and Policy on borrowing in advance of need for 2014/15 as referred to in sections 9 - 12 of Appendix 1;(c) Approve the Authorised Borrowing Limit (General Fund and HRA) of £500m for 2014/15, representing the statutory limit determined by the Council pursuant to section 3(1) of the Local Government Act 2003, as set out in Appendix 1B;(d) Approve the Treasury Management Indicators and Prudential Indicators for 2014/15, as set out in Appendix 1B; | |

- (e) Approve the Minimum Revenue Policy Statement for 2014/15, representing the Council's policy on repayment of debt, as set out in Appendix 1C; and
- (f) Approve the Annual Investment Strategy and Creditworthiness Policy for 2014/15 outlining the investments that the Council may use for the prudent management of its investment balances, as set out in Appendix 1D.

Reason(s)

To enable the Council to accord with the requirements of the Local Government Act 2003.

1. Introduction and Background

- 1.1 This report provides a brief explanation of the key elements of the Council's Treasury Management Strategy, its Minimum Revenue Provision (MRP) Strategy and the Annual Investment Strategy for 2014/15, which are set out in detail in Appendix 1 to this report. The Council is statutorily required to approve the Treasury Management Strategy prior to the new financial year.
- 1.2 The key elements of the Strategy relate to the following:
 - Investment Strategy – the management of the Council's cash balances;
 - Borrowing Strategy – the financing of the Council's capital programme; and
 - MRP Strategy – the Council has a duty to charge to its general fund an amount of MRP which it considers to be "prudent".
- 1.3 The report also summarises proposed changes to strategy from last year.

2. Proposal and Issues**2.1 Cash Management**

- 2.1.1 The Council has cash balances arising from its operational activities, i.e. sources of income such as grants and Council Tax are received during the year and this is offset by daily expenditure to run services. Due to the timing of these cash inflows and outflows, a surplus of cash is available at any point in time for investing. This is because, in general, significant sources of income for the year such as grants are received in advance of expenditure, plus the Council also holds specific reserves for future expenditure plans.
- 2.1.2 Cash balances are also affected by "working capital", which relates to amounts of outstanding payments to be made to suppliers (accounts payable) offset by amounts owed to the Council (accounts receivable).
- 2.1.3 The Council's year-end (31 March) cash balances since 2010/ 11 are provided below:

2013/14 - £120m (estimate)
2012/13 - £110m
2011/12 - £100m
2010/11 - £ 94m

2.1.4 These balances are made up of the following sources of cash:

- Capital grants and Section 106 funds received in advance of expenditure;
- General Fund and HRA Fund balances;
- Earmarked Reserves;
- Capital Receipts;
- Provisions;
- Loans from Public Works Loan Board (PWLB) and banks to fund capital expenditure but not yet spent; and
- Working Capital.

2.1.5 At the end of December 2013, the Council's cash balances totalled £107.8m and were invested as follows:

| Counterparty | £m |
|---|--------------|
| Internally Managed: | |
| Banks and Building Societies | |
| Lloyds Banking Group | 49.3 |
| Royal Bank of Scotland | 23.9 |
| Nationwide Building Society | 5.0 |
| Santander Group | 0.1 |
| Barclays | 0.1 |
| Money Market Funds | |
| Federated | 3.5 |
| Goldman Sachs | 0.1 |
| Local Authorities and Government | |
| UK Government GILTS | 5.8 |
| Local Authorities | 20.0 |
| Total | 107.8 |

2.2 Prospects for Interest Rates

2.2.1 After reasonable UK growth of 0.7% in quarter 2 and 0.8% in quarter 3, the speed of the UK GDP growth is forecast to be at an even faster pace in quarter 4 of 2013. Forward surveys are also very encouraging in terms of strong growth and there are positive indications that recovery is broadening away from reliance on consumer spending and the housing market into construction, manufacturing, business investment and exporting. This strong growth has resulted in unemployment falling faster towards the threshold of 7%, set by the MPC before it said it would consider any increases in Bank Rate, than it expected last August when that threshold was initially set. Accordingly, markets are expecting a first increase in early 2015 though recent comments from MPC members have emphasised they would want to see strong growth well established, and an increase in real incomes, before they would consider raising Bank Rate.

2.2.2 Also encouraging has been a sharp fall in inflation (CPI) to 2.1% in November and forward indications are that inflation will continue to be subdued. The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the Autumn Statement, and

fostered optimism for achieving a balance in the cyclically adjusted budget within five years, a year earlier than previously forecast.

2.2.3 In the United States the Federal Reserve, in December 2013, felt sufficiently confident that the premise for strong growth had been established in America that it could start to taper its asset purchases by reducing them by \$10bn per month from January 2014. These encouraging growth scenarios in the USA and UK led to a sharp jump up, in December, in short dated gilts; this, accordingly, increased the 5 and 10 year PWLB rates.

2.3 Investment Strategy

2.3.1 The Council's investments are managed on the following principles, in order of priority:

- **Security** – minimising the risk of losing cash arising from a bank failure and consequent default (as occurred with Icelandic Banks in 2008).
- **Liquidity** – ensuring the Council will have access to cash as required to meet daily expenditure obligations.
- **Yield** – after ensuring the above are met, the Council will aim to maximise interest earnings on cash invested.

2.3.2 The current economic outlook and structure of market interest rates and government debt yields have several key treasury investment:

1. Eurozone sovereign debt difficulties remain, with concerns as to how these will be managed over the next few years. Counterparty risks remain elevated and as a result the Council's strategy of using higher quality UK Bank and Building Societies for shorter time periods will remain in place during 2014/15.
2. Investment returns are forecast to remain low during 2014/15, with an average target return of 1% for the in-house Treasury section. To reach the 1% target, while ensuring risks are minimised, the Treasury section has lent a total of £25m to a number of Local Authorities, with an average duration of 22 months.

2.3.3 In the past the Council has set a minimum short term rating and long term credit rating restriction for investment. While this is a reasonable approach, the Counterparties the Council invests in are exposed to a greater range of factors that should be considered when monitoring their counterparty risk.

2.3.4 During 2014/15 the Council will continue to use the creditworthiness service provided by its advisor, Capita Asset Services, which employs a modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

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

2.3.5 This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments and are outlined in detail in Appendix 1 section 16.

2.3.6 The use of derivative financial products will continue to be excluded from the strategy.

2.4 Borrowing Strategy

2.4.1 The Council is allowed to borrow funds from the capital markets for two purposes:

- (i) Short term temporary borrowing for day to day cash flow purposes to ensure liquidity. This is likeliest to occur during the midyear period when the Council's cash balances are lowest and Council's own cash may be tied up in longer term investments.
- (ii) Long term borrowing to finance the capital programme where the Council can demonstrate the borrowing is affordable. The Council receives external funding (e.g. grants, contributions etc) to meet a large proportion of its capital expenditure but some projects do not attract specific funding. These projects have to be funded by the Council from sources such as capital receipts from the sale of property. However in the relatively recent past, the Council has not had these funds available and therefore has had to borrow.

2.4.2 The Council's borrowing as at 31 December 2013 was made up of five elements:

- a) External loans from Public Works Loan Board and private banks - £50m;
- b) Short Term Borrowing - £11.8m;
- c) HRA PWLB Loans - £266m;
- d) PFI/finance lease liabilities - £60m; and
- e) "Internal" borrowing - £103.8m.

2.4.3 The current economic outlook and structure of market interest rates and government debt yields have an effect on borrowing decisions. With borrowing rates increasing significantly during 2013 but with investment returns remaining low the Council used internal borrowing to fund capital expenditure. Internal borrowing represents the use of surplus available cash balances to pay for capital spend, rather than undertaking new external loans.

2.4.4 In 2014/15 a continuation of low short term interest rates compared to the medium and longer term rates is expected. This indicates that it is likely that there will be an on-going "cost of carry" for holding cash through borrowing in advance of capital expenditure being incurred. Cost of carry is the difference in the borrowing cost compared to the investment return the Council can achieve were it to borrow money before it is required. As an example, were the Council were to borrow £10m at 4% but did not to use the cash during the year and reinvested it at 1%, the cost of carry would be 3% for the year, or £300k.

2.4.5 Therefore, during 2014/15, the Council will continue the strategy of keeping cash balances low and utilising internal borrowing to finance capital expenditure.

2.5 Repayment of Borrowing

2.5.1 The Council's external borrowings are all loans where the principal is repaid at maturity. A loan of £10m is scheduled to be repaid in 2014/15 and it is proposed to fund the principal repayment from revenue or generating capital receipts.

2.5.2 Internal borrowing can be also be reduced by generating capital receipts, which will replenish cash balances and in accounting terms be used for financing historic spend rather than for new capital projects.

3. Financial Implications

3.1 The financial implications are discussed in detail in this report.

4. Legal Implications

Implications completed by: Eldred Taylor-Camara, Legal Group Manager

4.1 The Local Government Act 2003 (the "Act") requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy which sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments. The Council also has to 'have regard to' the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities when carrying out its functions under the Act.

4.2 This report sets out the Councils strategies in accordance with the Act.

5. Other Implications

5.1 **Risk Management** - This report has risk management issues for the Council, primarily that a counterparty could cease trading or risk that interest rates would rise adversely. The mitigation of these is contained in this report.

Public Background Papers Used in the Preparation of the Report: None

List of appendices:

- Appendix 1 – Treasury Management Strategy 2014/15
- Appendix 1A – Interest Rate Forecasts 2014 – 2017
- Appendix 1B – Prudential Indicators 2014/15 – 2016/17
- Appendix 1C – Minimum Revenue Provision Policy Statement
- Appendix 1D – Annual Investment Strategy
- Appendix 1E – Approved countries for investments
- Appendix 1F – Treasury management scheme of delegation