Executive Report

Report of Chief Finance Officer

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Treasury management annual strategy report 2015-16 and treasury prudential indicators 2015-16 to 2017-18

Executive Summary

Treasury management is the control and management of all the Council's cash, regardless of its source. It covers management of the daily cash position, investments and borrowing. Our cash balances have built up over a number of years, and reflect our strong balance sheet, with considerable reserves. Officers carry out the treasury management function within the parameters set by the Council each year in the treasury management strategy statement (TMSS).

The Chartered Institute of Public Finance and Accountancy's (CIPFA) code of practice on treasury management and the CIPFA Prudential Code requires local authorities to determine a TMSS and set prudential indicators, on an annual basis. The Department for Communities and Local Government also requires an investment strategy to be included in the TMSS.

This report covers those key reporting requirements.

Treasury management is defined as "the management of the Council's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

The Council considers security, liquidity and yield when making investment decisions. The most important part of making investments is the security of capital – ensuring we get our money back. Next, we consider liquidity – getting our money back when we need it. Once we are comfortable with both security and liquidity of the investment, we review the return on the investment.

The Council has an underlying need to borrow for capital expenditure. For the current capital programme, this is £60.85 million for 2014-15 to 2019-20, excluding the new bids

put forward as part of the General Fund capital programme report elsewhere on this agenda. The net cost of the capital bids is £88.36 million, taking the revised underlying need to borrow to £149.21 million.

The Council has defined its minimum credit rating as a high quality investment for specified investments as A- for a counterparty and AA- for a sovereign. These credit ratings are explained in **Appendix 4**.

The key changes from the 2014-15 approved strategy are:

- increased diversification in the portfolio by introducing more secured investment types
- setting different limits for banks for secured and non-secured investments:
    - reduction in the maximum limit for non-secured investments from £8 million in the current strategy to £6 million for 2015-16
    - introduction of a £10 million limit for secured investments
- setting longer duration limits for secured bank investments
- introduction of a non-specified investment category for investments in wholly owned subsidiaries, if we were to set one up.
- inclusion of £20 million in the liability benchmark as the minimum liquidity

Recommendation to Council (11 February 2015)

The Executive is asked to recommend to Council that the Treasury Management Strategy for 2015-16 contained within **Appendix 1** of the report be approved, specifically:

a) the investment strategy contained in section 4; and
b) the treasury prudential indicators and limits for 2015-16 to 2017-18

Reasons for Recommendation:
To enable the Council to set the Budget Requirement, Council Tax and Prudential Indicators for the 2015-16 financial year, and to agree the treasury management strategy.

1. Purpose of Report

1.1 This report covers the operation of the treasury management function for 2015-16 and incorporates the following key reporting requirements:

- the treasury management strategy for 2015-16 in accordance with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (attached at **Appendix 1**);
- the investment strategy, in accordance with Government investment guidance (section 4 within **Appendix 1**);
- the reporting of the treasury prudential indicators for 2015-16 to 2017-18 in accordance with the requirements of the CIPFA Prudential Code for Capital Finance in Local Authorities, contained within **Appendix 1**.

1.2 The Executive is asked to recommend to Council adoption of the treasury management strategy for 2015-16, treasury prudential indicators for the period, the borrowing strategy (**Appendix 1**, section 3), and the investment strategy (**Appendix 1**, section 4).

2. Strategic Framework

2.1 Treasury management is a key function in enabling the Council to achieve financial excellence and value for money. This report, the strategy and the prudential indicators are designed to help the Council achieve the best use of its resources therefore supporting all of the Corporate Plan.

3. Background

Introduction

3.1 CIPFA's code of practice for treasury management in the public services (the CIPFA TM Code) and the prudential code, require local authorities to determine a treasury management strategy statement (TMSS) and set treasury prudential indicators on an annual basis. The TMSS also includes the investment strategy as required under the Department for Communities and Local Government (CLG's) Investment Guidance.

3.2 This report covers the operation of the treasury management function for 2014-15 and incorporates the following key reporting requirements

- the Treasury Management Strategy for 2014-15 in accordance with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (attached at **Appendix 1**);
- the investment strategy, in accordance with the Government investment guidance (section 4 within **Appendix 1**);
- the reporting of the treasury prudential indicators for 2015-16 to 2017-18 in accordance with the requirements of the CIPFA Prudential Code for Capital Finance in Local Authorities (contained within **Appendix 1**)

3.3 The Executive is asked to consider the Treasury Management Strategy for 2015-16, treasury prudential indicators for the period and the investment strategy (**Appendix 1**, section 4) and recommend their approval to the Council at its meeting on 11 February 2015. The Corporate Improvement Scrutiny Committee also considered this report at its meeting on 8 January 2015. In supporting the recommendations in the report, the Committee specifically agreed that the Council should renew its credit rating and the inclusion of £20 million in the liability benchmark as the minimum liquidity.

Main considerations

3.4 The CIPFA definition of treasury management is:

"the management of the Council's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks

associated with those activities; and the pursuit of optimum performance consistent with those risks".

3.5 Overall responsibility for treasury management remains with the Council. Treasury management activity involves risk. The effective identification and management of risks are integral to the Council's treasury management objectives as is ensuring that borrowing activity is prudent, affordable and sustainable.

3.6 The strategy takes into account the impact of the Council's revenue budget and capital programme on the balance sheet position, the current and projected treasury position, the investment strategy and treasury prudential indicators (**Appendix 1**) and the outlook for interest rates (**Appendix 5**).

3.7 The main change to the strategy from last year is

- increased diversification in the portfolio by introducing more secured investment types
- setting different limits for banks for secured and non-secured investments:
    - reduction in the maximum limit for non-secured investments from £8 million in the current strategy to £6 million for 2015-16
    - introduction of a £10 million limit for secured investments
- setting longer duration limits for secured bank investments
- introduction of a non-specified investment category for investments in wholly owned subsidiaries, if we were to set one up
- inclusion of £20 million in the liability benchmark as the minimum liquidity

Credit rating

3.8 The Council's current credit rating with Moody's credit rating agency is Aa1 (see **Appendix 4** for credit rating definitions). Having a rating gives us the flexibility and greater access to a range of funding, such as capital markets, which will enable us to borrow for capital projects more cheaply.

3.9 Moody's undertake an annual review of credit ratings. Ours is due for renewal in March 2015.

4. Financial Implications

4.1 Interest earnings are an important source of revenue for the Council and the cost of servicing our external debt is a big part of the HRA budget. It is important that we manage the portfolio as to maximise our investment income and reduce our debt interest, whilst maintaining our exposure to risk and maintaining appropriate liquidity to meet our needs.

4.2 The financial implications of the treasury management strategy and treasury prudential indicators are detailed in the appendices to the report.

4.3 The budget for investment income in 2015-16 is £1.065 million, based on an average investment portfolio of £89 million, at an average interest rate of 1.22%. The budget for debt interest paid is £5.489 million, of which £5.2 million relates to the HRA. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

5. Legal Implications

5.1 A variety of professional codes, statutes and guidance regulate the Council's treasury management activities. These are:

- the Local Government Act 2003 ("The Act") provides the powers to borrow and invest. It also imposes controls and limits on these activities
- the Act permits the Secretary of State to set limits on either the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken. The HRA debt cap is the only restriction that applied in 2014-15
- Statutory instrument (SI) 3146 2003 ("the SI"), as amended, develops the controls and powers within the Act
- the SI requires the Council to undertake any borrowing activity with regard to the Prudential Code. The Prudential Code requires indicators to be set – some of which are limits – for a minimum of three forthcoming years
- the SI also requires the Council to operate the overall treasury management function with regard to the CIPFA treasury management code of practice
- under the terms of the Act, the Government issued "Investment Guidance" to structure and regulate the Council's investment activities. The emphasis of the guidance is on the security and liquidity of investments

5.2 The Council has a statutory requirement under the Local Government Act 2003 to adopt the CIPFA Prudential Code and produce prudential indicators. A requirement of the prudential code is the adoption of the CIPFA code of practice on treasury management (by Council on 13 June 2002) and the treasury management policy statement (by Council on 9 February 2012).

5.3 All treasury activity will comply with relevant statute, guidance and accounting standards.

6. Human Resource Implications

6.1 There are no human resource implications arising from this report.

7. Conclusion

7.1 The information included in this report shows the Council has adopted the principles of best practice and complied with relevant statute, guidance and

accounting standards and as such the strategy and prudential indicators should be approved.

8. Background Papers

None

9. Appendices

Appendix 1 – Treasury management strategy statement, annual investment strategy, and treasury management prudential indicators 2015-16 to 2017-19
Appendix 2 – Glossary
Appendix 3 – Current investment portfolio
Appendix 4 – Credit rating definitions
Appendix 5 – Arlingclose economic and interest rate forecast

Treasury management strategy statement, annual investment strategy and treasury prudential indicators 2015-16 to 2017-18

1. Introduction

1.1 The treasury management service is an important part of the overall management of the Council's financial affairs. Councils may borrow or invest for any purpose relevant to its functions, under any enactment, or for the purpose of the prudent management of its financial affairs.

1.2 Statutory requirements and the CIPFA TM Code regulate the Council's treasury activities. We adopted the CIPFA TM Code on 13 June 2002 which requires the Council to approve a treasury management strategy before the start of each financial year. We also approved the revised treasury management policy statement on 9 February 2012. This adoption meets the requirement of one of the treasury prudential indicators.

1.3 In addition, the Department for Communities and Local Government (CLG) issued revised 'Guidance on Local Authority Investments' in March 2010 that requires the Council to approve an investment strategy before the start of each financial year.

1.4 This report fulfils the legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Guidance.

1.5 A key requirement of this report is to explain the risks associated with the treasury management service and the management of those risks.

1.6 This strategy covers:

- the balance sheet and treasury position
- the borrowing strategy
- the investment strategy
- other items

1.7 As part of the above regulations, we are required to set Prudential Indicators for assessing the prudence, affordability and sustainability of capital expenditure and treasury management decisions. Prudential Indicators are split into treasury and non-treasury indicators. The non-treasury indicators are included in the capital programme report, detailed elsewhere on this agenda, and are derived primarily from capital expenditure.

1.8 The treasury prudential indicators are related to the treasury management activity of the Council, and are presented within this report. There is a link between the two sets of indicators. For example, unfinanced capital expenditure increases the Capital Financing Requirement (CFR) and then treasury management decisions need to focus on how the CFR can be financed.

Economic background (detail in appendix 5)

1.9 There is momentum in the UK economy, with a continued period of growth through domestically-driven activity and strong household consumption. There are signs that growth is becoming more balanced. The greater contribution from business investments should support continued, albeit slower, expansion of GDP. However, inflationary pressure is benign and is likely to remain low in the short-term. There have been large falls in unemployment but levels of part-time working, self-employment and underemployment are significant and nominal earnings growth remains weak and below inflation.

1.10 The Monetary Policy Committee (MPC) focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee. Despite two MPC members having voted for a 0.25% increase in rates at each of the meetings from August 2014 onwards, some Committee members have become more concerned that the economic outlook is less optimistic than at the time of the August Inflation Report.

Credit outlook

1.11 The transposition of two European Union directives into UK legislation in the coming months will place the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors. The 'Bank Recovery and Resolution Directive' promotes the interests of individual and small businesses covered by the Financial Services Compensation Scheme and similar European schemes, while the recast 'Directive Guarantee Schemes Directive' includes large companies into these schemes. The combined effect of these two changes is to leave public authorities and financial organisations (including pension funds) as the only senior creditors likely to incur losses in a failing bank after July 2015.

1.12 The continued global economic recovery has led to a general improvement in credit conditions since last year. This is evidenced by a fall in the credit default swap spreads of banks and companies around the world. However, due to the above legislative changes, the credit risk associated with making unsecured bank deposits will increase relative to the risk of other investment options available to the Council. This means that we will need to consider other forms of investment to maintain the security of our portfolio.

Interest rate forecast

1.13 Our treasury management advisors, Arlingclose, forecast the first rise in official interest rates in August 2015 and a gradual pace of increases thereafter, with the average for 2015-16 being around 0.75%. They believe the normalised level of the Bank Rate post-crisis to range between 2.5% and 3.5%. The risk to the upside (interest rates being higher) is weighted more towards the end of the forecast horizon. On the downside, Eurozone weakness and the threat of deflation have increased the risks to the durability of UK growth. If the negative indicators from the Eurozone become more entrenched, the Bank of England will likely defer rate rises to later in the year. Arlingclose projects gilt yields on an

upward path in the medium term, taking the forecast average 10-year PWLB loan rate for 2015-16 to 3.40%.

1.14 A more detailed economic and interest rate forecast provided by Arlingclose is attached at **Appendix 5**.

2. Balance sheet and treasury position

2.1 The following table shows the extent of the Council's need to borrow for capital purposes, what we have borrowed and is split between the GF and the HRA.

2.2 The CFR measures the Council's underlying need to borrow for a capital purpose. The Council's investments are made up of usable reserves and working capital and are the underlying resources available for investment. Our current strategy is to maintain external borrowing below the level of the CFR – known as internal borrowing.

2.3 We are assuming a minimum liquidity requirement of £20 million. This is the first time we have included this in the figures, and it represents the minimum level of cash / investments we will maintain to cover the Council's cash movements, at any point in time.

2.4 Our current liabilities at the end of the financial years ending March 2013 and March 2014 had current liabilities of £17.868 million and £24.456 million respectively, so by including £20 million we are using a mid-point between those two years. We will update this annually, but have included an inflationary increase moving forward in the table.

Guildford Borough Council					
Balance Sheet Summary and Projections - last updated 12 Jan 2015					
31st March:	**2014**	**2015**	**2016**	**2017**	**2018**
	£000	**£000**	**£000**	**£000**	**£000**
Loans Capital Financing Requirement	220,150	228,226	286,312	309,348	310,431
Less: External Borrowing	(194,045)	(203,815)	(198,585)	(204,355)	(199,125)
Internal / (Over) Borrowing	**26,105**	**24,411**	**87,727**	**104,993**	**111,306**
Less: Usable Reserves/Working Capital	(111,504)	(99,878)	(93,029)	(96,166)	(102,777)
Investments / (New Borrowing)	**85,399**	**75,467**	**5,302**	**(8,827)**	**(8,529)**
Net Borrowing Requirement	108,646	128,348	193,283	213,182	207,654
Minimum Liquidity	0	20,000	20,500	21,013	21,538
Liability Benchmark	**108,646**	**148,348**	**213,783**	**234,194**	**229,192**

Housing Revenue Account - Summary and Projections					
31st March:	2014	2015	2016	2017	2018
	£000	£000	£000	£000	£000
HRA CFR	196,664	196,664	196,664	196,664	196,664
HRA Reserves	(64,274)	(70,531)	(63,278)	(67,492)	(73,750)
HRA Working Capital	0	0	0	0	0
HRA Borrowing	(194,045)	(193,815)	(193,585)	(193,355)	(188,125)
HRA Cash Balance	**61,655**	**67,682**	**60,199**	**64,183**	**65,211**

General Fund - Summary and Projections					
31st March:	2014	2015	2016	2017	2018
	£000	£000	£000	£000	£000
GF Loans CFR	23,486	31,562	89,648	112,684	113,767
GF Reserves	(47,230)	(29,347)	(29,751)	(28,674)	(29,027)
GF Working Capital	(17)	(10)	(10)	(10)	(10)
GF Borrowing	0	(10,000)	(5,000)	(11,000)	(11,000)
GF Cash Balance	**23,761**	**7,795**	**(54,887)**	**(73,000)**	**(73,730)**
Less borrowing = GF borrowing need	23,761	(2,205)	(59,887)	(84,000)	(84,730)

2.5 The table above shows the Council has an increasing CFR due to the underlying need to borrow for the General Fund (GF) capital programme. The cash balance of the Council is projected to reduce significantly over the period shown in the table.

2.6 Housing Revenue Account (HRA) reserves are increasing over the period, whilst the HRA CFR remains the same because we are operating at our debt cap. Our priority continues to be to build homes rather than reduce the level of debt. HRA debt is reducing slightly, due to the Equal Instalments of Principal (EIP) loan we hold. The above figures exclude an allowance for future development projects, for example the potential to spend £50 million on the redevelopment at Slyfield (as referred to in the HRA business plan).

2.7 GF reserves are projected to remain stable, but the CFR is increasing sharply due to the capital programme. We are projecting a need to borrow for the GF from 31 March 2015, based on the profile of the current capital programme. To overcome this, we took out a 3-year £5 million loan from another Local Authority. The rate was very good, and we took the opportunity to start some borrowing whilst it was cost effective to do so to meet the liquidity requirement. We have also taken out £5 million of short-term loans maturing in April and June 2015 to cover cash-flow.

2.8 Working capital is the net debtors and creditors we have at the end of the financial year. If we owe more money to creditors than we are owed by debtors, the working capital is a negative figure (as in the table above).

2.9 We will not automatically borrow externally for the GF when the cash balance is negative, although we will review the position in line with our borrowing strategy.

2.10 There are a number of options we can consider, alongside externalising our internal borrowing including internally borrowing from the HRA or transferring loans from the HRA (both of which depend on HRA reserve availability).

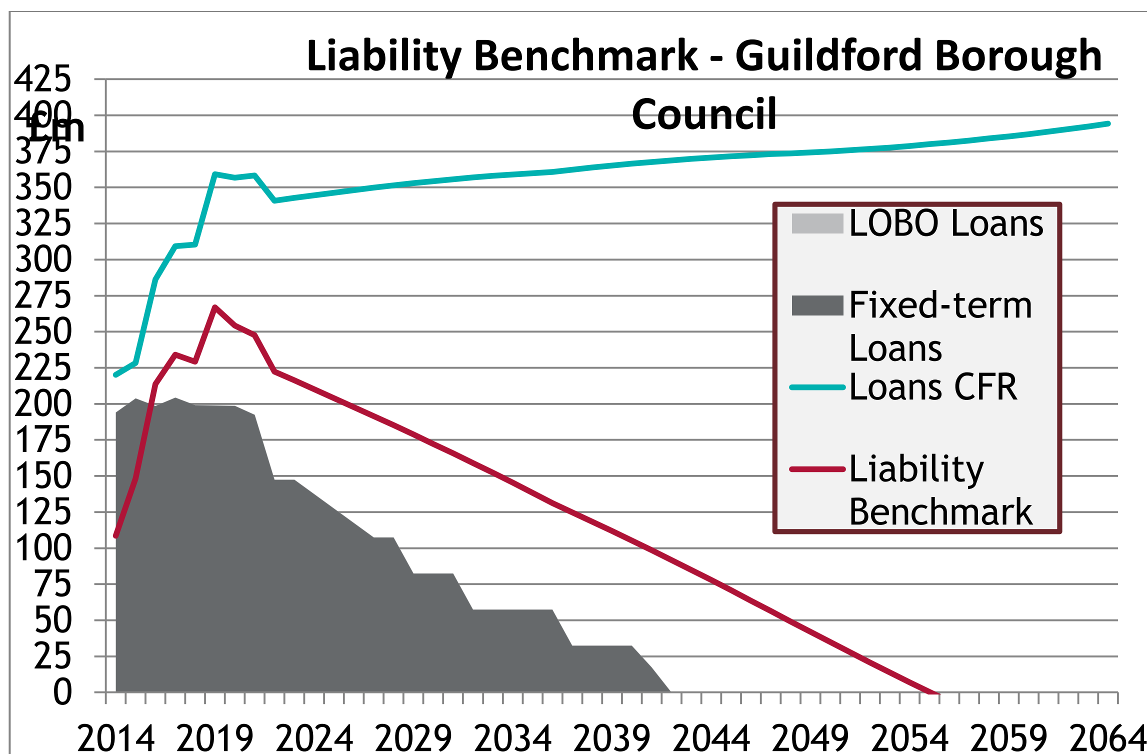
2.11 If some of the larger HRA redevelopment projects move forward, for example SARP, the HRA will spend its reserves and they will no longer be available for the GF to internally borrow from. In that case, we will have no choice but to externalise the GF borrowing.

2.12 We are currently negotiating with our development partner on the redevelopment of North Street and the outcome of this could impact on our capital programme and borrowing strategy and therefore the figures in the above table.

2.13 CIPFA's prudential code recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. The above table shows that the Council expects to comply with this recommendation during 2015-16.

2.14 To assist with the long-term treasury management strategy, the Council and its advisors have created a liability benchmark. This forecasts our need to borrow over the longer term. Following on from the medium term forecasts in the table above, the benchmark assumes:

- an allowance for currently known capital expenditure, until 2019-20, will be funded by internal borrowing, initially, and then an assumed level of capital expenditure moving forward, adjusted with a 2.5% adjustment each year
- minimum revenue provision (MRP) has been allowed for based on the underlying need to borrow for the GF capital programme until 2019-20, and then projected forward based on the assumed level of capital expenditure with MRP over 25 years repayment period
- income, expenditure and reserves are updated until 2019-20, based on estimated income and expenditure and then projected forward by using a 2.5% adjustment each year



2.15 The liability benchmark (the red line) shows our net debt position (the minimum amount of borrowing we would need to have zero investments). If the liability benchmark line rises above the amount of loans we have (the shaded area), we need to borrow externally and no longer have any internal borrowing capacity. Within the liability benchmark figure, we are assuming we will have a minimum level of cash investments of £20 million at any time moving forward to cover our cash flows.

2.16 The loans CFR, in the above graph, (blue line) is continuing to increase in line with the assumptions made around capital expenditure being financed from borrowing. We do not currently have any plans to reduce the HRA CFR because our priority is to use our reserves to build houses.

2.17 When making decisions about borrowing, we will review the liability benchmark to assess the length of time we need to borrow for, according to our projections on the level of reserves we may have, as well as other factors detailed in our borrowing strategy.

2.18 We will undertake some modelling taking into account the projects listed in the Corporate Plan, for example, which will tell us the potential impact on our borrowing requirement.

2.19 To ensure we ultimately finance the GF CFR, we are required to make a Minimum Revenue Provision (MRP) charge each year to the revenue account. There is no requirement to make MRP on the HRA CFR.

2.20 The Government has set a debt cap for the HRA CFR. This stands at £196.6 million, although we have approval to increase this to £197.205 million in 2016-17. As can be seen above, we are operating at our debt cap so are unable to take out any more external borrowing for the HRA.

2.21 The table in paragraph 2.4 shows our gross debt position against our CFR. This is one of the prudential indicators.

3. Borrowing

3.1 Borrowing can be for short-term (for cash flow purposes) and long-term (for funding the capital programme).

3.2 The Council currently has £199 million of long-term external loans, an increase of £5 million from the previous year. The £5 million relates to the GF and a 3-year loan was taken out to meet the liability benchmark need to borrow. £194 million relates to the HRA.

3.3 The balance sheet forecast, in para 2.4, shows the Council has a net GF external borrowing need of up to £53.6 million in 2015-16, including the new capital bids for 2015-16 to 2019-20. The net cost of these new schemes is £88.36 million. We may also borrow to externalise our current internal borrowing, or to pre-fund future year's requirements, providing this does not exceed the authorised borrowing limit and the highest level of the CFR in the next three years.

Objective

3.4 Our primary objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should our long-term plans change is a secondary option.

Strategy

3.5 Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to focus on affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to use internal borrowing or to borrow short-term loans instead.

3.6 By doing this, we are able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

3.7 The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose will assist us with this 'cost of carry' and breakeven analysis. Its output may determine whether we borrow additional sums at long-term fixed rates in 2015-16 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

3.8 We may borrow short-term loans for cash flow purposes.

3.9 In deciding when we externally borrow for the GF capital programme, we will also review other options. For instance, we have the flexibility to transfer PWLB loans from the HRA to the GF, if the HRA has enough resources to allow this.

Sources of borrowing

3.10 Sources of long and short-term borrowing we will consider are;

- Public Works Loans Board (PWLB)
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds
- capital market bond investors
- Local Capital Finance Company or other special purpose companies created to enable local authority bond issues

3.11 We may also raise capital finance by using the following methods that are not borrowing, but may be classes as other debt liabilities:

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

3.12 The Council has previously raised the majority of our long-term loans from the PWLB, but we will continue to investigate other sources of finance, such as local authority loans and bank loans, that may be available at more favourable rates.

LGA Bond Agency

3.13 The Local Government Association (LGA) established Local Capital Finance Company in 2014 as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB, for three reasons

a) borrowing authorities may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans
b) there will be a lead time of several months between committing to borrow and knowing the interest rate payable
c) up to 5% of the loan proceeds will be withheld from the Council and used to bolster the Agency's capital strength instead.

Debt Rescheduling

3.14 The PWLB allows local authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current

interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk, and where we have enough in reserves to fund the repayment.

Maturity structure of fixed rate borrowing treasury indicator

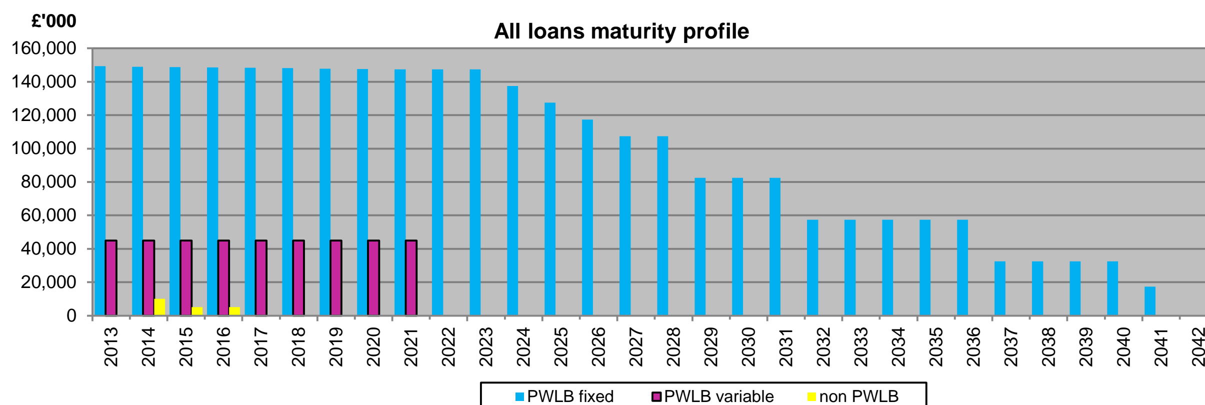
3.15 This indicator is set to control the Council's exposure to refinancing risk. It is calculated as the amount of fixed rate borrowing we can have maturing in each period as a percentage of total projected borrowing that is at a fixed rate. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Maturity Structure of fixed borrowing		
	2015-16	
	Lower	**Upper**
Under 12 months	0%	15.00%
1 year to 2 years	0%	20.00%
3 years to 5 years	0%	25.00%
6 years to 10 years	0%	50.00%
11 years and above	0%	100.00%

3.16 Time periods start on the first day of each financial year. The maturity of borrowing is the earliest date on which the lender can demand repayment.

3.17 This indicator gives us flexibility to have the above percentage of borrowing maturing in each time period shown, taking into account of our current debt profile, and providing an allowance for new borrowing.

3.18 The maturity profile, showing the outstanding level of loans each year is shown in the graph, and also illustrated as a summary in a table below:



Maturity Structure of fixed borrowing as at 30 November 2014		
Under 12 months	£	7,000,000
1 year to 2 years	£	5,000,000
3 years to 5 years	£	-
6 years to 10 years	£	66,495,000
11 years and above	£	127,435,000
	£	**205,930,000**

Interest rate exposures treasury indicator

3.19 This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures are shown in the table below expressed as absolute figures as the amount of net principal borrowed (investments counts as negative borrowing). We base these limits on our current position, with allowances for known changes. They are operational working limits not absolute limits.

Limits expressed as figures	2014-15 Approved	2015-16 Estimate	2016-17 Estimate	2017-18 Estimate
Net Debt / (investments):				
Limits on fixed interest rates (£000)	259,030	312,340	378,490	395,630
Limits on variable interest rates (£000)	(13,740)	(22,790)	8,010	19,120

3.20 Where the net debt is a negative figure, it means our investments are greater than our level of debt. For 2015-16, the table shows we are expecting our variable rate investments to be higher than our variable rate debt. We are allowing ourselves to have all of our debt to be at a fixed rate. This includes our current variable rate debt, which we can transfer to fixed rate at any of the re-set dates (six-monthly in September and March).

3.21 For the purposes of this indicator, where we place a fixed rate deposit, or take out a loan for a fixed rate for less than one-year, we class this as fixed rather than variable.

3.22 Future years' estimates are linked to the current debt portfolio, adjusted for any potential borrowing linked to the CFR projections. Investment limits are based on the maximum level of cash the Council may have during the year.

3.23 The following two Prudential Indicators are also detailed in the capital programme report, elsewhere in this agenda. The level of debt calculated is directly linked to the capital programme and treasury management activity.

Operational boundary for external debt

3.24 This is a monitoring indicator that shows the most likely (prudent) but not worst case scenario for external debt. It directly links to the Council's capital expenditure plans, the CFR and cash-flow requirements. It is a key management tool for in-year monitoring. Other long-term liabilities include finance leases, private finance initiatives and other long-term liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary of External Debt	2014-15 Approved £000	2015-16 Estimate £000	2016-17 Estimate £000	2017-18 Estimate £000
Borrowing - General Fund	74,595	181,605	280,165	206,635
Borrowing - HRA	196,665	196,665	197,025	197,025
Other Long Term Liabilities	0	26,000	26,000	26,000
Total	**271,260**	**404,270**	**503,190**	**429,660**

3.25 It represents the current debt portfolio and a maximum amount of temporary borrowing that may be required in the year. It is not a limit of total borrowing for the Council. It is calculated by taking the estimated CFR plus an allowance of headroom for cash movements. The HRA operational boundary is limited to the HRA debt cap set by the Government.

Authorised limit for external debt

3.26 The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003, and is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for any unusual cash movements.

Authorised Limit for External Debt	2014-15 Approved £000	2015-16 Estimate £000	2016-17 Estimate £000	2017-18 Estimate £000
Borrowing - General Fund	178,795	213,205	239,265	242,935
Borrowing - HRA	196,665	196,665	197,025	197,025
Other Long Term Liabilities	26,000	26,000	26,000	26,000
Total	**401,460**	**435,870**	**462,290**	**465,960**

3.27 The GF authorised debt level gives headroom for significant cash-flow movements, over the operational boundary, for example if we do not receive

Council Tax on the correct day. The HRA limit is set at the debt cap imposed by the Government.

3.28 We are required to set a limit for other long-term liabilities, for example finance leases. £26 million has been included in the authorised limit for investment property purchases and fleet purchases that could be classed as finance leases.

3.29 Officers monitor the authorised limit on a daily basis against all external debt items on the balance sheet (long and short-term borrowing, overdrawn bank balances and long-term liabilities).

4. Investments

4.1 As at 30 November, the Council has £109 million invested, representing surplus income plus balances and reserves held. Our average balance for the year to date is £104 million. We expect these balances to reduce in line with our capital expenditure plans, as highlighted in section 2 of this report and the General Fund Capital Programme report, elsewhere on this agenda.

Objectives

4.2 Both the CIPFA Code and the CLG Guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of our investments before seeking the highest rate of return, or yield. The Council's objective, when investing money, is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk receiving unsuitably low investment income.

Strategy

4.3 Given the increasing risk (lower rated counterparties and the risk of bail-in), explained throughout the report, and continued low returns from short-term unsecured bank investments, the Council aims to further diversify into more secure and / or higher yielding asset classes during 2015-16. This is especially the case for our longer-term investments.

4.4 The majority of our cash is currently invested in short-term unsecured bank deposits, certificates of deposit and money market funds. This move to more secured investments represents a substantial change in strategy over the coming year. This change was first introduced to Councillors in the revised Treasury Management Strategy mid-year update in November 2014.

4.5 We are required to classify investments as specified or non-specified by the investment guidance issued by CLG.

Specified investments

4.6 The CLG Guidance defines specified investments as those:

- denominated in pound sterling
- due to be repaid within 12 months of the arrangement

- not defined as capital expenditure by legislation and
- invested with one of:
    - the UK Government
    - a UK local authority, parish council or community council, or
    - a body or investment scheme of “high credit quality”

4.7 The Council defines high credit quality organisations as those having a long-term credit rating of A- or higher that are domiciled in the UK or a foreign country with a long-term sovereign rating of AA+ or higher. Money market funds do not need to be domiciled in a country with an AA+ rating.

Non-specified investments

4.8 Any investment not meeting the definition of a specified investment is classed as non-specified.

4.9 The Council will not make any investments denominated in foreign currencies.

4.10 We may make an investment that is defined as capital expenditure by legislation, such as company shares.

4.11 Non-specified investments will, therefore, be limited to long-term investments (those that are due to mature 12 months or longer from the date of the arrangement), and investments with bodies and schemes not meeting our definition of higher credit quality. This may include investments with banks that do not meet our credit criteria following the implementation of the two EU directives mentioned in 1.11.

4.12 Limits on non-specified investments are shown in the table below:

Non-specified investments	**Cash limit (£ million)**
Items currently in the strategy	
Total long-term investments	50
Total investments in institutions without credit ratings or rated below (A-)	45
Pooled funds without credit ratings or rated below (A-)	25
Money Market Funds, if new regulations are introduced and the funds are no longer rated	40
New items to the strategy	
Total investments with institutions domiciled in foreign countries rated below AA+	20
Investments in wholly owned subsidiaries of the Council (if we have one)	100
Maximum level of non-specified investments (% of portfolio)	**100%**

4.13 We may invest in institutions without credit ratings, or rated below A- to ensure we have diversification in our portfolio. We currently invest in some non-rated building societies, and if some of the banks on our lending list are downgraded following the introduction of the new bail-in legislation, they may no longer meet our minimum A- criteria. We need to ensure we have flexibility in our portfolio, whilst ensuring there is an appropriate mix with the security of our portfolio.

Approved counterparties

4.14 The Council may invest its surplus funds with any of the counterparty types in the following table, subject to the limits shown, and subject to other limits (**paragraph 4.15**) in this policy.

Credit Rating	Banks - unsecured	Banks - secured	Government (incl LAs)	Corporates	Registered Providers
Specified investments					
UK Government	n/a	n/a	£unlimited, 50 yrs	n/a	n/a
AAA	£6m, 5 yrs	£10m, 20 yrs	£10m, 50 yrs	£6m, 20 yrs	£6m, 20 yrs
AA+	£6m, 5 yrs	£10m, 10 yrs	£10m, 25 yrs	£6m, 10 yrs	£6m, 10 yrs
AA	£6m, 4 yrs	£10m, 5 yrs	£10m, 15 yrs	£6m, 5 yrs	£6m, 10 yrs
AA-	£6m, 3 yrs	£10m, 4 yrs	£10m, 10 yrs	£6m, 4 yrs	£6m, 10 yrs
A+	£6m, 2 yrs	£10m, 3 yrs	£6m, 5 yrs	£6m, 3 yrs	£6m, 5 yrs
A	£6m, 2 yrs	£10m, 3 yrs	£6m, 5 yrs	£6m, 2 yrs	£6m, 5 yrs
A-	£6m, 1yr	£10m, 2 yrs	£6m, 5 yrs	£6m, 18 mths	£6m, 5 yrs
Non Specified investments					
BBB+	£4m, 6 months	£6m, 1 yr	£4m, 2yrs	£4m 1 year	£4m, 2yrs
BBB or BBB-	£4m, 100 days	£6m, 6 months	n/a	n/a	n/a
None	£1m, 6 months	n/a	£4m, 25yrs	£500k, 5yrs	£6m, 5yrs
Pooled funds	£10m per fund				

4.15 These limits are per counterparty and the higher level is the maximum. For instance, we will not invest more than £10 million with a bank or group of banks, which can all be secured or a maximum of £6 million unsecured with £4 million secured. We propose to allow ourselves to invest in secured investments for longer periods of time than unsecured deposits. An example of a counterparty with no credit rating is a non-rated building society, where we can invest £1 million per counterparty. These time limits are the maximum for the year, and operationally we could have a shorter duration – these are reviewed throughout the year with Arlingclose.

4.16 Credit rating: Investment decisions are made by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class or investment is used, otherwise the counterparty credit rating is used.

4.17 Banks unsecured: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. Unsecured investment with banks rated BBB or BBB- are restricted to overnight deposits at our current bank account.

4.18 Banks secured: Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in.

Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

4.19 Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50-years.

4.20 Corporates: Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made as part of a diversified pool in order to spread the risk widely.

4.21 Registered Providers: Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formally known as Housing Associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services, they retain a high likelihood of receiving government support if needed.

4.22 Pooled Funds: Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Money market funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

4.23 Bond, equity and property funds offer enhanced returns over the longer-term, but are more volatile in the short-term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.

Investment limits

4.24 In order to ensure that no more than 10% of available reserves will be out at risk in the case of a single default, the maximum that will be lent to any one organisation or group (other than the UK government) will be £10 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

Treasury management risk and Credit Ratings

4.25 Credit ratings are obtained and monitored by the Council's treasury advisors, Arlingclose, who notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made
- any existing investments that can be recalled or sold at no cost will be
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

4.26 Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") and that it may fall below the approved rating criteria, we will limit new investments with that organisation to overnight until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

4.27 The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

4.28 We will not make investments with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

4.29 When deteriorating financial market conditions affect the credit worthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest with the Councils cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

4.30 The Council measures and manages its exposure to treasury management risk by using the following indicators.

4.31 <u>Security</u>: We have adopted a voluntary measure of our exposure to credit risk by monitoring the value-weighted average credit rating of the investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc) and taking the arithmetic average, weighted by the size of each investment.

4.32 The average portfolio credit rating target is set at A- for 2015-16.

4.33 Liquidity: We monitor our liquidity by using a cash flow system called Treasurynet. We project forward for the financial year, and enter all known cash flows at the beginning of the financial year and then update the position on a daily basis. This forms the basis of our investment decisions in terms of length and value of investments made. We have set £20 million as our minimum liquidity requirement.

Principal sums to be invested for periods longer than 364 days

4.34 The purpose of this indicator is to control the Council's exposure to the risk of incurring glosses by seeking early repayment of our investments. The limits on the total principal sum invested to final maturity beyond the end period will be:

	2014-15 Approved	2015-16 Estimate	2016-17 Estimate	2017-18 Estimate
Upper Limit for total principal sums invested for longer than 364 days	£9m	£50m	£30m	£20m

4.35 The large increase in the 2015-16 estimate reflects the increasing size of our cash and investment portfolio. It also reflects the change in our investment strategy of some of the types of new investments we have introduced that may require us to invest longer-term. This is just a limit and does not mean we will invest £50 million longer than 364 days.

5. Other items

5.1 There are a number of additional items that the Council is obliged by CIPFA or CLG to include in our treasury management strategy.

The Council's banker

5.2 Following a competitive tender exercise held in 2009 (with effect from 1 January 2010), the Council's current accounts are held with HSBC Bank plc, which is currently rated above our minimum credit criteria. Should the credit rating fall below the minimum credit rating, the Council may continue to deposit surplus cash with HSBC Bank plc providing that investments can be withdrawn on the next working day, and that the bank maintains a credit rating no lower than BBB- (the lowest investment grade rating).

Policy on the use of Financial Derivatives

5.3 Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (for example interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (for example LOBO loans and callable deposits). The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (those that are not embedded into a loan or investment).

5.4 The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds, will not be subject to this policy, although the risk they present will be managed in line with the overall treasury risk management strategy.

5.5 Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

Policy on apportioning interest to the HRA

5.6 The Council operates a two-pooled approach to its loans portfolio, which means we separate long-term HRA and GF loans.

5.7 Interest payable and other costs or income arising from long-term loans (for example premiums and discounts on early redemption) will be charged or credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. We will calculate an average balance for the year and interest transferred between the GF and HRA at the Council's weighted average return on its investments, adjusted for credit risk.

5.8 This credit risk adjustment reflects the risk to the GF that any investment default will be a charge to the GF, even if it is HRA cash that is lost.

Training

5.9 The needs of the Council's treasury management staff for training in investment management are assessed regularly throughout the year, and additionally when the responsibilities of individual members of staff change.

5.10 Staff regularly attend training courses, seminars and conferences provided by Arlingclose, CIFPA and other bodies. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.

5.11 Councillors undertake training as and when required, for example when there is a change in committee membership, and on an ad-hoc basis as required. The Lead Councillor for Finance and Asset Management attends the quarterly strategy meetings with Arlingclose and is briefed and updated on treasury management matters as and when required.

5.12 We will organise training for councillors after the election, particularly for those new to the Treasury Management Panel.

Investment consultants

5.13 Arlingclose are the Council's appointed treasury management advisors, with the contract running until 31 March 2015. We receive specific advice on investments, debt and capital finance issues. We have regular contact with the advisors and hold quarterly meetings with them to discuss changes on all aspects on treasury management and specifically in relation to the changing requirements of the Council.

5.14 Officers are currently preparing the specification documents to invite tenders for a new contract with effect from 1 April 2015.

5.15 The Council has access to five brokers to gather information and place deals where it is financially advantageous compared to direct dealing and where we are unable to access counterparties directly. The information received will be compared with information from other service providers in the market to gauge its applicability within the Council's strategy.

Investment of money borrowed in advance of need

5.16 The Council may, from time to time, borrow externally in advance of need, where this is expected to provide the best long-term value for money. Since we will invest the amounts borrowed until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

5.17 The total amount borrowed will not exceed the authorised borrowing limit.

Other options considered

5.18 The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer, having consulted with the Lead Councillor for Finance and Asset Management, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications are:

Alternative	**Impact on income and expenditure**	**Impact on risk management**
Invest in a narrower range of counterparties and/or shorter times	Interest income will be lower	Lower change of losses from credit related defaults, but any such losses will be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses will be smaller

Alternative	Impact on income and expenditure	Impact on risk management
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leaving to a higher impact in the event of default; however long-term interest costs will be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium-term, but long-term costs will be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs will be less certain

Treasury management performance monitoring

5.19 CIPFA advocates the principle that Council's should create appropriate methods by which the performance of their treasury management activities can be measured and recommend the selection of appropriate measures and setting of benchmarks.

5.20 Officers monitor the treasury management activity and prudential indicators on a monthly basis. Reports are made to Councillors quarterly via the Wey Ahead and half-yearly to scrutiny committee. Other monitoring includes:

- the Council will produce an outturn report on its treasury activity no later than 30 September after the end of the financial year
- the treasury management panel will meet at key stages during the financial year to review compliance of indicators and performance of treasury activity in the year, review the annual strategy and the annual report
- the Corporate Improvement Scrutiny Committee is responsible for the scrutiny of the Council's treasury management activity and practices

5.21 The Council sets performance indicators to assess the return against the Bank of England base rate on treasury activities over the year. These include the separate monitoring of in-house investments (both longer-term and for cash flow purposes) and externally managed funds.

5.22 We also monitor performance through benchmarking with both CIPFA and other Arlingclose clients. The Council is a member of the Surrey treasury management officers group who meet twice a year to discuss treasury management issues and share practices.

Glossary

Affordable Housing Grants – grants given to Registered Providers to facilitate the provision of affordable housing.

Arlingclose – the Council's treasury management advisors

Authorised Limit – the maximum amount of external debt at any one time in the financial year

Bail in risk – Following the financial crisis of 2008 when governments in various jurisdictions injected billions of dollars into banks as part of bail-out packages, it was recognised that bondholders, who largely remained untouched through this period, should share the burden in future by making them forfeit part of their investment to "bail-in" a bank before taxpayers are called upon.

A bail in takes place before a bankruptcy and under current proposals, regulators would have the power to impose losses on bondholders while leaving untouched other creditors of similar stature, such as derivatives counterparties. A corollary to this is that bondholders will require more interest if they are to risk losing money to a bail-in.

Balances and Reserves – accumulated sums that are maintained either earmarked for specific future costs or commitments or generally held to meet unforeseen or emergency expenditure

Bank Rate – the Bank of England base rate

Banks – Secured – covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the banks assets, which limits the potential losses in the unlikely event of insolvency and means they are exempt from bail in.

Banks – Unsecured – accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. Subject to the risk of credit loss via a bail in should the regular determine that the bank is failing or likely to fail.

Bonds – Bonds are debt instruments issued by government, multinational companies, banks and multilateral development banks. Interest is paid by the issuer to the bond holder at regular pre-agreed periods. The repayment date of the principal is also set at the outset.

Capital expenditure – expenditure on the acquisition, creation or enhancement of capital assets

Capital Financing Requirement (CFR) – the Council's underlying need to borrow for a capital purpose, representing the cumulative capital expenditure of the Council that has not been financed

Certainty rate – the government has reduced by 20 basis points (0.20%) the interest rates on loans via the Public Works Loan Board (PWLB) to principal local authorities who provide information as specified on their plans for long-term borrowing and associated capital spending.

Certificates of deposit – Certificates of deposit (CDs) are negotiable time deposits issued by banks and building societies and can pay either fixed or floating rates of interest. They can be traded on the secondary market, enabling the holder to sell the CD to a third party to release cash before the maturity date.

CIPFA - the Chartered Institute of Public Finance and Accountancy. The institute is one of the leading professional accountancy bodies in the UK and the only one which specialises in the public sector. It is responsible for the education and training of professional accountants and for their regulation through the setting and monitoring of professional standards. Uniquely among the professional accountancy bodies in the UK, CIPFA has responsibility for setting accounting standards for a significant part of the economy, namely local government. CIPFA's members work, in public service bodies, in the national audit agencies and major accountancy firms.

CLG – department of Communities and Local Government

Corporates – loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent.

Corporate bonds – Corporate bonds are those issued by companies. Generally, however, the term is used to cover all bonds other than those issued by governments. The key difference between corporate bonds and government bonds is the risk of default.

Cost of Carry - Costs incurred as a result of an investment position, for example the additional cost incurred when borrowing in advance of need, if investment returns don't match the interest payable on the debt.

Counterparty – the organisation the Council is investing with

Covered bonds – a bond backed by assets such as mortgage loans (covered mortgage bond). Covered bonds are backed by pools of mortgages that remain on the issuer's balance sheet, as opposed to mortgage-backed securities such as collateralised mortgage obligations (CMOs), where the assets are taken off the balance sheet.

Credit default swaps (CDS) – similar to an insurance policy against a credit default. Both the buyer and seller of a CDS are exposed to credit risk. The buyer effectively pays a premium against the risk of default.

Credit Rating – an assessment of the credit worthiness of an institution

Creditworthiness – a measure of the ability to meet debt obligations

Derivative investments – derivatives are securities whose value is derived from the some other time-varying quantity. Usually that other quantity is the price of some other asset such as bonds, stocks, currencies, or commodities.

Diversification / diversified exposure – the spreading of investments among different types of assets or between markets in order to reduce risk.

Derivatives – Financial instruments whose value, and price, are dependent on one or more underlying assets. Derivatives can be used to gain exposure to, or to help protect against, expected changes in the value of the underlying investments. Derivatives may be traded on a regulated exchange or traded 'over the counter'.

DMADF – Debt Management Account Deposit Facility operated by the DMO where users can place cash in secure fixed-term deposits. Deposits are guaranteed by the government and therefore have the equivalent of the sovereign credit rating.

DMO – debt management office. An Executive Agency of Her Majesty's Treasury (HMT) with responsibilities including debt and cash management for the UK Government, lending to local authorities and managing certain public sector funds.

EIP Loans – Equal Instalments of Principal. A repayment method whereby a fixed amount of principal is repaid with interest being calculated on the principal outstanding

European Investment Bank (EIB) – The European Investment Bank is the European Union's non-profit long-term lending institution established in 1958 under the Treaty of Rome. It is a "policy driven bank" whose shareholders are the member states of the EU. The EIB uses its financing operations to support projects that bring about European integration and social cohesion.

Finance Lease - a finance lease is a lease that is primarily a method of raising finance to pay for assets, rather than a genuine rental. The latter is an operating lease. The key difference between a finance lease and an operating lease is whether the lessor (the legal owner who rents out the assets) or lessee (who uses the asset) takes on the risks of ownership of the leased assets. The classification of a lease (as an operating or finance lease) also affects how it is reported in the accounts.

Floating rate notes – Floating rate notes (FRNs) are debt securities with payments that are reset periodically against a benchmark rate, such as the three month London inter-bank offer rate (LIBOR). FRNs can be used to balance risks incurred through other interest rate instruments in an investment portfolio.

Government – loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail in, and there is an insignificant risk of insolvency.

Gilts – long term fixed income debt security (bond) issued by the UK Government and traded on the London Stock Exchange

Housing Grants – see Affordable Housing Grants

Illiquid – cannot be easily converted into cash

Interest rate risk – the risk that unexpected movements in interest rates have an adverse impact on revenue due to higher interest paid or lower interest received.

Liability benchmark – the minimum amount of borrowing required to keep investments at a minimum liquidity level (which may be zero)

LIBID – London Interbank BID Rate – the interest rate at which London banks are willing to borrow from one another

LIBOR - London Interbank Offer Rate – the interest rate at which London banks offer one another. Fixed every day by the British Bankers Association to five decimal places.

Liquidity risk – the risk stemming from the inability to trade an investment (usually an asset) quickly enough to prevent or minimise a loss.

Market risk – the risk that the value of an investment will decrease due to movements in the market.

Mark to market accounting – values the asset at the price that could be obtained if the assets were sold (market price)

Maturity loans – a repayment method whereby interest is repaid throughout the period of the loan and the principal is repaid at the end of the loan period.

Minimum Revenue Provision (MRP) - the minimum amount which must be charged to an authority's revenue account each year and set aside towards repaying borrowing

Money Market - the market in which institutions borrow and lend

Money market funds – an open-end mutual fund which invests only in money markets. These funds invest in short-term debt obligations such as short-dated government debt, certificates of deposit and commercial paper. The main goal is the preservation of principal, accompanied by modest dividends. The fund's net asset value remains constant (e.g. £1 per unit) but the interest rates does fluctuate. These are liquid investments, and therefore, are often used by financial institutions to store money that is not currently invested. Risk is extremely low due to the high rating of the MMFs; many have achieved AAA credit status from the rating agencies:

- <u>Constant net asset value (CNAV)</u> refers to funds which use amortised cost accounting to value all of their assets. They aim to maintain a net asset value (NAV), or value of a share of the fund, at £1 and calculate their price to two decimal places known as "penny rounding". Most CNAV funds distribute income to investors on a regular basis (distributing share class), though some may choose to accumulate the income, or add it on to the NAV

(accumulating share class). The NAV of accumulating CNAV funds will vary by the income received.

- Variable net asset value (VNAV) refers to funds which use mark-to-market accounting to value some of their assets. The NAV of these funds will vary by a slight amount, due to the changing value of the assets and, in the case of an accumulating fund, by the amount of income received.

This means that a fund with an unchanging NAV is, by definition, CNAV, but a fund with a NAV that varies may be accumulating CNAV or distributing or accumulating VNAV.

Money Market Rates – interest rates on money market investments

Multilateral Investment banks – International financial institutions that provide financial and technical assistance for economic development

Municipal Bonds Agency – An independent body owned by the local government sector that seeks to raise money on the capital markets at regular interval to on-lend to participating local authorities.

Non Specified Investments - all types of investment not meeting the criteria for specified investments.

Operational Boundary – the most likely, prudent but not worse case scenario of external debt at any one time

Pooled Funds – investments are made with an organisation who pool together investments from other organisations and apply the same investment strategy to the portfolio. Pooled fund investments benefit from economies of scale, which allows for lower trading costs per pound, diversification and professional money management.

Project rate – the government has reduced by 40 basis points (0.40%) the interest rates on loans via the Public Works Loans Board (PWLB) for lending in respect of an infrastructure project nominated by a Local Enterprise Partnership (LEP).

Prudential Code – a governance procedure for the setting and revising of prudential indicators. Its aim is to ensure, within a clear framework, that the capital investment plans of the Council are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good practice.

Prudential Indicators – indicators set out in the Prudential Code that calculates the financial impact and sets limits for treasury management activities and capital investment

PWLB (Public Works Loans Board) - a central government agency which provides long- and medium-term loans to local authorities at interest rates only slightly higher than those at which the Government itself can borrow. Local authorities are able to borrow to finance capital spending from this source.

Registered Providers (RPs) – also referred to as Housing Associations.

Repo - A repo is an agreement to make an investment and purchase a security (usually bonds, gilts, treasuries or other government or tradeable securities) tied to an agreement to sell it back later at a pre-determined date and price. Repos are secured investments and sit outside the bail-in regime.

Reserve Schemes – category of schemes within the General Fund capital programme that are funded from earmarked reserves, for example the Car Parks Maintenance reserve or Spectrum reserves.

Sovereign – the countries the Council are able to invest in

Specified Investments - Specified investments are defined as:

a. denominated in pound sterling;
b. due to be repaid within 12 months of arrangement;
c. not defined as capital expenditure; and
d. invested with one of:
   i. the UK government;
   ii. a UK local authority, parish council or community council, or
   iii. a body or institution scheme of high credit quality

Stable Net Asset Value money market funds – the principle invested remains at its invested value and achieves a return on investment

Subsidy Capital Financing Requirement – the housing capital financing requirement set by the Government for Housing Subsidy purposes

SWAP Bid – a benchmark interest rate used by institutions

Temporary borrowing – borrowing to cover peaks and troughs of cash flow, not to fund spending

Treasury Management – the management of the Council's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risk associated with those activities and the pursuit of optimum performance with those risks.

Treasurynet – the Council's cash management system

Treasury Management Practices – schedule of treasury management functions and how those functions will be carried out

Treasury Management Strategy Statement – also referred to as the TMSS.

Voluntary Revenue Provision – a voluntary amount charged to an authority's revenue account and set aside towards repaying borrowing.

Working capital – timing differences between income and expenditure (debtors and creditors)

Investment portfolio at 30 November 2014

	At 30-11-14	Category in TMSS (para 4.12)	Limit in 15-16 TMSS
Specified Investments			
Call accounts	4,016,395	Banks unsecured	
Notice accounts	18,051,902	Banks unsecured	
Money Market Funds	2,926,000	Pooled fund	
Corporate Bonds	935,993	Corporates	
Certificates of Deposit	12,000,000	Banks unsecured	
Fixed Deposits			
Banks	33,500,000	Banks unsecured	
Building Societies	8,000,000	Banks unsecured	
Local Authorities	7,000,000	Government	
	86,430,290		
Non-specified investments			
Investments >1year	2,000,000	Banks Secured / Long term investment	20,000,000
Non-rated building societies	5,000,000	Institution without credit rating or rated below A-	45,000,000
Pooled Funds	15,801,506	Pooled funds without rating or below A-	25,000,000
Money Market Funds	0	MMF with new regulations	40,000,000
	22,801,506		
Total investments	**109,231,796**		

Credit Rating Equivalents and Definitions

	Fitch	Moody's	Standard & Poor's
Long Term Investment Grade	AAA	Aaa	AAA
	AA+ AA AA-	Aa1 Aa2 Aa3	AA+ AA AA-
	A+ A A-	A1 A2 A3	A+ A A-
	BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-
Sub Investment Grade	BB+ BB BB-	Ba1 Ba2 Ba3	BB+ BB BB-
	B+ B B-	B1 B2 B3	B+ B B-
	CCC+ CCC CCC-	Caa1 Caa2 Caa3	CCC+ CCC CCC-
	CC+ CC CC-	Ca1 Ca2 Ca3	CC+ CC CC-
	C+ C C-	C1 C2 C3	C+ C C-
	D		D or SD

Fitch	Moody's	Standard & Poor's
AAA Highest credit quality. 'AAA' ratings denote the lowest expectation of credit risk. They are assigned only in the case of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.	**Aaa** Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.	**AAA** An obligator rated 'AAA' has extremely strong capacity to meet its financial commitments. 'AAA' is the highest issuer credit rating assigned by Standard & Poors.
AA Very high credit quality. 'AA' ratings denote expectations of very low credit risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.	**Aa** Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.	**AA** An obligator rated 'AA' has very strong capacity to meets its financial commitments. It differs from the highest rated obligators only to a small degree.
A High credit quality. 'A' ratings denote expectations of low credit risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.	**A** Obligations rated A are considered upper-medium grade and are subject to low credit risk.	**A** An obligator rated 'A' has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligators in higher rated categories.
BBB Good credit quality. 'BBB' ratings indicate that there are currently expectations of low credit risk. The capacity for payment of financial commitments is considered adequate but adverse changes in circumstances and economic conditions are more likely to impair this capacity. This is the lowest investment grade category.	**Baa** Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.	**BBB** An obligator rated 'BBB' has adequate capacity to meets its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligator to meet its financial commitments.

Arlingclose Economic & Interest Rate Forecast October 2014

Underlying assumptions

- The UK economic recovery has continued. Household consumption remains a significant driver, but there are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP throughout this year.
- We expect consumption growth to slow, given softening housing market activity, the muted outlook for wage growth and slower employment growth. The subdued global environment suggests there is little prospect of significant contribution from external demand.
- Inflationary pressure is currently low and is likely to remain so in the short-term. Despite a correction in the appreciation of sterling against the US dollar, imported inflation remains limited. We expect commodity prices will remain subdued given the weak outlook for global growth.
- The MPC's focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee.
- Nominal earnings growth remains weak and below inflation, despite large falls in unemployment, which poses a dilemma for the MPC. Our view is that spare capacity remains extensive. The levels of part-time, self-employment and underemployment are significant and indicate capacity within the employed workforce, in addition to the still large unemployed pool. Productivity growth can therefore remain weak in the short term without creating undue inflationary pressure.
- However, we also expect employment growth to slow as economic growth decelerates. This is likely to boost productivity, which will bear down on unit labour costs and inflationary pressure.
- In addition to the lack of wage and inflationary pressures, policymakers are evidently concerned about the bleak prospects for the Eurozone. These factors will maintain the dovish stance of the MPC in the medium term.
- The continuing repair of public and private sector balance sheets leave them sensitive to higher interest rates. The MPC clearly believes the appropriate level for Bank Rate for the post-crisis UK economy is significantly lower than the previous norm. We would suggest this is between 2.5 and 3.5%.
- While the ECB is likely to introduce outright QE, fears for the Eurozone are likely to maintain a safe haven bid for UK government debt, keeping gilt yields artificially low in the short term.
- The probability of potential upside risks crystallising have waned a little over the past two months. The primary upside risk is a swifter recovery in the Eurozone.

Forecast:

- We continue to forecast the first rise in official interest rates in Q3 2015; general market sentiment is now close to this forecast. There is momentum in the economy, but inflationary pressure is benign and external risks have increased, reducing the likelihood of immediate monetary tightening.

- We project a slow rise in Bank Rate. The pace of interest rate rises will be gradual and the extent of rises limited; we believe the normalised level of Bank Rate post-crisis to range between 2.5% and 3.5%.

- The short run path for gilt yields is flatter due to the deteriorating Eurozone situation. We project gilt yields on an upward path in the medium term.

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Dec-17
Official Bank Rate												
Upside risk		0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75
Downside risk				0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.00
3-month LIBID rate												
Upside risk	0.05	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.55	0.60	0.65	0.85	1.00	1.15	1.30	1.45	1.60	1.75	1.85	2.05
Downside risk	0.10	0.15	0.20	0.30	0.40	0.55	0.65	0.75	0.85	-0.95	-0.95	-0.95
1-yr LIBID rate												
Upside risk	0.10	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.95	1.00	1.05	1.20	1.35	1.50	1.65	1.80	1.95	2.10	2.20	2.40
Downside risk	-0.30	-0.35	-0.40	-0.45	-0.50	-0.55	-0.60	-0.65	-0.70	-0.75	-0.80	-0.80
5-yr gilt yield												
Upside risk	0.30	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55
Arlingclose Central Case	1.70	1.75	1.90	2.00	2.10	2.20	2.30	2.40	2.50	2.60	2.70	2.90
Downside risk	-0.30	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.60	-0.65	-0.70	-0.70
10-yr gilt yield												
Upside risk	0.30	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55
Arlingclose Central Case	2.40	2.45	2.55	2.60	2.65	2.70	2.75	2.80	2.85	2.90	2.95	3.05
Downside risk	-0.30	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.55	-0.55	-0.60	-0.60
20-yr gilt yield												
Upside risk	0.30	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55
Arlingclose Central Case	2.90	2.95	3.05	3.10	3.15	3.20	3.25	3.30	3.35	3.40	3.45	3.50
Downside risk	-0.30	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.50	-0.55	-0.55	-0.60	-0.60
50-yr gilt yield												
Upside risk	0.30	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55
Arlingclose Central Case	3.00	3.05	3.10	3.15	3.20	3.25	3.30	3.35	3.40	3.45	3.50	3.55
Downside risk	-0.30	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.55	-0.55	-0.60	-0.60