Mole Valley District Council

Agenda Item 4

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Subject	Treasury Management Strategy Report 2015/16 to 2017/18

RECOMMENDATIONS

The Audit Committee is asked to consider each of the four key elements of this report:

1. The capital expenditure Prudential Indicators and Limits for 2015/16 to 2017/18 contained within Appendix A of the report.
2. The Minimum Revenue Provision (MRP) Statement contained within Appendix A that sets out the Council's policy on MRP.
3. The Treasury Management Strategy 2015/16 to 2017/18 and the treasury Prudential Indicators contained within Appendix B.
4. The Investment Strategy 2015/16 contained in the Treasury Management Strategy (Appendix B), and the detailed criteria included in Annex B1.

1. BACKGROUND

1.1 This report outlines the Council's prudential indicators for 2015/16 to 2017/18 and sets out the expected treasury operations for this period. It fulfils four key legislative requirements:

- The reporting of the **prudential indicators** setting out the expected capital activities (as required by the CIPFA Prudential Code for Capital Finance in Local Authorities - Appendix A). The treasury management prudential indicators are now included as treasury indicators in the CIPFA Treasury Management Code of Practice;

- The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year (as required by Regulations issued by the Department for Communities and Local Government (DCLG) – Also Appendix A);

- The **treasury management strategy statement** which sets out how the Council's treasury service will support the capital decisions taken above, the day to day treasury management and the limitations on activity through treasury prudential indicators. The key indicator is the **Authorised Limit**, the maximum amount of debt the Council could afford in the short term, but which would not be sustainable in the longer term. This is the Affordable Borrowing Limit required by Section 3 of the Local Government Act 2003. This is in

accordance with the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code and is detailed in Appendix B;

- The **investment strategy** that sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss. This Strategy is in accordance with the Department for Communities and Local Government Investment Guidance and is detailed in Appendix B.

1.2 One requirement of the Code of Practice on Treasury Management is that the approach is set out and forms part of the Council's financial regulations. This is shown at Annex B4. The key is that a responsible body be accountable for ensuring effective scrutiny of the treasury management strategy and policies. The policies and parameters provide an approved framework within which the officers undertake the day-to-day capital and treasury activities. In view of the timescales this item is being considered by the Council on 10th March 2015.

2. CORPORATE IMPLICATIONS

2.1 Legal Implications

In addition to the statutory requirements mentioned in the report, the prudential indicators, the treasury management strategy and annual plan must be approved before the start of the new financial year, in this case, 1st April, 2015.

2.2 Financial & Risk Implications

Financial implications and risk inherent in the Council's borrowing and investment strategy have been considered throughout this report in line with statutory guidance and the requirement to set indicators that are affordable, sustainable and prudent.

Risk Management is a fundamental aspect of implementing an effective Treasury Management Strategy. The Strategy outlines the way in which the Council's investments will be managed and there is always an element of risk in these activities. This Strategy provides a framework that it considers provides a good return on the Council's investments, but without placing these at undue risk.

Clearly the nature of the financial markets is such that the risks can vary throughout the year. These will be managed in line with the usual ongoing risk arrangements, although in addition the Finance Team maintain an overview of these risks and will vary the investments, in consultation with the Deputy Chief Executive (Section 151 Officer), Portfolio Holder for Finance and Corporate Services and Chairman of Audit Committee as considered appropriate.

2.3 Equalities Implications

None identified in this report.

2.4 Employment Issues

None identified in this report.

2.5 Sustainability Issues

None identified in this report

2.6 Consultation

Capita Asset Services (Capita Asset Services is a trading name of Capita Treasury Solutions Limited and are the Council's treasury management advisors) views have been incorporated within this report.

2.7 Reputational Issues

In undertaking treasury management activities, the Council is investing and potentially borrowing public money. In doing so, the Council must have regard to security, liquidity and yield of investments (in that order). Failure to follow this professional code can result in loss of capital as was recently experienced by some local authorities following the Icelandic banking crisis. Achievement of a reasonable yield, in line with requisite security and liquidity requirements can provide funding to support front line Council services which the public demand.

3. Background Papers

CIPFA – The Prudential Code for Capital Finance in Local Authorities (2011 Edition).
CIPFA – Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes (2011 Edition).
Capita Asset Services Model Treasury Management Strategy Statement 2015/16.
The Council's latest Medium Term Financial Statement (MTFS).
DCLG - Guidance on Local Government Investments (2010).
Treasury Management (Internally Managed Funds) System Document – including Treasury Management Practices (TMPs).

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Appendix A	The Capital Prudential Indicators 2015/16 – 2017/18 and the Minimum Revenue Provision (MRP) Statement
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Appendix A

The Capital Prudential Indicators 2015/16 – 2017/18

Introduction

1. The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, and reflects the outcome of the Council's underlying capital appraisal systems. The Council is asked to approve the prudential indicators set out below for the period up to 2017/18.

2. Within this overall prudential framework there is an impact on the Council's treasury management activity, as it will directly impact on borrowing or investment activity. As a consequence the treasury management strategy for 2015/16 to 2017/18 is included in Appendix B to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

The Capital Expenditure Plans

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

4. The Council's capital expenditure plans are summarised overleaf and this forms the first of the prudential indicators. A certain level of capital expenditure is grant supported by the Government (ie for Mole Valley, grants towards disability adaptations). Any decisions by the Council to spend above this level will be considered unsupported capital expenditure. This unsupported capital expenditure needs to have regard to:
   - Service objectives (e.g. strategic planning);
   - Stewardship of assets (e.g. asset management planning);
   - Value for money (e.g. option appraisal);
   - Prudence and sustainability (e.g. implications for external borrowing and whole life costing);
   - Affordability (e.g. implications for the council tax and rents);
   - Practicality (e.g. the achievability of the Corporate Plan).

5. The revenue consequences of capital expenditure, particularly the unsupported capital expenditure, will need to be paid for from the Council's own resources.

6. This capital expenditure can be paid for immediately (by applying capital resources such as capital receipts, capital grants or revenue resources), but if these resources are insufficient any residual capital expenditure will add to the Council's borrowing need.

7. The key risks to the plans are that the level of Government support has been estimated and therefore maybe subject to change. Similarly some estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale. For instance, developer contributions may not be forthcoming due to the impact of the recession on the property market and implementation of the Community Infrastructure Levy (CIL) arrangements or due to the Government change in policy last November which reduced the developer contributions towards affordable housing on small-scale developments.

8. The Council is asked to approve the summary capital expenditure projections below. The levels of expenditure for 2015/16 and 2016/17 are higher than usual due to the inclusion of two major schemes in excess of £4m, the refurbishments of Pippbrook and Dorking Football Ground. This forms the first prudential indicator:

Prudential Indicator 1 – Capital Expenditure Plans

Capital Expenditure	2013/14 Actual £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Capital Expenditure	3.389	5.396	7.402	7.177	2.937
Financed by:					
Capital receipts	2.171	2.286	4.772	2.266	1.200
Government grants	0.272	0.270	0.270	0.270	0.270
Other grants and contributions	0.946	1.138	0.950	1.583	0.912
Revenue	0	1.702	1.410	3.058	0.555
Net financing need for the year	**0**	**0**	**0**	**0**	**0**

The Council's Borrowing Need (the Capital Financing Requirement)

9. The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is that element of historic capital expenditure which has not yet been paid for through capital or revenue resources. It therefore reflects the underlying need to finance capital expenditure by borrowing or other long-term liability arrangements. In Mole Valley's case, the Council is debt-free but some of our contract arrangements are deemed to constitute 'finance leases' and are therefore long-term liabilities for the purpose of these regulations. A positive CFR indicates the requirements to provide MRP. In the Council's case the positive CFR is entirely in relation to finance leases. The MRP option used for the Authority's finance lease agreements is the asset life method in that it will run over the life of the lease.

10. The Council is asked to approve the CFR projections below:

Prudential Indicator 2 – CFR Projections

Capital Financing Requirement (CFR)	2013/14 Actual (31/03/14) £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Total CFR	3.085	2.885	2.585	2.285	1.985

Movement in CFR represented by					
Net financing need for the year (above)	0	0	0	0	0

Less MRP/VRP and other financing movements	(0.307)	(0.300)	(0.300)	(0.300)	(0.300)
Movement in CFR	(0.307)	(0.300)	(0.300)	(0.300)	(0.300)

11. The Council is required to pay off an element of the accumulated capital spend each year (the CFR) through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary revenue payments (VRP).
12. DCLG 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 prudent provision. The Council is recommended to approve the following MRP Statement:
13. For capital expenditure incurred before 1 April 2008 or which in the future is Supported Capital Expenditure, the MRP policy will be:
    - **Existing practice** - MRP will follow the existing practice outlined in former DCLG Regulations

    Note: Supported capital expenditure is capital spend that central government provides with a contribution through grant.
14. From 1 April 2008 for all unsupported borrowing (including finance leases) the MRP policy will be:
    - **Asset Life Method** – MRP will be based on the estimated life of the assets.
15. The Council is currently debt free. The MRP the Council pays is purely in relation to the finance lease repayments.

The Use of the Council's Resources and the Investment Position

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

Year End Resources	2013/14 Actual £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Fund balances					
Fund balances/reserves	3.424	3.526	3.385	3.526	3.663
Capital reserves	9.343	8.178	4.456	2.607	2.457
Earmarked reserves	7.315	5.189	4.791	1.583	1.116
Total Core Funds	**20.082**	**16.893**	**12.632**	**7.716**	**7.236**
Working Capital *	2.000	2.000	2.000	2.000	2.000
Expected Investments	**22.082**	**18.893**	**14.632**	**9.716**	**9.236**
Investments change		**(3.189)**	**(4.261)**	**(4.916)**	**(0.480)**

* Working capital balances shown are estimated year end, these may be higher mid-year.

Affordability Prudential Indicators

17. 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:

18. **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.

Prudential Indicator 3 – Ratio of financing costs to net revenue stream

Ratio of Finance Costs to Net Revenue Stream	2013/14 Actual £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Net Finance Cost (Interest)	(0.43)	(0.48)	(0.50)	(0.48)	(0.39)
Revenue Budget	9.69	10.06	10.06	10.07	10.04
Ratio %	**(4.4)**	**(4.8)**	**(5.0)**	**(4.8)**	**(3.9)**

19. The estimates of financing costs include current commitments and the proposals in the 2015/16 budget report.

20. **Incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the revenue costs associated with changes to the three year capital programme recommended in the 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.

Prudential Indicator 4 - Incremental impact of capital investment decisions on the Band D Council Tax

	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
2014/15 MTFS	3.1	7.4	2.7	2.6	2.6
2015/16 MTFS	3.4	5.4	7.4	7.2	2.9
Increase / (Decrease) in Capital Programme	0.3	(2.0)	4.7	4.6	0.3
Interest rate assumption	0.50%	0.50%	0.75%	1.25%	2.00%
(Loss) / Increase of interest due to use / (investment) of capital reserves	(0.002)	0.010	(0.035)	(0.058)	(0.006)
Council Tax Base	38,651	38,631	39,632	39,672	39,711
Increase / (Decrease) in Band D Council Tax	£0.05	(£0.26)	£0.88	£1.46	£0.15

Treasury Management Strategy 2015/16 – 2017/18

1. This Authority adopts the following form of words to define the policies and objectives of its treasury management activities:

   This Authority defines its treasury management activities as:

   - The management of the 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.
   - This Authority regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the Authority.
   - This Authority acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

2. The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators in Appendix A consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the processes that ensure the Council meets its balanced budget requirement under the Local Government Act 2003.
3. The Council's treasury activities are strictly regulated by statutory requirements (the Local Government Finance Act 2003, the CIPFA Prudential Code, CLG MRP and investment guidance) and a professional code of practice (the CIPFA Code of Practice on Treasury Management – revised 2011). This Council has adopted the revised Code.
4. As a result of adopting the Code the Council also adopted a Treasury Management Policy Statement. This adoption is a requirement of one of the prudential indicators. The Treasury Management Policy Statement is appended at Annex B4.
5. The Council's Constitution requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks and the management of the risks associated with the treasury service. A further treasury report is produced monitoring the mid-year position as well as a report after the year-end detailing the actual activity for the year. The above reports are required to be adequately scrutinised by the Audit Committee. The Council on 10th March 2015 will approve this report subject to this Committee being satisfied.
6. This Strategy covers:
   - Debt and investment projections (including the Operational Boundary);
   - Limits to borrowing activity (including the Authorised Limit for external debt);
   - Expected movement in interest rates;
   - Borrowing strategy;

- Investment strategy;
- Economic investment considerations;
- Sensitivity to interest rate movements;
- Treasury management limits on activity;
- Additional treasury issues.

Debt and Investment Projections 2015/16 – 2017/18

Prudential Indicator 5 - Gross Borrowing and Long-term Liabilities and the Capital Financing Requirement (CFR).

7. In order to ensure that borrowing will only be for a capital purpose, the Council should ensure that gross external borrowing does not, except in the short-term, exceed the total CFR (ie the underlying capital borrowing need).

External debt	2013/14 Actual £m	2014/15 Est. £m	2015/16 Est. £m	2016/17 Est. £m	2017/18 Est. £m
Debt at 1st April	0	0	0	0	0
Expected change in debt	0	0	0	0	0
Other long-term liabilities (OLTL)	3.1	2.9	2.6	2.3	2.0
Expected change in OLTL	(0.2)	(0.3)	(0.3)	(0.3)	(0.3)
Debt at 31st March	2.9	2.6	2.3	2.0	1.7
CFR	3.1	2.9	2.6	2.3	2.0
Under/(over) borrowing	0.2	0.3	0.3	0.3	0.3

Treasury Indicators: Limits to Borrowing Activity

8. Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well-defined limits.

9. One of these is that the Council needs to ensure that its total borrowing 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 2015/16 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.

10. The Deputy Chief Executive (Section 151 Officer) reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the 2015/16 budget report.

11. The borrowing requirement comprises the expected movement in the CFR and any maturing debt that will need to be re-financed. The table below shows this effect on the treasury position over the next three years. The **Operational Boundary** is an indicator based on the expected maximum external debt during the course of the year and focuses on day-to-day treasury management activity. It is not a limit in the strictest sense in that it may be breached. The Operational Boundary represents a level of short-term indebtedness that the Deputy Chief Executive (Section 151 Officer) considers would be prudent to cover any unforeseen circumstance that may arise in the management of the Council's day-to-day cash flow activities. The Council has an actual policy of never going into overdraft yet it is advisable that this limit is set at £4,000,000 for 2015/16 – 2017/18. This limit is lower than the Authorised Limit because cash flow activities may lead to occasional, but not sustained, breaches of the Operational Boundary.

12. The Operational Boundary links directly to the Council's estimates of the CFR and estimates of other cash flow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent, but not

worst case scenario but without the additional headroom included within the Authorised Limit.

13. The Deputy Chief Executive (Section 151 Officer) has the authority, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long-term liabilities. Decisions will be based on consideration of the risk the Council may be exposed to in the course of pursuing its responsibilities and it is considered the current spread of the Council's investment portfolio provides sufficient capacity to counteract any adverse economic news regarding security of financial institutions. Any movement between these separate limits would be reported to the next available meeting of the Audit Committee.

Prudential Indicator 6 – Operational Boundary

Operational Boundary	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Debt	1.1	1.4	1.7	2.0
Other long-term liabilities	2.9	2.6	2.3	2.0
Total	**4.0**	**4.0**	**4.0**	**4.0**

14. The related impact of the above movements on the revenue budget is:

Revenue Budgets	2014/15 Estimate £m	2014/15 Updated £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Interest on Borrowing	0	0	0	0	0
Net General Fund Borrowing Cost	0	0	0	0	0
Investment income	**0.477**	**0.510**	**0.498**	**0.476**	**0.390**

15. **The Authorised Limit for External Debt** – A further key prudential indicator represents a control on the overall level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by full Council. It reflects the level of external debt that, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

16. 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 no control has yet been exercised.

17. The Council is asked to approve the following Authorised Limit:

Prudential Indicator 7 – Authorised Limit

Authorised Limit	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Debt	2.6	2.9	3.2	3.5
Other long term liabilities	2.9	2.6	2.3	2.0
Total	**5.5**	**5.5**	**5.5**	**5.5**

18. Borrowing in advance of need – The Council has some flexibility to borrow funds in year for use in future years. The Deputy Chief Executive (Section 151 Officer) may do this under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. Whilst the Deputy Chief Executive (Section 151 Officer) will adopt a cautious approach to any such borrowing, where there is a clear business case for doing so borrowing may be undertaken to fund the approved capital programme. Borrowing in advance will be made within the constraints that:

- It will be limited to no more than 100% of the expected increase in borrowing need (CFR) over the three year planning period; and
- Would not look to borrow more than 18 months in advance of need.

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

Prospects for interest rates

20. The Council has appointed Capita Asset Services, Treasury Solutions as its external treasury management advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives their central view.

Month/Year	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Mar 2015	0.50	2.10	3.30	3.30
Jun 2015	0.50	2.20	3.40	3.40
Sep 2015	0.50	2.30	3.60	3.60
Dec 2015	0.50	2.50	3.80	3.80
Mar 2016	0.75	2.60	3.90	3.90
Jun 2016	0.75	2.70	4.00	4.00
Sep 2016	1.00	2.80	4.20	4.20
Dec 2016	1.25	3.00	4.30	4.30
Mar 2017	1.25	3.10	4.40	4.40
Jun 2017	1.50	3.20	4.50	4.50
Sep 2017	1.50	3.30	4.60	4.60
Dec 2017	1.75	3.40	4.60	4.60
Mar 2018	2.00	3.50	4.70	4.70

21. UK gross domestic product (GDP) growth surged during 2013 and 2014 but cooled somewhat towards the end of 2014. However, growth is expected to regain stronger momentum during 2015 and 2016 under the stimulative effect of the sharp fall in oil prices and inflation potentially falling into negative territory, but anyway being near to zero until towards the end of 2015. Combined with a significant rise in average wage rates, this is expected to lead to consumer disposable income rising by around 3.5% in 2015. This would therefore strengthen consumer expenditure without much downside to the savings ratio. However, there still needs to be a significant rebalancing of the economy away from consumer spending to manufacturing, business investment and exporting in order for this recovery to become more firmly established. The Bank of England February Inflation Report drew attention to the falling level of unemployment and the reduction of spare capacity or slack in the economy. This is expected to feed through into an increase in pressure for wage increases and together with the sharp fall in the price of oil starting to fall out of the twelve month calculation of consumer price index (CPI) inflation in quarter 4 of 2015, is expected to result in a sharp rise in inflation from near zero in that quarter and also onward into 2016.

22. The United States, the biggest world economy, has generated stunning growth rates of 4.6% (annualised) in Q2 2014 and 5.0% in Q3, followed by a cooler 2.6% in Q4 (overall 2.4% for 2014 as a whole). This is hugely promising for the outlook for strong growth going forwards and it very much looks as if the US is now firmly on the path to full recovery from the financial crisis of 2008. Consequently, it is now confidently expected that the US will be the first major western economy to start on central rate increases by the end of 2015.

23. The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

- Greece: the general election on 25th January 2015 is likely to bring a political party to power which is anti European Union (EU) and anti austerity. However, if this eventually results in Greece leaving the Euro, it is unlikely that this will directly destabilise the Eurozone (EZ) as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect

effects of the likely strenthening of anti EU and anti austerity political parties throughout the EU is much more difficult to quantify;

- As for the Eurozone in general, concerns in respect of a major crisis subsided considerably in 2013. However, the downturn in growth and inflation during the second half of 2014, and worries over the Ukraine situation, Middle East and Ebola, have led to a resurgence of those concerns as risks increase that it could be heading into deflation and prolonged very weak growth. Sovereign debt difficulties have not gone away and major concerns could return in respect of individual countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2015/16 and beyond;
- Borrowing interest rates have been volatile during 2014 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. The closing weeks of 2014 saw gilt yields dip to historically remarkably low levels after inflation plunged, a flight to quality from equities (especially in the oil sector), and from the debt and equities of oil producing emerging market countries, and an increase in the likelihood that the European Central Bank (ECB) will commence quantitative easing (purchase of EZ government debt) in early 2015. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt;
- There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

Borrowing Strategy 2015/16 – 2017/18

24. It is anticipated that there will be no borrowings required to fund the capital programme during 2015/16 – 2017/18. However, the increased size of the capital programme in 2015/16 means that the Council will be drawing heavily on its reserves. On current estimates, borrowing will not be necessary but a relatively small increase in capital expenditure may make it so. The position will be closely monitored.

Investment Strategy 2015/16 – 2017/18

Changes to Credit Rating Methodology

25. The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings 'uplift' due to implied levels of sovereign support. More recently, in response to the evolving regulatory regime, the agencies have indicated they may remove these 'uplifts'. This process may commence during 2014/15 and or 2015/16. The actual timing of the changes is still subject to discussion, but this does mean immediate changes to the credit methodology are required.
26. It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level

of sovereign support that has been built into ratings through the financial crisis. The eventual removal of implied sovereign support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

27. Both Fitch and Moody's provide 'standalone' credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody's has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments, both agencies have suggested going forward that these will be in line with their respective long-term ratings. As such, there is no point monitoring both long-term and these 'standalone' ratings.

28. Furthermore, Fitch has already begun assessing its Support ratings, with a clear expectation that these will be lowered to 5, which is defined as 'A bank for which there is a possibility of external support, but it cannot be relied upon'. With all institutions likely to drop to these levels, there is little to no differentiation to be had by assessing Support ratings.

29. As a result of these rating agency changes, the credit element of Capita's future methodology will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor's that Capita have always taken, but a change to the use of Fitch and Moody's ratings. Furthermore, Capita will continue to utilise credit default swap (CDS) prices as an overlay to ratings in their new methodology.

Investment Policy

30. The Council's investment policy has regard to the DCLG'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').

31. In accordance with the above guidance from the DCLG and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk.

32. Continuing regulatory changes in the banking sector are designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key ratings used to monitor counterparties being the short-term and long-term ratings only. Viability, Financial Strength and Support Ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes.

33. As with previous practice, ratings will 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.

34. 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.

35. **Key Objectives -** The Council's primary objectives for its investment strategy are safeguarding the repayment of the principal and interest of its investments on time first and ensuring adequate liquidity second. The investment return being a third objective. Following the economic background (Annex B6), the current investment climate has one over-riding risk consideration that of counterparty security risk. As a result of these underlying concerns, officers' are implementing an operational investment strategy that tightens the controls already in place in the approved investment strategy.

36. **Risk Benchmarking** – A development in the revised Codes and the Department for Communities and Local Government (DCLG) consultation paper is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are fairly new requirements to the Member reporting, although the application of these is more subjective in nature. Additional background in the approach taken is attached at Annex B2.

37. These benchmarks are broad limits and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers' will monitor the current and trend position and amend the operational strategy depending on any changes. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

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

    - 0.09% historic risk of default when compared to the whole portfolio.

    The change in investment strategy to utilise some longer-term funds has meant this overall benchmark has been raised. Longer-term funds have been placed with a nationalised bank that currently maintains a long-term rating of A with the credit rating agencies. This has pushed the benchmark up, but is mitigated by separate counterparty creditworthiness criteria.

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

39. **Liquidity** – In respect of this area the Council seeks to maintain:

    - Bank overdraft - £100,000
    - Liquid short-term deposits of at least £2m available with a week's notice.

40. **Yield** - Local measures of yield benchmarks are:
    - Investments – Internal returns above the 7-day LIBID (London Interbank BID) rate

41. **Creditworthiness policy -** The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:

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

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

42. The Deputy Chief Executive (Section 151 Officer) will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. The criteria is separate to that which chooses Specified and Non-Specified investments as it provides an overall pool of counterparties considered high quality the Council may use rather than defining what its investments are.

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

44. The criteria for providing a pool of high quality investment counterparties both Specified and Non-specified investments are; (refer to Annex B1 for a definition of each)

- Banks 1 - Good Credit Quality – the Council will only use banks which:

  (a) are UK banks (it should be noted that 'Banks 1' criteria does not rely upon the UK sovereign rating remaining at AA+); and/or

  (b) are non-UK and domiciled in a country which has a minimum sovereign long term rating of AAA (see Annex B3).

  And have, as a minimum, the following credit ratings (where rated):

  (a) Short Term – F1/P-2/A-1 (Fitch/Moody's/Standard and Poor's)

  (b) Long Term – A/A3/A (Fitch/Moody's/Standard and Poor's)

- Banks 2 – Guaranteed Banks with suitable Sovereign Support – In addition, the Council will use banks whose ratings fall below the criteria specified above if all of the following conditions are met:

  (a) wholesale deposits in the bank are covered by a government guarantee;

  (b) the government providing the guarantee is rated 'AAA' by all three major rating agencies (Fitch, Moody's and Standard & Poor's); and

  (c) the Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.

- Banks 3 – Part nationalised UK banks – Lloyds Banking Group and Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.

- Banks 4 – The Council's own banker, National Westminster Bank, for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

- Building Societies – the Council may use all UK Societies which:

  - have assets in excess of £1 billion

- Money Market Funds – any AAA rated fund

- UK Government (including gilts and the DMADF (Debt Management Account Deposit Facility)).

- Supranational bonds
- Local Authorities, Parish Councils etc – the maximum permitted investment with any one bank/building society/fund is £7.5million (as agreed by Council – 21st February 2011).
- Pooled property funds – up to £7.5m

A limit of 60% will be applied to the use of Non-Specified investments.

45. **Country and sector considerations** - Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part the country selection will be chosen by the credit rating of the Sovereign state in Banks 1 above. In addition:
    - no more than 20% will be placed with any non-UK country at any time;
    - limits in place above will apply to a group of companies;
    - sector limits will be monitored regularly for appropriateness.

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

47. **Time and monetary limits applying to investments** - The time and monetary limits for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch (or equivalent)	**Money Limit**	**Time Limit**
Upper Limit Category – UK Banks and Building Societies	A (Minimum long-term credit rating)	60% of fund	5 years
Middle Limit Category – UK Banks and Building Societies	F1 (Minimum short-term credit rating)	£7.5m	364 days
Lower Limit Category – UK Banks and Building Societies	F1 (Minimum short-term credit rating)	£7.5m	364 days

Group Limit (Parent Companies and all subsidiaries)	F1 (Minimum short-term credit rating)	£7.5m	364 days
Other Institution Limits (see note below)	-	£7.5m	364 days
Guaranteed Organisations*	-	£7.5m	*

* Guaranteed institutions will be restricted to the terms of the guarantee.

Note: The Upper and Middle Limit categories - If these are for greater than 1 year, they will include relatively high rated institutions (A). The Lower Limit Category will normally just be used for unrated subsidiaries and building societies. In all cases building societies will have a minimum asset base of £1bn. The Other Institution Limit will be for other local authorities, the Debt Management Account Deposit Facility (DMADF), Money Market Funds and Gilt and Supranational investments. These are all considered high quality names – although not always rated – and therefore will likely have the same limit as the Upper Category.

48. The proposed criteria for Specified and Non-Specified investments are shown in Annex B1 for approval.

49. In the normal course of the Council's cash flow operations it is expected that both Specified and Non-Specified investments will be utilised for the control of liquidity as both categories allow for short-term investments.

50. The use of longer-term instruments (greater than one year from inception to repayment) will fall in the Non-Specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the longer-term investment limits.

51. **Country Limits** - The Council currently limits its investment criteria to entities domiciled in the UK, although the Strategy does allow use of foreign banks as long as they meet the minimum long-term credit rating of A and sovereign rating of AAA. When combined with the prudent credit criteria, this means that potential financial institutions will be limited. Given the expected total investments this means that the current £7.5m limit will force the Council to either invest with other local authority bodies or direct with the UK government via the Debt Management Office (DMO) deposit facility. Both of these options will likely act as a drag on overall investment performance.

Economic Investment Considerations

52. **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 (ie rates of investments up to 12 months).

53. **Investment returns expectations** - the Bank Rate is forecast to remain unchanged at 0.50% before starting to rise from quarter 1 of 2016. Bank Rate forecasts for financial year ends (March) are:

- 2015/16 0.75%
- 2016/17 1.25%
- 2017/18 2.00%

There are downside risks to these forecasts (i.e. start of increases in Bank Rate occurs later) if economic growth weakens. However, should the pace of growth quicken, there could be an upside risk.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next eight years are as follows:

2015/16 0.60%
2016/17 1.10%
2017/18 1.75%
2018/19 2.25%
2019/20 2.75%
2020/21 3.00%
2021/22 3.25%
2022/23 3.25%
Later years 3.50%

54. **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.

Prudential Indicator 8 – Principal Sums Invested > 364 days

Maximum principal sums invested > 364 days			
	2015/16	**2016/17**	**2017/18**
Principal sums invested > 364 days	£12m	£12m	£12m

Sensitivity to Interest Rate Movements

55. Future Council accounts will be required to disclose the impact of risks on the Council's treasury management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 1% increase/decrease in all interest rates to the estimated treasury management costs/income for next year. That element of the debt and investment portfolios, which are of a longer term, fixed interest rate nature, will not be affected by interest rate changes.

Revenue Budgets	**2015/16 Estimated + 1%**	**2015/16 Estimated - 1%**
Investment income	£249,000	£249,000

Interest on balances for 2015/16 is estimated at £498,000 based on 0.5% for investments up to 3 months duration, with higher rates for the Council's 'cap and collar' loan, property fund investment and other potential longer term investments.

Treasury Management Limits on Activity

56. There are three further treasury activity limits. The purpose of these are to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The 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 this covers a maximum limit on fixed interest rates.
    - Maturity structures 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.

57. The Audit Committee is asked to approve the limits:

Prudential Indicator 9 – Interest Rate Exposures

Interest rate exposures	2015/16	2016/17	2017/18
	Upper	Upper	Upper
Limits on variable interest rates: (investments only)	35%	35%	35%
Limits on fixed interest rates: (investments only)	100%	100%	100%

Prudential Indicator 10 – Fixed Interest Rate Borrowing

Maturity Structure of fixed interest rate borrowing 2015/16		
	Lower	Upper
Under 12 months	0%	0%
12 months to 2 years	0%	0%
2 years to 5 years	0%	0%
5 years to 10 years	0%	0%
10 years and above	0%	0%

Additional treasury issues

Performance Indicators

58. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. These are:

    - Investments – Internal returns above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Management Annual Report.

Treasury Management Advisors

59. The Council uses Capita Asset Services as its external treasury management advisor. The company provides a range of services that include:
    - Technical support on treasury matters and capital finance issues;
    - Economic and interest rate analysis;
    - Generic investment advice on interest rates, timing and investment instruments;
    - Credit ratings/market information service comprising the three main credit rating agencies;
    - Attendance at Member/Officer treasury management meetings.
60. Whilst the advisors provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice, the final decision on treasury matters remains with the Council.
61. This service is subject to regular review.

Member and Officer Training

62. The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for members and officers. This Council has addressed this important issue by:

- Members' attendance at meetings with our treasury advisors.
- The training needs of treasury management officers' are periodically reviewed.

Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management

The Council's investment policy has regard to the Department for Communities and Local Government (DCLG) Guidance on Local Government Investments ('the Guidance') issued in 2010 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 finally **yield**.

The Guidance forms the structure of the Council's policy below.

The key intention of the Guidance is to maintain the current requirement for Councils' to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the Guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the Code on 23rd February, 2010 and will apply its principles to all investment activity. In accordance with the Code, the Deputy Chief Executive (Section 151 Officer) has produced treasury management practices (TMPs). This part, TMP 1(1), covering investment counterparty policy requires approval each year.

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

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

The investment policy proposed for the Council is:

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

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

1. The UK Government (such as the Debt Management Account Deposit Facility, UK Treasury Bills or a Gilt with less than one year to maturity).
2. Supranational bonds of less than one year's duration.
3. A local authority, parish council or community council.
4. Pooled investment vehicles (such as money market funds) that have been AAA rated by Standard and Poor's, Moody's or Fitch rating agencies.

5. A body that is considered of a high credit quality (such as a bank or building society). Although non-rated building societies are classified as non-specified investments. For category 5 this covers bodies with a minimum short term rating of F1/P-2/A-1 as rated by Fitch, Moody's or Standard and Poor's rating agencies.

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. This criterion is detailed in paragraph 44 of Appendix B.

Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non-specified investments would include any sterling investments with:

	Non Specified Investment Category	Limit
a.	**Supranational Bonds greater than 1 year but less than 5 years to maturity** **(a) Multilateral development bank bonds** - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.). **(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company (GEFCO)). The security of interest and principal on maturity is on a par with the Government and so very secure, and these bonds usually provide returns above equivalent gilt-edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£7.5m
b.	**Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£7.5m
c.	The **Council's own banker** (National Westminster Bank) if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.	£7.5m
d.	**Building societies not meeting the basic security requirements under the specified investments.** The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. The Council may use such building societies which have a minimum asset size of £1 billion, but will restrict these type of investments to £7.5 million	£7.5m
e.	Any **bank or building society** that has a minimum long-term credit rating of A for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	£7.5m
f.	Any **non-rated subsidiary** of a credit rated institution included in the specified investment category. These institutions will be included as an investment category subject to guarantee from the parent company.	£5m
g.	**Pooled property funds** – the use of these instruments will normally be	£7.5m

	deemed to be capital expenditure. The key exception to this is an investment in the CCLA Property Fund.	

Within categories c and d, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies that will be invested in these bodies. This criterion is detailed in Appendix B.

The Monitoring of Investment Counterparties - The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Capita Asset Services as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Deputy Chief Executive (Section 151 Officer), and if required new counterparties which meet the criteria will be added to the list. Any urgent and immediate changes that are required to the Treasury Management (TM) Strategy will be directed to the Portfolio Holder for Finance and Corporate Services, Chairman of Audit Committee as well as the Deputy Chief Executive (Section 151 Officer). If all are in agreement the TM Strategy and Treasury Management Practices (TMP's) will be modified to reflect this change. Ultimately any change will be ratified at the next available Council meeting after having been considered at the first available meeting of the Audit Committee.

Use of External Fund Managers – It is the Council's policy to use external fund managers for part of its investment portfolio. On 30th June 2013 the Council invested £5m in the Charities, Churches and Local Authorities (CCLA) Property Fund. This is a high quality, well diversified managed property fund. To realise the full potential of this investment it should be considered as a medium to long term placement. Income is received quarterly and in the current economic climate good yields are anticipated.

The Fund Manager will use non-specified investment categories and are committed to keep to the Council's investment strategy. The performance of the Fund Manager is reviewed monthly by the Deputy Chief Executive (Section 151 Officer).

All other investments are managed by the in-house team.

Policy on the use of external service providers

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

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.

Security, Liquidity and Yield Benchmarking

Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service - A proposed development for Member reporting are the consideration and approval of security and liquidity benchmarks. These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury Report.

Yield – These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – internal returns above the 7-day LIBID rate

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

Liquidity – This is defined as 'having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives' (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

- Bank overdraft - £100,000
- Liquid short-term deposits of at least £2m available with a week's notice.

The Authority, with the help of its treasury advisor, is in the process of developing further benchmarking analysis by the monitoring of the Weighted Average Life (WAL) of the portfolio. This is done by analysing the availability of liquidity and term risk in the portfolio. A shorter WAL would embody less risk. The investment policy that is proposed for internally managed funds is shown in Annex B1.

Security of the investments – In the context of benchmarking security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard and Poor's). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy. The table beneath shows average defaults for differing periods of investment grade products for each of the three main credit rating agencies long term rating categories over the period 1990 to 2013.

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.00%	0.02%	0.06%	0.09%	0.13%
AA	0.02%	0.04%	0.14%	0.27%	0.38%
A	0.09%	0.24%	0.43%	0.61%	0.86%

BBB	0.20%	0.59%	1.02%	1.52%	2.00%
BB	0.86%	2.26%	3.83%	5.39%	6.76%
B	3.04%	7.63%	11.27%	14.77%	17.50%
CCC	22.54%	32.55%	38.74%	42.75%	46.27%

The Council's minimum long term rating criteria is currently A, meaning the average expectation of default for a one year investment in a counterparty with a long term rating would be 0.09% of the total investment (eg for a £1m investment the average loss would be £900). This is only an average, any specific counterparty loss is likely to be higher, but these figures do act as a proxy benchmark for risk across the portfolio.

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

- **0.09% historic risk of default when compared to the whole portfolio.**

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

Annex B3

Approved countries for investments

Based on lowest available sovereign rating of;

AAA

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

Treasury Management Clauses to form part of Standing Orders/Financial Regulations/Constitution

1. This Council will create and maintain, as the cornerstones for effective treasury management:
   - A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities;
   - Suitable Treasury Management Practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.
2. The Council will receive reports on its treasury management policies, practices and activities, including as a minimum, an annual strategy and plan in advance of the year, a mid year review and an annual report after its close, in the form prescribed in its TMPs.
3. The Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to the Audit Committee, and for the execution and administration of treasury management decisions to the Deputy Chief Executive (Section 151 Officer), who will act in accordance with the Council's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.
4. The organisation nominates the Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

The Treasury Management Role of the Section 151 Officer

The Section 151 (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.

Economic Background

United Kingdom (UK) - After strong UK GDP growth in 2013 at an annual rate of 2.7%, and then growth in 2014 of 0.6% in Q1, 0.8% Q2, 0.7% Q3 and 0.5% Q4 (annual rate for 2014 of 2.6%), growth is expected to gain increased momentum during 2015 and 2016 to annual rates of 2.9%, (2017 2.7%). This will be a response to two developments; firstly, the stimulative effect of the sharp fall in oil prices in quarter 4 of 2014 and then inflation potentially falling into negative territory during 2015, but anyway being near to zero until towards the end of the year. Secondly, due to an expected return to a significant rise in average wage rates due to the continuing fall in unemployment to about 5.5% by mid 2015, (the long run equilibrium level is 5.0%), and the further erosion of spare capacity, (slack), to about 0.5% of GDP. This is expected to lead to total consumer disposable income rising by no less than around 3.5% during quarter 3 2015. This would therefore strengthen consumer expenditure, but without much downside to the savings ratio.

However, for this recovery to become more balanced and sustainable in the longer term, the recovery still needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. In addition, there has been a need for a major improvement in labour productivity, which has languished at dismal levels since 2008, to support longer term increases in pay rates and economic growth after the positive effect of the fall in oil prices dissipates. The February Inflation Report contained good news on that score that productivity was forecast to increase by just under 0.75% in the first three quarters of 2015.

The February Inflation Report also explained that the initial fall in the price of oil of over 50% would cause an overall reduction in CPI of about 0.8% in quarter 2 2015 and boost UK GDP by around 0.5% during the Monetary Policy Committee (MPC's) three year forecast period. It also forecast that the sharp fall in the price of oil and its knock on effects, would start falling out of the twelve month calculation of CPI inflation in quarter 4 of 2015. This is expected to result in a sharp rise in inflation from near zero in that quarter and also onward into 2016. The report also mentioned a potential risk of deflation becoming embedded, which could then require remedial action by the MPC such as a cut in Bank Rate and/or further quantitative easing. This is viewed as being a small risk given the above expected sharp increase in inflationary pressures. However, while inflation is at or near 0% for much of 2015, it is unlikely that the MPC would make a start on increasing Bank Rate. Market expectations for the first increase in Bank Rate have therefore moved from quarter 3 2015 after the November 2014 report, to around mid year 2016 during February 2015. However, the MPC is focused on where inflation will be over a 2 – 3 year time horizon so too much emphasis should not be placed on the short term inflation outlook, especially when the February report identified a slight increase in inflationary pressures on that time horizon to just above the 2% target. This treasury management report is therefore based on a forecast of a first increase in Bank Rate in quarter 1 of 2016, though it would be quite possible for it to be in quarter 4 of 2015 if events were to turn out favourably in Greece, the Eurozone (EZ) as a whole and elsewhere.

The return to strong growth has helped lower forecasts for the increase in Government debt over the last year but monthly public sector deficit figures during 2014 have disappointed, being only a fraction lower than the previous year through to December 2014. The autumn statement, therefore, had to revise the speed with

which the deficit is forecast to be eliminated. The flight to quality in January 2015 has seen gilt yields fall to incredibly low levels, which will reduce interest costs on new and replacement government debt.

Eurozone (EZ) - The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In January 2015, the inflation rate fell further, to reach a low of -0.6%. However, this is an average for all EZ countries and includes some countries with even higher negative rates of inflation. Initially, the ECB took some rather limited action in June and September 2014 to loosen monetary policy in order to promote growth. As this failed to have much of a discernible effect, the ECB launched a massive €1.1 trillion programme of quantitative easing in January 2015 to buy up high credit quality government debt of selected EZ countries. This programme will run to September 2016.

Concern in financial markets for the Eurozone had subsided considerably after the prolonged crisis during 2011-2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, as Ireland has done. It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. The ECB's pledge in 2012 to buy unlimited amounts of bonds of countries which ask for a bailout has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the degree of recession. However, debt to GDP ratios (2013 figures) of Greece 180%, Italy 133%, Portugal 129%, Ireland 124% and Cyprus 112%, remain a cause for concern, especially as some of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are likely to continue to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US.

Greece - the general election on 25th January 2015 has brought to power a coalition which is anti EU imposed austerity. Although it is not certain that Greece will leave the Euro, the recent intractability of the troika (the EU, ECB and IMF), to finding a negotiated compromise with the new Greek government leaves this as a real possibility. However, if Greece was to leave the EZ, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. Nevertheless, the indirect effects of the likely strengthening of anti EU and anti austerity political parties throughout the EU is much more difficult to gauge. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries which have high unemployment rates. Of particular concern is the fact that Spain and Portugal have general elections coming up in late 2015. This will give ample opportunity for anti austerity parties to make a big impact.

There are also major concerns as to whether the governments of France and Italy will effectively implement austerity programmes and undertake overdue reforms to improve national competitiveness. These countries already have political parties with major electoral support for anti EU and anti austerity policies. Any loss of market confidence in either of the two largest Eurozone economies, after Germany, would present a huge challenge to the resources of the ECB to defend their debt.

USA - The US Federal Reserve ended its monthly asset purchases in October 2014. GDP growth rates (annualised) for Q2 of 4.6%, Q3 of 5.0% and Q4 of 2.6%, (overall 2.4% during 2014 as a whole), provides great promise for strong growth going

forward. It is confidently forecast that the first increase in the Federal Reserve rate will occur by the end of 2015.

China - Government action in 2014 to stimulate the economy almost succeeded in achieving the target of 7.5% growth but recent government statements have emphasised that growth going forward will slow marginally as this becomes the new normal for China. There are concerns that the Chinese leadership has only just started to address an unbalanced economy, which is heavily over dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

Japan - Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth to the extent that it has slipped back into recession. The Japanese government already has the highest debt to GDP ratio in the world.

CAPITA ASSET SERVICES FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Their Bank Rate forecasts, and also MPC decisions, will be liable to further amendment depending on how economic data transpires over 2015. 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.

The overall longer run trend is for gilt yields and Public Works Loans Board (PWLB) rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

There has been exceptionally high volatility in gilt yields and PWLB rates during January and February 2015. It is likely that this trend could continue through 2015 and that there could be swings of 50 basis points, (0.50%), during even one quarter.

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last. It also remains exposed to vulnerabilities in a number of key areas.

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis. There is an increased risk that Greece could end up leaving the Euro but if this happens, the EZ now has sufficient fire walls in place that a Greek exit would have little immediate direct impact on the rest of the EZ and the Euro. It is therefore expected that there will be an overall managed, albeit painful and tortuous, resolution of any EZ debt crisis that may occur where EZ institutions and governments eventually do what is necessary, but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be weak at best for the next couple of years with some EZ countries experiencing low or negative growth, which will, over that time period, see an increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries, especially if growth disappoints and/or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is impossible to forecast whether any individual country will lose such confidence, or

when, and so precipitate a sharp resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

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

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK strong economic growth is weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.

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

- An adverse reaction by financial markets to the result of the UK general election in May 2015 and the EU, economic and debt management policies adopted by the new government.
- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.
- The commencement by the US Federal Reserve of increases in the Federal funds rate in 2015, 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. There could also be a sharp fundamental reassessment of investments in the debt and equities of emerging countries which have chased higher yields during a prolonged period when yields and returns in western countries have been heavily suppressed. Countries such as Brazil and Russia are already in recession and facing major economic and political challenges.
- 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.

Interest Rate Forecasts 2015 – 2018

Annex B7

Capita Asset Services Interest Rate View													
	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%
3 Month LIBID	0.50%	0.50%	0.50%	0.60%	0.80%	0.90%	1.10%	1.30%	1.40%	1.50%	1.80%	1.90%	2.10%
6 Month LIBID	0.70%	0.70%	0.70%	0.80%	1.00%	1.10%	1.30%	1.50%	1.60%	1.70%	2.00%	2.10%	2.30%
12 Month LIBID	0.90%	1.00%	1.00%	1.10%	1.30%	1.40%	1.60%	1.80%	1.90%	2.00%	2.30%	2.40%	2.60%
5yr PWLB Rate	2.10%	2.20%	2.30%	2.50%	2.60%	2.70%	2.80%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PWLB Rate	2.70%	2.80%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%
25yr PWLB Rate	3.30%	3.40%	3.60%	3.80%	3.90%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%	4.70%
50yr PWLB Rate	3.30%	3.40%	3.60%	3.80%	3.90%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%	4.70%
Bank Rate													
Capita Asset Services	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%
Capital Economics	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	-	-	-	-	-
5yr PWLB Rate													
Capita Asset Services	2.10%	2.20%	2.30%	2.50%	2.60%	2.70%	2.80%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
Capital Economics	1.80%	2.05%	2.30%	2.55%	2.80%	2.80%	3.05%	3.05%	-	-	-	-	-
10yr PWLB Rate													
Capita Asset Services	2.70%	2.80%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%
Capital Economics	2.30%	2.55%	2.55%	2.80%	3.05%	3.05%	3.30%	3.30%	-	-	-	-	-
25yr PWLB Rate													
Capita Asset Services	3.30%	3.40%	3.60%	3.80%	3.90%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%	4.70%
Capital Economics	2.95%	3.15%	3.15%	3.50%	3.90%	3.90%	4.15%	4.15%	-	-	-	-	-
50yr PWLB Rate													
Capita Asset Services	3.30%	3.40%	3.60%	3.80%	3.90%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%	4.70%
Capital Economics	3.10%	3.30%	3.30%	3.60%	4.00%	4.00%	4.30%	4.30%	-	-	-	-	-

PWLB rates and forecast shown below have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012.