

CABINET

15 February 2016

Title: Treasury Management Strategy Statement 2016/17	
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, Strategic Director, Finance & Investment	
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 2016/17 and, in doing so, to:<ul style="list-style-type: none">a) Note the current treasury position for 2016/17 and prospects for interest rates, as referred to in section 6;b) Approve the Council's Borrowing Strategy, Debt Rescheduling Strategy and Policy on borrowing in advance of need for 2016/17 as referred to in section 9;c) Approve the Annual Investment Strategy and Creditworthiness Policy for 2016/17 outlining the investments that the Council may use for the prudent management of its investment balances, as set out in Appendix 2.d) Approve the Authorised Borrowing Limit of £800m for 2016/17, representing the statutory limit determined by the Council pursuant to section 3(1) of the Local Government Act 2003, as set out in Appendix 4;	

- e) Approve the Treasury Management Indicators and Prudential Indicators for 2016/17, as set out in Appendix 4;
- f) Approve the Minimum Revenue Policy Statement for 2016/17, representing the Council's policy on repayment of debt, as set out in Appendix 5; and
- g) To maintain the authority delegated to the Strategic Director, Finance & Investment, in consultation with the Cabinet Member for Finance, to proportionally amend the counterparty lending limits agreed within the Treasury Management Strategy Statement to take into account the increase in cash from the European Investment Bank but also the subsequent decrease in cash balances as payments are made to the Special Purpose Vehicle.
- h) To next review this delegated responsibility as part of the 2015/16 Treasury Management Outturn Report to Assembly

Reason(s)

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

1. Introduction and Background

- 1.1 The Council is required to operate a balanced budget, with cash raised during the year sufficient to meet the Council's cash expenditure. Treasury management supports the Council by seeking to ensure its cash flow is adequately planned, with cash being available when it is needed. Surplus cash is invested in counterparties or instruments commensurate with the Council's risk appetite, providing adequate security and liquidity while also considering the investment return.
- 1.2 A second function of treasury management is funding 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.
- 1.3 The Council is responsible for its treasury decisions, activity and risk appetite. The successful identification, monitoring and control of risk are integral elements of treasury management, including credit and counterparty risk, liquidity risk, market risk, interest risk, refinancing risk and legal and regulatory risk. The Council is statutorily required to approve the Treasury Management Strategy Statement (TMSS) prior to the new financial year.

2. Reporting Requirements

- 2.1 The Council is required to receive and approve at least three main treasury reports each year. These reports are required to be adequately scrutinised by Cabinet before being recommended to the Council. The three main treasury reports are:
 - i. **The Treasury Management Strategy Statement (TMSS)** is the most important report and takes into account the impact of the Council's proposed Revenue Budget and Capital Programme on the Balance Sheet position, the current and

projected Treasury position, the Prudential Indicators (PIs) and the outlook for interest rates. In addition the current market conditions are factored into any decision making process.

- ii. **An Annual Treasury Report** which outlines the actual PIs, treasury indicators and treasury operations compared to the estimates within the strategy.
- iii. **A Mid-Year Treasury Management Report** to update Members on the progress of the capital position, amending PIs and investment strategy as necessary.

- 2.2 As the Council is responsible for housing, PIs relating to capital expenditure, financing costs and the Capital Financing Requirement (CFR) are split between the Housing Revenue Account (HRA) and the General Fund (GF). The impact of new capital investment decisions on housing rents will also need to be considered.
- 2.3 This report provides an explanation of the key elements of the Council's Treasury Management Strategy, its Minimum Revenue Provision (MRP) Strategy, the Annual Investment Strategy (AIS) for 2016/17 and the borrowing strategy, which are set out in detail in the appendices attached to this report.

3. Treasury Management Strategy for 2016/17

- 3.1 The Local Government Act 2003 and supporting regulations require the Council to have regard to the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years and ensure the Council's capital programme is affordable, prudent and sustainable.
- 3.2 The Act requires councils to set out their 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.
- 3.3 The Council has adopted the Department of Communities and Local Government (DCLG) investment guidance that came into effect from 1 April 2010. The strategy for 2016/17 covers two main areas:

Treasury Management Issues

- Current Portfolio Position;
- Treasury Position at 31 March 2015;
- Medium term capital finance budget;
- Treasury Management Advisors;
- Economic Update and Rate Forecast;
- The Annual Investment Strategy and Investment Policies;
- The Capital Expenditure Plans 2016/17 – 2018/19;
- The Council's Borrowing Strategy and Borrowing Requirement; and
- Treasury indicators which limit the treasury risk and activities of the Council.

Capital Issues

- The capital plans and the prudential indicators; and
- The minimum revenue provision (MRP) strategy.

4. Current Portfolio Position

4.1 The Council holds cash balances arising from its operational activities, including income from grants and Council Tax, which are offset by expenditure to run services. The timing of these cash flows can result in surplus cash which is then available to invest. Cash balances are also affected by “working capital”, which relates to amounts of outstanding payments to be made to suppliers offset by amounts owed to the Council.

4.2 The Council's year-end (31 March) cash balances since 2012/13 are shown below:

2015/16 - £220m (estimate)

2014/15 - £218m

2013/14 - £120m

2012/13 - £110m

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

- Capital grants and Section 106 funds received in advance of expenditure;
- General Fund, Housing Revenue Account and School cash balances;
- Earmarked Reserves and provisions;
- Capital Receipts and Working Capital;
- European Investment Bank Loans to fund regeneration; and
- Public Works Loan Board and bank loans to fund capital expenditure.

4.4 Table 1 below shows the Council's investments and borrowing balances as at 31 December 2015, including the average life and the Rate of Return. The loans have been split between HRA borrowing and GF borrowing to match the two pool approach the Council has adopted for borrowing. The Council invests all cash in one investment pool, with interest distributed between the HRA, schools and GF.

Table 1: Council's Treasury Position at 31 December 2015

	Principal Outstanding 31/12/2015 £'000s	Average Life as at 31/12/2015 (yrs)	Average Rate of Return 31/12/2015 %
Housing Revenue Borrowing			
Public Works Loan Board	265,912	40.06	3.50
General Fund Borrowing			
Long Term Borrowing	129,000	47.77	2.76
Short Term Borrowing	66,005	0.07	0.44
Total General Fund Debt	195,005	31.62	1.98
Total Borrowing	460,917	36.49	2.86
Investments (In-House)	258,461	0.99	1.27
Net Borrowing	202,456		

4.5 Medium Term Capital Finance Budget

A key part of the Council's budget strategy is the medium term capital finance budget shown as Table 2. It is a statutory requirement that the level of borrowing is kept under review and is affordable.

Table 2: Medium Term Capital Finance Budget

£'000s	2015/16 Budget	2016/17 Budget	2017/18 Budget	2018/19 Budget
MRP	7,088	4,738	5,238	5,738
GF Interest Payable	2,251	2,251	5,251	5,251
HRA Interest Payable	9,294	10,059	10,059	10,059
Investment Income	(2,010)	(2,570)	(2,570)	(2,570)
Net Cost	16,623	14,478	17,978	18,478

4.6 Treasury Position at 31 March 2015

The Council's treasury portfolio position at 31 March 2015, with forward projections are summarised in table 3. The table shows the actual external debt against the underlying capital borrowing need (CFR), highlighting any over or under borrowing. The CFR and the Gross Debt includes borrowing to fund the first Barking & Dagenham Reside scheme as well as the borrowing from the EIB to fund Abbey Road Phase 2 and the Gascoigne Regeneration.

Table 3: Treasury Position at 31 March 2015, with Forward Projections

£'000s	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
External Debt					
Debt at 1 April	315,912	394,912	404,912	404,912	404,912
Expected change in Debt	79,000	10,000	0	0	0
Other long-term liabilities	58,078	55,245	52,308	49,407	47,707
Reside 1 Debt	84,847	84,481	84,100	83,703	83,291
Gross Debt at 31 March	537,837	544,638	541,320	538,022	535,910
CFR	578,098	589,112	631,980	649,350	652,401
Under / (over) borrowing	40,261	44,474	90,660	111,328	116,491

5. Treasury Management Advisors

- 5.1 The Council uses Capita Asset Services (CAS) for external treasury advice. However the Council recognises that it is ultimately responsibility for all treasury management decisions and will ensure that undue reliance is not placed on the external advisors.
- 5.2 The Council recognises that there is value in receiving advice from an external treasury advisor 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 documented, and subjected to regular review. For its cash flow generated balances, the Council will utilise a range of investment instruments, as agreed within the Annual Investment Strategy restrictions (appendix 1) in order to benefit from the compounding of interest.

6. Economic Update and Rate Forecast

6.1 The Bank Rate Forecast to 2019 is provided below. These indicate a slow but steady increase in rates, potentially starting towards the end of 2016 or early 2017.

Q1 2017 0.75%

Q1 2018 1.25%

Q1 2019 1.75%

6.2 Economic forecasting remains difficult with many external influences weighing on the UK. Bank Rate forecasts are liable to further amendment depending on how economic data and developments in financial markets transpire over the next year.

6.3 Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

6.4 The overall longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. An eventual world economic recovery will also see investors switching from the safe haven of bonds to equities.

6.5 The United States Federal Reserve (the Fed) increased rates in December 2015 and is likely to increase more strongly than Bank Rate in the UK. These increases will have a corresponding effect of pushing up US Treasury and UK gilt yields. While there is usually a high degree of correlation between the two yields, it is expected that there will be a decoupling of yields between the two i.e. US yields to go up faster than UK yields.

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

6.7 There is currently an exceptional level of volatility within the bond markets which are highly correlated to emerging market, geo-political and sovereign debt crisis developments.

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

- Emerging economy currencies and corporates destabilised by falling commodity prices and/or Fed rate increases; Geopolitical risks in Eastern Europe, the Middle East and Asia increasing investments in gilts thereby reducing yields.
- UK economic growth and increases in inflation are weaker than anticipated.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government support.

- Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the Eurozone and Japan.

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

- Uncertainty around the risk of a UK exit from the EU.
- The pace and timing of increases in the Fed rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

6.10 A detailed economic update is included as Appendix 1 of this report.

7. The Annual Investment Strategy and Investment Policies

7.1 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code").

7.2 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. The Council's investment priorities are:

- Security** of the investment capital: Minimising the risk of losing cash arising from a bank failure and consequent default (as occurred with Icelandic Banks in 2008).
- Liquidity** of the investment capital: Ensuring the Council will have access to cash as required to meet daily expenditure obligations.
- An optimum yield** which is commensurate with security and liquidity: The return provided will be considered alongside security and yield in order to achieve the target return required to meet the interest budget.

7.3 The Annual Investment Strategy (AIS) is attached Appendix 2 of this report. It is the Council's responsibility to agree an appropriate minimum acceptable credit quality of counterparties for inclusion on the lending list in the AIS in accordance with the above principles. A creditworthiness methodology has been used to create the counterparty list, which takes into account the ratings and watches published by all three ratings agencies with a full understanding of what the ratings reflect in the eyes of each agency. Using the CAS ratings service, banks' ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

7.4 Withdrawal of Implied Sovereign Support

7.4.1 The main rating agencies, namely Fitch, Moody's and Standard & Poor's (S&P) 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.

- 7.4.2 A consequence of these new methodologies is they have lowered the importance of Fitch’s Support and Viability ratings and have seen Moody’s Financial Strength rating withdrawn by the agency. As a result of this change the rating element of the Council’s 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 for S&P, this has been a change in the use of Fitch and Moody’s.
- 7.4.3 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. During the financial crisis the Council assigned the highest sovereign rating (AAA) to its investment 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 will continue to specify a minimum sovereign rating of AA. 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.
- 7.4.4 It is important to stress that these rating agency changes do not reflect changes in the underlying status or credit quality of the institution but merely reflect a reassessment of rating agency 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.

7.5 **Bail in Legislation**

- 7.5.1 As part of regulation changes within the banking sector the UK Government will remove the expectation that governments will support financial institutions in the event of an institution fail. This move is to set aside a structure that will be followed should a financial institution fail. To do this the UK Government has agreed a process to deal with a financial institution failure, which includes the option for institutional investors to lose part of their invested cash as part of a “bail in”.

7.5.2 It could be argued that the potential for institutional investors to lose part of their investment has always been there and is the main driver behind the rates “rewarded” when an investment is made. The structure to be adopted does still keep the equity investor and bond holders at the top with Institutional Investors after these. Therefore there is a significant buffer before the Council’s cash holdings would be affected.

7.5.3 One area of concern is the potential for the rating agencies to downgrade the banks the Council currently is invested with due to the loss of the implied government support. This potentially would bring them below the minimum credit rating agreed by the Council in the 2015/16 TMSS. As a result, where the credit rating is taken into account, it is recommended that the minimum credit rating criteria be revised from A / F1 to A- F2. This change is reflected in the Annual Investment Strategy (Appendix 2).

7.6 Treasury Savings Targets

7.6.1 Historically the Council has maintained a prudent and low risk treasury investment strategy. This approach has ensured that the Council has not lost money from any of its investments, while achieving a return commensurate with the risk taken. This approach has led to treasury having a significant impact on the Council’s overall funding requirements, both in terms of generating income from investments and from reducing the costs of borrowing to support the Council’s capital programme.

7.6.2 In order for Treasury to support the significant savings target the Council has for 2016/17 to 2017/18, Members agreed a number of savings targets for treasury as outlined in table 4 below, which shows the accumulative effect of the savings. A total of £1.6m worth of savings will have been removed from the annual treasury budget from 2017/18.

Table 4: Treasury Savings Targets for 2016/17 to 2017/18

Saving Reference	Savings Proposal	2015/16 £000	2016/17 £000	2017/18 £000	Total £000
CEX/SAV/27	Increase in Average Return as Rates Rise	500	500	250	1,250
CEX/SAV/29	Increase Counterparty Risk	250	0	0	250
CEX/SAV/54e	Increase Duration Risk	100	0	0	100
	Total Savings	850	500	250	1,600

7.7 Return Target 2015/16 to 2017/18

7.7.1 To achieve the interest target the treasury section needs to achieve the following average returns on an estimated average cash balance of £140m (excluding EIB):

2015/16	1.25%
2016/17	1.60%
2017/18	1.80%

7.7.2 The increased return is heavily reliant on interest rates increasing from their current near historic lows. The increase does not need to occur in the first half of 2016 as treasury team has secured a return through longer dated investments, which is currently expected to achieve the 1.60% return for 2016/17. However if rates do not

increase by early 2017 then the return target for 2017/18 will be very challenging to meet without significantly increasing either the duration risk and / or the counterparty risk.

7.8 Risk Monitoring

- 7.8.1 The Council recognises that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment takes account of information that reflects the opinion of the markets.
- 7.8.2 To this end the Council will engage with its advisors to maintain a monitor on market pricing such as Credit Default Swaps (CDS). However due to the volatility of the CDS market, this will be monitored but will not be included in the investment rating of any financial institutions.
- 7.8.3 Other information sources used will include the financial press and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.
- 7.8.4 The aim of the strategy is to generate a list of creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk. The intention of the strategy is to provide security of investment and to minimise risk to the level agreed by Members and included in the Investment Strategy.

7.9 Proposed Strategy Changes

The changes in investment strategy compared to the 2015/16 TMSS include:

- 7.9.1 **Duration Risk:** Generally the longer the duration of an investment the better the return. There are a number of risks associated with this including:

- i. the risk of locking in a low rate for a long period; and
- ii. liquidity risks as the cash will not be available for the Council to use.

To achieve the interest income budget set, without taking significant risk the treasury section has sought to increase the duration of a number of investments during 2015/16 where opportunities have arisen to do so. This strategy will continue in 2016/17, although the benefit from higher returns will be weighed against the risk of locking in investments at low rates at a time when there is a view that interest rates will begin to increase.

- 7.9.2 **Counterparty Risk:** During 2016/17 the Council will continue to use the creditworthiness service provided by its advisor, Capita Asset Services, which employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- i. credit watches and credit outlooks from credit rating agencies;
- ii. Sovereign ratings to select counterparties from only creditworthy countries.

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system 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 guide the suggested duration for investments and are outlined in detail in Appendix 1 section 16.

The financial institutions the Council invests with all have credit ratings and as a general rule, the lower the credit rating the higher the return. The Council has historically had a prudent, although not completely risk adverse, approach to treasury investments.

The Council have agreed that in order to increase investment income treasury will be able to take additional risk. The additional risk proposed includes:

- i. Maintain the Royal Bank of Scotland limit for deals at £90m with a maximum duration of two years.
- ii. Remove the specific limit for Certificate of Deposits.
- iii. Increase the individual Local Authority Limit over one year to £40m per authority and remove the total Local Authority Limit.
- iv. Revise the minimum credit rating from A / F1 to A- F2.

7.9.3 Short Term Borrowing: Currently there is little return (approximately 0.50%) gained from investing over a short-term period and therefore the main focus of the investment strategy will be to take advantage of investments over the medium term (one to three years) where returns of 1.0% to 1.82% is available.

In addition there is a significant difference of approximately £40m between the Councils highest cash balance in February to June and its lowest cash balance in December to January.

To take advantage of medium term investment opportunities as they arise and to allow the Council to smooth the volatility of its cash flow, without overly relying on short-term investments, it will be necessary for the Council to carryout short-term borrowing. Where short-term borrowing is required this will be secured as early as possible to ensure liquidity risk is reduced. Short-term borrowing will also predominantly be from other Public Sector bodies.

7.9.4 Lloyds Banking Group

The Council has, over the past three years, held a high allocation to Lloyds Banking Group (Lloyds) as it was viewed as having an implied guarantee from the UK government, which held a significant number of Lloyds shares.

In the 2015/16 Investment Strategy the limit for Lloyds was £80m with a maximum investment duration of three years. This limit was dependent on the UK Government holdings of Lloyds shares remaining above 10%. On 29 October 2015 the Government reduced its holdings of Lloyds shares to less than 10%, with a view to sell the remaining shares as soon as possible. As a result the Council's exposure to Lloyds was reduced to £34.5m as at 29 January 2016.

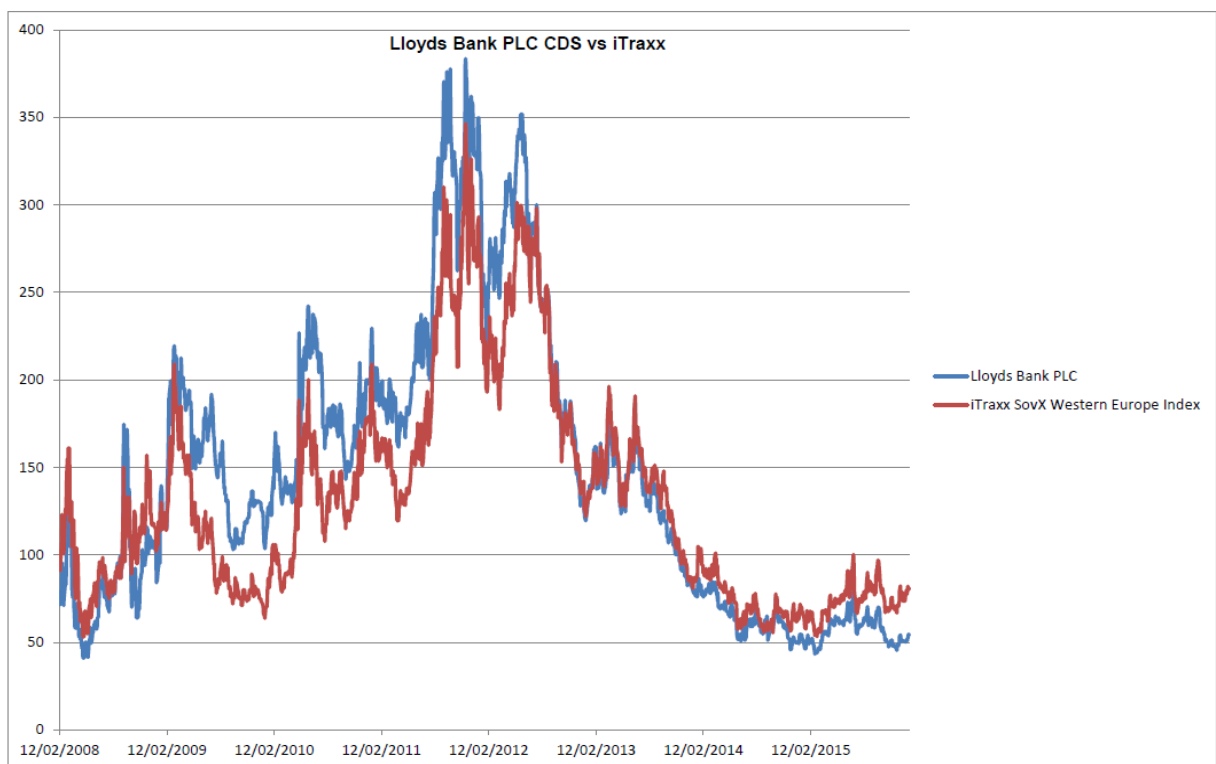
In the 2016/17 TMSS, as part of the overall investment strategy of taking more risk, it is proposed to maintain the duration for Lloyds at 3 years, with a limit of £50m.

CAS, the Council's Treasury Advisors, suggested investment duration with Lloyds is currently 6 months.

In terms of the rating agencies, Fitch's long term rating for Lloyds is A+, which is equivalent to Moody's rating of A1. These ratings are higher than S&P's long-term rating for Lloyds, which was downgraded to A in 2011. All three agencies affirm a stable medium term view on Lloyds at present.

A graph showing the movements in Lloyd's CDS prices over the years 2008 to 2015 benchmarked against the iTraxx, which is used to illustrate credit risk. The graph illustrates the spikes in Lloyds CDS prices over the first five years following the effects of the financial crisis, with the main reason for the spike being Lloyds merger with HBOS. In the latter two years, the graph presents a much more convincing picture as Lloyds' CDS prices have fallen below the iTraxx benchmark.

Chart 1: Lloyd's CDS prices (2008 to 2015) benchmarked against the iTraxx



In terms of outlooks, all three ratings agencies changed their methodologies mid-2015, which saw alterations to Lloyds' outlook positions. Moody's revised their bank methodology and changed their outlook on Lloyds to positive on 05/06/2015. Moody's placed Lloyds in the group of other UK banks which they believed to reflect a positive trend, more importantly in terms of the bank's capital and asset quality, but also in terms of their profitability.

S&P changed its outlook on Lloyds to stable on 29/07/2015 to reflect their view that Lloyds over the next two years will continue to build its capital buffer and will see improvements to its statutory earnings. Further, they believe that Lloyds will maintain a risk-adjusted capital ratio in line with S&P's ratio of around 8.5-9% and while they believe asset growth will continue, they do not expect this to be at the expense of any increase in risk appetite. Similarly, on changing its rating methodology, Fitch changed its rating outlook for Lloyds to stable on 14/05/2015

despite the negative outlook on their issuer ratings, with this being primarily due to the fact that Lloyd's bond prices were significantly above their 'a-' viability rating at the time.

As the Authority is considering taking on more credit risk by lending longer than CAS's suggested 6 months, up to 3 years the long-term ratings are more relevant than the short term ratings. The current definition (and therefore the credit opinion) of the rating agencies based on the above long-term ratings are as follows:

	Fitch	Moody's	S&P
Long Term Rating:	A+	A1	A

Definition of Long Term Rating: Very high credit quality Superior credit quality Possibly more prone to adverse effects of changes in circumstances than higher-rated categories.

The justification for differing from the Capita limits is outlined below:

On 1st December 2015, stress tests were conducted and Lloyds comfortably passed these tests.

Currently all Lloyds ratios and stress testing results confirm that Lloyds is one of the strongest UK banks and is ranked the 16th largest bank in the world. Lloyds has the lowest CDS of all financial institutes (49.3bps compared to 72.7bps for HSBC) and has tier 1 capital (core equity capital compared to total risk weighted assets) of 13.7%, which is higher than any other UK bank and provides a significant buffer if there were to be a run on the bank. It performed very well in the recent stress tests and is rated A+ by Fitch (marginally behind HSBC at AA-).

There is still a risk from bail-in but Lloyds would need to write-off £52.8b (mainly mortgages and small business loans) before unsecured senior creditors (the Council) would be affected. That would mean that the equity and sub debt would need to be wiped out before the Council's investments would be affected. This is a bigger loss than the loss incurred when Lloyds absorbed HBOS and is a very unlikely scenario.

Currently Lloyds are paying relatively high returns over the two year and three year period (between 1.40% and 1.82%). If Lloyds did not provide sufficient reward for the risk taken then the additional duration risk would not be taken. However if the rates remain high then the treasury section would seek to take advantage of these.

7.10 HRA Investments

7.10.1 Cash balances held by the HRA will be invested as part of the Council's overall treasury strategy. Cash balances will generally earn the average rate of the Council's investments, which will be calculated at the financial year end.

7.10.2 Where there is agreement between the Strategic Director, Finance & Investment (SDF&I) and the Strategic Director Growth and Homes, individual investments can be ring-fenced for the HRA, with the allocations made within the Council's overall treasury strategy requirements.

7.10.3 For further details please refer to the HRA Business Plan.

7.11 **Derivatives:** The use of derivative financial products will continue to be excluded from the strategy.

8. The Capital Expenditure Plans 2016/17 – 2018/19

8.1 The Council's Housing and General Fund capital expenditure plans, together with Balances and Reserves, are the key drivers of treasury management activity. The estimates for Capital expenditure, and its funding based on current proposed Revenue Budget and Capital Programmes, are reflected in prudential indicators, which are designed to assist Members overview and confirm capital expenditure plans. The Prudential Indicators are included in Appendix 1A of this report.

8.2 Table 5 below shows the proposed capital expenditure over the coming three financial years. It is a requirement of the Prudential Code to ensure that capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council Tax and, in the case of the HRA, housing rent levels.

Table 5: Proposed Capital Expenditure 2016 to 2019

Capital expenditure	2014/15	2015/16	2016/17	2017/18	2018/19
	Actual	Estimate	Estimate	Estimate	Estimate
	£000	£000	£000	£000	£000
General Fund	67,275	53,253	105,838	76,480	11,740
HRA	78,544	81,493	79,059	56,070	63,128
Total	145,819	134,746	184,897	132,550	74,869
Financed by:					
Capital Grants	47,724	48,816	63,206	49,906	0
Section 106	1,187	119,319	1,000	-	0
Revenue Contributions	13,161	1477,421	875	400	400
Capital Receipts	51,861	40,730	56,568	45,338	47,378
HRA Contributions	14,035	22,920	11,741	10,732	15,750
Sub-Total	127,966	114,063	133,390	106,376	63,528
Net financing need for the year	17,853	20,683	51,507	26,174	11,340

8.3 The estimated financing need for the year in Table 5 represents a shortfall of resources resulting in a requirement to borrow. This underlying need to borrow is the CFR. The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. Any capital expenditure above, which has not immediately been paid for, will increase the CFR. A portion of the net financing need has already been borrowed as this relates to the Abbey Road Phase 2 and Gascoigne regeneration schemes which was borrowed from the European Investment Bank in January 2015.

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

8.5 Sufficient headroom has been provided within the Authorised Limit on external borrowing to ensure that any major capital investment projects where finance has

yet to be finalised, are not restricted by this statutory limit. The limit covers any short term borrowing for cash flow purposes as well as long term borrowing for capital projects, finance leases PFI initiatives as well as any unforeseen incidences where expected capital receipts are not forthcoming due to unexpected economic factors.

- 8.6 In addition sufficient headroom has been included within the Operational Boundary and Authorised Limit if it is necessary for the costs of Reside to be included within the CFR. The estimated additional costs and subsequent increase in the CFR if Reside were included would be an estimated £220m, although the structure would mean that no additional long term borrowing would be required.
- 8.7 There is potential that the work undertaken by the Growth Commission and Ambition 2020 programme will lead to a change in the Capital Expenditure Plans and, in turn, the Operational Boundary and Authorised Limit. Should any significant changes occur then these will be reflected in the Treasury 2015/16 Outturn Report and/or the Treasury Mid-Year review.

9. The Council's Borrowing Strategy and Borrowing Requirement

- 9.1 The decision to borrow is a treasury management decision and is taken by the SPF&I under delegated powers of the Council's constitution. The key objective of the Council's borrowing strategy is to secure long term funding for capital projects at borrowing rates that are as low as possible. This can result in a trade off of short term returns on deposits to obtain the best possible rate on long term borrowings.
- 9.2 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.
- 9.3 Treasury management, and borrowing strategies in particular, continues to be influenced by the absolute level of borrowing rates and also the relationship between short and long term interest rates. Rate forecasts indicate that interest rates will remain low until 2017 which creates a "cost of carry" between what is paid on the borrowing and what is earned on the investment for any new longer term borrowing. This is because borrowing requirements are generally over a long term period of up to 50 years, while cash is currently being invested for a maximum of a year.
- 9.4 As a result the Council expects to maintain an under-borrowed position throughout 2016/17. This means that the CFR will not be fully funded with loan debt during the year as cash supporting the Council's reserves, balances and cash flow will be used as a temporary measure. This strategy is prudent as it reduces the "cost of carry"

while investment returns remain low, as well as reduces the Council's counterparty risk, which continues to be high and is likely to will continue throughout 2016/17.

9.5 As circumstances can change during the year, the SPF&I will monitor interest rates and adopt a flexible approach to any changes. The Council's borrowing strategy will also give consideration to the following when deciding to take-up new loans:

- Use internal cash balances while the current rate of interest on investments remains low and cash flow forecasts indicate that borrowing is not required;
- Consideration given to weighing the short term advantage of internal borrowing against long term costs if long term borrowing rates increase more than forecast;
- Using PWLB, the EIB or Local Authorities for fixed term and variable rate loans;
- Maintain an appropriate debt balance between PWLB and market debt;
- Ensure new borrowings are drawn at suitable rates and periods; and
- Consider the issue of stocks and bonds if appropriate.

9.6 The Council has £40m of fixed rate Lender's Options Borrower's Option (LOBO) loans and all of them will be in their call period during 2016/17. A LOBO is called when the Lender exercises its right to amend the interest rate on the loan at which point the Borrower (the Council) can accept the revised terms or reject them and repay the loan. LOBO loans present a potential refinancing risk to the Council since the decision to call a LOBO is entirely at the Lender's discretion. As LOBOs currently make up 10.1% of the total long term external debt portfolio and that the Council is operating with high cash balances, this is not a significant risk. Any LOBO called will have the default position of repayment of the LOBO without penalty, i.e. the revised terms will not be accepted.

9.7 **European Investment Bank (EIB) Borrowing:** In 2014/15 Cabinet agreed to borrow £89m from the European Investment Bank (EIB) and £4.5m from the PWLB which will be used as outlined below:

- £66.0m from the EIB to finance the Gascoigne Estate (East) Phase 1;
- £4.5m from the PWLB to fund 50% of 51 private for sale units; and
- £23.0m from the EIB to finance Abbey Road Phase 2.

The EIB borrowing will be a liability for the Council and will be include in the Council's CFR but will then be placed within a Special Purpose Vehicle (SPV), which will then be used to manage the repayment of the borrowing and interest as well as the funding of the regeneration of the Gascoigne Estate (East) Phase 1 and the Abbey Road Phase 2. The SPV will pay for these costs through the rental returns generated.

Although investment decisions will be made on behalf of the SPV, with interest returns paid to the SPV, as the risk will remain with the Council, any investment will need to be made within the parameters set within this report.

The drawdown of the full £89m was completed on 30 January 2015 at a rate of 2.207%. The £4.5m proposed to be borrowed from the PWLB will now be borrowed using internal borrowing.

To allow treasury to maintain flexibility to manage the increase in cash it is recommended that Members agree to maintain the authority delegated to the

SPF&I, in consultation with the Cabinet Member for Finance, to proportionally amend the counterparty lending limits agreed within the TMSS to take into account the initial increase in cash from the EIB but also the subsequent decrease in cash balances as payments are made to the SPV.

9.8 Green Investment Bank (GIB) Borrowing

At its meeting on 2 December 2015 the Council agreed to borrow £7.5m from the GIB arising from the Cabinet's decision under Minute 67, 10 November 2015 to finance the Low Energy Street Light Replacement Programme via the UK GIB Green Loan. Officers are currently negotiating contracts with the GIB, with a likely agreement completed by 31 March 2016

9.9 HRA Self Financing

Central Government completed the reform of the HRA subsidy system on 28 March 2012. The Council is required to recharge interest expenditure and income attributable to the HRA in accordance with Determination issued by the CLG.

The Determinations do not set out a methodology for calculating the interest rate to use in each instance. The Council is therefore required to adopt a policy that will set out how interest charges attributable to the HRA will be determined. The CIPFA Treasury Management Code of Practice recommends that authorities present this policy in the annual TMSS.

The Council has adopted a two loans pool approach for long term debt.

- The full £265.9m of PWLB long term debt from the HRA reform settlement is allocated to the HRA, with the remaining £129.0m of debt (including EIB borrowing) allocated to the GF; and
- All future long term loans are allocated into either the HRA or GF pool.

A breakdown of the HRA borrowing is provided in table 5 below:

Table 5: HRA borrowing:

Loan Type	Loan Amount	Maturity profile	Interest Rate
	£'000s	Yrs	%
PWLB	50,000	25	3.51
PWLB	50,000	35	3.52
PWLB	50,000	43	3.49
PWLB	50,000	44	3.48
PWLB	65,910	45	3.48
Total	265,910		

The HRA debt cap is currently set at £277.65m; however the Council has recently been given approval from the Department for Communities and Local Government, to exceed this by £3.2m in 2016/17 and by a further £10.75m in 2016/17, making the new total cap £291.60 onwards from 2016/17.

9.10 Repayment of Borrowing

As short term borrowing rates are usually 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, any savings will need to be based on 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; and
- enhance the balance of the portfolio (amend the maturity profile).

No loans are proposed to be repaid in 2016/17.

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.

9.11 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 CFR estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

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

Given that the Council has held a significant under borrowing position over the past years, the borrowing of £89 million from the EIB has not resulted in the Council borrowing in advance of its needs.

Current forecasts indicate that it is unlikely that the Council will seek to borrow in advance in 2016/17.

10. Minimum Revenue Provision Policy Statement

10.1 In accordance with Statutory Instrument 2008 number 414 and new guidance issued by the Government under section 21 (1A) of the Local Government Act 2003 a statement on the Council's policy for its annual MRP needs to be approved before the start of the financial year.

10.2 The Council are asked to approve the Minimum Revenue Provision Statement set out in Appendix 5.

11. Member and Officer Training

- 11.1 The CIPFA Code requires the responsible officer, the SPF&I, to ensure that members with responsibility for treasury management receive adequate training in treasury management. Training will be arranged for Members as required. The training needs of treasury management officers are periodically reviewed.

12. Financial Implications

- 12.1 The financial implications are discussed in detail in this report.

13. Legal Implications

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

- 13.1 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.

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

14. Other Implications

- 14.1 **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 – Economic Update
- Appendix 2 – Annual Investment Strategy
- Appendix 3 – Interest Rate Forecasts 2016 – 2019
- Appendix 4 – Prudential Indicators 2016/17 – 2017/18
- Appendix 5 – Minimum Revenue Provision Policy Statement
- Appendix 6 – Treasury management scheme of delegation