AGENDA ITEM NO. 2(1)

CABINET - 27TH FEBRUARY 2013

SUBJECT: **TREASURY MANAGEMENT ANNUAL STRATEGY, CAPITAL FINANCE PRUDENTIAL INDICATORS AND MINIMUM REVENUE PROVISION POLICY FOR 2013/2014**

REPORT BY: **DEPUTY CHIEF EXECUTIVE**

1. PURPOSE OF REPORT

1.1 To submit for approval the Council's Annual Strategy for Treasury Management.

1.2 To submit for approval a dataset of Prudential Indicators relevant to Treasury Management and Capital Finance. The report also cross-references to the report by the Deputy Chief Executive on Revenue and Capital Budgets ["the budget report"] also considered in this meeting.

1.3 To seek approval for the Minimum Revenue Provision (MRP) policy to be adopted by the Authority for 2013/2014.

2. SUMMARY

2.1 The revised (2011) "Code of Practice for Treasury Management in the Public Services" provides that an Annual Strategy be submitted to Members on or before the start of a financial year to outline the activities planned within the parameters of the Treasury Management Policy Statement and the Treasury Management Practices.

2.2 The Local Government Act 2003 (the '2003 Act') also requires the Council to set out its treasury strategy for borrowing for the forthcoming year and to prepare an Annual Investment Strategy, which sets out the policies for managing its investments, giving priority to the security and liquidity of those investments.

2.3 Under Section 15 of the '2003 Act', the Welsh Government (WG) issued guidance on local government investments which is incorporated within the report. Definitions of Local Government investments are given in ***Appendix 1***.

2.4 Under the provisions of the Local Government Act 2003, The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 and subsequent amendments [The Capital Regulations], and the CIPFA's "The Prudential Code for Capital Finance in Local Authorities" [the Code], the Authority is obliged to approve and publish a number of indicators relevant to Capital Finance and Treasury Management.

2.5 With effect from 31 March 2008, WG introduced the Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2008 [the "Amendment Regulations"] which requires the Council to prepare an Annual Minimum Revenue Provision Policy Statement. This report sets out what the Authority needs to do in order to comply with this requirement.

3. LINKS TO STRATEGY

3.1 The report has links to the four basic strategic themes of the Council, taking into account cross-cutting issues where relevant. It has specific links to the effective and efficient application and use of resources.

4. THE REPORT

4.1 The format of the report is as follows:

Section 5 will deal with Treasury Management, supported by, and cross-referenced to Appendices 1 to 5 attached.
Section 6 discloses the Council's policy on financial derivatives.
Section 7 and 8 deal with treasury management advisers and training respectively.
Section 9 will consider the Prudential Indicator requirements for Capital Finance, cross-referenced to Appendices 6 to 7 attached.
Section 10 will consider the calculation of the Minimum Revenue Provision, cross-referenced to Appendix 8 attached.
Section 11 will deal with specific treasury management issues relating to the Council.

5. TREASURY MANAGEMENT

5.1 Interest Rate Prospects

5.1.1 The Council has appointed both Sector Treasury Services (Sector) and Arlingclose as its treasury advisers and part of their service is to assist the Council to formulate a view on interest rates.

5.2 Short-term Interest Rates

5.2.1 The Monetary Policy Committee [MPC] decided to decrease Bank Rate in March 2009 to 0.50% as part of the Governments strategy to stimulate the economy. No further changes to the rate have been made since then, and the Bank Rate is likely to remain at this level until 2016. A table showing forecasts of base rates by both Treasury Advisors is included in ***Appendix 2.***

5.3 Long-term Interest Rates

5.3.1 The general view is that Public Works Loan Board [PWLB] rates are likely to remain flat in the short-term and gradually increase in the medium-term. A forecast of the various periods (based mainly on data from Sector) is shown in the table in ***Appendix 2***.

5.4 External Debt - Capital Borrowings and Borrowing Portfolio Strategy

5.4.1 The difference between current long-term borrowing rates and short-term investment rates has resulted in a "cost of carry" scenario, indicating that it is more advantageous to use internal funding in lieu of borrowing. The cost of carry is likely to remain an issue until the Bank Rate and short term market rates increase in the future. The Council, having adopted the policy of internal borrowing from the latter half of 2008/09, has an internal borrowing position of some £45m (as at 31 March 2012) from which capital expenditure has been funded. Unless the policy is prudent, the Council will no longer adopt the policy of internal borrowing as it is becoming unsustainable. It is anticipated that the borrowing requirement of some £11.8m will need to be taken up in 2013/14 and provision has been made in the budget to fund this externally. The borrowing requirement comprises of £7.8m supported borrowing approvals and £4m unsupported borrowing. Whilst PWLB interest rates have been included in Appendix 2, it is possible that loans may be taken from other sources if interest rates are more advantageous. It is suggested that the target rate for new borrowing be set at 4.50% for a 25 year period loan.

5.4.2 Current PWLB forecasts suggest interest rates are likely to remain relatively flat during 2013/14. It is proposed that capital expenditure for 2013/14 be internally funded from reserves following the slippage in prior years, therefore deferring the decision to externally borrow in 2013/14. However, the risk in deferring the need to borrow could expose the Council to rising interest rates thus making it expensive to borrow. A budget to cover the cost of raising new debt finance will remain in place should the decision to borrow change.

5.4.3 Any short-term funding would need to be in line with the 'Upper Limit for Variable Rates' as defined in the prudential indicators in ***Appendix 6*** (30% of Net Debt Outstanding) within the CIPFA "Prudential Code for Capital Expenditure in Local Government".

5.4.4 Council officers, in conjunction with the treasury advisers, will continue to monitor both the prevailing rates and the market forecasts, responding to changes when necessary. The following borrowing sources will be considered by the Council (and in no particular order):

- Internal
- PWLB
- Local authorities
- European Investment Bank (NB the EIB will only lend up to 50% towards the funding of a specific project and needs to meet the EIB's specific criteria. The project cost must also be at least €25m)
- Leasing
- Capital markets

5.5 Authorised Limit for External Debt (The Authorised Limit)

5.5.1 As a consequence of 5.4.1 to 5.4.4 above**,** the Authorised Limit will be the upper limit of the Council's borrowing, based on a realistic assessment of risks. It will be established at a level that will allow the Authority to borrow sums, in excess of those needed for normal capital expenditure purposes in the event that an exceptional situation arises and would allow for take-up of supported borrowing. It is not a limit that the Authority would expect to borrow up to on a regular basis.

5.5.2 The limit will include borrowing and other long-term liabilities such as finance leases, private finance schemes and deferred purchase schemes.

5.6 The Operational Boundary

5.6.1 This is based on the maximum level of external debt anticipated to be outstanding at any time in each year. It will be consistent with the assumptions made in calculating the borrowing requirements of the capital programme, but will also include an estimate of any borrowing for short term purposes, such as temporary shortfalls in incomes or to support active treasury management which would seek to take advantage of beneficial interest rate movements. It also allows for other long-term liabilities such as finance leases, private finance schemes and deferred purchase schemes.

5.6.2 The Operational Boundary should be set at a level which allows some flexibility but should be sufficiently below the Authorised Limit so that any breach of the operational boundary provides an early warning indicator of a potential breach of the Authorised Limit, allowing corrective action to be taken.

5.7 Interest Rate Exposure

5.7.1 The Authority's borrowing policy makes use of both fixed and variable rate opportunities. Whilst fixed-rate borrowing and investment provides certainty with regard to future interest rate fluctuations, the flexibility gained by the use of variable interest rate instruments can aid performance. It allows the Treasury Manager to respond more quickly to changes in the market and to short term fluctuations in cash flow without incurring the penalties that would result from the recall of fixed rate investments.

5.8 Maturity Structure of Borrowing

5.8.1 Whilst the periods of loans are dictated by the interest rates prevalent at the time, it is important to be mindful of the maturity profile of outstanding debt. Large ‘peaks’ are to be avoided, as it is possible for substantial loans to reach maturity at times when prevailing interest rates are high, and conversely, when interest rates are low, windows of opportunity may be lost.

5.8.2 As a result, it is necessary to determine both an upper and lower limit for borrowings which will mature in any one year.

5.8.3 Over the course of the medium term financial plan and future years, a number of high interest rate PWLB loans will mature resulting in a saving to the Council as the interest rate on replacement loans are likely to be lower in comparison.

5.8.4 Historically, the Council has favoured PWLB loans with a twenty five year loan maturity profile, but in the current climate of low interest rates (including Bank Rate); the Council will also consider shorter dated loans (including local authority borrowing) to fund capital expenditure.

5.8.5 The Council has £40m of LOBO loans (Lender’s Option Borrower’s option) of which £30m of these can be “called” within 2013/14. A LOBO is called at its contract review date when the Lender is able to amend the interest rate on the loan at which point the Borrower can accept the new terms or reject and repay the loan. Any LOBOs called will be discussed with the treasury advisers prior to acceptance of any revised terms.

5.9 Gross Debt and the Capital Financing Requirement

5.9.1 A further new requirement of the revised Prudential Code is ensure that over the medium term debt will only be for a capital purpose, the Council will ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years.

5.10 Debt Rescheduling

5.10.1 Due to the difference in the rates, it is unlikely that there will be many viable opportunities to reschedule loans in the foreseeable future. However, should any such opportunities arise; any decision on debt rescheduling will be supported by the appropriate report detailing the options and potential savings from the Council’s advisers.

5.11 Policy on Borrowing In advance of Need

5.11.1 Whilst the Council is able to borrow in advance of need, it is a requirement of the Code that any instance of pre-funding must be supported by a clear business case setting out the reasons for such activity.

5.12 Annual Investment Strategy

5.12.1 Current strategy (2012/13) - The ongoing uncertainty surrounding financial markets and the weak economic recovery has meant lending to financial institutions has been suspended. Surplus funds are deposited with the Debt Management Office (DMADF) or with other local authorities in accordance with the parameters set within the 2012/13 strategy, albeit at unfavourable interest rates.

5.12.2 This strategy (2013/14), in line with the Welsh Government guidance, sets out the Council’s policies for (and in order of priority) the security, liquidity and yield of its investments. It will have regard to credit ratings and determine the periods for which funds may be prudently invested, whilst aiming to achieve, or better a target rate for investments of **0.25%.** Creditworthiness approach, investment periods and the rationale for the target rate are explained in ***Appendix 3.***

5.12.3 The strategy sets out which investments the Council may use for the prudent management of its balances during the financial year within the areas of ‘specified’ and ‘non-specified’ investments, and provides the appropriate authorisation for the in-house investment team to manage such investments. These are listed in ***Appendix 4.***

5.12.4 In view of the uncertainty in the markets, it is recommended that investments (both new and maturing) be placed with the most secure institutions as detailed in ***Appendix 3***. Currently this would be the Debt Management Office (Deposit Facility and Treasury Bills), other Local Authorities and Public Bodies, such as Police and Fire Authorities, AAA Money Market Funds, and highly credit rated banks (subject to the creditworthiness limits referred to in the appendix). With the exception of the DMO it is recommended that no more than **£5m** is deposited with any one institution or group.

5.12.5 To allow the Treasury Management team some operational flexibility it is recommended that the practice of using bank call accounts be considered subject to the appropriate credit indicators, market/economic conditions and limits as referenced in the above paragraphs. A detailed explanation of the operational requirements is included in ***Appendix 3***.

5.12.6 The Welsh Government maintains that the borrowing of monies for the purposes of investing or on-lending to benefit from differences in interest rates is unlawful. This Council will not engage in such activity.

5.12.7 Under the Local Authorities (Capital Finance and Accounting) (Wales) (Amendment) Regulations 2004 regulation 12(b), the acquisition of share or loan capital in any body corporate would not be defined as capital expenditure as long as it is an investment for the purposes of the prudent management of the Council’s financial affairs. Due to the high risk of capital loss involved with such instruments, this Council will not engage in such activity.

5.12.8 A loan or grant to another body for capital expenditure by that body is also deemed by the 2003 Regulations to be capital expenditure by the Council. This Council will only engage in such activity with the approval of Council.

5.12.9 In the event that any existing investment appears to be at risk of loss, the Council will make proper revenue provision of an appropriate amount in accordance with the relevant Accounting Regulations.

5.12.10 At the end of the financial year, the Council will prepare a report on its investment activity as part of its Annual Treasury Report. This report will be supported throughout the year by quarterly monitoring reports to the Policy & Resources Scrutiny Committee (the responsible body for scrutiny of TM activities as required by the Code), which will include a review of the current strategy. A report to Council will also be prepared on a half-yearly basis.

5.12.11 It is a fundamental requirement of the Code that officers engaged in Treasury Management follow all TM policies and procedures and all activities must comply with the Annual Strategy.

5.12.12 The Welsh Government has reservations with regard to borrowing in advance of need on the grounds that more money than is strictly necessary is likely to be put at risk in the investment market. As a result the Strategy must report any investment made as a result of borrowing in advance and must set out the maximum period for which the funds can be prudently committed. In the event that this Council decides to take up such borrowing, it is suggested that any deposit made with these funds be limited to a maturity period of three months.

6. POLICY ON USE OF FINANCIAL DERIVATIVES

6.1 The Localism Act 2011 includes a general power competence that removes the uncertain legal position over English local authorities’ use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). Although this change does not apply to Wales, the latest CIPFA Code requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

6.2 In the absence of any legislative power, the Council's policy is not to enter into standalone financial derivatives transactions such as swaps, forwards, futures and options. Embedded derivatives will not be subject to this policy, although the risks they present will be managed in line with the overall risk management strategy.

7. TREASURY MANAGEMENT ADVISERS

7.1 The Council uses Arlingclose and Sector as its external treasury management advisers and receives a number of services including counterparty advice; debt and investment advice; economic forecasts and commentary; workshops, training and seminar events; and technical advice (including accountancy).

7.2 The Council will hold quarterly meetings and tendering periodically. The current contracts commenced in April 2010 for two years with a further option to renew annually up to two years. The Council exercised its option to extend in April 2012. The next option review date is April 2013.

8. TREASURY MANAGEMENT TRAINING

8.1 The revised CIPFA Code, adopted by Council in January 2012, requires that Local Authorities must ensure that all staff and those Members with responsibility for Treasury Management receive the appropriate training. To this end the following will be observed:

- The contracts for Treasury Consultancy Services include requirements for Member and officer training to be provided during any year.
- Officers will attend any courses/seminars that are appropriate especially where new regulations are to be discussed.
- Officers will update Members during the financial year by way of seminars/workshops/reports.
- Officers will utilise on line access to the CIPFA Treasury Forum and the CIPFA Technical Information Service.

8.2 Member training has been provisionally scheduled for April 2013 and autumn 2013. Further training will be undertaken as and when required.

9. PRUDENTIAL INDICATORS

9.1 Capital Financing Requirement

9.1.1 The Capital Financing Requirement measures the authority's underlying need to borrow for a capital purpose. In accordance with best professional practice, the authority does not associate borrowing with particular items or types of expenditure.

9.1.2 The capital financing requirement is below the authorised borrowing limits in order to allow scope for short-term cash flow borrowing and provision for unforeseen contingencies.

9.1.3 The estimated values of Capital Financing Requirement for the period under review are shown in ***Appendix 6*** attached.

9.1.4 Changes in accounting treatment, first introduced via CIPFA's 2009 Statement of Recommended Practice (SORP), require the full value of the Authority's Private Finance Initiative (PFI) schemes to be included as fixed assets in its balance sheet. This contrasts with previous practice, whereby the value was required to be built up gradually over the period of the PFI schemes and categorised as a deferred asset. One impact of this is to increase the value of the capital financing requirement accordingly. The introduction of International Financial Reporting Standards (IFRS), with effect from 1 April 2010, has also had a similar effect in bringing "on balance sheet" certain leasing arrangements (as a result of reclassification from operating leases).

9.2 Prudential Indicators – "Prudence"

9.2.1 The proposed Prudential Indicators for Treasury Management Strategy, discussed in 5.4. Et seq. are detailed in ***Appendix 5***.

9.3 Prudential Indicators – "Affordability" [*Appendices 6 and 7*]

9.3.1 There is a requirement to analyse and report the capital financing costs, and express those costs as a percentage of the net revenue streams of the authority.

9.3.2 The estimate of the incremental effect on council tax and housing rents for 2012-13 as a consequence of the proposed capital investment is shown in *Appendix 7*. It should be noted that this is a notional, not an actual, figure.

9.3.3 The General Fund future revenue streams are based upon the content of "the budget report".

9.3.4 Future revenue streams for Housing Revenue Account (H.R.A.) have been projected on the basis of 4% inflation (2% inflation and 2% growth) applied to the rental income (using 2012/13 as a base), less an adjustment for estimated reduction in housing stock as a result of the "Right to Buy" sales.

9.4 Capital Expenditure and Funding

9.4.1 The summary Capital Expenditure and funding, as shown in ***Appendix 7*** of this report has been considered in "the Budget Report".

9.4.2 The revenue support grant provided by the Welsh Government (WG) includes an element to off-set the costs of borrowing funds for capital purposes. WG has announced a level of supported borrowings of £4.96m in respect of the 2013/14 financial year, together with General Capital Grant funding of £3.03m. The combined allocation is equivalent to 10.7% decrease compared to 2012/13 allocation. This excludes the capital settlement under the Local Government Borrowing Initiative of £2.8m that the Council will receive in 2013/14 as part of the revenue support grant.

9.4.3 For calculation purposes, it has been assumed that those two elements of funding support will remain static for 2014/15 and for 2015/16. HRA provisional values for the years 2013-2016 are based on an estimated 2012/13 allocation of the Major Repairs Allowance of £7.3m and assumed to continue at this level for future years.

10. MINIMUM REVENUE PROVISION

10.1 In accordance with the Amendment Regulations, rather than applying a defined formula, the Authority is now only required to apply a charge that is 'prudent'. A "prudent" period of time for debt repayment is defined as one which reflects the period over which the associated capital expenditure provides benefits.

10.2 The Amendment Regulations also introduced an additional reporting requirement. Authorities are now required to submit to full Council, for approval, an Annual MRP Statement, setting out the policy to be adopted for the year following.

10.3 A different approach to MRP calculation is now applied depending upon whether the borrowing concerned is "supported" (for which the revenue implications are provided for by WG in the annual revenue settlement) or "unsupported" (also known as "prudential", the revenue effects of which are not provided for in the settlement and authorities must fund from other sources). The options available and the recommended approach for 2013/14, which continues the policy approved by Council for 2012/13, are detailed in **Appendix 8**.

10.4 Welsh Government has introduced the Local Government Borrowing Initiative (LGBI). This gives Local Authorities the opportunity to borrow funding to accelerate road improvements. The borrowing will be taken up in 2013/14 which will give rise to an increase in the MRP charge from 2014-15.

11. OTHER LOCAL ISSUES

11.1 Icelandic Banks

11.1.1 The Council is in the process of recovering outstanding monies with the failed Icelandic Banks. As at 31st January 2013, the Council had recovered 67% of the outstanding claim (10.20m against a claim of £15.17m). A further £3.76m will be recovered in accordance with the latest payment schedule, with the remainder of balance representing the impaired value. The final dividend is expected in December 2019. The Council has in the past received monies in foreign currencies, such as Euros, US Dollars and Icelandic Kroner, and there is a strong possibility that the Council could receive future Icelandic repayments in such currencies. Under such circumstances, the Council will seek to convert foreign currencies immediately to minimise exchange rate losses.

11.2 Welsh HRA Reform

11.2.1 The Welsh Government is in negotiations with HM Treasury regarding the reform of the HRA subsidy system in Wales. Details of the precise mechanism & timing are not available at this stage. The Council will monitor developments in this area as further details become available and report will be submitted to Cabinet and Council if any changes materialise.

12. FINANCIAL IMPLICATIONS

12.1 The TM strategy for 2013/14 as outlined in this report, if approved by Members, is likely to generate interest in the region of £163k and this has been reflected in the budget strategy for 2013/14. A provision has also been made to cover the estimated costs of the supported borrowing requirements for 2013/14. Officers have not invested the Authority’s funds in financial institutions since October 2008 due to the volatility and uncertainty in the financial markets. There has been a significant increase in the credit warnings issued by the TM Advisors together with the additional information that is now forthcoming in respect of Credit Default Swap data and Sovereign ratings.

13. PERSONNEL IMPLICATIONS

13.1 There are no personnel implications.

14. CONSULTATION

14.1 No external consultation is required for the purposes of the report. However, advice has been sought from the Authority’s current Treasury Advisers.

15. RECOMMENDATIONS

15.1 That the Annual Strategy for Treasury Management 2013/14 be approved.

15.2 That the strategy be reviewed quarterly within the Treasury Management monitoring reports presented to Policy & Resources Scrutiny Committee and any changes recommended be referred to Cabinet, in the first instance, and to Council for a decision. The Council will also receive a half-yearly report on TM activities.

15.3 That the Prudential Indicators for Treasury Management be approved as per Appendix 5.

15.4 That the Prudential Indicators for Capital Financing be approved as per Appendices 6 & 7.

15.5 That Members approve the use of Option 2 (for supported borrowing) and Option 3 Equal Instalment Method (for unsupported borrowing) for MRP purposes for 2013/14.

16. REASONS FOR THE RECOMMENDATIONS

16.1 The Annual Strategy report is a requirement of the CIPFA "Code of Practice for Treasury Management in the Public Services".

16.2 The Investment Strategy is a requirement of the Local Government Act 2003.

16.3 To comply with the legislative framework and requirements as indicated in paragraph 1.2.

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Background Papers:
Treasury Management Working Papers – Accountancy Section
CIPFA "Code of Practice for Treasury Management in the Public Services" (Revised 2011)
The Local Government Act 2003
Local Authorities (Capital Finance and Accounting) (Amendment) (Wales) Regulations 2004
Welsh Government – Guidance on Local Government Investment issued under
Section 15 (1) of the Local Government Act 2003

Appendices:
Appendix 1 Local Government Investments - Definitions
Appendix 2 Interest Rates – Forecasts/Indicative
Appendix 3 Credit Policy, Investment Ratings, Periods and Targets
Appendix 4 Investments to be used and "in house" authorisations
Appendix 5 Treasury Management Strategy Indicators
Appendix 6 Prudential Indicators – Capital Finance
Appendix 7 Capital Expenditure and Funding
Appendix 8 MRP Options