MAIDSTONE BOROUGH COUNCIL

27 FEBRUARY 2013

REPORT OF THE CABINET HELD ON 13 FEBRUARY 2013

TREASURY MANAGEMENT STRATEGY 2013/14

Issue for Decision

In accordance with CIPFA's Code of Practice on Treasury Management, Council is asked to consider the Draft Treasury Management Strategy for 2013/14 including the Treasury and Prudential Indicators.

Recommendation Made

That the Treasury Management Strategy 2013/14 be adopted.

Reasons for Recommendation

The Cabinet considered the report of the Head of Finance and Customer Services regarding the Treasury Management Strategy 2013/14 at the meeting held on 13 February 2013.

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 recommendation considers the proposed strategy for 2013/14 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.

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

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

<u>The 2012/13 Strategy</u>

The Strategy for 2012/13 was approved by Council in February 2012 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. This would leave a balance of £2m if there were to be any unexpected events;

c) No planned borrowing, other than for short-term cash flow purposes. The council is currently debt-free;

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

e) Group limits placed on institutions within the same group and not separate for each institution. This is an added security measure as there is a burden upon the parent company. The group limit will be the highest individual credit criteria for the group.

f) 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.

g) A reduction in overseas institutions due to the uncertainty of Sovereignty status', with the exception of Svenska Handelsbanken, a AAA rated Swedish Organisation with whom the Council currently has funds.

h) The top 5 Building Societies, ranked using the management expenses and asset size ranking.

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

At the November 2012 meeting of the Audit Committee an amendment was agreed to the 2012/13 Strategy and this was formally presented to Council and approved. This amendment was to agree a revised item c) in the paragraph above, to recognise the potential to borrow during 2012/13. This amendment included a change to the prudential indicators that was also agreed by Council to increase the limits for prudential borrowing by £2m, coupled with the existing £4m limit this set a maximum for long term borrowing to finance the capital programme of £6m.

Consideration by Audit Committee

On 14th January 2013 this draft strategy was presented to Audit Committee for consideration in line with the approved process set above.

Audit Committee debated the proposed changes and the risks surrounding the proposed prudential borrowing limit.

As a result of the debate the Committee indicated that it was satisfied with the adequacy of the draft Treasury Management Strategy 2013/14 and resolved that it be recommended to Cabinet for submission to Council.

Current Cashflow Performance

Also at the November 2012 meeting of the Audit Committee the mid-year performance report included details for 2012/13 of the position as at 30th September 2012. Given below is an update on that position.

	£m	%
Investments as at 1st April 2012	13.6	
Investment Balance as at 31st Dec 2012	31.1	
Investment Income as at 31st Dec 2012	0.3	
Ave Balance/Rate of Investments during year	25.5	1.2
Est. Investments as at 31st March 2012	11.0	

Investments with Lloyds TSB (part nationalised bank) total £5m. This is made up of two longer term investments, one of £3m for 346 days and the other of £2m for 367 days.

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

During 2012/13 to date the Council has not borrowed either for cash flow purposes or financing. During the last quarter of 2012/13 there is a high probability 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 1st April 2013 available for investment totalling £11m.

Developing the Strategy

In formulating and executing the strategy for 2013/14, the Council will continue to have regard to the DCLG’s guidance on Local Government

Investments and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectional Guidance Notes.

CIPFA's Treasury Management Code of Practice states that "in balancing risk against return, local authorities should be more concerned to avoid risks rather than maximising return". Therefore the underlying principles of the strategy are to ensure absolute security of Council funds, and to minimise large variations in annual investment returns, which would impact upon the budget.

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 existing operational arrangements which have been agreed to achieve its Treasury Management objectives are summarised above.

The Council, in conjunction with its treasury management advisor, Sector, 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 Sector creditworthiness service.

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 & Customer Services 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 to 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 & Customer Services 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 2013/14 and the total of this balance which will be needed to fund the revenue/capital expenditure.

Investment	**2013/14 £m**
Short Term Investments at start of Year	11.0
Use of Balances/Capital receipts	6.0
Total Core Cash	5.0

These maturities will therefore cover the anticipated use of cash balances for the period and leave a minimum of £5.0m available for investment, along with day to day cash flow management funds.

<u>A Forward Look</u>

The economic problems facing the UK and similar problems in the remainder of Europe and the USA are expected to require a long term resolution. The Chancellor of the Exchequer announced in his Autumn Statement that the Government currently expected the deficit reduction plan to be in force until 2018 and for the public sector to face a second spending review that brings significant reductions in resources.

Against the backdrop of the global economic problems Sector, the Council's Treasury Management Advisors, have given the following forward look.

a) The focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

b) Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

c) Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries

This indicates that there will be a very slow recovery and the prospects for investment are reducing as institutions reduce their borrowing levels. In order for the Council to sustain viable and secure investments the strategy must begin to look longer term.

Interest Rate Forecast

As part of their service Sector Treasury Management 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	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-

5yr PWLB Rate	NOW	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Sector's View	1.66%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
UBS	1.66%	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	1.66%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.50%	1.60%	-	-	-	-	-

10yr PWLB Rate	NOW	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Sector's View	2.64%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
UBS	2.64%	2.80%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	-	-	-	-	-
Capital Economics	2.64%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	-	-	-	-	-

25yr PWLB Rate	NOW	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Sector's View	3.88%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
UBS	3.88%	4.00%	4.20%	4.30%	4.40%	4.50%	4.50%	4.50%	4.50%	4.50%	-	-	-	-	-
Capital Economics	3.88%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	-	-	-	-	-

50yr PWLB Rate	NOW	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Sector's View	4.04%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
UBS	4.04%	4.10%	4.30%	4.40%	4.50%	4.60%	4.60%	4.60%	4.60%	4.60%	-	-	-	-	-
Capital Economics	4.04%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	-	-	-	-	-

Growth in the UK economy is expected to be weak in the next two years and there is a risk of a technical recession (i.e. two quarters of negative growth). Bank Rate, currently 0.5%, underpins investment returns and is not expected to start increasing until quarter 1 of 2015.

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. The report of the Head of Finance & Customer Services 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 permits the use of up to £3m of core cash for longer term investment of over one year where rates on longer term investments are at a premium. As detailed above, 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. During 2012/13 the return from the Council's investment of greater than one year was 2.85%, during 2013/14 a similar deal available at 1.1%. Call accounts currently return 0.4%. This means that the premium on investments of greater than one year will be 0.7% in future, compared to 2.45% currently.

The current long term borrowing rate from the Public Works Loan Board given in the table at paragraph 1.8.1 is 3.88% 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 2.78% of the amount borrowed. Consequently the affordability of the capital programme as set out in the prudential indicators accompanying this draft strategy has been calculated based upon the assumption that internal borrowing would occur initially.

In future years, once the Council's commercial activities have provided evidence of being self-financing, the Council should consider the option of external borrowing. This should be considered at an appropriate time to ensure the Council takes advantage of low rates of interest before a significant upturn occurs. Considering the forecast above, a suitable time for a review would be during the development of the 2014/15 strategy.

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 before the 2014/15 review occurs.

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 2013/14 onwards. The cash flow projection shows that anticipated investment income will be consistently £0.25m per annum over the period from 2013/14 to 2015/16. 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 by the Local Authorities (Capital Finance and Accounting) (Amendment) Regulations 2008 to make a prudent provision for the repayment of debt. 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).

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. In this case the financial arrangement set out in the contract with Maidstone Leisure Trust is that the Council directly repays the cost of borrowing arising from the improvements at the 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 recommended that the Council adopts a clear policy for how the Minimum Revenue Provision is calculated and that the 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 it is felt that the Depreciation method is overly complex for the Council’s property portfolio and that the asset life method of calculating MRP would provide a more stable and comprehendible method for the Council to use.

Summary of Changes Proposed

With this outlook in mind it was recommended that the Council should consider changes to the policy for use of the core revenue funds of the Council and the level of investment with the most secure counterparties on the Council’s list. It is proposed that the Treasury Management Strategy for 2013/14 therefore looks to enhance these areas as follows:

a) Increasing the maximum investment limits with some part-nationalised groups to £8m;

b) The inclusion of enhanced cash funds (which are similar to the money market funds already in use by the Council) in the portfolio of investment options to be used. The major difference is that these funds take a longer term investment view and provide a higher return for a longer notice period but still within the limits of the current strategy;

c) To consider the use of core cash during 2013/14 for internal borrowing; and

d) Introducing a minimum revenue provision policy.

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

Strategy for 2013/14

The council will maintain a counterparty list to identify institutions suitable for investment. The current list is given 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 modeling 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) Limit the Lloyds TSB group and the Royal Bank of Scotland group (part nationalised) to £8m to reduce exposure to lower rated institutions. Remaining institutions at £5m.

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

f) The Head of Finance & Customer Services be given delegated responsibility to add or withdraw institutions from the counterparty list when ratings change, either as advised by Sector Treasury Management (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 list of specified and non-specified investment types that the Council may use is given at Appendix B. The following principles are applied to their use.

a) Only the top five building societies and other local authority investments 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 £3m 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.

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 2013/14

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 & Customer Services, 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) Principal 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

Given at Appendix C are the Prudential and Treasury Management Indicators. These have been produced based upon the proposed strategy set out above.

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