

**Treasury Management Strategy Statement**  
Minimum Revenue Provision Policy Statement and  
Annual Investment Strategy

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Gloucester City Council  
2013/16

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# 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 polices, 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 the treasury strategy is meeting the strategy or 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 Audit Committee.

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### **1.3 Treasury Management Strategy for 2013/16**

The strategy for 2013/16 covers two main areas:

#### **Capital issues**

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

#### **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 for Members has been provided in the past and further training will be arranged during 2013/14.

The training needs of treasury management officers are periodically reviewed.

### **1.5 Treasury management consultants**

The Council uses Sector 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.

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## 2 THE CAPITAL PRUDENTIAL INDICATORS 2013/14 – 2015/16

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans are 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	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Regeneration	2.552	2.437	5.374	1.750	0.550
Services & Neighbourhoods	1.635	1.851	0.891	0.630	0.630
Resources	1.571	0.328	0.200	0.200	0.200
Housing General Fund	0.943	0.540	0.744	0.854	0.854
<b>Total Non-HRA</b>	<b>6.701</b>	<b>5.156</b>	<b>7.209</b>	<b>3.434</b>	<b>2.234</b>
HRA	3.925	7.970	10.030	6.100	6.100
<b>Total</b>	<b>10.626</b>	<b>13.126</b>	<b>17.239</b>	<b>9.534</b>	<b>8.334</b>

The capital expenditure relating to the HRA assumes the continuation of Gloucester City Homes as an ALMO. In 2013/14 it is planned that the HRA capital expenditure will result in the HRA Debt Cap of £62.750m being reached. Therefore, in future years the HRA capital expenditure will be funded from HRA major repairs reserves and HRA revenue. The Treasury implications of the potential Co-Co will be evaluated as part of the negotiations and approval process. In view of the relative size of the HRA external debt the treasury implications will be significant.

The Council has other long term liabilities which relate to the difference between the Local Government Pension liabilities and assets. These do not have any treasury impact on Gloucester City Council as the Pension Fund is managed by Gloucestershire County Council. Therefore, other long term liabilities have been excluded from this strategy.

Capital expenditure £m	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Non-HRA	6.701	5.156	7.209	3.434	2.234
HRA	3.925	7.970	10.030	6.100	6.100
<b>Total</b>	<b>10.626</b>	<b>13.126</b>	<b>17.239</b>	<b>9.534</b>	<b>8.334</b>
<b>Financed by:</b>					
Capital receipts	4.230	3.145	3.764	0.050	0.050
Capital grants	1.188	2.011	1.910	0.814	0.754
HRA Major Repairs	0	0	3.171	3.200	3.200
HRA Revenue	0	2.900	2.900	2.900	2.900
<b>Net financing need for the year</b>	<b>5.208</b>	<b>5.070</b>	<b>5.494</b>	<b>2.570</b>	<b>1.430</b>

## 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 Council is asked to approve the CFR projections below:

£m	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
<b>Capital Financing Requirement</b>					
CFR – non housing	16.766	16.325	17.436	19.489	20.320
CFR – housing	53.820	58.840	62.750	62.750	62.750
<b>Total CFR</b>	<b>70.586</b>	<b>75.165</b>	<b>80.186</b>	<b>82.239</b>	<b>83.070</b>
<b>Movement in CFR</b>	<b>5.015</b>	<b>4.579</b>	<b>5.021</b>	<b>2.053</b>	<b>0.831</b>

<b>Movement in CFR represented by</b>					
Net financing need for the year (above)	5.320	5.070	5.494	2.570	1.430
Less MRP/VRP and other financing movements	(0.305)	(0.491)	(0.473)	(0.517)	(0.599)
<b>Movement in CFR</b>	<b>5.015</b>	<b>4.579</b>	<b>5.021</b>	<b>2.053</b>	<b>0.831</b>

## 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 the approximate asset life. The method of the reduction can either be through an annuity calculation (providing a consistent overall annual borrowing charge) or straight line (where the principal repayment is the same each year but the overall borrowing costs reduces).

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).

## 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.

<b>Year End Resources £m</b>	<b>2011/12 Actual</b>	<b>2012/13 Estimate</b>	<b>2013/14 Estimate</b>	<b>2014/15 Estimate</b>	<b>2015/16 Estimate</b>
Fund balances / reserves	3.838	6.700	5.900	5.600	5.300
Capital Grants Unapplied	1.731	1.500	1.000	1.000	1.000
Provisions	0.433	0.400	0.400	0.400	0.400
Earmarked Reserves/Other	0.340	0.300	0.300	0.300	0.300
<b>Total core funds</b>	<b>6.342</b>	<b>8.900</b>	<b>7.600</b>	<b>7.300</b>	<b>7.000</b>
Working capital deficit*	<b>(6.737)</b>	<b>(1.534)</b>	<b>(1.713)</b>	<b>(1.760)</b>	<b>(1.729)</b>
(Under)/over borrowing**	18.519	(0.566)	(5.287)	(4.940)	(4.671)
<b>Expected investments</b>	<b>18.124</b>	<b>6.800</b>	<b>0.600</b>	<b>0.600</b>	<b>0.600</b>

\*Working capital balances represent difference between money owed to the Council and invested in stock less money owed by the Council to creditors. The figures shown are estimated year end; these may be higher 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.

<b>%</b>	<b>2011/12 Actual</b>	<b>2012/13 Estimate</b>	<b>2013/14 Estimate</b>	<b>2014/15 Estimate</b>	<b>2015/16 Estimate</b>
Non-HRA	9.1%	8.9%	9.4%	10.0%	10.1%
HRA	11.6%	12.3%	12.7%	12.3%	12.0%

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

£	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
<b>Council tax - band D</b>	£10.12	(£0.96)	£2.41	£4.48	£1.80

## 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.

## 2.9 Incremental impact of capital investment decisions on housing rent levels

£	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
<b>Weekly housing rent levels</b>	£0.04	£0.81	£0.63	£0.00	£0.00

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

### 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 appropriate 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 31 March 2012, 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	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
<b>External Debt</b>					
Debt at 1 April	89.836	89.105	74.599	74.899	77.299
Expected change in Debt	(0.831)	(14.506)	0.300	2.400	1.100
<b>Actual gross debt at 31 March</b>	<b>89.105</b>	<b>74.599</b>	<b>74.899</b>	<b>77.299</b>	<b>78.399</b>
<b>The Capital Financing Requirement</b>	<b>70.586</b>	<b>75.165</b>	<b>80.186</b>	<b>82.239</b>	<b>83.070</b>
<b>Under / (over) borrowing</b>	<b>(18.519)</b>	<b>0.566</b>	<b>5.287</b>	<b>4.940</b>	<b>4.671</b>

£m	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
<b>Investments at 31<sup>st</sup> March</b>					
<b>Investments</b>	<b>18.124</b>	<b>6.800</b>	<b>0.600</b>	<b>0.600</b>	<b>0.600</b>
<b>Investment Change</b>	<b>(12.061)</b>	<b>(11.324)</b>	<b>(6.200)</b>	<b>-</b>	<b>-</b>

At the 31st March 2012 there was an over borrowing of £18.519m compared with the capital financing requirement. This had reduced from £23.729m at 31st March 2011. It is estimated that by 31st March 2013 the position will have changed to £0.566 million under-borrowing with debt lower than the capital financing requirement. This change is consistent with the approved Treasury Management Strategy and has been achieved by using external investments to fund the in year capital financing requirement/reduce debt.

From 1st April 2012 the Housing Subsidy system has been replaced by a new self financing system. One consequence of this is that the formula used to charge interest to the housing revenue account is no longer applicable. CIPFA has issued a consultation paper which states a preference for a two pool approach in the future where debt is split between the General Fund and Housing Revenue Account. This approach has been adopted with the external long term debt held at 1st April 2012 being split so that the Housing Revenue Account capital financing requirement is fully covered by external debt. In the future , new long term borrowing will be split to maintain a fully borrowed Housing Revenue Account position, however, to the extent that the Housing Revenue Account

capital financing requirement exceeds the long term debt then the average all long term borrowing will be used as an internal charge.

The logic for this approach is that the Housing Revenue Account accounts for almost 80% of the debt and holds assets with the longest life.

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. From 2013/14 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 2013/14 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 Corporate Director of Resources 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	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Debt	85.000	83.000	85.000	86.000

**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	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Debt	86.000	84.000	86.000	87.000

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	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Total	62.750	62.750	62.750	62.750

### 3.3 Prospects for interest rates

The Council has appointed Sector 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 Sector central view.

Annual Average %	Bank Rate	PWLB Borrowing Rates (including certainty rate adjustment)		
		5 year	25 year	50 year
Dec 2012	0.50	1.50	3.70	3.90
March 2013	0.50	1.50	3.80	4.00
June 2013	0.50	1.50	3.80	4.00
Sept 2013	0.50	1.60	3.80	4.00
Dec 2013	0.50	1.60	3.80	4.00
March 2014	0.50	1.70	3.90	4.10
June 2014	0.50	1.70	3.90	4.10
Sept 2014	0.50	1.80	4.00	4.20
Dec 2014	0.50	2.00	4.10	4.30
March 2015	0.75	2.20	4.30	4.50
June 2015	1.00	2.30	4.40	4.60
Sept 2015	1.25	2.50	4.60	4.80
Dec 2015	1.50	2.70	4.80	5.00
March 2016	1.75	2.90	5.00	5.20

The economic recovery in the UK since 2008 has been the worst and slowest recovery in recent history, although the economy returned to positive growth in the third quarter of 2012. Growth prospects are weak and consumer spending, the usual driving force of recovery, is likely to remain under pressure due to consumers focusing on repayment of personal debt, inflation eroding disposable income, general malaise about the economy and employment fears.

The primary drivers of the UK economy are likely to remain external. 40% of UK exports go to the Eurozone so the difficulties in this area are likely to continue to hinder UK growth. The US, the main world economy, faces similar debt problems to the UK, but urgently needs to resolve the fiscal cliff now that the the Presidential elections are out of the way. The resulting US fiscal tightening and continuing Eurozone problems will depress UK growth and is likely to see the UK deficit reduction plans slip.

This challenging and uncertain economic outlook has several key treasury management implications:

- The Eurozone sovereign debt difficulties provide a clear indication of high counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2013/14 and beyond;
- Borrowing interest rates continue to be attractive and may remain relatively low for some time. The timing of any borrowing will need to be monitored carefully;

- There will remain a cost of carry – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

### 3.4 Borrowing strategy

The Council has now successfully moved from an over to an under borrowed position. This means that investments are being used as they mature to fund the in year capital financing requirement/reduce external debt. This has resulted in external debt being lower than the capital financing requirement with Council reserves and balances being utilised to reduce debt rather than being externally invested. This strategy is prudent as there is no differential between temporary borrowing and investment rates and this will also reduce counterparty risk.

The Housing Revenue Account accounts for almost 80% of the capital financing requirement and external debt. The potential creation of a Co-Co will have a significant impact and the Council will actively consider the treasury implications during the negotiation and approval processes.

Against this background and the risks within the economic forecast, caution will be adopted with the 2013/14 treasury operations. The Corporate Director of Resources 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 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 were still relatively cheap.*

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	2013/14	2014/15	2015/16
<b>Interest rate exposures</b>			
	<b>Upper</b>	<b>Upper</b>	<b>Upper</b>
<b>Limits on fixed interest rates based on net debt</b>	£86m	£84m	£86m
<b>Limits on variable interest rates based on net debt</b>	£30m	£30m	£30m
<b>Maturity structure of fixed interest rate borrowing</b>			
	<b>Lower</b>	<b>Upper</b>	
Under 12 months	0%	20%	
12 months to 2 years	0%	20%	
2 years to 5 years	0%	50%	
5 years to 10 years	0%	50%	
10 years and above	0%	90%	
<b>Maturity structure of variable interest rate borrowing</b>			
	<b>Lower</b>	<b>Upper</b>	
Under 12 months	0%	100%	
12 months to 2 years	0%	100%	
2 years to 5 years	0%	100%	
5 years to 10 years	0%	50%	
10 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.

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 the Cabinet, at the earliest meeting following its action

## 4 ANNUAL INVESTMENT STRATEGY

### Investment policy

The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second and then return.

In accordance with guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings, watches and outlooks published by all three ratings agencies with a full understanding of what these reflect in the eyes of each agency. Using the Sector ratings service potential counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

Furthermore, the Council's officers recognise 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 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. This is fully integrated into the credit methodology provided by the advisors, Sector in producing its colour codings which show the varying degrees of suggested creditworthiness.

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.

The aim of the strategy is to generate a list of highly 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 minimisation of risk.

Investment instruments identified for use in the financial year are listed in appendix 5.3 under the 'specified' and 'non-specified' investments categories. Counterparty limits will be as set through the Council's treasury management practices – schedules.

### 4.1 Creditworthiness policy

This Council applies the creditworthiness service provided by Sector. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

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

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands:

- Yellow           5 years
- Purple           2 years
- Blue             1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange          1 year
- Red              6 months
- Green           3 months
- No colour       not to be used

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

Typically the minimum credit ratings criteria the Council use will be a short term rating (Fitch or equivalents) of short term rating F1, long term rating A-, viability rating of A-, and a support rating of 1 There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored daily. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service.

- if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the Council will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

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

## **4.2 Country limits**

The Council has determined that it will only use approved counterparties from the UK and from other countries (where the approved counterparties from outside of the UK are from countries with a minimum sovereign credit rating of AAA from Fitch). The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 5.5. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

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### 4.3 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).

**Investment returns expectations.** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 1 of 2015. Bank Rate forecasts for financial year ends (March) are:

- 2012/13 0.50%
- 2013/14 0.50%
- 2014/15 0.75%
- 2015/16 1.75%

There are downside risks to these forecasts (i.e. start of increases in Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if Bank of England inflation forecasts for two years ahead exceed the Bank of England's 2% target rate.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to three months during each financial year for the next four years are as follows:

2012/13	0.50%
2013/14	0.50%
2014/15	0.60%
2015/16	1.50%

**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: -

<b>Maximum principal sums invested &gt; 364 days</b>			
<b>£m</b>	<b>2013/14</b>	<b>2014/15</b>	<b>2015/16</b>
Principal sums invested > 364 days	£m Nil	£m Nil	£m Nil

### 4.4 Icelandic bank investments

#### Heritable Bank

Heritable bank is a UK registered bank under Scottish law. The company was placed in administration on 7 October 2008. The current position on actual payments received and estimated future payouts is as shown in the table below and this council has used these estimates to calculate the impairment based on recovering 88.61p in the £.

<b>Date</b>	<b>Repayment</b>
Received to date	77.30%
July 2013	5.50%
January 2014	5.81%

Recoveries are expressed as a percentage of the authority's claim in the administration, which includes interest accrued up to 6 October 2008.

#### **4.5 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 Appendices

(These can be appended to the report or omitted as required)

1. Interest rate forecasts
  2. Economic background
  3. Treasury management practice 1 – credit and counterparty risk management (option 1)
  4. Treasury management practice 1 – credit and counterparty risk management (option 2)
  5. Approved countries for investments
  6. Treasury management scheme of delegation
  7. The treasury management role of the section 151 officer
-

APPENDIX: Interest Rate Forecasts 2013 - 2016

Bank														
	NOW	Mar-13	Jun-	Sep-	Dec-13	Mar-14	Jun-	Sep-	Dec-14	Mar-15	Jun-	Sep-15	Dec-	Mar-
Sector's View	0.50	0.50	0.50%	0.50	0.50	0.50%	0.50	0.50	0.50	0.75	1.00	1.25%	1.50	1.75%
UB	0.50	0.50	0.50%	0.50	0.50	0.50%	0.50	0.50	0.50	-	-	-	-	-
Capital Economics	0.50	0.50	0.50%	0.50	0.50	0.50%	0.50	0.50	0.50	-	-	-	-	-
5yr PWLB Rate														
	NOW	Mar-13	Jun-	Sep-	Dec-13	Mar-14	Jun-	Sep-	Dec-14	Mar-15	Jun-	Sep-15	Dec-	Mar-
Sector's View	1.62	1.80	1.80%	1.80	1.80	1.90%	2.00	2.10	2.20	2.40	2.50	2.60%	2.80	3.00%
UB	1.62	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	1.62	1.60	1.60%	1.50	1.30	1.30%	1.30	1.60	1.80	-	-	-	-	-
10yr PWLB Rate														
	NOW	Mar-13	Jun-	Sep-	Dec-13	Mar-14	Jun-	Sep-	Dec-14	Mar-15	Jun-	Sep-15	Dec-	Mar-
Sector's View	2.74	2.90	2.90%	2.90	2.90	3.00%	3.10	3.20	3.30	3.50	3.60	3.80%	3.90	4.10%
UB	2.74	3.00	3.10%	3.20	3.40	3.50%	3.60	3.70	3.80	-	-	-	-	-
Capital Economics	2.74	2.80	2.80%	2.55	2.30	2.30	2.30	2.55	2.55	-	-	-	-	-
25yr PWLB Rate														
	NOW	Mar-	Jun-	Sep-13	Dec-13	Mar-14	Jun-14	Sep-	Dec-	Mar-	Jun-	Sep-15	Dec-	Ma
Sector's View	3.95	4.10	4.10%	4.10	4.10	4.20	4.20	4.30	4.40	4.60	4.60	4.80	4.90	5.00%
UB	3.95	4.20	4.30%	4.40	4.50	4.50	4.50	4.50	4.50	-	-	-	-	-
Capital Economics	3.95	3.90	3.85%	3.70	3.55	3.55	3.55	3.78	3.78	-	-	-	-	-
50yr PWLB Rate														
	NOW	Mar-	Jun-	Sep-13	Dec-13	Mar-14	Jun-14	Sep-	Dec-	Mar-	Jun-	Sep-15	Dec-	Ma
Sector's View	4.11	4.20	4.20%	4.20	4.20	4.40	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10%
UB	4.11	4.30	4.40%	4.50	4.60	4.60	4.60	4.60	4.60	-	-	-	-	-
Capital Economics	4.11	4.20	4.10%	4.00	3.90	3.90	3.90	4.10	4.10	-	-	-	-	-

## 5.1 APPENDIX: Economic Background

### The Global economy

The Eurozone debt crisis has continued to cast a pall over the world economy and has depressed growth in most countries. This has impacted the UK economy which is unlikely to grow significantly in 2012 and is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy; this recession is the worst and slowest recovery of any of the five recessions since 1930. A return to growth @ 1% in quarter 3 is unlikely to prove anything more than a washing out of the dip in the previous quarter before a return to weak, or even negative, growth in quarter 4.

The **Eurozone sovereign debt crisis** has abated somewhat following the ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement was Spain which continues to prevaricate on making such a request and so surrendering its national sovereignty to IMF supervision. However, the situation in Greece is heading towards a crunch point as the Eurozone imminently faces up to having to relax the time frame for Greece reducing its total debt level below 120% of GDP and providing yet more financial support to enable it to do that. Many commentators still view a Greek exit from the Euro as inevitable as total debt now looks likely to reach 190% of GDP i.e. unsustainably high. The question remains as to how much damage a Greek exit would do and whether contagion would spread to cause Portugal and Ireland to also leave the Euro, though the longer a Greek exit is delayed, the less are likely to be the repercussions beyond Greece on other countries and on EU banks.

Sentiment in financial markets has improved considerably since this ECB action and recent Eurozone renewed commitment to support Greece and to keep the Eurozone intact. However, the foundations to this "solution" to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse.

**The US economy** has only been able to manage weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing (QE) combined with a commitment to a continuation of ultra low interest rates into 2015. Unemployment levels have been slowly reducing but against a background of a fall in the numbers of those available for work. The fiscal cliff facing the President at the start of 2013 has been a major dampener discouraging business from spending on investment and increasing employment more significantly in case there is a sharp contraction in the economy in the pipeline. However, the housing market does look as if it has, at long last, reached the bottom and house prices are now on the up.

Hopes for a broad based recovery have, therefore, focused on the **emerging markets**. However, there are increasing concerns over flashing warning signs in various parts of the Chinese economy that indicate it may be heading for a hard landing rather than a gradual slow down.

### The UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order over the next four years, now look as if they will fail to achieve their objectives within the original planned timeframe. Achieving this target is dependent on the UK economy growing at a reasonable pace but recession in the Eurozone, our biggest trading partner, has depressed growth whilst tax receipts have not kept pace with additional welfare benefit payments. It will be important for the Government to retain investor confidence in UK gilts so there is little room for it to change course other than to move back the timeframe.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. There is, though, little evidence that consumer confidence levels are recovering nor that the manufacturing sector is picking up. On the positive side, growth in the services sector has rebounded in Q3 and banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lending scheme, which started in August 2012, has not yet had the time to make a significant impact. Finally, the housing market remains tepid and the outlook is for house prices to be little changed for a prolonged period.

**Economic Growth.** Economic growth has basically flat lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation quarterly report for August 2012 and were then further lowered in the November Report. Quantitative Easing (QE) was increased again by £50bn in July 2012 to a total of £375bn. Many forecasters are expecting the MPC to vote for a further round of QE to stimulate economic activity regardless of any near-term optimism. The announcement in November 2012 that £35bn will be transferred from the Bank of England's Asset Purchase Facility to the Treasury (representing coupon payments to the Bank by the Treasury on gilts held by the Bank) is also effectively a further addition of QE.

**Unemployment.** The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years as over one million jobs have been created in the private sector in the last two years.

**Inflation and Bank Rate.** Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. However, inflation increased back to 2.7% in October though it is expected to fall back to reach the 2% target level within the two year horizon.

#### **AAA rating.**

On 22<sup>nd</sup> February 2013 Moody's Credit Rating Agency downgraded the UK Long term rating from AAA to Aa1. This move, while regrettable, had largely been factored into money market rates although it would appear to have exacerbated the relative decline in sterling.

#### **Sector's forward view**

Economic forecasting remains difficult with so many external influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains relatively fragile and whilst there is still a broad range of views as to potential performance, expectations have all been downgraded during 2012. Key areas of uncertainty include:

- the potential for the Eurozone to withdraw support for Greece at some point if the costs of such support escalate were to become prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- inter government agreement on how to deal with the overall Eurozone debt crisis could fragment; the impact of the Eurozone crisis on financial markets and the banking sector;

- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;
- the risk of the UK's main trading partners, in particular the EU and US, falling into recession ;
- stimulus packages failing to stimulate growth;
- elections due in Germany in 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.
- the potential for action to curtail the Iranian nuclear programme
- the situation in Syria deteriorating and impacting other countries in the Middle East

The focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. The interest rate forecast in this report represents a balance of downside and upside risks. The downside risks have already been commented on. However, there are specific identifiable upside risks as follows to PWLB rates and gilt yields, and especially to longer term rates and yields: -

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields
- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held
- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Eurozone
- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth
- The possibility of a UK credit rating downgrade (Moody's has stated that it will review the UK's Aaa rating at the start of 2013).

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

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

**NON-SPECIFIED INVESTMENTS:** These are any investments which do not meet the specified investment criteria. A maximum of 50% \*\* will be held in aggregate in non-specified investment

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

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

	* Minimum credit criteria / colour band	** Max % of total investments/ £ limit per institution	Max. maturity period
<b>DMADF – UK Government</b>	N/A	<b>100%</b>	<b>6 months</b>
UK Government gilts	UK sovereign rating	50%	5 years
UK Government Treasury bills	UK sovereign rating	50%	6 months
Bonds issued by multilateral development banks	UK sovereign rating	50%	6 months
Money market funds	AAA	100%	Liquid
Local authorities	N/A	100%	1year
Term deposits with banks and building societies	Yellow Purple Blue Orange Red Green No Colour	£5m £5m £5m £5m £5m 0	Up to 5 years Up to 2 years Up to 1 year Up to 1 year Up to 6 Months Up to 3 months Not for use
CDs or corporate bonds with banks and building societies	Yellow Purple Blue Orange Red Green No Colour	0 0 0 0 0 0 0	Up to 5 years Up to 2 years Up to 1 year Up to 1 year Up to 6 Months Up to 3 months Not for use

Enhanced cash funds		nil	
Corporate bond funds		nil	
Gilt funds	UK sovereign rating	nil	
Property funds		nil	

**Accounting treatment of investments.** The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

### 5.3 APPENDIX: Approved countries for investments

*Based on lowest available rating*

#### AAA

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

#### AA+

- France
- Hong Kong
- U.S.A.
- UK

#### AA

- Abu Dhabi (UAE)
- Qatar

#### AA-

- Belgium
- Japan
- Saudi Arabia

## **5.4 APPENDIX: Treasury management scheme of delegation**

### **(i) Full board/council**

- receiving and reviewing reports on treasury management policies, practices and activities;
- approval of annual strategy.

### **(ii) Boards/committees/council/responsible body**

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- budget consideration and approval;
- approval of the division of responsibilities;
- receiving and reviewing regular monitoring reports and acting on recommendations;
- approving the selection of external service providers and agreeing terms of appointment.

### **(iii) Body/person(s) with responsibility for scrutiny**

- reviewing the treasury management policy and procedures and making recommendations to the responsible body.

## **5.5 APPENDIX: The treasury management role of the section 151 officer**

### **The S151 (responsible) officer**

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.