MAIDSTONE BOROUGH COUNCIL

COUNCIL

25 FEBRUARY 2015

REPORT OF THE CABINET HELD ON 11 FEBRUARY 2015

TREASURY MANAGEMENT STRATEGY 2015/16

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 2015/16 including the Treasury and Prudential Indicators.

Recommendation Made

That the Treasury Management Strategy 2015/16 and related appendices be adopted.

Reasons for Recommendation

The Council has adopted CIPFA's Code of Practice on Treasury Management (the Code) which requires an annual report on the strategy and plan to be pursued in the coming year to be made to full Council. This report considers the proposed strategy for 2015/16 onwards along with current guidance from CIPFA and the DCLG as set out in **Appendix A**.

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.

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 previously 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.

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

<u>The 2014/15 Strategy</u>

The Strategy for 2014/15 was approved by Council in March 2014 and set the following objectives:-

a) Increasing the maximum duration limits with some part-nationalised groups to 2 years from 1 year;
b) Investing up to £5m of core cash for over 1 year if rates were to improve. Maybe using property funds;
c) Considering the use of core cash during 2014/15 for internal borrowing if not used for longer term investments.

<u>Current Cashflow Performance</u>

At the November 2014 meeting of the Audit Committee the mid-year performance report included details for 2014/15 of the position as at 30 September 2014. An update on that position is provided below.

£3m has been invested with Lloyds Bank (part nationalised bank) for 2 years at a rate of 1.3%. £2m has been set aside for investment with Royal Bank of Scotland for two years duration, although this deal is yet to be finalised. This represents the £5m core cash as agreed within the strategy, to use for investments with a duration of over 1 year.

All other investments have been short term (less than 1 year).

During 2014/15, the Council had to borrow for one week due to cash flow shortage in June 2014.

Due to capital slippage and revenue underspends, there have been some difficulties in finding highly rated institutions in which to invest Council funds.

Details of the Council's investments and performance to date are as follows:

	£m	%
Investments as at 1st April 2014	19.186	
Investment Balance as at 31st Dec 2014	32.1	
Investment Income as at 31st Dec 2014	0.156	
Ave Balance/Rate of Investments to 31st Dec 2014	30.6	0.69
Est. Investments as at 31st March 2015	22.4	

Developing the Strategy

In formulating and executing the strategy for 2015/16, the Council will continue to have regard for 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 Capita's creditworthiness service.

The Council has previously only used UK institutions to invest funds, with the exception of Svenska Handelsbanken. However it is proposed that overseas institutions are used where the country's sovereign rating is the same as or better than the UK's AA+ rating and the institution itself is of a high credit quality. All the relevant counterparties with associated durational bands based on the above credit criteria are detailed within **Appendix B**.

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 potentially incur 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, 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 the downgrade of an institution or removal from the Council's lending list.

The strategy will permit the use of leading building societies for investment purposes. This will be limited to 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.

A Forward Look

Capita Asset Services has revised its Interest Rate Forecast. Previously, it was thought that rates would increase in June 2015, however it looks like this will now be either late 2015 or early 2016. This has reduced investment rates. Current investment rates are as follows:

- Instant Access 0.40%
- 3 months 0.50%
- 6 months 0.65%
- 1 year 0.95%
- 2 years 1.25%
- 5 years 1.85%

The Council's advisors, Capita Asset Services, have provided the following interest rate forecast.

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Mar 2015	0.50	2.20	3.40	3.40
Jun 2015	0.50	2.20	3.50	3.50
Sep 2015	0.50	2.30	3.70	3.70
Dec 2015	0.75	2.50	3.80	3.80
Mar 2016	0.75	2.60	4.00	4.00
Jun 2016	1.00	2.80	4.20	4.20
Sep 2016	1.00	2.90	4.30	4.30
Dec 2016	1.25	3.00	4.40	4.40
Mar 2017	1.25	3.20	4.50	4.50
Jun 2017	1.50	3.30	4.60	4.60
Sep 2017	1.75	3.40	4.70	4.70
Dec 2017	1.75	3.50	4.70	4.70
Mar 2018	2.00	3.60	4.80	4.80

The previous change in bank rate was expected to be June 2015, however partly due to the UK economy growth not being as high as previously predicted, the rate change has now moved to the end of 2015.

Short Term PWLB rates have also reduced to reflect the current abnormally low level in rates.

The following table shows the balance of investments which will mature during 2015/16 and the total of this balance which will be needed to fund the revenue/capital expenditure.

Investment	2015/16 £m
Short Term Investments at start of Year	17.4
Use of Balances/Capital receipts	13.6
Total Core Cash	3.8

These maturities will therefore cover the anticipated use of cash balances for the period and leave a minimum of £3.8m available for investment, along with day to day cash flow management funds. It is suggested that £3m of these funds may be set aside to be used for longer term rates if they become more appealing.

The use of property funds has been considered as an alternative source of investment income. At this stage the expected returns from such investments are not sufficient to justify the additional risks to security of capital and liquidity associated with this type of investment, although this will continue to be monitored during the course of the year.

A number of authorities have been investing in certificates of deposits (CDs) which allow authorities to invest with highly secure counterparties such as HSBC and Standard Chartered which would not normally be accessed by the Council through other means. Certificates of deposits are purchased via a custodian who takes a small fee from the purchase. CDs are highly liquid as they do not need to be held to maturity and can be sold in the secondary bond market. However, the downside risk to this is that these may be sold at a loss.

Capital Programme and Prudential Borrowing

As part of the development of the prudential indicators attached as **Appendix C**, which form part of the treasury management strategy, the Council must consider the affordability of its capital programme.

In the past the 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. The affordability of the programme is therefore 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 additional core cash of up to £3m to be held for longer term investment of over one year, if the rates are appealing.

The current long term borrowing rate from the Public Works Loan Board is 3.4% 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 2.7% 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 Customer Services to take advantage of external borrowing.

Cashflow Projection to 2017/18

A cash flow projection up to March 2018 has been created reflecting the spending proposals in the Budget Strategy 2015/16 onwards. The cash flow projection shows that anticipated investment income will be £0.27m 2015/16, £0.3m 2016/17 and £0.3m in 2017/18. The Council may need to accept a higher level of risk in order to achieve these targets, whilst maintaining due regard for security of capital and liquidity.

With reference to the proposal to use internal borrowing to finance the capital programme, as set out in the Capital Programme and Prudential Borrowing section 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 installments 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 it is felt appropriate that a policy statement is approved by Council in line with the requirements of the Code. The Code states that there is a choice between two options, or a mix of both:

a. **Asset life method** – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction;

b. **Depreciation method** – MRP will follow standard depreciation accounting procedures.

Due to the requirement to split assets into component parts and depreciate different components at different rates, the asset life method of calculating MRP would provide a more stable and transparent method for the Council to use.

Summary of Changes Proposed

The following changes are proposed to the existing strategy:

Invest additional core cash of up to £3m for over 1 year if rates were to improve, potentially using this amount to invest in property funds;

Include overseas institutions within the council's counterparty list who are listed on Capita's credit quality listing and where the country's sovereignty rating is equal or above the UK rating AA+.

The Head of Finance & Resources be given delegated authority to invest within the certificate of deposit market to access highly secure counterparties.

Draft Strategy for 2015/16

The council will maintain a counterparty list to identify institutions suitable for investment. The counterparty list will be maintained using the following principles:

a) Use of 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 will be 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 will be 2 years.

e) Use of the top 5 Building Societies will be ranked using the management expenses and asset size ranking.

f) The Head of Finance & Resources will have 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. The following principles are applied to their use:

a) Only the top five building societies (with the exception of Nationwide Building Society) 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 an additional £3m core cash deposits for greater than one year (bringing maximum total long term investments to £8m) if rates are at a premium over predicted base rates and funds are available for the term. These may be used to invest within property funds.

d) The use of enhanced cash funds and Money Market Funds which are AAA rated funds. These funds spread the risk over many counterparties and funds may be withdrawn by giving a short notice period.

e) The use of overseas banks to be included which are on Capita Asset Services counterparty list and whose country sovereignty rating is the same or higher than the UK.

Minimum Revenue Provision 2015/16

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;

c) The Minimum Revenue Provision relating to the arrangement with Serco Paisa for leisure centre improvements will be based on principal repaid during the year.

Prudential and Treasury Management Indicators

The Prudential and Treasury Management Indicators that have been developed based upon the proposed strategy set out in the section above.

Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsibe for scrutiny. A treasury management training session was delivered by Capita, the Council's treasury management advisors in December 2014 and was open for all members to attend. It is expected that all members responsible for scrutiny will attend future training sessions.

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