Appendix B

Treasury Management Strategy 2012/13 to 2014/15

Draft for Consideration by Cabinet 14 February 2012

Introduction

1. The treasury management function is an important part of the overall financial management of the Council's affairs. Its importance has increased as a result of the freedoms provided by the Prudential Code. Whilst the prudential indicators consider the affordability and impact of capital expenditure decisions, the treasury function covers the effective funding of these decisions. There are also specific treasury indicators included in this strategy that need approval.
2. The Council's activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management, revised 2011: the "Code"). This Council originally adopted the Code on 13 February 2002, and has adopted any updates as these have come into force.
3. The Code requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A further report is produced after the year-end to report on actual activity for the year as well as a mid year monitoring report. Quarterly reports will continue to be presented to Cabinet with the Quarter 2 report being forwarded on to full Council.
4. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury function.
5. This strategy therefore covers:
   - the current treasury position;
   - expected movement in interest rates;
   - the Council's borrowing and debt strategy (including its policy on making provision for the repayment of debt);
   - the Council's Investment Strategy;
   - specific limits on treasury activities;
   - treasury management indicators; and
   - specific sections on training and the use of consultants.

   This strategy document contains the relevant information to comply with both the Code and the Investment Guidance issued by Government. The sections that specifically satisfy requirements of the Investment Guidance are: specified and non specified investments (32-40 and ***Appendix B1***), credit risk assessment (32-45), use of investment consultants (51-52), training (53), borrowing in advance of need (23) and length of deposits (table 3).

Treasury Position

6. The forecast treasury position and the expected movement in debt and investment levels over the next three years are as follows.

Table 1: Gross external debt and investment forecast

	2012/13 £'000	2013/14 £'000	2014/15 £'000
External Debt			
Borrowing			
Existing	39,215	39,215	39,215
Additional HRA borrowing	31,241	31,241	31,241
Other long term liabilities	225	225	225
Finance lease liability	2,514	2,282	2,127
Total External Debt at 31 March	**73,195**	**72,963**	**72,808**
Investments			
Total investment 31 March	**14,930**	**13,990**	**14,920**
Projected average investment balances	**26,770**	**26,460**	**26,430**

7. The current capital programme assumes a reduction of £4.4M (during the 5 years 2012/13 to 2016/17) against the 'underlying need to borrow' for capital expenditure to reverse prudential funding from prior years. This is reliant on the sale of land at South Lancaster, receipt of which is assumed in the balances above. These balances may appear high but there are factors which are very likely to reduce these materially, as follows.

8. No amounts have been included for potential capital expenditure on Lancaster Indoor Market. Whatever the decision, this is likely to reduce materially the cash balances in Table 1 above. The figures also assume that the Municipal Building works budgets are reasonable estimates; should the new condition survey find additional liabilities in terms of backlog repair works, the cash figure could be reduced further. In addition, should any decision be made about significant spend on housing projects or any other capital growth items, these figures would be further reduced (see 13 – 18 below). As such, the core cash balance at the end of 2012/13 could well be more in the region of £3.5M rather than £15M.

9. Opportunities to net down the cash balances through early repayment of loans will be reviewed during the year as these factors, and therefore the likely cash balances, become clearer.

10. The revenue consequences of the balances in Table 1, namely investment income and borrowing costs, are included within the overall revenue budget. These do not currently take account of the major uncertainties outlined in paragraph 8 and so any option appraisals on these schemes will need to include their full impact on the revenue budget.

11. Although the Council holds both investment balances and long term borrowings, this is not a result of borrowing in advance of need or to on-lend. The Council's external borrowings provide the cash to help pay for a proportion of the Council's accumulated, prudentially funded, capital spend (the Capital Financing Requirement - CFR). Separate to this, the Council is required to hold a certain amount of balances, provisions and other items to ensure that resources are available when needed; these are generally cash backed. Flexibility is allowed on utilising these cash funds in lieu of borrowing, which the Council is doing in part.

Capital programme scenarios

12. The position above assumes that following the Housing Revenue Account (HRA) financing in 2011/12, there will be no pressure to physically borrow to support the capital programme over the next three years and that over the life of the current programme (including the anticipated out-turn on 2011/12) Council will be able to reverse £1.99M of

previously incurred, prudentially funded, capital expenditure. This is in line with the targets agreed by Council in the prior year.

13. There are however a number of material variables which could alter this position, the main one being Lancaster Market. Whatever proposals are taken forward on the Market, this is likely to incur prudentially funded capital expenditure in the £millions. Work is currently ongoing to investigate the various options and fully worked up proposals are to be brought back before Members in due course. These proposals are focussed on reducing the ongoing revenue deficit and so although may incur high up front cash demands, should eventually generate material savings.

14. Further, following the withdrawal of external funding for housing schemes in the West End of Morecambe, if these are to progress Council funding will be required. These proposals would not be expected to generate net savings and so need to be within the framework of a balanced revenue budget that can accommodate the growth.

15. Previous years have included Luneside East as a significant variable. It is hoped, however, that there will be no further Council budget requirement on this scheme.

16. In addition, Icelandic bank investments have also cast a shadow over previous strategies. Following the successful outcome of the court case, the Council has secured preferential creditor status and now expects to get the vast majority of its investments back. This means that the impact of these investments on the capital programme has been neutralised in 2011/12 and will have no ongoing impact in capital terms. Depending on the timing of payments from the claims, these will still impact on the treasury position overall; the estimated repayment dates have been included in the projected cash flows over the 3 years 2012/13 to 2014/15.

17. There is still a risk around the large capital receipt for sale of land at South Lancaster. However, this is judged to be more a risk over timing rather than whether it will actually be received or not. The capital budget and associated revenue costs now assume receipt in 2012/13.

Expected Movement in Interest Rates

Table 2: Medium-Term Rate Estimates (averages)

Annual Average %	Bank Rate	Money Rates		PWLB Borrowing Rates		
		3 month	1 year	5 year	25 year	50 year
March 2012	0.50	0.70	1.50	2.30	4.20	4.30
June 2012	0.50	0.70	1.50	2.30	4.20	4.30
Sept 2012	0.50	0.70	1.50	2.30	4.30	4.40
Dec2012	0.50	0.70	1.60	2.40	4.30	4.40
March 2013	0.50	0.75	1.70	2.50	4.40	4.50
June 2013	0.50	0.80	1.80	2.60	4.50	4.60
Sept 2013	0.75	0.90	1.90	2.70	4.60	4.70
Dec 2013	1.00	1.20	2.20	2.80	4.70	4.80
March 2014	1.25	1.40	2.40	2.90	4.80	4.90
June 2014	1.50	1.60	2.60	3.10	4.90	5.00

Information provided by Sector December 2011.

18. 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 3 of 2013 despite inflation currently being well above the Monetary Policy Committee inflation target. Hopes for an export led recovery appear likely to be disappointed due to the Eurozone sovereign debt crisis depressing growth in the UK's biggest export market. The

Comprehensive Spending Review, which seeks to reduce the UK's annual fiscal deficit, may also depress growth during the next few years.

19. Fixed interest borrowing rates are based on UK gilt yields. The outlook for borrowing rates is currently much more difficult to predict. The UK total national debt is forecast to continue rising until 2015/16; the consequent increase in gilt issuance is therefore expected to be reflected in an increase in gilt yields over this period. However, gilt yields are currently at historically low levels due to investor concerns over Eurozone sovereign debt and have been subject to exceptionally high levels of volatility as events in the Eurozone debt crisis have evolved.

20. This challenging and uncertain economic outlook has several key treasury mangement implications:

   - The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
   - Investment returns are likely to remain relatively low during 2012/13;
   - Borrowing interest rates are currently attractive, but may remain low for some time. The timing of any borrowing will need to be monitored carefully;
   - There will remain a cost of capital – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

Borrowing and Debt Strategy 2012/13 to 2014/15

21. The continued uncertainty over future interest rates increases the risks associated with treasury activity. As a result there is no strong argument for a significant relaxation of the Council's treasury strategy. As outlined in the scenarios section above, there are also a number of other factors outside of the Council's direct control, which could have a significant impact on its need to borrow. As these issues are clarified, the options around borrowing will be considered in relation to the longer term prospects of rate rises.

22. The Head of Financial Services, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, if need be, taking into account the risks shown in the forecast above. It is likely that shorter term fixed rates may provide lower cost opportunities in the short to medium term.

23. Borrowing will only be taken on once a liability has been established although the timing of the borrowing may precede the point at which the liability actually falls due for payment. This would only be done to secure a preferential position for the Council, for example to benefit from lower interest rates. Following discussion with the Council's treasury advisors, the Treasury Indicator for Gross and Net debt has not been included as this is currently under revision by CIPFA.

24. With the likelihood of rates increasing, any debt restructuring is likely to focus on switching from longer term fixed rates to cheaper shorter term debt, although the Head of Financial Services and treasury consultants will monitor prevailing rates for any opportunities during the year. The benefit of this will be balanced against the risks attached to the more frequent refinancing that would be required.

25. The option of postponing borrowing and running down investment balances will also be considered; this would have the added benefit of further reducing counterparty risk and also could improve the revenue situation with the cost of loans currently far outweighing the return on investments, as already mentioned above. However, this will only be done once the cash needs of the Council have been clarified (see paragraph 8 above).

HRA borrowing

26. In relation to the HRA subsidy buy out, the Council will need to have the cash settlement amount of £31.2M available by the 28 March 2012. The PWLB are providing loans at interest rates 0.85% lower than the usual PWLB interest rates solely for the settlement requirements. As per the cash projections above, due to the uncertainty over material elements of capital expenditure for the Council as a whole it is judged that the full amount will need to be borrowed, rather than underborrowing to reduce cash balances and interest charges. The exact structure of debt to be drawn down will be finalised by the Head of Financial Services, ensuring that it meets the requirements of the HRA business plan and the overall requirements of the Council.

27. CIPFA have issued guidance on the accounting policies for 'post HRA buy out' debt and how the cost of this could be shared between the General Fund (GF) and the HRA. The Council is now required to approve its approach to apportioning this debt between the HRA and GF in the absence of the prescribed method, previously issued in the annual HRA item 8 determination. It is currently proposed to use a '1 pool' approach as this is judged to promote decision making that is good for the authority as a whole whilst satisfying the principles set down in the CIPFA Code (section 10), namely:

    - There should be no detriment to the General Fund.
    - The apportionment should be broadly equitable.
    - Future charges to the HRA in relation to borrowing are not influenced by the General Fund.
    - Un-invested balance sheet resources which allow borrowing to be below the CFR are properly identified between the HRA and the General Fund.

28. However, as the actual apportionment will not be made until the closure of the 2012/13 accounts, this will be subject to review once the settlement has physically happened and the overall impact on the authority is clearer.

Provision for the Repayment of Debt 2012/13 to 2014/15

29. New arrangements for calculating the Minimum Revenue Provision (MRP) were introduced from 01 April 2008 with refinements added in guidance published by Government in March 2010.

30. In line with this guidance, for 2012/13 the Council's policy for the making of provision for the repayment of debt will be as follows:

    - For all relevant capital expenditure prior to 01 April 2008, with the exception of that in respect of motor vehicles (i.e. less than 15 years life), by the application of the former prescribed formula *(i.e. for General Fund, 4% of the non-housing related Capital Financing Requirement at the start of the year)*.
    - For capital expenditure on motor vehicles prior to 01 April 2008, and for all supported or unsupported capital expenditure on or after that date, equal annual amounts based on the estimated life of each individual asset so financed, as is consistent with the revised Minimum Revenue Provision guidance (DCLG MRP guidance, March 2010, method 3).
    - For finance leases the annuity method will be used to ensure the total charges in year remain constant (MRP plus interest cost) and match what would otherwise be an annual revenue cost. This is also to be applied retrospectively to any operating leases subsequently re-classified as finance leases.

31. Although it is not mandatory to make a set aside for repayment of HRA debt, repayment of borrowing is considered an important part of the HRA debt strategy and so resources will be set aside annually to repay the new HRA debt over the 30 year business plan, but this aspect of the strategy is also subject to review during 2012/13.

Investment Strategy 2012/13 to 2014/15

32. The primary objective of the Council's investment strategy is to safeguard the re-payment of the principal and interest of its investments, with ensuring adequate liquidity being the second objective, and achieving investment returns being the third.

33. The types of investment allowable are categorised as either Specified and Non Specified investments. Details of these are set out in ***Appendix B1***.

34. Following the economic background described above, the current investment climate has one over-riding risk consideration, that of counterparty security risk. The Head of Financial Services will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. The use of these criteria provides an overall pool of counterparties that are considered as high quality and that may be chosen for investment, subject to other considerations.

35. The rating criteria use the lowest common denominator method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside of the lending criteria. This complies with a CIPFA Treasury Management Panel recommendation in March 2009 and the Code.

36. Credit rating information is supplied by the Council's treasury consultants (Sector) on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria will be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. More information on credit ratings is included in ***Appendix B2***.

37. The criteria for providing a pool of high credit quality investment counterparties (for both specified and non-specified investments) are:

Banks 1 - Good Credit Quality

The Council will only use banks that:

a) are UK banks; or
b) are non-UK but are domiciled in an EU country with a long term sovereignty rating of AAA,

and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated, as is consistent with the middle limit as per table 3):

i. **Short Term:** F1/P-1/A-1

ii. **Long Term:** A/A2/A

iii. **Individual Viability / Financial Strength:** bb+/C (Fitch / Moody's only)

iv. **Support:** 3 (Fitch only)

Banks 2 – Part nationalised UK banks

Lloyds Bank and Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or if they meet the ratings in Banks 1 above. Investment limits will be subject to the short and long term rating limits in table 3 below.

Banks 3 – The Council's own Banker

The bank may be used for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

Building Societies – all Societies that meet the ratings for banks outlined above.

Money Market Funds – AAA-rated sterling funds with constant unit value.

UK Government – Debt Management Account Deposit Facility (DMADF)

Local Authorities (including Police and Fire Authorities), Parish Councils

Supranational institutions (e.g. European Central Bank)

38. Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part the country selection will be chosen by the credit rating of the Sovereign state in *Banks 1* above. In addition:

- no more than 25% will be placed with any one non-UK country at any time;
- limits in place above will apply to Group companies (eg Natwest and RBS count as a single counterparty);
- sector limits will be monitored.

39. The Code and Investment Guidance require the Council to supplement credit rating information. Whilst the Council's strategy relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (e.g. credit default swaps, equity price, media coverage) will be reviewed prior to investments being placed.

40. For the above categories of Specified and Non Specified Investments, and in accordance with the Code, the Council has developed additional criteria to set the maximum amounts that may be invested in these bodies. The criteria, using the lowest common denominator approach are set out below.

Table 3: Counterparty Criteria and Investment Limits

	Minimum across all three ratings			Money Limit[8]	Time Limiit[9]
	Fitch	Moody's	Standard & Poors		
Upper Limit[1]	F1+/AA-	P-1/AA3	A-1+/AA-	£6M	Instant access only
				£3M	100 days
Middle Limit[2]	F1/A	P-1/A2	A-1/A	£3M	Instant access only
Other Institutions[3]	N/A	N/A	N/A	£6M	1 Year
Lancashire County[4]	N/A	N/A	N/A	£12M	1 Year
Money Market Funds[5]	AAA	AAA	AAA	£6M	Instant Access Only
DMADF deposit[6]	N/A	N/A	N/A	No limit	1 Year
Sovereign rating to apply to all non UK counterparties[7]	AAA	AAA	AAA	N/A	N/A

Notes:

1 & 2: The Upper and Middle Limits apply to appropriately rated banks and building societies.
3: The Other Institutions limit applies to other local authorities and supranational institutions (i.e. ECB).
4: This recognises the special status of Lancashire County Council as the City Council's upper tier authority.
5: Sterling, constant net asset value funds only.
6: The DMADF facility is direct with the UK government; it is extremely low risk.
7: UK counterparties are defined as those listed under UK banks or building societies in the Sector counterparty listing.
8: Money limits apply to principal invested and do not include accrued interest.
9: Time Limits start on the trade date for the investment.

41. In the normal course of the Authority's cash flow operations it is expected that both specified and non-specified Investments will be utilised for the control of liquidity as both categories allow for short term investments. The Council will maintain a minimum £2M of investments in Specified Investments provided that the cashflow allows for this. In addition, although the Council will consider using non specified investments (as described in ***Appendix B1***), these should not exceed 50% of the portfolio at any one time. The limits applied will be consistent with the short and long term ratings in table 3 above.

42. The use of longer term instruments (greater than one year from trade date to maturity) and forward deals will not be used.

43. Expectations on shorter-term interest rates, on which investment decisions are based, show a low likelihood of the current 0.5% Bank Rate increasing over the next 12 months but with the possibility of a moderate rise in 2013/14.

44. There is some operational difficulty arising from the legacy of the banking crisis; although there is some value returning to longer term investment, credit risk remains within the market. Whilst some selective options do provide additional yield, uncertainty over counterparty creditworthiness indicates that shorter dated investments still provide better security. However, in line with limits in table 3, fixed term investing is judged to be acceptable for certain institutions or where certain credit rating limits are met.

45. Members are asked to approve the base criteria above, however, the Head of Financial Services may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval.

Risk benchmarking

46. A further development in terms of managing risk is the use of benchmarks. Yield benchmarks are currently widely used to assess investment performance but there is little comparative data available to Members to assess where this strategy sits in comparison to other authorities in terms of the types of counterparty used and the lengths of deposit.

47. At present, the criteria set down in table 3 above and through the treasury management indicators below, limit activity in terms of length of deposit (liquidity) and in terms of strength of the counterparty (security). The current strategy follows on from the 2011/12 strategy in being low risk through, for example, restricting the amount and length of deposit in any one counterparty as well as requiring high liquidity on most large deposits. The use of information from other authorities might allow the officers to refine the investment strategy once it is clearer how other local districts are performing and the investment parameters they are using. Officers will work towards obtaining comparative information from other Districts over the course of 2012/13 with a view to presenting this information to Members in due course.

Treasury Management Indicators and Limits on Activity

48. There are four mandatory treasury management indicators. The purpose of these indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. The full list of Prudential Indicators is included elsewhere on the agenda, but the treasury management indicators are as follows:

    - Upper limits on fixed interest rate exposure – This indicator identifies a maximum limit for fixed interest rates based upon the debt position net of investments.
    - Upper limits on variable interest rate exposure – Similar to the previous indicator, this covers a maximum limit on variable interest rates.

- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

- Total principal funds invested for greater than 364 days – given the current economic climate the Authority is not willing to risk investing sums for fixed terms of greater than 1 year and so this is £0.

49. Council will also be requested to approve the treasury management indicators, as updated in line with final budget proposals, at its meeting on 29 February 2012.

Table 5: Treasury Management Indicators

	2012/13		2013/14		2014/15	
Interest Rate Exposures (TM 1 & 2)						
	Upper		**Upper**		**Upper**	
Limits on exposure to fixed interest rates	100%		100%		100%	
Limits on exposure to variable interest rates	30%		30%		30%	
Maturity Structure of fixed interest rate borrowing (TM 3)						
	Lower	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	50%	0%	50%	0%	50%
12 months to 2 years	0%	50%	0%	50%	0%	50%
2 years to 5 years	0%	50%	0%	50%	0%	50%
5 years to 10 years	0%	50%	0%	50%	0%	50%
10 years to 15 years	0%	100%	0%	100%	0%	100%
15 years to 25 years	0%	100%	0%	100%	0%	100%
25 years to 50 years	50%	100%	50%	100%	50%	100%
Actual current position (not including new HRA debt)						
Under 12 months	0%					
12 months to 2 years	0%					
2 years to 5 years	0%					
5 years to 10 years	0%					
10 years to 15 years	0%					
15 years to 25 years	0%					
25 years to 50 years	100%					
Maximum principal sums invested > 364 days (TM 4)						
Principal sums invested, in 2012/13, for periods of greater than 364 days, to mature after the end of each financial year	£0M		£0M		£0M	

Performance Indicators

50. The Code requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators that are predominantly forward looking. Examples of performance indicators to be used for the treasury function are:

- Debt – Average rate movement year on year

- Investments – Internal returns above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report and the mid-year report as required under the Code.

Treasury Management Advisers

51. The Council currently uses Sector as its treasury management consultants. The company provides a range of services that include:

    - technical support on treasury matters, capital finance issues and the drafting of Member reports;
    - economic and interest rate analysis;
    - debt services which includes advice on the timing of borrowing;
    - debt rescheduling advice surrounding the existing portfolio;
    - generic investment advice on interest rates, timing and investment instruments;
    - credit ratings/market information service comprising the three main credit rating agencies.

52. Whilst the advisers provide support to the internal treasury function, under current market rules and the Code the final decision on treasury matters remains with the Council. The service is subject to regular review.

Member and Officer Training

53. The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers. This Council addresses this important issue by providing Member training in liaison with its treasury advisors and through ongoing training and supervision of officers involved the day to day operation of the treasury function.