APPENDIX 1

CABINET – 5TH FEBRUARY 2014 AND COUNCIL – 26TH FEBRUARY 2014

SUBJECT: **TREASURY MANAGEMENT ANNUAL STRATEGY, CAPITAL FINANCE PRUDENTIAL INDICATORS AND MINIMUM REVENUE PROVISION POLICY FOR 2014/2015**

REPORT BY: **ACTING DIRECTOR OF CORPORATE SERVICES AND SECTION 151 OFFICER**

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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 Acting Director of Corporate Services & S151 Officer 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 2014/2015.

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 uses 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 £45m (as at 31 March 2013) 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 £19.8m will need to be taken up in 2014/2015 and provision has been made in the budget to fund this externally. The borrowing requirement comprises of:-

- 2014/15 supported borrowing approvals - £5.0m
- Bargoed Cinema - £4.0m
- Highways LGBI - £2.8m
- WHQS- General Fund contribution £8.0m

5.4.2 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.

5.4.3 Current PWLB forecasts suggest interest rates are likely to remain relatively flat during 2014/2015. It is proposed that capital expenditure for 2014/2015 be internally funded from reserves following the slippage in prior years, and the decision to externally borrow for major capital schemes in 2014/2015 may be deferred. 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.

5.4.4 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".

5.4.5 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
- Other commercial and not for profit sources

5.5 Authorised Limit for External Debt (The Authorised Limit)

5.5.1 As a consequence of 5.4.1 to 5.4.5 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 2014/2015. 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 (2013/2014) - 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 2013/2014 strategy, albeit at unfavourable interest rates.

5.12.2 This strategy (2014/2015), 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 and 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 THE 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 final option to extend in April 2013, expiring in March 2014. In November 2013 the Council started a procurement exercise with the objective of putting in place a new contract for the provision of treasury management advisory services for April 2014.

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 2014 and autumn 2014. 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, 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 2014-2015 as a consequence of the proposed capital investment is shown in ***Appendix 6***. 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 2013/2014 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 (RSG) provided by the Welsh Government (WG) includes an element to offset the costs of borrowing funds for capital purposes. WG has announced a level of supported borrowings of £4.98m in respect of the 2014/2015 financial year, together with General Capital Grant funding of £3.03m. There is no change in the allocation when compared to 2013/2014 allocation. As part of the RSG settlement the Council will also receive a contribution to fund the £2.8m LGBI unsupported borrowing.

9.4.3 For calculation purposes, it has been assumed that those two elements of funding support will remain static for 2015/2016 and for 2016/2017. HRA provisional values for the years 2014-2017 are based on an estimated 2014/2015 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 2014/2015, which continues the policy approved by Council for 2013/2014, 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 2014/2015, which will give rise to an increase in the MRP charge from 2015/2016.

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 December 2013, the Council had recovered 80% of the outstanding claim (£12.14m against a claim of £15.17m).

11.1.2 **Heritable** - As at 31st December 2013, £604k remains outstanding and it is not known whether the Council will be able to recover this amount.

11.1.3 **Landsbanki** - As at 31st December 2013, £2.42m remains outstanding. The Council is currently engaged with its legal advisors and the LGA with regards to selling the outstanding claim in Landsbanki following a shift in political and market risks associated with the ongoing administration of the failed Icelandic banks. Cabinet was advised of this on 11th December 2013. Members will be kept up to date on further developments.

11.1.4 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 and 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.

11.3 The Council's Banker

11.3.1 The Council will ensure that its day-to-day banking activity is undertaken with an investment grade bank. If the Council's Bank is downgraded during the contract period (as specified under the Banking Services Contract) to non-investment grade, reasonable measures will need to be undertaken to mitigate the risk associated with further downgrades, and the risk of losing funds if the Bank was to default.

11.3.2 Reasonable measures will need to include (and not limited to) keeping balances to a minimum; hourly review of bank balances for the Group Accounts and subsequently transferring surplus balances to a Call Account; re-routing material income (maturing investments, grants) to a bank account held outside of the existing bank arrangement; and consideration of contingency banking arrangements with another bank should the risk be severe to the Council's operational requirements. Cabinet will be kept informed when such risks arise.

12. EQUALITIES IMPLICATIONS

12.1 An EIA screening has been completed in accordance with the Council's Strategic Equality Plan and supplementary guidance. No potential for unlawful discrimination and/or low level or minor negative impact has been identified regarding this report; therefore a full EIA has not been carried out.

13. FINANCIAL IMPLICATIONS

13.1 The TM strategy for 2014/2015 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 2014/2015. A provision has also been made to cover the estimated costs of the supported borrowing requirements for 2014/2015. Officers have not invested the Authority's funds in financial institutions since October 2008 due to the volatility and uncertainty in the financial markets. The number of credit warnings and downgrades has significantly reduced and the UK economic recovery is gaining momentum (but will be constrained by the weak recovery in the Eurozone). Whilst financial markets have stabilised aided by a collective approach by central banks around the world to inject liquidity, the reversal of these measures is likely to create further volatility in the bond markets, which will have a consequence on PWLB rates. If the UK economy continues to grow, and if inflation falls to the 2% target level along with the unemployment rate (falling below 7% target), the Bank of England will raise Bank rate from the current level of 0.50%.

14. PERSONNEL IMPLICATIONS

14.1 There are no personnel implications.

15. CONSULTATION

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

16. RECOMMENDATIONS

16.1 That the Annual Strategy for Treasury Management 2014/2015 be approved.

16.2 That the strategy be reviewed quarterly within the Treasury Management monitoring reports presented to Policy and 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.

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

16.4 That the Prudential Indicators for Capital Financing be approved as per Appendices 6 and 7.

16.5 That Members approve the use of Option 2 (for supported borrowing) and Option 3 Equal Instalment Method (for unsupported borrowing) for MRP purposes for 2014/2015.

17. REASONS FOR THE RECOMMENDATIONS

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

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

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

18. STATUTORY POWER

18.1 Local Government Acts 1972

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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 Policy and Options

APPENDIX 1

LOCAL GOVERNMENT TREASURY MANAGEMENT DEFINITIONS

- **Investment**

  In the context of a local authority cash deposit, an investment is a monetary asset deposited with a credible institution with the objective of providing income in the future. This is a transaction which relies upon the power in section 12 of the 2003 Act and is recorded in the balance sheet under the heading of investments within current assets or long-term investments.

- **Long-term Investment**

  This is any investment other than one which is contractually committed to be paid within 12 months of the date on which the investment was made.

- **Credit Rating Agency**

  An independent company that provides investors with assessments of an investment's risk and the three most prominent are.

  Standard and Poor's (S & P)
  Moody's Investors Service Limited (Moody's)
  Fitch Ratings Limited (Fitch)

- **Specified Investment**

  An investment is a specified investment if it satisfies the following conditions:

  1. The investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling.

  2. The investment is not a long-term investment (as defined above).

  3. The investment is not considered to be capital expenditure.

  4. One or both of the following conditions is both:

     - The investment is made with the UK Government or a local authority (as defined in section 23 of the 2003 Act) or local authorities in Scotland and Northern Ireland or a parish or community council.

     - The investment is made with a body or in an investment scheme which has been awarded a high credit rating by a credit rating agency

  5. The principal sum to be repaid at maturity is the same as the initial sum invested other than investments in the UK Government.

- **Non-specified Investments**

  These are investments, which do not meet the conditions of specified investments.

APPENDIX 2

INTEREST RATE FORECASTS

Bank Rate (Forecasts as at 31/12/2013 and subject to change)

	Arlingclose	Sector
2014/15 - Q1	0.50%	0.50%
Q2	0.50%	0.50%
Q3	0.50%	0.50%
Q4	0.50%	0.50%
2015/16	0.50%	0.50%
2016/17	0.50%	1.50%

PWLB (Forecasts as at 31/12/2013 and subject to change)

	Q1 – 2014/15	Q2 – 2014/15	Q3 – 2014/15	Q4 – 2014/15
5 Year	2.60%	2.70%	2.70%	2.80%
10 Year	3.70%	3.70%	3.80%	3.90%
25 year	4.40%	4.50%	4.50%	4.60%
50 Year	4.40%	4.50%	4.60%	4.70%

Deposit rates available to the Authority as at 31/12/2013 and subject to change.

	1 Month	2 Months	3 Months	6 Months	12 Months
Debt Management Office	0.25%	0.25%	0.25%	0.25%	-
Local Authorities	0.26%	0.27%	0.29%	0.40%	0.55%
Treasury Bills	0.21%	-	0.21%	0.30%	-
AAA Money Market Funds (Average rates-net fee)	0.35%	0.35%	0.35%	0.35%	0.35%
UK Banks AA	0.25%	0.25%	0.35%	0.40%	0.50%
UK Banks A	0.40%	0.50%	0.55%	0.70%	1.00%
Part Government Owned Banks	0.40%	0.70%	0.75%	0.83%	0.98%
Nationwide B/S	0.30%	0.40%	0.44%	0.64%	0.80%

For budget setting and financial planning, the following rates have been assumed.

Budget Period	Investment Returns	Borrowing Rates (PWLB 50 Years)
2014/15	0.25%	5.00%
2015/16	0.25%	5.50%
2016/17	0.25%	5.50%
2017/18	0.75%	6.00%
2018/19	1.50%	6.00%
2019/20	2.50%	6.00%

APPENDIX 3

CREDIT RISK POLICY

a) Counterparty Criteria

The Council considers, in order of priority, security, liquidity and yield when making investment decisions. Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Council's assessment of counterparty credit risk.

The Council also considers alternative assessments of credit strength, and information on corporate developments of and market sentiment towards counterparties. In accordance with the 2011 Treasury Management Code of Practice, the Council will use the following key tools to assess credit risk:

- Published credit ratings of the financial institution and its sovereign rating;
- Sovereign support mechanisms;
- Credit default swaps (where quoted);
- Share prices (where available);
- Economic fundamentals, such as a country's net debt as a percentage of its GDP;
- Corporate developments, news, articles, markets sentiment and momentum;
- Subjective overlay.

The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

The Council uses two Treasury Management Advisers to provide a counterparty risk management service- Arlingclose and Sector. Credit rating lists are provided by the Advisers based on the Council's minimum credit rating criteria as set out below. Both Arlingclose and sector have a different approach to counterparty risk management.

The Council will engage with its Advisers to maintain a monitor on market pricing such as credit default swaps, equity prices, economic data and overlay data to monitor credit ratings in order to generate a list of highly creditworthy counterparties. The intention of the strategy is to provide security of investment and minimisation of risk, which will also enable diversification and thus avoidance of concentration risk.

The minimum credit ratings criteria the Council will use are:-

	Fitch (or equivalent)
Short-term	F1
Long-term	A-
Support	1
Viability / Individual	a
Non-UK Sovereign	AAA
MMFs	AAA

The ratings set out above relate to Fitch, but Moody's and Standard's & Poor (S&P) have equivalent ratings. The following monetary and time limits will apply:

Counterparty	2014/2015 Limits	
	Money Limit per Counterparty/ Banking Group	Maximum Duration
DMADF	Unlimited	3 Months
UK Government Bonds - T Bills	Unlimited	12 Months
UK Government Bonds - Gilts	Unlimited	2-Years
Part Nationalised Banks (UK)	£5m	3 Months
Banks & Building Societies	£5m	3 Months
MMFs	£5m	On Call
Local Authorities (inclu Police & Fire)	£5m	3 Months
Non-Specified Investments (as per Appendix 4)	£5m	2-Years
Council's Banker	Unlimited	Per Operational/ Business Continuity Requirements

b) Arlingclose:

It is the practice of Arlingclose to provide a counterparty list consisting of UK and non-UK institutions with whom, they feel, the Council can make deposits with a degree of confidence.

The most up-to-date Counterparty list (31/12/2013) lists the following qualifying institutions that are rated at least "AA" category across the three main rating agencies, and in accordance with the Council's minimum lending criteria as set out in the 2013/2014 Strategy:

UK	Non-UK	Country
HSBC	Australia and NZ Banking Group	Australia
DMO	Commonwealth Bank of Australia	Australia
Local Authorities	National Australia Bank	Australia
	Westpac Banking Group	Australia
	Bank of Nova Scotia	Canada
	Royal Bank of Canada	Canada
	Toronto-Dominion Bank	Canada
Supernationals & Multinational Banks		
	Nordic Investment Bank	Finland
European Bank for Reconstruction	Council of European Development	France
	Kreditanstalt Fuer Wieferauf	Germany
	European Investment Bank	Luxembourg
	Inter-American development Bank	US
	International Bank for Reconstruction & Development	US

Arlingclose's creditworthiness methodology consists of reviewing a range of credit indicators when assessing current and potential counterparties. Indicators include a minimum long-term credit rating of A- (or equivalent), GDP data, CDS levels, share prices, economic fundamentals and corporate developments.

The institutions listed in the above table currently meet the Council's 2013/2014 minimum lending criteria. Credit ratings are provided from all three main credit rating agencies.

Sector Treasury Services

Sector continues to provide information in the form of a creditworthiness matrix with which some Members are familiar from previous years, as well as one based on the minimum credit ratings criteria. The ratings are provided from all three main credit ratings agencies.

The matrix counterparty list gives an initial suggested lending period. This is subsequently adjusted to take into account any rating outlook/watch and the credit default swap (CDS) data (in relation to the CDS benchmark). The result is a **suggested** duration for lending, with an extensive list of institutions to choose from. The counterparty list based on the minimum credit ratings list has a narrower selection of banks to choose from, based on the Council's minimum lending criteria. Monetary and duration limits are as per the approved strategy.

The difference between the matrix counterparty list and the minimum credit rating counterparty list is that in the case of the latter the list is more restricted resulting in a superior credit quality of banks that qualify. The Council will continue to maintain both counterparty lists from Sector.

Sovereign Ratings

Many countries have ratings in their own right. In recent times, several have suffered downgradings (France, Greece, Ireland, Portugal, Spain, UK and US for example) due to the financial crisis and weak economic recovery. Standard & Poor's have reduced the rating of both the USA and France to below AAA.

The continued use of Sovereign ratings may, ultimately, be counterproductive in relation to the UK. The success of the UK government's austerity programme in reducing the public sector deficit depends heavily on the economy as a whole. As nearly 50% of all UK exports go to the Euro zone, this inevitably raises a question mark over the potential for success of the UK austerity programme over the next two years which, in turn, increases the risk of one or more of the rating agencies downgrading the UK from AAA status over the next twelve months. As a result, it is recommended that, whilst retaining the requirement for other countries to have a AAA sovereign rating, this should not apply to the UK, as to retain it would remove the ability to make deposits in the DMO and other local authorities should the UK suffer a rating change.

Bank Call Accounts and Term Deposits

The current strategy (2013/2014) with respect to bank deposits (calls accounts and term deposits) is one of suspension following a number of downgrades in bank credit ratings. The ongoing economic uncertainty and weak recovery and weak banking sector have further increased counterparty risk. In light of this the Council still retains its bank call accounts with the Bank of Scotland (part of the Lloyds/TSB group), National Westminster (part of the Royal Bank of Scotland group) and Santander, albeit with small nominal amounts.

It is proposed that the Council will continue with existing arrangements and reinstate its existing call accounts and open further calls (if required) when market and economic conditions stabilise, and when credit ratings meet the Council's minimum credit rating criteria. In the absence of bank call accounts and term deposits, the Council will continue to make use of the DMADF at the DMO as a means to managing liquidity risk, albeit at unfavourable interest rates. The Council will also continue to use the call account facility with its Banker, but only for overnight, weekend arrangements or to meet business continuity requirements.

Other short-term counterparties

Debt Management Office (DMO) – DMADF

This is, as Members are aware, the UK Government. It has been the counterparty of choice for 2013/2014 due to the ongoing concerns regarding all other counterparties. However, the rates achievable from the DMO are very low (currently 0.25%), but deposits are considered to be at least risk in the current climate. Members will need to be aware that there is some probability of interest rates falling below the 0.25% if the Bank Rate (currently 0.50%) is reduced to stimulate the economy. If this is the case the impact of this rate cut will diminish investment income further.

DMO - UK Treasury Bills (T-Bills)

T-Bills have not been used in 2013/2014 as the yields (interest returns) have been trading at rates below or equivalent to the DMADF. The cause of yields falling has been due to the ongoing economic recovery as investors see the UK government as a safe haven for investments. Furthermore, the ongoing economic measures, such as quantitative easing and the Funding-to-Lend Scheme, undertaken by the Bank of England has driven down yields. Consequently, gilts and T-bills are oversubscribed with the inevitable result that the yields (interest returns) have fallen. As at 31/12/2013, T-bills continued to trade at rates below the DMADF.

The Council will only invest in T-Bills if rates improve and exceed the rate achievable with the DMADF.

Local Authorities

Whilst local authorities have always been regarded as having an implied AAA rating, only a handful of UK Authorities have public ratings as a means to raising alternative forms of debt finance in the capital markets. In the current economic cycle and program of austerity measures pursued by Central Government, credit rating agencies are concerned with the future funding implications for many local authorities in light of falling income streams and local authorities holding highly leveraged debt portfolios. This highlights a “downside risk” to the probability of default if there is no central government support. A view held by the main credit rating agencies.

Credit rating agencies actively monitor credit quality for over 150. These studies are usually commissioned by bank lenders to Authorities and are conducted without the co-operation of the authority, with studies based on publically available information. Given the limited scope of this type of credit estimate the ratings produced tend to be on the conservative side.

This clearly raises the question of how we should assess other local authorities for credit worthiness and what controls should be put in place. The 2013/2014 Strategy recommended a monetary limit and maximum duration of £5m and 3 months respectively. However, it is worth considering policy in this area. While Local Authorities are likely to be amongst the highest quality counterparties on our list they are not all equal.

Using Arlingclose’s matrix, local authorities that do not have an individual rating are given a score of 2.50, which is the average score of those authorities that are rated. However, it would be impractical to stipulate that deposits are made only with those local authorities that are rated as the numbers are too few. It would however be practical to stipulate that deposits should not be made with any local authority with a rating higher than two (equivalent to AA+).

AAA Rated Money Market Funds

Money Market Funds (MMFs) are pooled investments consisting of short-term money market instruments such as Certificates of Deposits (CDs), Treasury Bills, Gilts, etc. MMFs can be of a constant net asset value (CNAV) where the assets within the fund are valued at £1 per unit, or variable net asset value (VNAV) where assets prices fluctuate on a daily basis, and potentially result in a capital loss. Authorities (Capital Finance and Approved Investments) Regulations 2002, subsequently replaced by the Local Government Act 2003.

MMFs are rated by the Credit Rating agencies. The highest ratings being:

• Standard & Poor's	AAAm	Credit quality rating
• Moody's	Aaa-mmf MR1+	Credit quality rating and volatility rating
• Fitch	AAA-mmf V1+	Credit quality rating and volatility rating

Since their inception in the 1970's, no sterling CNAV AAA MMF has been downgraded by the rating agencies.

The benefits of using MMFs:

- Active management of cash balances for short periods
- Daily access
- AAA rated – higher rating than bank call accounts
- Enhanced returns due to 'pooled' sums, experienced investment managers.
- Diversification of risk
- Easy management of short-term cash.

The risks of using MMFs:

- Capital fluctuations – underlying assets e.g. CDs are subject to capital fluctuations as a result of interest rate and credit risk. The structure of the fund minimises the movement of capital value due to the restrictions laid down by the credit rating agencies. **This is only true if the MMF is a VNAV fund.**
- Credit risk- risk to capital

Principles of MMFs:

- Security – AAA rated
- Liquidity – daily access to funds
- Yield – overnight investment but with returns between 7 day and 1 month LIBID

It is proposed that CNAV MMFs be considered for use as and when Members feel that the markets have become suitably stable. Due to the risk of capital loss, the current capital finance regulations classify MMFs as non-specified investments and are treated as capital expenditure.

c) Investment Periods

- **Short-term (up to 364 days)**

At the time of writing, all short-term investments are managed in-house as a result of day-to-day cash flow management.

For the purpose of flexibility to respond to day-to-day cash flow demands, the proposed minimum percentage of its overall investments that the Council will hold in short-term investments is **30%**.

Members are reminded that once a deposit has been made for a fixed period it can only be withdrawn (repaid early) by mutual consent albeit at a cost and subject to the underlying terms and conditions of the contract.

- **Long-term (one year and over)**

Currently the Authority has no long-term investments. Should the decision be taken to invest in non-specified investments, it is suggested that no more than £5m be placed with any one institution with duration of no longer than **two years.**

c) Target Rate

Forecasts of base rates can be quite diverse as illustrated by the table in ***Appendix 2***. In view of the uncertainty inherent in such predictions, it would be imprudent to set a target rate, which may be difficult to achieve. In view of the foregoing, it is proposed to set a target rate of return for short-term deposits in 2014/2015 of **0.25%.**

This rate reflects the forecast of Bank Rate and the relationship between that rate and the rate achievable from the DMADF. If deposits are made with other counterparties as detailed in Section (a) of this Appendix, it is possible that the above rate could be exceeded.

APPENDIX 4

SPECIFIED AND NON-SPECIFIED INVESTMENTS

Investments are categorised as “Specified” or “Non-Specified” within the investment guidance issued by the Welsh Government.

Specified investments are sterling denominated investments with a maximum maturity of one year. They also meet the “high credit quality” as determined by the Council and are not deemed capital expenditure investments under Statute. Non specified investments are, effectively, everything else.

The Council’s credit ratings criterion is set out in **Appendix 3** and will be consulted when using the investments set out below. Credit ratings are monitored on a daily basis and the Treasury Management Advisers advise the Council on rating changes and appropriate action to be taken.

The types of investments that will be used by the Authority and whether they are specified or non-specified are listed below.

Investment	**Specified**	**Non-Specified**
Debt Management Account Deposit Facility	✓	×
Term deposits with banks and building societies	✓	✓
Term deposits with other UK local authorities	✓	✓
Certificates of deposit with banks and building societies	✓	✓
Gilts (UK Government)	✓	✓
Treasury Bills (T-Bills- UK Government)	✓	×
Bonds issued by Multilateral Development Banks	×	✓
Local Authority Bills	✓	×
AAA-Rated Money Market Funds	✓	✓
Other Money Market and Collective Investment Schemes	✓	✓
Council’s Banker	✓	×

Council’s Banker

The Council currently banks with the Co-Operative Bank. At the current time, it does not meet the Council’s minimum credit criteria. In November 2013 the Co-Operative Bank announced its intentions to exit the local authority market in light of its decision to restructure the bank and to re-capitalise its balance sheet. The Council has undertaken a mini-tender exercise and has appointed Barclays Bank on a short-term basis. Barclays Bank meets the minimum lending criteria as well as regarded as an investment grade bank.

Non-specified – Longer-Term

Investments will be made only with institutions (e.g. multilateral institutions such as the European Investment Bank) with the highest credit ratings for long-term investments. The proposed credit ratings are as follows:

Moody's Investors Service Limited	Aaa
Fitch Ratings Limited	AAA
Standard & Poor's	AAA

Multilateral institutions such as the European Investment Bank are fundamentally secure and, as a result, it is proposed that the limit with regard to these investments be the limit of long-term investments.

Authorisation for the in-house team

a) Short-Term Investments

Due to the nature of the in-house team's duties, in that they need to respond to cash-flow fluctuations by dealing on the money market generally between 9.00am and 10.00am each day, it is impractical for each decision to be referred to the most senior management levels.

As a result, it is proposed that day-to-day decisions remain the responsibility of the Group Accountant (Financial Advice and Support) who is the *de facto* Treasury Manager. In the absence of the Group Accountant (Financial Advice and Support), the responsibility will pass to any of the appropriate line managers.

It is proposed that all Treasury Management decisions that arise from the daily cashflow will be supported by the completion of a pro-forma, which will evidence compliance with the strategy.

a) Long-Term Investments

It is proposed that decisions regarding long-term investments be referred to the Acting Director of Corporate Services & S151 Officer (as Chief Financial Officer) after consultation with the Acting Head of Corporate Finance and the Finance Manager for Corporate Finance.

c) General Authorisations

Whilst it is generally the intention to refer all decisions regarding long-term borrowing to the Head of Corporate Finance, there are times when to do so will risk the loss of a potentially advantageous deal, due to non-availability. This is particularly relevant to the raising of PWLB loans.

The Council's Treasury Advisers continually monitor the movement of interest rates and are able to predict the changes in PWLB rates. On occasions it may be necessary to respond to advice from the Advisers to take up PWLB loans (whether as part of the current years funding requirement, or as part of a rescheduling exercise) before interest rates increase and make the necessary application to the PWLB before their cut-off time. In these circumstances, it is not always possible to have access to the Head of Corporate Finance, at short notice, for approval.

As a result, it is proposed that, in the event that the Acting Director of Corporate Services & S151 Officer is unavailable, the decision be referred, in the first instance, to the Acting Head of Corporate Finance, then to Corporate Finance Manager. In the absence of all three, then the decision will be made by the Group Accountant (Financial Advice and Support) provided that the reason for the transaction is appropriately documented, falls within the approved annual strategy and prudential indicators, and failure to act upon the advice given would result in additional interest charges.

In all of the foregoing, it must be remembered that any action taken, based on a view of interest rates, can only be assessed on the data available at the time.

Appendix 5 Treasury Management Strategy Indicators 2014/15-2016/17

	Budget 2014-15	Budget 2015-16	Budget 2016-17
	£000	£000	£000
Authorised limit for external debt -			
Borrowing	267,369	284,763	304,994
Other long term liabilities	40,303	37,897	35,818
Total	**307,672**	**322,660**	**340,812**
Operational boundary for external debt -			
Borrowing	213,895	227,810	243,995
Other long term liabilities	40,303	37,897	35,818
Total	**254,198**	**265,707**	**279,813**
Capital Financing Requirement	293,287	299,988	305,885
Upper limits for interest rate exposure			
Principal outstanding on borrowing	213,895	227,810	243,995
Principal outstanding on investments	65,000	65,000	65,000
Net principal outstanding	**148,895**	**162,810**	**178,995**
Fixed rate limit – 100%	148,895	162,810	178,995
Variable rate limit – 30%	44,668	48,843	53,699
Upper limit for total invested for over 364 days	**5,000**	**5,000**	**5,000**

Maturity structure of fixed rate borrowing	Upper Limit	Lower Limit
Under 12 months	**35%**	**0%**
Over 12 months and within 24 months	**40%**	**0%**
Over 2 years and within 5 years	**50%**	**0%**
Over 5 years and within 10 years	**75%**	**0%**
Over 10 years	**100%**	**0%**

Gross Debt and Net Debt	2014/15	2015/16	2016/17
	£m	£m	£m
Outstanding Borrowing	213,895	227,810	243,995
Other long term liabilities	40,303	37,897	35,818
Gross Debt	**254,198**	**265,707**	**279,813**
Less investments	65,000	65,000	65,000
Net Debt	**189,198**	**200,707**	**214,813**

Gross and The CFR	2014/15	2015/16	2016/17
Gross Debt	254,198	265,707	279,813
CFR	293,287	299,988	305,885
CFR Breached?	No	No	No

Appendix 6 - Prudential Indicators - Capital Finance

Ratio of Financing costs to net revenue stream	**Budget 2014-15**	**Budget 2015-16**	**Budget 2016-17**
General Fund	**£000**	**£000**	**£000**
Principal repayments	8,089	8,580	9,019
Interest costs	9,152	9,804	10,115
Debt Management costs	80	80	78
Rescheduling discount	-226	-226	-226
Investment income	-163	-163	-163
Interest applied to internal balances	764	836	912
Total General Fund	**17,696**	**18,911**	**19,736**
Net revenue stream	**329,919**	**327,787**	**329,361**
Total as percentage of net revenue stream	**5.36%**	**5.77%**	**5.99%**
Housing Revenue Account			
Principal repayments	884	850	824
Interest costs	2,024	2,066	2,421
Rescheduling discount	-58	-58	-58
Debt Management costs	14	14	16
Total HRA	**2,864**	**2,872**	**3,203**
Net revenue stream	41,596	43,069	44,599
Total as percentage of net revenue stream	**6.89%**	**6.67%**	**7.18%**

Estimate of incremental impact of capital investment on Council Tax and Housing Rents	**Budget 2014-15**	**Budget 2015-16**	**Budget 2016-17**
General Fund	**£000**	**£000**	**£000**
Unsupported borrowings - principal	791	775	747
- interest	1,034	1,012	962
Loss of investment income	4	2	-
Total	**1,829**	**1,789**	**1,709**
Impact on Band D council tax	**30.72**	**30.04**	**28.69**
Housing Revenue Account			
Loss of investment income	51	31	30
Running costs	-	-	-
Total	**51**	**31**	**30**
Impact on average weekly rent	**0.09**	**0.05**	**0.05**

This is a notional calculation

Capital financing requirement [end of year position]	**Budget 2014-15**	**Budget 2015-16**	**Budget 2016-17**
	£000	**£000**	**£000**
Council Fund	250,812	258,805	252,686
Housing Revenue Account	42,475	41,183	53,200
Total Authority	**293,287**	**299,988**	**305,885**

Appendix 7 - Capital Expenditure and Funding

	Budget 2014-15	Budget 2015-16	Budget 2016-17
Expenditure	**£000**	**£000**	**£000**
Council Fund	13,462	12,028	8,466
Housing Revenue Account	27,500	36,058	35,571
Total	**40,962**	**48,086**	**44,037**
Funding			
Surplus/ (Deficit) Balance b/f	1,099	858	-309
RCCO - General Fund	112	52	
- HRA	20,214	12,285	12,011
Earmarked reserves- General Fund	300		
Borrowings - Supported (GF)	7,779	4,979	4,979
Borrowings - Unsupported (GF)	2,000	18,500	5,500
Capital earmarked Reserve- Bargoed Cinema	-	800	-
General Capital Grant - WG	3,030	3,030	3,030
Borrowings - Unsupported (HRA)	-	-	10,800
Major Repairs Allowance	7,286	7,273	7,260
Total	**41,820**	**47,777**	**43,271**
Surplus C/f	**858**	**-309**	**-766**

APPENDIX 8

MRP 2014/2015 POLICY AND OPTIONS

1. SUPPORTED BORROWING

OPTION 1 Regulatory Method	OPTION 2 Capital Financing Requirement Method
Existing method of charge, no change to revenue account	Similar to Option 1, but with a change that omits a Calculation 'Adjustment A' that was caused by LGR in 1996.

Recommendation - to use Option 2, which reflects the continuation of current arrangements.

2. UNSUPPORTED BORROWING

OPTION 3 Asset Life Method	OPTION 4 Depreciation Method
Two approaches to calculate charge to revenue: - Equal Instalment Method (EIM) Divides value of borrowing by estimated life of asset. Currently use 25 years. Annuity Method More complex with lower charge in early years, higher charge towards end of asset, when life of asset coming to end.	Similar to Option 3 but considers the revaluation of the asset and revisions to the expected asset life. Can lead to uncertainty in respect of future charges to revenue account.

Recommendation - to use Option 3 and EIM, which reflects the continuation of current arrangements.

One further change, applicable to the introduction of Options 3 and 4, is a delay in the commencement of the MRP charge. Under the existing statutory approach, the charge commences in the financial year following that in which the borrowing was incurred. Under these Options, it commences when the asset, which the borrowing has been used to finance, becomes operational. There will be no ongoing effect to the revenue account as a consequence of this change.

MRP in respect of leases and Private Finance Initiative schemes brought on Balance Sheet under the International Financial Reporting Standards (IFRS) based Accounting Code of Practice will match the annual principal repayment for the associated deferred liability.