Report of the Service Director – Finance and Procurement

Treasury Management Strategy 2014/15

Introduction

1. Treasury Management is defined by the Chartered Institute of Public Finance and Accountancy (CIPFA) as:

   "the management of the organisation'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".

2. The Local Government Act 2003 (the Act) requires local authorities "to have regard –
   (a) to such guidance as the Secretary of State may issue, and
   (b) to such other guidance as the Secretary of State may by regulations specify for the purposes of this provision."

3. The Local Authorities (Capital Finance and Accounting)(England) Regulations 2003 state that:
   "In carrying out its capital finance functions, a local authority must have regard to the code of practice in 'Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes' (regulation 24)."

4. The 2003 regulations further require local authorities to have regard to the code of practice entitled the 'Prudential Code for Capital Finance in Local Authorities' (published by CIPFA), when considering how much they can afford to borrow. Both the Treasury Management Code (the Code) and the Prudential Code were updated in November 2011.

5. With regard to investment of funds, the Secretary of State issued revised guidance in 2010 that requires local authorities to prepare an annual investment strategy which has the key objectives of security and liquidity of funds.

6. The Code has 3 key principles which are:

   i) the establishment of 'comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of their treasury activities'.
   ii) the effective management and control of risk are prime objectives and that responsibility for these lies clearly within the organisation.
   iii) the pursuit of value for money and the use of suitable performance measures are valid and important tools.

7. In accordance with the CIPFA Code the Council adopts the following:

   (a) The Council will create and maintain, as the cornerstones for effective treasury management:
      - a Treasury Management Policy Statement, stating the policies, objectives and approach to risk management of its treasury management activities
      - suitable Treasury Management Practices (TMPs), setting out the manner in which the Council will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

   The content of the policy statement and TMPs will follow the recommendations contained in Sections 6 and 7 of the Code, subject to amendment only where necessary to reflect the particular circumstances of the Council. Such amendments will not result in the Council materially deviating from the Code's key principles.

   (b) The Council will receive reports on its treasury management policies, practices and activities, including an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMPs.

   (c) The Council delegates responsibility for the implementation, scrutiny and monitoring of its treasury management policies and practices to the Treasury Management Group, comprising the Service Director (Finance & Procurement), the Group Manager (Financial Strategy & Compliance), the Senior Accountant (Pensions & Treasury Management) and the Senior Finance Business Partner (Capital & External Funding). The responsible officer for the execution and administration of treasury management decisions is the Senior Accountant (Pensions & Treasury Management), who will act in accordance with the policy statement and TMPs.

8. This Treasury Management Strategy has been prepared in accordance with the regulations, guidance and codes of practice to support the Council's Medium Term Financial Strategy and in particular the financing of the capital programme and the management of cash balances. In addition to this strategy there is a Treasury Management Policy Statement in Appendix L that underpins the strategy, together with the TMPs that govern treasury management operations.

9. The strategy covers:
   - the current treasury position
   - the borrowing requirement
   - Treasury Indicators
   - interest rate forecasts
   - the borrowing strategy
   - the investment strategy
   - Pension Fund cash.

Current Treasury Position

10. The table below shows the Council's forecast treasury position as at 31/03/2014:

Table K1			Average Interest Rate
		£m	%
EXTERNAL BORROWING			
Fixed Rate	PWLB	239.0	5.78
	Market Loan	100.0	3.85
	Other	55.0	0.78
		394.0	**4.59**
Variable Rate	PWLB	0.0	0.00
	Market Loan	0.0	0.00
	Other	0.0	0.00
		0.0	**0.00**
Total External Borrowing		**394.0**	
Other Long Term Liabilities		130.0	
Total Gross Debt		**524.0**	
Less: Investments		5.0	
Total Net Debt		**519.0**	

Note 1: PWLB = Public Works Loans Board
Note 2: Market Loans = Lenders' Option Borrowers' Option (LOBO)

Borrowing Requirement

11. Under the Prudential Code, the Council is required to calculate the 'Capital Financing Requirement' (CFR). This represents the Council's underlying need to borrow for the approved capital programme. New capital expenditure, financed by borrowing or by credit arrangements such as finance leases and private finance initiative schemes, increases the CFR.

12. The Council also sets aside an amount each year as a provision for the repayment of debt. This is known as the Minimum Revenue Provision (MRP) and is, in effect, the principal repayment for the borrowing undertaken by the Council to finance its capital programme. MRP amounts set aside reduce the CFR.

13. The difference between the CFR and the total of long-term liabilities and existing and new borrowing indicates that the Council has made temporary use of internal cash balances (from its own earmarked reserves and working capital) to finance the capital programme. This is known as “Internal borrowing”. Internal borrowing is a way of making short-term savings and avoiding the risks associated with holding large cash balances and is explained further in the “Borrowing Strategy” section below.

14. The Local Government Act 2003 and supporting regulations requires the Council to determine and keep under review how much it is prepared to borrow, termed the ‘Authorised Limit’. This limit is determined for external borrowing (including both long-term and temporary borrowing and other forms of long-term liability, such as credit arrangements). This limit reflects the need to borrow for capital purposes. The ‘Authorised Limit’ is set for at least the forthcoming financial year and two successive financial years. The Council must have regard to the Prudential Code when setting the ‘Authorised Limit’, which essentially requires it to ensure that its total capital investment is ‘affordable, prudent and sustainable’.

15. In practice during the year the level of borrowing will be monitored against the ‘Operational Boundary’. This represents the planned level of borrowing for capital purposes and, as shown in Appendix J, is made up as follows:
    - Existing borrowing and other long-term liabilities
    - Increased by:
        - planned new borrowing
        - net change in long-term liabilities
    - Reduced by amounts set aside for repayment of debt (referred to as Minimum Revenue Provision or MRP).

16. The ‘Operational Boundary’ is set for the forthcoming financial year and next two financial years. Any breach of this indicator would provide an early warning of a potential breach of the ‘Authorised Limit’ and allow time for the Council to take appropriate action.

17. There are two main reasons why planned actual borrowing may be lower than that shown as being required to finance the capital programme. These are slippage in capital schemes and the Council temporarily making use of its cash reserves to delay external borrowing (the internal borrowing referred to above). The main components involved in calculating planned actual borrowing over the next three years are shown in the table below.

Table K2	2013/14 Revised £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Capital Financing Requirement	735	751	759	739
Less:				
- Long-term liabilities	(130)	(131)	(131)	(129)
- Existing borrowing	(394)	(373)	(362)	(351)
- Cap Ex financed by borrowing		(43)	(38)	(22)
- Replenishment/Replacement borrowing		(24)	(52)	(59)
Internal borrowing	**211**	**180**	**176**	**177**
Forecast investments	**5**	**5**	**5**	**5**
Cash deployed (Internal borrowing + forecast investments)	**216**	**185**	**181**	**182**
comprising:				
- Earmarked reserves	159	128	124	125
- Working capital	57	57	57	57
Planned actual borrowing		**67**	**90**	**81**

18. The table above shows that, even after factoring in internal borrowing, the Council is expecting to borrow an additional £238m from the financial markets over the next 3 years. Though ultimately driven by the capital programme this borrowing will largely be used to provide the funds to replenish internal balances and to replace maturing debt. The table also shows that this level of borrowing is *the minimum*, providing enough to cover anticipated cash outflows, but not enough to result in any surplus cash that could be held as short-term investments. It still leaves the Council 'under borrowed' by some £182m by the end of 2016/17.

19. Under the capital finance regulations, local authorities are permitted to *fully borrow* up to three years in advance of need as determined by the Capital Financing Requirement. This Council could therefore consider borrowing up to £420m (£239m plus £181m) if market conditions indicate that it is the best course of action. One of the reasons for borrowing more than the minimal amount is to take advantage of, and lock in, low long-term interest rates. There will almost certainly be a short term 'carry cost' to borrowing in advance of need when current investment rates are lower than long-term borrowing rates, but this could be offset by long-term savings, and would be fully evaluated before any decision is taken.

20. Borrowing in advance of need also increases the level of temporary investments and makes the security of those funds even more important. However, the Council's treasury management practices ensure that risks of investing funds are minimised.

21. A summary of the proposed Treasury Management Indicators for 2014-17 are set out below. The ‘Authorised Limit and ‘Operational Boundary’ are detailed in Appendix J but are shown in the table below for completeness.

Table K3. TREASURY INDICATORS	**Proposed 2014/15 £m**	**Proposed 2015/16 £m**	**Proposed 2016/17 £m**
Authorised Limit			
Borrowing	458	518	559
Other long term liabilities	127	127	125
TOTAL	**585**	**645**	**684**
Operational Boundary			
Borrowing	433	493	534
Other long term liabilities	127	127	125
TOTAL	**560**	**620**	**659**
Upper limit for Rate Exposure			
Fixed Rate	100%	100%	100%
Variable Rate	75%	75%	75%
Upper limit for principal sums invested for over 364 days	Higher of £20m and 15%	Higher of £20m and 15%	Higher of £20m and 15%

Table K4. Maturity structure of fixed rate borrowing	**Lower limit**	**Upper limit**
under 12 months	0%	25%
12 months and within 24 months	0%	25%
24 months and within 5 years	0%	75%
5 years and within 10 years	0%	100%
10 years and above	0%	100%
Adoption of CIPFA’s Treasury Management in the Public Services Code of Practice and Cross Sectoral Guidance Notes	Adopted	

Review of 2013/14

22. The abiding feature of 2013 was the marked recovery in UK activity, contrary to consensus expectations at the start of the year that the economy was destined to remain in recession. Short-term interest rates remained close to the low point that has featured since the early days of the financial crisis. Longer-term rates, on the other hand, rose in reaction to a number of influences.

23. The economy entered 2013 on a subdued note but there were tentative signs that conditions could improve as the year progressed. The stock market had begun a strong recovery; unemployment was falling at a healthy pace, and surveys of purchasing manager activity across all sectors pointed towards rising activity.

24. The recovery took hold by mid-year and GDP growth accelerated to a year-on-year rate of 2.8% in the final quarter. In addition to this, official forecasts published by all major institutions shifted to a much more optimistic footing.

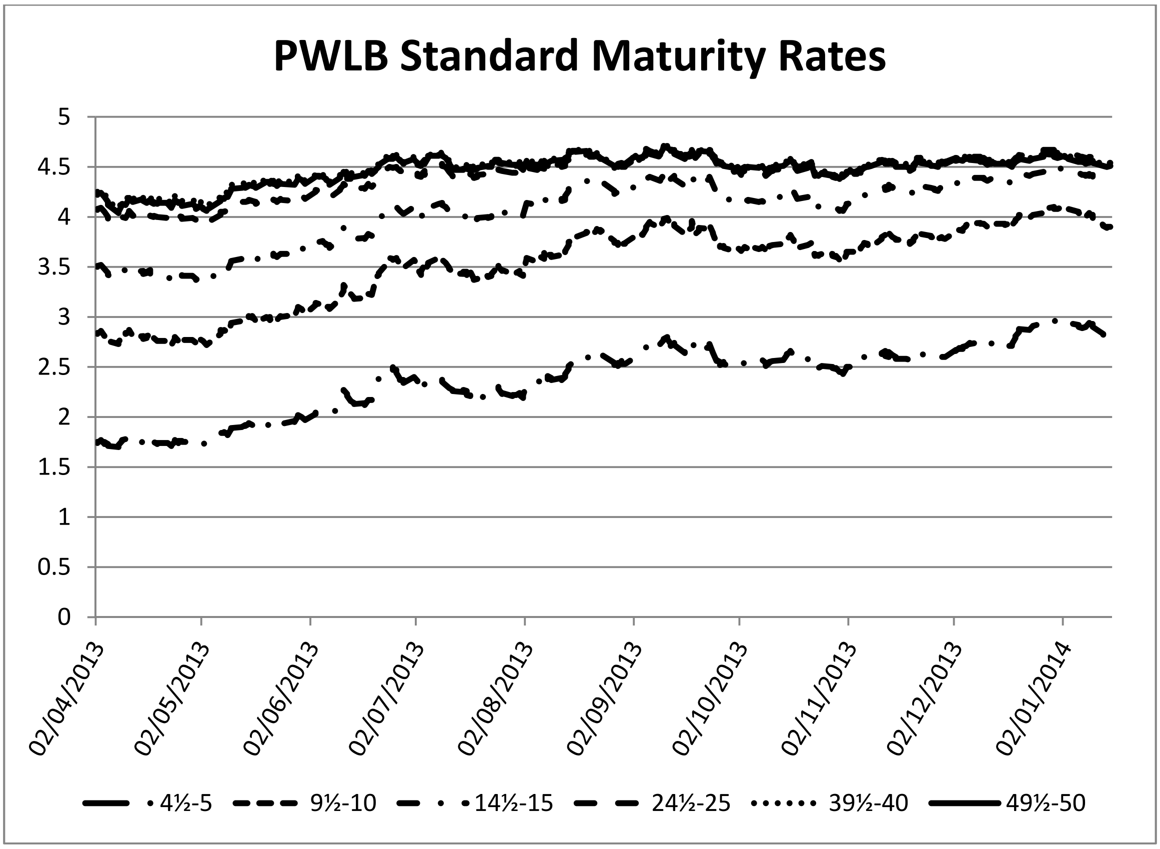
25. CPI inflation also trended lower, falling to the government's 2% target rate in December – the first time in more than four years. Nevertheless, the persistence of low wage increases meant that real earnings growth remained negative, a situation that is still considered a threat to the sustainability of the recovery over the longer term.

26. Short-term interest rates continued to trade at the low levels established in the early stages of the financial crisis, anchored by the Monetary Policy Committee's (MPC) decisions to continue with quantitative easing (QE). At the request of the Chancellor, the Bank of England, under the leadership of its new governor, Mark Carney, examined the scope for additional policy measures.

27. The result was the introduction in August 2013 of the Forward Guidance system whereby policy would hinge upon the performance of a key economic variable. The aim was to reassure companies and individuals that official interest rates would not return to a rising path for some years. The MPC chose a target rate of unemployment of 7% as its guiding force. However, the recovery in growth was accompanied by a rapid fall in the unemployment rate (to 7.1% by November), a development that has caused many commentators to question the validity of this new policy initiative.

28. Longer-term rates shifted to a rising path before mid-year and by the close of 2013, 10-year yields were more than a percentage point above the low point reached in March. Market sentiment altered markedly in late spring, partly on the back of reduced concerns over the survival of the Euro and in reaction to suggestions by the US Federal Reserve that it might start to reduce its QE programme. In addition, and in spite of the MPC's Forward Guidance, the revival of the domestic economy prompted investors to start discounting a rise in official rates well before the time implied by the monetary authorities (2016). Yields rose in reaction to these influences.

29. The movement in PWLB maturity rates over 2013/14 is shown in the chart below.

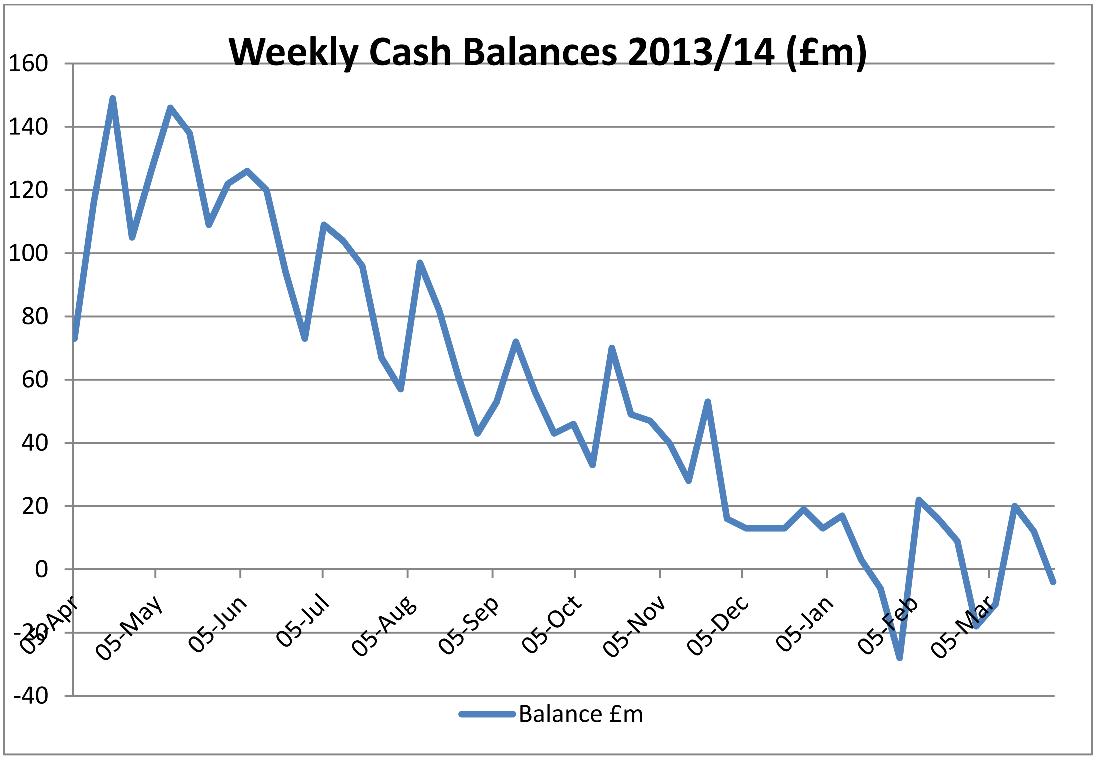


30. The outlook for interest rates remains benign in the near term, although increases across the maturity range are likely to be seen over a longer time frame. With unemployment continuing to fall and inflation relatively low, the MPC is unlikely to tighten policy during 2014.

31. Long-term rates, on the other hand, are likely to move higher. The current weakness in gilt yields, and hence PWLB rates, has been sparked by renewed demand for safe-haven assets on the back of the sharp downturn in many of the world’s emerging markets. This may continue in the short term but yields are likely to return to a rising path due to strengthening growth in the developed world and the removal of official support for the markets from QE. This adds to the risk that interest rates on the Council’s future borrowing will be higher than current rates.

Borrowing Strategy

32. The chart below shows how the Council’s cash position has progressed over the financial year 2013/14. This is a fairly typical profile, showing how cash balances are higher in the early part of the year, when a lot of grant money is received prior to being spent, and lower towards the year end when often large capital invoices are paid, and negative balances need to be made good by temporary borrowing.



33. This profile means that the activity of investing surplus cash comes to the fore in the first few months of the financial year, when the Council can afford to lend its cash for several months. Towards the end of the year the focus shifts towards the borrowing strategy, and decisions have to be taken about the mix of short- and long-term borrowing and the extent to which use can be made of internal borrowing.

34. Over the past several years the Council has to a large extent temporarily financed the capital programme by using its cash balances. These are essentially earmarked reserves, general fund reserves and net movement on current assets. As the cash in these reserves is not required in the short term for the reserves' specific purposes, it has been utilised to reduce external borrowing (thereby generating savings for the Council) and also to reduce credit risk by having lower balances available for investments.

35. The advantage to the Council of internal borrowing is that it costs less than external borrowing, the cost being the opportunity cost of interest foregone by not investing the cash (investment rates are typically around 0.5% for short-term deposits). Another advantage is that counterparty risk is reduced by having less cash to invest.

36. The borrowing strategy will therefore need to (i) provide funds not only to finance the capital programme but also to (ii) replenish reserves as and when these are required and (iii) cover principal repayments on any maturing debt. If long-term borrowing is not taken to cover these outflows of cash then the Council could experience cash flow difficulties and be forced to resort to other sources of finance (such as the bank overdraft facility or market loans).

37. These strategic factors drive the Council's objective need to secure long-term debt finance, but there are a number of day-to-day factors – relating to market conditions and the Council's own revenue budget - that must be taken into account when deciding precisely when to borrow.

38. The gilt market is such that short-term debt is considerably cheaper than long-term: 1 year loans are approximately 1.1% (taking account of the 'certainty' rate offered by PWLB), whereas 40 year loans (reflecting the asset life of the assets within the capital programme) are approximately 4.3%. In cash terms taking the very short-dated debt would equate to a saving of £32,000 per annum for every £1m of Council borrowing.

39. However, there would be a significant risk in pursuing such a short-term approach, since short-term loans need regular refinancing and at these points the Council would find itself exposed to interest rate risk, ie. it would be forced to accept whatever the prevailing interest rates were at the time. The is a particular concern as current forecasts suggest that UK gilt yields are likely to rise. If this happened the Council could find itself facing considerably higher interest rates, which would quickly undermine any saving made by taking short-dated debt.

40. Given that the Council's current portfolio of PWLB loans average 5.78% the long-term rates being offered by PWLB look relatively attractive. However, long-term loans being offered by the market or even by other local authorities can be a competitive alternative to PWLB loans, and it may be worth taking on a proportion of this type of debt as part of a balanced portfolio.

41. In practice, this balances portfolio will include a mix of:
    - Temporary use of the Council's cash reserves
    - Short-term debt provided by the market/other local authorities
    - Short-term or variable rate debt provided by PWLB
    - Long-term debt provided by PWLB
    - Long-term debt provided by the market or other local authorities

42. Given these contingencies the amount, type, period, rate and timing of new borrowing will be an operational matter falling under the responsibility of the Service Director, Finance and Procurement exercised by the Senior Accountant (Pensions & Treasury Management) within the approved borrowing strategy, taking into account the following factors:
    - expected movements in interest rates as outlined above
    - current maturity profile relative to planned MRP amounts set aside
    - the impact on the medium term financial strategy
    - the capital financing requirement
    - the operational boundary
    - the authorised limit.

43. Opportunities to reschedule debt will be reviewed periodically throughout 2014/15 but the current structure of repayment rates from the PWLB indicate significant premiums to be paid on the premature repayment of existing loans which would not be compensated by lower rates available for new loans.

Investment Strategy

44. During 2014/15 cash balances are expected to be kept at a low level with the aim of a minimum level of £5m. This will provide a level of liquidity without recourse to temporary borrowing, and will minimise the risk of having to seek funds when availability may be restricted or expensive.

45. As the 2013/14 cash flow chart above shows, the profile of cash balances suggests that the most suitable strategy will be to make a number of fixed-term investments in the early part of the financial year and use call accounts or money market funds for a substantial part of its portfolio in order to manage the liquidity risk.

46. Another consideration would be to manage the counterparty risk by increasing the number of institutions in which to invest. This is made more difficult by the current economic and financial climate in the Eurozone. It is still considered prudent to avoid exposure to the Eurozone by investing in UK banks and other overseas banks. However, this cannot eliminate exposure completely due to individual institutions' holdings of Eurozone debt. The advantage of UK banks is that they have stronger balance sheets than European banks together with support from a central bank responsible for financial stability and monetary policy. The criteria for selecting counterparties are detailed in TMP 1 in Appendix L.

47. A further measure to ensure security of the Council's investments is to maintain the Council's exposure to the UK local authority sector and UK government securities. When lending to local authorities fixed term deposits would be used but these are subject to demand and cannot be relied upon in the same way as bank lending. The use of treasury bills and UK government gilts may be considered and would ensure priority is given to security and liquidity of funds.

Pension Fund Cash

48. The Council is an administering authority in the Local Government Pension Scheme and is required, under the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009, to invest any fund money that is not needed immediately to make payments. Since 1 April 2011 the Council is also required to have a separate bank account for transactions associated with the pension fund.

49. A separate Treasury Management Policy has been approved by the Nottinghamshire Pension Fund Committee and investments will be made on the Fund's behalf by the Council in accordance with that policy.

50. Joint investments with the County Council may be made where this is in the best interests of the Fund. In considering such investments, guidance issued by the Department for Communities and Local Government will be followed and the Fund will receive its fair share of interest in proportion to the share of cash invested. If losses occur the Fund will bear its share of those losses.