MAIDSTONE BOROUGH COUNCIL

COUNCIL

5 MARCH 2014

REPORT OF THE CABINET HELD ON 12 FEBRUARY 2014

TREASURY MANAGEMENT STRATEGY 2014/15

Issue for Decision

In accordance with CIPFA's Code of Practice on Treasury Management, the Council is asked to consider the Draft Treasury Management Strategy for 2014/15 including the Treasury and Prudential Indicators.

Recommendation Made

1. That the Treasury Management Strategy 2014/15 be adopted.

2. That a review be undertaken at mid-year of the use of foreign banks for last resort, short term investments.

Reasons for Recommendation

The Cabinet considered the report of the Director of Regeneration & Communities regarding the Treasury Management Strategy 2014/15, including the Treasury and Prudential Indicators.

The Council has adopted CIPFA's Code of Practice on Treasury Management (the Code) and this requires that the Council sets out a Treasury Management Strategy on an annual basis. This report considers the proposed Strategy for 2014/15 onwards along with current guidance from CIPFA and the DCLG.

The primary requirements of the Code are as follows:

a) Receipt by full Council of an annual Treasury Management Strategy that includes the Annual Investment Strategy and Minimum Revenue Provision Policy for the year ahead;

b) Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions; and

c) Delegation by the Council of the role of scrutiny of the Treasury Management Strategy and policies, a mid-year Review Report and an Annual Report covering activities during the previous year to an appropriate committee. These functions have been delegated to the Audit Committee by the Council.

The agreed process previously approved by Council is:

a) Audit Committee will consider, as part of their monitoring role, the initial draft and make recommendations to Cabinet;

b) Cabinet will consider the draft and any recommendations from Audit Committee and recommend to Council; and

c) Council will approve the strategy by March of each year for the forthcoming financial year.

The 2013/14 Strategy

The Strategy for 2013/14 was approved by Council in February 2013 and set the following objectives:

a) Keep investments short term (up to 1 year) to make funds available to invest if rates increase;

b) Use up to £3m from core cash balances to be invested for 1 year or above if rates are at a premium over predicted base rates and funds are available for the term;

c) The use of enhanced cash funds which is an extension to the current AAA rated money market funds. These offer higher yields to money market funds due to giving short term notice to withdraw funds; and

d) The Head of Finance & Resources be given delegated responsibility to add or withdraw institutions from the counterparty list when ratings change, either as advised by Capita Treasury Management (the Council's advisors) or from another reliable market source.

Current Cashflow Performance

At the 25 November 2013 meeting of the Audit Committee the mid-year performance report included details for 2013/14 of the position as at 30 September 2013. Given below is an update on that position.

	£m	**%**
Investments as at 1st April 2013	13.5	
Investment Balance as at 31st Dec 2013	31.1	
Investment Income as at 31st Dec 2013	0.17	
Ave Balance/Rate of Investments during year	26.9	0.76
Est. Investments as at 31st March 2014	17.9	

Investments with Lloyds TSB (part nationalised bank) total £5m. This is made up of two longer term investments, one of £3m for 365 days and the other of £2m for 364 days.

All other investments have been completed on a short term basis (up to one year), as agreed within the Strategy.

During 2013/14 to date the Council has not borrowed either for cash flow purposes or financing. During the last quarter of 2013/14 there is a possibility that the Council will borrow as the first purchases arising from the commercialisation projects occur.

Based on the current cash flow projection the Council has anticipated cash balances at 1 April 2014 available for investment totalling £17.9m.

<u>Developing the Strategy</u>

In formulating and executing the Strategy for 2014/15, the Council will continue to have regard to the DCLG's guidance on Local Government Investments and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectional Guidance Notes.

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

The Council will also achieve optimum return on its investments commensurate with proper levels of security and liquidity. The borrowing of monies purely to on lend and make a return is unlawful and the Council will not engage in such activity.

The Council, in conjunction with its treasury management advisor, Capita Asset Services, will use Fitch, Moodys and Standard and Poors ratings in combination to derive its credit criteria. All credit ratings will be monitored daily. The Council is alerted to changes in ratings of all agencies through its use of the Capita's creditworthiness service.

The Council will therefore use counterparties with durational bands and these are set out later in the report and at Appendix A.

It is proposed that UK part-nationalised banks (e.g. RBS & Lloyds) duration be extended from 1 year to 2 years, as these have the added security of government backing if the Council were to invest in longer term deposits.

If a downgrade means the counterparty or investment scheme no longer meets the Council's minimum criteria, its use for further investment will be withdrawn immediately. If funds are already invested with the downgraded institution, a decision will be made by the Head of Finance & Resources whether to withdraw the funds and maybe incurring a penalty.

If a body is placed under negative rating watch (i.e. there is a probability of a rating change in the short term and the likelihood of that change being negative) and it is currently at the minimum acceptable rating for placing investments, then no further investments will be made with that body.

In addition to the use of Credit Ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in a downgrade of an institution or removal from the Council's lending list.

The use of leading building societies for investment purposes will use the top 5 ranked on a combination of management expenses of the group, as shown within the Income and Expenditure Account, as well as the asset size.

Other market intelligence will also be used to determine institutions' credit worthiness, such as financial press, financial broker advice and treasury management meetings with other authorities, e.g. Kent Treasury Management Forum. If this information shows a negative outcome, no further investments will be made with that body.

The Head of Finance & Resources has previously been given delegated authority to use alternative forms of investment, should the appropriate opportunity arise to use them, and should it be prudent and of advantage to the Council to do so. This delegated authority is subject to prior consultation with the Cabinet Member for Corporate Services on any possible use of these instruments. This delegation has not been exercised to date.

The following table shows the balance of investments which will mature during 2014/15 and the total of this balance which will be needed to fund the revenue/capital expenditure.

Investment	**2014/15 £m**
Short Term Investments at start of Year	17.9
Use of Balances/Capital receipts	11.9
Total Core Cash	8.0

These maturities will therefore cover the anticipated use of cash balances for the period and leave a minimum of £8.0m available for investment, along with day to day cash flow management funds. However, £5m has been identified for possible investment leaving a surplus of £3m worth of funds for contingencies.

A Forward Look

The MPC has previously stated that an increase in interest rates will not be discussed until unemployment levels reach 7% or below which was originally thought to be 3 years away. The current unemployment rate is now 7.1%. It is believed that the Governor of the Bank of England will look at other variables, such as economic growth, before deciding raising rates.

Interest Rate Forecast

As part of their service Capita Asset Services assist the Council to formulate a view on interest rates. Below is a table which forecasts short term (Bank Rate) and longer term fixed interest rates that reflects their current view on the future.

Bank Rate	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.00%	1.25%
UBS	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	-	-	-	-	-
Capital Economics	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-

5yr PWLB Rate	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	**2.73%**	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.40%
UBS	**2.73%**	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	**2.73%**	2.30%	2.30%	2.30%	2.30%	2.30%	2.50%	2.90%	3.30%	-	-	-	-	-

10yr PWLB Rate	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	**3.82%**	3.60%	3.70%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.20%	4.30%	4.30%	4.40%	4.50%
UBS	**3.82%**	3.70%	3.80%	3.90%	4.05%	4.05%	4.30%	4.55%	4.55%	-	-	-	-	-
Capital Economics	**3.82%**	3.55%	3.55%	3.55%	3.55%	3.55%	3.55%	3.55%	3.80%	-	-	-	-	-

25yr PWLB Rate	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	**4.41%**	4.40%	4.50%	4.50%	4.60%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.10%	5.10%	5.10%
UBS	**4.41%**	4.55%	4.55%	4.80%	4.80%	5.05%	5.05%	5.30%	5.30%	-	-	-	-	-
Capital Economics	**4.41%**	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.35%	-	-	-	-	-

50yr PWLB Rate	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	**4.36%**	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.20%	5.20%	5.20%
UBS	**4.36%**	4.45%	4.45%	4.70%	4.70%	4.90%	4.90%	5.05%	5.05%	-	-	-	-	-
Capital Economics	**4.36%**	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.50%	-	-	-	-	-

Bank Rate, currently 0.5%, underpins investment returns and is not expected to start increasing until June 2016.

Shorter term investment rates are still currently more appealing than longer term. Current investment rates are as follows:

- Instant Access 0.6%
- 95 Day Notice 0.8%
- 2yrs 0.95%
- 3yrs 1.5%
- 5yrs 2.45%

The interest rate change being brought forward from September 2016 may increase longer term rates during 2014/15 so the Head of Finance and Resources may use the £5m core funds set aside for this purpose.

The use of property funds has been discussed with the Council's advisors, Capita. Some Kent Authorities are already investors in such funds. Charities, Churches and Local Authorities (CCLA) have their own property fund specifically for Local Authorities however rates are around 2.4% which is currently low to tie up funds for 5 years. If the situation changes, the Head of Finance & Resources will, in discussion with the Cabinet Member for Corporate Services, decide if it is a prudent time to invest in property funds.

Capital Programme and Prudential Borrowing

As part of the development of the prudential indicators, that themselves form part of the Treasury Management Strategy, the Council must consider the affordability of its capital programme.

In the past this programme has been financed by the use of capital resources such as receipts from asset sales and grants. More recently the Council has also used receipts from the New Homes Bonus initiative. In which case affordability of the programme is calculated by the lost revenue income from the possible investment of the resources.

The authority to borrow up to £6m for the financing of capital expenditure is included in the current capital programme and the current prudential indicators. This report includes the continuation of that authority within the calculation of the indicators. If the Council is to borrow then the affordability of the capital programme must include an assessment of the cost of borrowing along with the loss of investment income from the use of capital resources held in cash.

At this time the Strategy proposes the use of up to £5m of core cash held for longer term investment of over one year, if the rates are appealing. As detailed earlier in this report when considering a forward look, the income from investments of greater than one year is diminishing as the counterparties used by the Council are becoming less interested in longer term borrowing.

The current long term borrowing rate from the Public Works Loan Board given in the table above is 4.41% for 25 years. Were the Council to temporarily borrow the necessary resources from its own cash balances rather than complete a further one year investment it would save the equivalent of 3.46% of the amount borrowed. The affordability of the capital programme has been calculated based upon the assumption that internal borrowing would occur initially.

Should rates move quicker than the forecast predicts, the current and proposed Strategies do allow the Head of Finance and Resources to take advantage of external borrowing.

Cash Flow Projection to 2015/16

A cash flow projection up to March 2016 has been created reflecting the spending proposals in the Budget Strategy 2014/15 onwards. The cash flow projection shows that anticipated investment income will be consistently £0.25m per annum over the period from 2014/15 to 2016/17. This is based on interest rates remaining as forecast.

Considering the proposal to use internal borrowing to finance the capital programme, as set out above, the investment income suggested by the cash flow projection may be provided in part from internal charges or through the surplus generated by commercialisation projects.

Minimum Revenue Provision

Where spend is financed through the creation of debt, the Council is required to pay off an element of the accumulated capital spend each year. The total debt is identified as the capital financing reserve and ensures that the Council includes external and internal borrowing along with other forms of financing considered to be equivalent to borrowing.

The payment is made through a revenue charge (the minimum revenue provision - MRP) made against the Council's expenditure, although it is also allowed to undertake additional voluntary payments if required (voluntary revenue provision - VRP).

Although the Council has maintained a capital financing reserve based upon the prudential borrowing limit previously set, the MRP was based upon the actual payments made under the Serco Paisa arrangements for the capital works completed by Serco at Maidstone Leisure Centre. Debt repayment is made by annual instalments over the 15 year life of the contract and is suitably equivalent to a MRP value.

With the real potential for the use of prudential borrowing the development of the Strategy for 2013/14 considered the most appropriate option for future borrowing and agreed to use the asset life method due to the requirement to split assets into component parts and depreciate different components at different rates.

Summary of Changes Proposed

With this outlook in mind it is appropriate to consider changes to the policy for the core funds of the Council and the level of investment with the most secure counterparties on the Council's list. The strategy for 2014/15 therefore looks to enhance these areas as follows:

a) Increasing the maximum duration limits with some part-nationalised groups to 2yrs from 1yr;

b) Invest up to £5m of core cash for over 1 year if rates were to improve; maybe using property funds; and

c) To consider the use of core cash during 2014/15 for internal borrowing if not used for longer term investments.

Based on the issues outlined and following consultation with the Council's Treasury Management advisors the following Strategy is recommended.

<u>Draft Strategy for 2014/15</u>

The Council will maintain a counterparty list to identify institutions suitable for investment. The proposed list is set out at Appendix A and will be maintained using the following principles:

a) Use the Council's Treasury Management Consultant's scheme for rating of institutions for creditworthiness which uses a sophisticated modelling approach with credit rating agencies, Moodys, Fitch and Standard & Poors, along with Sovereign ratings, CDS spreads and credit watches;

b) Group limits placed on institutions within the same group and not separate for each institution. The group limit will be the highest individual credit criteria for the group;

c) An institution will never have a higher credit rating than the sovereign country it operates within. If the sovereign is downgraded below the rating of an institution, the institution is downgraded to the same level;

d) Duration limits with part nationalised to increase to 2 yrs;

e) Use of the top 5 Building Societies is ranked using the management expenses and asset size ranking; and

f) The Head of Finance & Resources be given delegated responsibility to add or withdraw institutions from the counterparty list when ratings change, either as advised by Capita Assets Services (the Council's advisors) or from another reliable market source.

The DCLG provides criteria for specified investments with all other investments being non-specified. These are set out at Appendix B and the following principles are applied to their use:

a) Only the top five building societies and investments over a 1 year duration with a credit worthy institution will be non-specified;

b) Funds will be invested short term (up to one year) so that funds are available to invest when rates increase;

c) The use of £5m core cash deposits limits with part nationalised institutions can be greater than one year if rates are at a premium over predicted base rates and funds are available for the term; and

d) The use of enhanced cash funds which is an extension to the current AAA rated money market funds. These offer higher yields to money market funds due to giving short term notice to withdraw funds.

Minimum Revenue Provision 2014/15

a) The assumption is to borrow up to a maximum of £6m through the most economically advantageous method, as decided by the Head of Finance & Resources, from: internal borrowing of core cash balances; PWLB loans; or other reputable sources of lending;

b) The Council will use the asset life method for the calculation of the Minimum Revenue Provision on all future unsupported borrowing; and

c) Principle repaid will be used to calculate the Minimum Revenue Provision on the arrangement with Serco Paisa regarding the Leisure Centre improvements.

Prudential and Treasury Management Indicators

The Prudential and Treasury Management Indicators that have been developed based upon the proposed Strategy are set out above and detailed in Appendix C.

Consideration by Audit Committee

The draft Treasury Management Strategy 2014/15 was presented to the Audit Committee on 10 February 2014 in line with the approved process set out above. The Committee debated the proposed changes and the risks surrounding last resort, short term investments in foreign banks. The Committee concluded that it was satisfied with the adequacy of the draft Treasury Management Strategy 2014/15, and agreed that the Cabinet be recommended to approve the document for submission to the Council for adoption subject to a review at mid-year of the use of foreign banks for last resort, short term investments.

Alternatives Considered and Why Not Recommended

The Council is required to endorse a Treasury Management Strategy and monitor and update the Strategy and Prudential Indicators as necessary. The Council could endorse a simple Strategy for Treasury Management. However this would be contrary to best advice from the Council's advisors and likely to produce a reduced income stream from investments.

Within the Strategy proposed the Council could chose to retain a maximum investment with any institution of £5m or even reduce this level. Given the difficulty in identifying opportunities to lend at suitable rates within the counterparty list it is necessary to increase the level of investment possible with the most secure organisations.

Also within the Strategy proposed the Council could chose to utilise additional counterparties with the investments from the non-specified investments group. Due to the fact that this increases the risk to capital it is appropriate that the Council continues to only use such investments with the top five building societies and other local authorities.

As an additional action the Council could consider alternative investment options such as Certificates of Deposit or corporate bonds with banks and building societies. At this time the yields on these arrangements are not significantly higher and often these come with a management fee or requiring a high level of initial capital investment. As the Strategy identifies other appropriate methods of investment for the Council these options are not recommended as they do not offer benefits commensurate with the cost. They will continue to be reviewed and proposed if suitable in future Strategies.

The Council could utilise the resources invested in expenditure on key priority outcomes. However the core cash held by the Council is either set aside for future expenditure, such as the capital programme, or held as a form of risk mitigation, such as the minimum level of revenue balances. To utilise these resources for alternative projects would put the Council at future risk should an unforeseen event occur.

External Fund Managers – by appointing external managers local authorities may possibly benefit from security of investments, diversification of investment instruments, liquidity management and the potential of enhanced returns. Managers do operate within the parameters set by local authorities but this involves varying degrees of risk. This option has been discounted on the basis of the risk to capital receipts which would make it difficult to ascertain a suitable sum to assign to an external manager.

Background Papers

None