TREASURY MANAGEMENT POLICY STATEMENT, ANNUAL MINIMUM REVENUE PROVISION FOR DEBT REPAYMENT STATEMENT AND ANNUAL INVESTMENT STRATEGY 2012/13

Portsmouth City Council
Head of Financial Services and Section 151 Officer
(Written by Michael Lloyd, Financial Services)

TREASURY MANAGEMENT POLICY STATEMENT 2012/13

Section No.	CONTENTS	Page

1 BACKGROUND

1.1 This Council defines its Treasury Management activities 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."

1.2 This Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

1.3 This Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance management techniques, within the context of effective risk management.

1.4 The City Council's borrowing is governed by a Prudential Code which local authorities are required to have regard to under the Local Government Act 2003. The Prudential Code requires the City Council to approve an authorised limit and an operational boundary for external debt together with other prudential indicators designed to ensure that the capital investment plans are affordable, prudent and sustainable.

2 BORROWING LIMITS AND THE PRUDENTIAL CODE

i) Authorised Limit

The authorised limit for external debt is the maximum amount of debt which the authority may legally have outstanding at any time. The Authorised Limit includes headroom to enable the Council to take advantage of unexpected movements in interest rates and to accommodate any short-term debt or unusual cash movements that could arise during the year

	£m
Borrowing	422
Other Long Term Credit Liabilities	86
	508

2 BORROWING LIMITS AND THE PRUDENTIAL CODE (Continued)

ii) Operational Boundary

The Operational Boundary is based on the probable external debt during the course of the year. It is not a limit, but acts as a warning mechanism to prevent the authorised limit being breached.

	£m
Borrowing	398
Other Long Term Credit Liabilities	86
	484

iii) Other Prudential Indicators Contained in the Prudential Code

The following indicators are also included in the Prudential Code:

- Capital expenditure
- Ratio of financing costs to net revenue stream
- Capital financing requirement
- Incremental effect of capital investment decisions on council tax at band D

It is recommended that the prudential indicators contained in Appendix A be approved **(Recommendation 4.1(a))**.

The Prudential Code also requires local authorities to adopt the Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. These are guides to good practice that the City Council has adopted and followed for several years.

3. GROSS AND NET DEBT

3.1 The borrowing and investment projections for the Council are as follows:

	2011/12 £'000	**2012/13** £'000	**2013/14** £'000	**2014/15** £'000
Debt				
Borrowing at 1 April	191,073	374,045	377,862	377,406
Finance leases at 1 April	5,608	5,310	4,481	3,763
Service concession arrangements (including PFIs) at 1 April	88,055	85,444	84,182	83,335
Transferred debt administered by HCC at 1 April	16,230	15,577	14,924	14,271
Total Debt at 1 April	**300,966**	**480,376**	**481,449**	**478,775**
Maximum expected change in borrowing	182,972	3,817	(456)	(3,351)
Debt at 31 March	**483,938**	**484,193**	**430,993**	**475,424**
Investments				
Investments at 1 April	(136,242)	(220,198)	(212,140)	(193,890)
Maximum expected change in investments	(83,956)	8,058	18,250	8,477
Investments at 31 March	**(220,198)**	**(212,140)**	**(193,890)**	**(185,413)**
Estimated Net Debt	**263,740**	**272,053**	**287,103**	**290,011**

3.2 CIPFA's Treasury Management in the Public Services Code of Practice which the City Council is legally obliged to have regard to requires local authorities to set an upper limit on the amount of their gross debt less investments. It is recommended that the upper limit of gross debt less investments be set as follows **(recommendation 4.1(b))**:

2011/12 £263,740,000
2012/13 £272,053,000
2013/14 £287,103,000
2014/15 £291,639,000

3. GROSS AND NET DEBT (Continued)

3.2 The Council has a high level of investments relative to its gross debt due to having a high level of reserves and provisions, mainly built up to meet future commitments under the Private Finance Initiative schemes and future capital expenditure. In addition Councils are required to set aside a minimum revenue provision (MRP) for the repayment of debt, but it is often not economic to actually repay debt because of the premiums that would be incurred if loans are repaid early which therefore gives rise to investments pending the repayment of debt.

3.3 With the exception of one £11m loan, the interest rates on the Council's long-term borrowings are fixed for the next 26 years at an average rate of 4.3%. However the Council's current gross debt of £385m is £49m less than the 2012/13 capital financing requirement of £434m, ie. the Council's underlying need to borrow. This will necessitate further borrowing in the future exposing the Council to interest rate risk, ie. the risk that interest rates will rise. The CIPFA National Treasury Risk Study shows that the average interest rate on the Council's debt is projected to be between 4.1% and 4.7% in 2023. The average interest rate on local authorities' debt generally is projected to be between 4.3% and 5.9% in 2023.

3.4 The high level of investments increases the Council's exposure to credit risk, ie. the risk that an approved borrower defaults on the Council's investment. There is a short term risk that the rates at which the money can be invested will be less than the rates at which the loans were taken out. The level of investments will fall as capital expenditure is incurred, commitments under the PFI schemes are met and loans are repaid.

4 TREASURY MANAGEMENT POLICY STATEMENT

4.1 The prime objective of the Treasury Management function is the effective management and control of risk associated with the activities described in paragraph 1.1. The Code identifies the main Treasury Management risks, some of which may not apply to the City Council, as:

- Credit risk – ie. that the local authority is not repaid, with due interest in full, on the day repayment is due.

- Liquidity risk – ie. that cash will not be available when it is needed, or that the ineffective management of liquidity creates additional, unbudgeted costs.

- Interest rate risk – ie. that the authority fails to get good value for its cash dealings (both when borrowing and investing) and the risk that interest costs incurred are in excess of those for which the authority has budgeted.

4 TREASURY MANAGEMENT POLICY STATEMENT (Continued)

- Exchange rate risk – This is the risk that the authority enters into a contract priced in a foreign currency and the exchange rate fluctuates adversely between entering the contract and settling the contract.

- Maturity (or refinancing risk) – This relates to the authority's borrowing or capital financing activities, and is the risk that the authority is unable to repay or replace its maturing funding arrangements on appropriate terms.

- Legal risk – ie. that one or other party to an agreement will be unable to honour its legal obligations.

- Procedures (or systems) risk – ie. that a treasury process, human or otherwise, will fail and planned actions are not carried out through fraud, error or corruption.

- Market risk – This is the risk of adverse market fluctuations in the value of the principal sums of tradable investments such as Government gilts.

4.2 The approved activities of the Treasury Management operation are as follows: -

(a) Cash flow (daily balance and longer term forecasting);

(b) Investing surplus funds in approved investments;

(c) Borrowing to finance cash deficits;

(d) Funding of capital payments through borrowing, capital receipts, grants or leasing;

(e) Management of debt (including rescheduling and ensuring an even maturity profile);

(f) Interest rate exposure management;

(g) Dealing procedures;

(h) Use of external managers for temporary investment of funds.

4 TREASURY MANAGEMENT POLICY STATEMENT (Continued)

4.3 It is proposed that the Head of Financial Services and Section 151 Officer and officers nominated by him be given authority to lend surplus funds as necessary in accordance with the Treasury Management Policy **(Recommendation 4.1(c))**.

5 TREASURY MANAGEMENT STRATEGY FOR 2012/13

5.1 Objectives

It is estimated that the net interest and debt repayment costs for 2012/13 will amount to approximately £37.7m. The Treasury Management policy will therefore form a cornerstone of the Medium Term Resource Strategy. Specific objectives to be achieved in 2012/13 are:

(a) Borrowing

- To minimise the revenue costs of debt

- To manage the City Council's debt maturity profile to ensure that no single financial year exposes the authority to a substantial borrowing requirement when interest rates may be relatively high

- To match the City Council's debt maturity profile to the provision of funds to repay debt if this can be achieved without significant cost (see paragraph 5.9)

- To effect funding in any one year at the cheapest long term cost commensurate with future risk

- To forecast average future interest rates and borrow accordingly (i.e. short term and/or variable when rates are 'high', long term and fixed when rates are 'low').

- To monitor and review the level of variable interest rate loans in order to take greater advantage of interest rate movements

- To reschedule debt in order to take advantage of potential savings as interest rates change or to even the maturity profile.

- To maximise the use of all capital resources including Supported Capital Expenditure, usable capital receipts, grants and contributions, etc. **(recommendation 4.1(d))**.

5 TREASURY MANAGEMENT STRATEGY for 2010/11 (Continued)

5.1 Objectives (continued)

(b) Lending

- To ensure the security of lending (the maximisation of returns remains a secondary consideration) by investing in:
  - the United Kingdom Government;
  - Other local authorities in England, Scotland and Wales
  - Aaa rated money market funds;
  - British financial institutions that meet the City Council's investment criteria
  - Foreign financial institutions that meet the City Council's investment criteria within the jurisdiction of a Aaa government
- To maintain £10m in instant access accounts
- To make funds available to Council's subsidiaries
- To optimise the return on surplus funds
- To manage the Council's investment maturity profile to ensure that no single month exposes the authority to a substantial re-investment requirement when interest rates may be relatively low to the extent that this can be managed without compromising the security of lending

5.2 Interest Rates

5.2.1 Interest Rate Forecasts for 2012/13

No treasury consultants are currently employed by the City Council to advise on the borrowing strategy. However, the City Council does employ Sterling Consultancy Services to provide an economic and interest rate forecasting service and maintains daily contact with the London Money Market.

5 TREASURY MANAGEMENT STRATEGY (Continued)

5.2.2 Long Term Borrowing Interest Rates

Most City Council borrowing in the past has been through the Public Works Loans Board (PWLB). The PWLB interest rates are determined by HM Treasury and are set by reference to the rates in the secondary market for gilts; the public sector is therefore able to benefit from Government borrowing rates. However the Government introduced a 1% mark up between gilt rates and PWLB rates in October 2010 as part of the Comprehensive Spending review. Within a highly uncertain environment, the Bank of England must decide the stance of monetary policy. The consensus is that policymakers will pursue loose policy by keeping interest rates low and possibly expanding the asset purchase programme known as quantitative easing. In this light, and with a chance of a recession in 2012, short term interest rate futures suggest little chance of monetary tightening before 2014. Unlike the pessimistic stance of the market, Sterling Consultancy Services believe economic growth will be on the higher side and inflation will not fall as far below target as suggested by the Bank of England's inflation forecast. The Bank of England is also likely to tighten policy in the future ahead of economic activity growing, rather than having to make a sharper correction at a later date. This will cause both gilt yields and PWLB rates to rise. Gilt yields are likely to rise slowly as easing Euro zone concerns reduce the demand for safe havens, although continued asset purchases by the Bank of England will maintain the downward pressure in the first half of 2012. Sterling Consultancy Services estimate that 25-year PWLB rates will be 4.20% at the start of 2012/13, rising to 4.40% by the end of 2012/13 and 5.0% in the end of 2014. On this basis the estimated interest rate on any new long-term loans in 2012/13 will be between 4.20% and 4.40%.

5.2.3 Short Term Investment Interest Rates

The Bank of England's base rate is currently 0.5%. Sterling Consultancy Services expect a small rise in base rate in quarter 4 of 2012. The rate is them forecast to remain unchanged until midway through 2013 at which point it is forecast to start rising at roughly 25 basis points per quarter, rising to 2.5% by the end of 2014.

5 TREASURY MANAGEMENT STRATEGY (Continued)

5.3 Borrowing Requirements in the remainder of 2011/12 and 2012/13

The City Council's actual borrowing is £49m less than its underlying need to borrow as measured by its capital financing requirement. It is currently anticipated that this shortfall will be met through external borrowing from the Public Works Loans Board.

As part of the budget for 2012/13 it has been assumed that existing maturing debt of £2.5m in 2012/13 will not be replaced. Instead this debt will be repaid using internal funds (see paragraph 7.1(f)). It is recommended however, that the Head of Financial Services and Section 151 Officer be given delegated authority to either replace maturing debt or repay it depending on the outlook for long term interest rates that exists at the time **(Recommendation 4.1(e)).**

5.4 Volatility of Budgets

The budget for interest payments and receipts is based on both the level of cash balances available and the interest rate forecasts contained in paragraph 5.2. Any deviation of interest rates from these forecasts will give rise to budget variances.

The Council is exposed to interest rate fluctuations through the need to borrow £49m to fund its capital financing requirement, ie. underlying need to borrow in the medium term.

The Council also currently has substantial sums of cash invested in the short term, and if interest rates fall below the budget forecast, investment income will be less than that budgeted. For example, if short-term interest rates fall to 0.5% below the budget forecast, the income from the Council's investments will be £415k below budget in 2012/13. Conversely, if short-term interest rates rise to 0.5% above the budget forecast, income from the Council's investments will exceed the budget by £415k in 2012/13.

5 TREASURY MANAGEMENT STRATEGY (Continued)

5.5 <u>Upper limits for fixed interest rate exposures</u>

The CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes require local authorities to set upper limits for fixed interest rate exposures.

The City Council's maximum fixed interest rate exposure throughout each year is anticipated to be as follows:

	2011/12 **£m**	**2012/13** **£m**	**2013/14** **£m**	**2014/15** **£m**
Maximum Projected Gross Borrowing – Fixed Rate	374	378	378	377
Minimum Projected Gross Investments – Fixed Rate	(16)	-	-	-

It is recommended that the upper limits for fixed interest rate exposures be set as follows **(Recommendation 4.1(f)**):

2011/12	£358m
2012/13	£378m
2013/14	£378m
2014/15	£377m

The recommended upper limits for fixed interest rate exposure are set to provide sufficient flexibility for the Head of Financial Services and Section 151 Officer to take out fixed rate loans to finance capital expenditure if interest rates fall or are expected to rise significantly.

5 TREASURY MANAGEMENT STRATEGY (Continued)

5.6 Upper limits for variable interest rate exposures

The CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes require local authorities to set upper limits for variable interest rate exposures.

The City Council's maximum variable interest rate exposure throughout each year is anticipated to be as follows:

	2011/12 **£m**	**2012/13** **£m**	**2013/14** **£m**	**2014/15** **£m**
Minimum Projected Gross Borrowing – Variable Rate	-	-	-	-
Maximum Projected Gross Investments – Variable Rate	(374)	(378)	(378)	(377)

The Council's variable interest rate exposure is negative because it has no variable rate loans and a high proportion of its investments are either variable rate or will need to be reinvested within a year. The Council's requirement for cash varies considerably through the year. Therefore the Council needs to invest a proportion of its surplus cash either in instant access accounts or short term investments to avoid becoming overdrawn. The Council is exposed to an interest rate risk in that its investment income will fall if interest rates fall, whilst its borrowing costs will remain the same as all its loans are fixed at rates that will not fall with investment rates. Investment rates are currently very low and the scope for further reductions is very limited. The Council could mitigate this risk through making long term investments. However, this will increase credit risk. It would also be prudent to maintain an even maturity profile so that the Council can benefit from rising interest rates in the future

It is recommended that the upper limits for variable interest rate exposures be set as follows **(Recommendation 4.1(g))**:

2011/12 (£374m) - Investments up to £374m

2012/13 (£378m) – Investments up to £378m

2013/14 (£378m) – Investments up to £378m

2014/15 (£377m) – Investments up to £377m

5 TREASURY MANAGEMENT STRATEGY (Continued)

5.7 Limits on total principal sums invested for periods longer than 364 days

Under the Treasury Management Code it is necessary to specify limits on the amount of long term investments, ie. investments exceeding 364 days that have maturities beyond year end.

Appendix B shows the City Council's core cash which could be invested long term, ie. in excess of 364 days. Investing long term at fixed rates provides certainty of income and reduces the risk of interest rates falling. However this benefit is significantly reduced at the moment as the interest rates on new investments are low, typically less than 1% which restricts how much further returns can fall. At the current time, investing long term allows higher yields to be obtained, although it would be prudent to maintain opportunities to invest when interest rates are higher. It is recommended that the limits on sums invested for periods longer than 364 days be set on the basis of the forecast core cash so that there is flexibility to take advantage of the yield. It is recommended that the following limits be placed on total principal sums invested for periods longer than 364 days to **(Recommendation 4.1(h))**:

31/3/2012 = £129m
31/3/2013 = £110m
31/3/2014 = £90m
31/3/2015 = £80m

5.8 Limits for the maturity structure of borrowing

The Government has issued guidance on making provision for the repayment of debt (see paragraph 9) which the Council is legally obliged to have regard to. The City Council is required to make greater provision for the repayment of debt in earlier years. Therefore the City Council is required to provide for the repayment of debt well in advance of it becoming due. This is illustrated in Appendix C. This means that it is necessary to invest the funds set aside for the repayment of debt with its attendant credit and interest rate risks (see paragraph 4.1). The City Council could reschedule its debt, but unless certain market conditions exist at the time, premium payments have to be made to lenders (see paragraph 5.9).

CIPFA's Treasury Management in the Public Services Code of Practice which the City Council is legally obliged to have regard to requires local authorities to set upper and lower limits for the maturity structure of their borrowing.

It is recommended that the upper limit should be set high enough to allow for debt to be rescheduled into earlier years and for any new borrowing to mature over a shorter period than that taken out in 2007/08 and 2008/09. The high upper limit for debt maturing in 40 to 50 years time reflects existing borrowing as the upper limit cannot be set lower than the existing maturity profile. This is illustrated in Appendix C.

It is recommended that the lower limit be set at 0%.

5 TREASURY MANAGEMENT STRATEGY (Continued)

5.8 Limits for the maturity structure of borrowing (Continued)

In order to ensure a reasonably even maturity profile (paragraph 5.1(a)), it is recommended that the council set upper and lower limits for the maturity structure of its borrowings as follows **(Recommendation 4.1(i)).**

Amount of fixed rate borrowing maturing in each period as a percentage of total projected borrowing that is fixed rate.

	Upper limit	**Lower limit**
Under 12 months	6%	0%
12 months and within 24 months	6%	0%
24 months and within 5 years	18%	0%
5 years and within 10 years	30%	0%
10 years and within 20 years	60%	0%
20 years and within 30 years	60%	0%
30 years and within 40 years	60%	0%
40 years and within 50 years	80%	0%

The current maturity pattern contained in Appendix C is well within these limits.

5.9 Debt Rescheduling

5.9.1 At the present time, all the City Council's long term external debt has been borrowed at fixed interest rates ranging from 3.9% to 4.78%. 46% of the Council's debt matures in over 40 years time. Appendix C shows the long term loans maturity pattern. Therefore debt rescheduling could be beneficial in evening out the debt maturity profile.

5.9.2 In the event that it was decided to further reschedule debt, account will need to be taken of premium payments to the PWLB. These are payments to compensate the PWLB for any losses that they may incur.

5 TREASURY MANAGEMENT STRATEGY (Continued)

5.9 Debt Rescheduling (Continued)

5.9.3 The HRA will be responsible for its proportion of the premium due for early redemption of debt, based on the percentage of debt attributable to the HRA at the start of the financial year. The premiums would be charged to the General Fund and the HRA. Regulations allow the City Council to spread the cost of the premiums over a number of years, during which the accounts would benefit from reduced external interest rates.

5.9.4 The Head of Financial Services and Section 151 Officer will continue to monitor the Council's debt and will undertake further rescheduling if it would be beneficial.

5.9.5 It is recommended that authority to reschedule debt during the year be delegated to the Head of Financial Services and Section 151 Officer subject to conditions being beneficial to the City Council **(Recommendation 4.1(j))**.

6 APPROVED METHODS OF RAISING CAPITAL FINANCE

6.1 The following list specifies the various types of borrowing instruments which are available: -

	Variable	Fixed
PWLB	Y	Y
Market Long-term	Y	Y
Market Temporary	Y	Y
Overdraft	Y	
Negotiable Bonds	Y	
Internal (capital receipts & revenue balances)	Y	Y
Commercial Paper	Y	Y
Medium Term Notes	Y	Y
Leasing	Y	Y
Bills & Local Bonds	Y	Y

6.2 The main methods of raising capital finance used by the City Council are discussed in greater detail within Section 7 of this report. Other methods are not generally used because of the perceived risk or because administrative costs are high, such as in the case of Local Bonds.

6 APPROVED METHODS OF RAISING CAPITAL FINANCE (Continued)

6.3 Local authorities are not required to conform to the Money Laundering Regulations stipulated in the Financial Services Acts. However, these principles where practical will be applied when arranging future money market borrowing to ensure that funds are not obtained from potentially unscrupulous sources.

7 APPROVED SOURCES OF BORROWING

7.1 Further information on some of the main borrowing instruments used by the City Council is set out below: -

(a) Public Works Loans Board (PWLB)

The main source of longer term borrowing for the City Council for many years has been from the Government through the Public Works Loans Board. The PWLB offers fixed rate loans from 1 year to 50 years at varying rates with different methods of repayment.

Alternatively the PWLB offers variable rate loans for 1 to 10 years, where the interest rate varies at 1, 3 or 6 month intervals. These loans can be replaced by fixed rate loans before maturity at an opportune time to the authority.

(b) Money Market Loans – Long Term

Loans for 1 to 70 years are available through the London Money Market although, depending of the type of loan being arranged, the rates of interest offered may not match those available from the PWLB, especially for Equal Instalment of Principal loans (E.I.P. loans). Any loans to be taken are evaluated to ensure that the interest rate is the lowest the City Council could obtain.

Loans offered by the money market are often LOBO (Lenders Option, Borrowers Option) loans. This enables the authority to take advantage of low fixed interest for a number of years before an agreed variable rate comes into force. At the time when the interest rate becomes variable, the lender has the option to increase the rate charged every 6 months (or any other agreed review period). The borrower has the option to repay the loan with no penalties if the interest rate is increased on any of the review dates.

7 APPROVED SOURCES OF BORROWING (Continued)

(c) Bonds

Bonds may be suitable for raising sums in excess of around £150m. The interest payable on bonds may be less than that charged by the PWLB, but considerable upfront fees would be incurred. To obtain the best interest rate, the Council would need to obtain a credit rating which would need to be maintained. This would incur a further upfront fee and an annual maintenance fee.

Because such a large amount needs to be borrowed to attract investors and also to reduce the upfront fees and negate the need for an individual credit rating a pooled issuance with other local authorities may be more viable.

(d) Money Market Loans – Temporary (Loans up to 364 days)

The use of temporary borrowing through the London Money Market forms an important part of the strategy. The authorised limit for external debt in 2012/13 of £458m set by the City Council on 14 February 2012 must not be exceeded. It is anticipated that the City Council will not need to use the temporary borrowing facility in 2012/13.

(e) Overdraft

An overdraft limit of £2m has been agreed with the Co-operative Bank plc. Interest on the overdraft is charged at 1% above base rate. The City Council does not anticipate that short-term borrowing will generally be necessary during 2012/13 as it currently holds sufficient funds to enable the authority's cash flow to be managed without the need to borrow. However, the overdraft facility may be used when there are unforeseen payments and funds placed on temporary deposit cannot be called back in time.

(f) Internal Funds

Internal funds include all revenue reserves and other specific reserves maintained by the City Council, including the minimum revenue provision which is available to either repay debt or to be used instead of new borrowing. The cash held in internal funds such as earmarked reserves can be borrowed in the short term to fund capital expenditure or the repayment of debt, thus delaying the need to borrow externally.

7.2 It is recommended that no restriction be placed on the amount that can be borrowed in sterling from an individual lender provided it is from a reputable source and within the authorised limit for external debt approved by the City Council **(Recommendation 4.1(k)).**

8. APPORTIONMENT OF BORROWING COSTS TO THE HOUSING REVENUE ACCOUNT (HRA)

8.1 The Localism Act 2011 will require local authorities to allocate existing and future borrowing costs between council housing (the HRA) and the General Fund as the current statutory method of apportioning debt charges between the General Fund and the HRA will cease. The Government has signalled its intention not to impose a single solution and it is for local authorities to choose an allocation method that achieves the principals detailed in their treasury management strategies.

8.2 It is proposed to continue with a single loans pool and apportion costs according to locally established principals. It is recommended that the principals upon which the apportionment of borrowing costs should be based are as follows **(recommendation 4.1(l))**:

- The apportionment is broadly equitable between the HRA and the General Fund, and is detrimental to neither;
- The loans portfolio is managed in the best interests of the whole authority;
- The benefits of uninvested balance sheet resources which allow borrowing to be below the capital financing requirement (CFR) are equitably shared between the General Fund and the HRA.

8.3 For the purpose of apportioning borrowing costs it will be assumed that the HRA is under or over financed in the same proportion as the Council as a whole. The HRA will be charged interest at the Council’s average cost of borrowing adjusted to take account of any under or over financing which will be charged at the average return on the Council’s investments.

9 ANNUAL MINIMUM REVENUE PROVISION FOR DEBT REPAYMENT STATEMENT

9.1 The Local Authorities (Capital Finance and Accounting) (Amendment) Regulations 2012 require the Council to make “prudent provision” for the repayment of General Fund debt from 2008/09 onwards. There is no requirement to make “prudent provision” for the repayment of Housing Revenue Account (Council Housing) debt. The Government has provided a definition of “prudent provision” which the Council is legally obliged to “have regard” to. The guidance aims to ensure that the provision for the repayment of borrowing which financed the acquisition of an asset should be made over a period bearing some relation to that over which the asset continues to provide a service.

9.2 The guidance also requires the Council to adopt an Annual Minimum Revenue Provision (MRP) for Debt Repayment Statement. This is contained within paragraphs 10, 11, 12 and 13 below.

10 GOVERNMENT- SUPPORTED BORROWING OTHER THAN FINANCE LEASES AND SERVICE CONCESSIONS INCLUDING PRIVATE FINANCE INITIATIVE SCHEMES

10.1 The Government has supported some local authority borrowing through the Formula Grant. Provision may be made for the repayment of existing and new government supported borrowing through the Capital Financing Requirement Method or the Regulatory Method.

10.2 For debt that is supported by Formula Grant, authorities are able to make revenue provision for the repayment by setting aside 4% of their Adjusted Non-Housing Capital Financing Requirement (CFR). The CFR represents the underlying requirement to borrow for capital expenditure. It takes the total value of the City Council's fixed assets and determines the amount that has yet to be repaid or provided for within the Council's accounts. The CFR is adjusted so that it excludes self-financed debt incurred after 1 April 2008. This is known as the CFR Method.

10.3 Alternatively, for debt that is supported by Formula Grant, authorities are able to continue to use the formulae in the previous regulations, since Formula Grant is calculated on that basis. This is known as the Regulatory Method. This method is also based on the CFR but is adjusted by the effect of the previous regulations. This method is more complex than the CFR method. However it is estimated that the MRP under this method will be £320k less per annum than under the CFR method. It is therefore recommended that the Regulatory Method of calculating MRP be applied to pre 1 April 2008 debt and new government supported debt **(Recommendation 4.1(m))**. This is the same method as that adopted for 2011/12.

11. SELF- FINANCED BORROWING OTHER THAN FINANCE LEASES AND SERVICE CONCESSIONS INCLUDING PRIVATE FINANCE INITIATIVE SCHEMES

11.1 For new borrowing under the prudential system for which no Government support is being given and is therefore self-financed, there are three options offered by the guidance, the Asset Life (Equal Instalment) Method, the Asset Life (Annuity) Method and the Depreciation Method. The guidance suggests that the Asset Life (Annuity) Method is only appropriate for projects where income or savings will increase over time. Both the Asset Life (Equal Instalment) Method and the Depreciation Method should result in a similar MRP. Of these two methods the Asset Life method is the simplest to calculate and therefore it is recommended that this method be used and that MRP begin to be made in the year after the asset is completed **(Recommendation 4.1(n))**. This is the same method as that adopted for 2011/12.

12 FINANCE LEASES AND ON BALANCE SHEET SERVICE CONCESSIONS INCLUDING PRIVATE FINANCE INIATIVE SCHEMES

12.1 The move to International Financial Reporting Standards has involved arrangements under the Private Finance Initiative (PFI) and service concessions coming onto the balance sheet. A part of the service charge or rent payable will be taken to reduce the balance sheet liability rather than being charged to the service revenue account. This accounting treatment is similar to that for finance leases. Under these leases the risks and rewards of asset ownership rest with the City Council and the assets are shown on the City Council's balance sheet. These leases are therefore in effect a form of borrowing. Statutory guidance allows, in the case of finance leases and on balance sheet service concessions including PFI contracts, the MRP requirement to be regarded as met by a charge equal to the element of the rent / charge that goes to write down the balance sheet liability. It is recommended that this methodology be used to calculate the MRP on finance leases and service concessions including PFI arrangements **(Recommendation 4.1(o))**.

13 HOUSING REVENUE ACCOUNT (HRA) BORROWING

13.1 There is no statutory requirement for the HRA to provide for the repayment of its debt. On 28 March 2012 the HRA will be required to make a self financing payment to the Government of £88.619m. It is recommended that the HRA provide for the repayment of this debt over 30 years in line with the HRA Business Plan **(recommendation 1(p))**. The HRA will continue its practice of not providing for its other debts.

14 ANNUAL INVESTMENT STRATEGY

14.1 The Government has also issued guidance on investments. The guidance requires the City Council to adopt an Annual Investment Strategy. This is contained within paragraphs 15, to 21 below. The requirements of the Department for Communities and Local Government are in addition to the requirements of the Chartered Institute of Public Finance and Accountancy's Treasury Management in Public Services: Code of Practice.

14.2 During the year the Council may be asked to approve a revised strategy if there are investment issues which the full Council might wish to have brought to their attention.

14.3 The guidance defines a prudent policy as having two objectives:

- achieving first of all security (protecting the capital sum from loss);
- liquidity (keeping the money readily available for expenditure when needed).

Only when proper levels of security and liquidity have been secured should yield be taken into account.

14.4 Investment strategies usually rely on credit ratings and both the current and recommended Investment Strategies are based on credit ratings. Although the recommended Investment Strategy is based on credit ratings other sources of information will be taken into account prior to placing deposits such as information in the quality financial press and credit default swaps (CDS) prices.

14.5 CDS are a financial instrument for swapping the risk of debt default. The buyer of a credit default swap pays a premium for effectively insuring against a debt default. He receives a lump sum payment if the debt instrument is defaulted. The seller of a credit default swap receives monthly payments from the buyer. If the debt instrument defaults they have to pay an agreed amount to the buyer of the credit default swap. Absolute prices can be unreliable; however trends in CDS spreads do give an indicator of relative confidence about credit risk.

15. INVESTMENT CONSULTANTS

15.1 The City Council currently employs consultants to provide the following information:

- Interest rate forecasts
- Credit ratings
- CDS prices

15.2 The City Council does not employ consultants to provide strategic advice.

15.3 Forecasts prepared by consultants will be compared periodically with actual interest rates.

16. SPECIFIED INVESTMENTS

16.1 The Government requires the Council to identify investments offering high security and high liquidity. These are known as specified investments. Specified investments will be made with the minimum of procedural formalities. They must be made in sterling with a maturity of no more than one year and must not involve the acquisition of share capital or loan capital in any corporate body.

16.2 Credit rating information is available to the financial market through three main credit rating bodies ie. Moody's, Fitch, and Standard and Poor. The credit ratings provided are as follows:

- Short Term Rating (measures an institution's suitability for short term investment)
- Long Term Rating (measures an institution's suitability for long term investment). These ratings are explained in Appendix D.
- Viability / Financial Strength Rating (measures the likelihood that an organisation will require assistance from third parties such as its owners or official institutions)
- Support Rating (where available measures a potential supporter's (either a sovereign state's or an individual owner's) propensity to support a bank and its ability to support it)

16. SPECIFIED INVESTMENTS (Continued)

16.3 The grades of short and long term credit rating are as follows with the best credit ratings at the top. The credit ratings that meet the City Council's investment criteria are shaded.

Fitch		Moody's		Standard & Poor's	
Short Term	Long Term	Short Term	Long Term	Short Term	Long Term
F1+	AAA	P-1	Aaa	A-1+	AAA
	AA+		Aa1		AA+
	AA		Aa2		AA
	AA-		Aa3		AA-
F1	A+		A1	A-1	A+
	A	P-2	A2		A
	A-		A3	A-2	A-
F2	BBB+	P-3	Baa1	A3	BBB+
	BBB		Baa2		BBB
F3	BBB-		Baa3		BBB-

Support ratings are graded 1 to 5, with 1 being the highest rating.

16.4 It is recommended that deposits should only be placed with institutions that have credit ratings from at least two rating agencies and have the following credit ratings:

Short Term Rating
F1 (or equivalent) from Fitch, Moody's (P-1) or Standard & Poor (A-1)

Long Term Rating
A- (single A category) or equivalent from Fitch, Moody's or Standard & Poor

Viability / Financial Strength Rating
bbb from Fitch or C- Moody's (Standard and Poor do not provide these ratings)

Support Rating
1 from Fitch

16. SPECIFIED INVESTMENTS (Continued)

16.5 In addition to rating financial institutions the rating agencies also rate governments. These are known as sovereign credit ratings. Sovereign credit ratings give an indication of a government's capacity to support its financial institutions. Sovereign credit ratings are also dependent on a government's ability to raise taxes and thus also give an indication of the state of a nation's general economy. It is recommended that investments should only be placed with institutions based in either the United Kingdom or states with an AAA credit rating, as reflected in Appendix E.

16.6 When an institution or state has differing ratings from different agencies, the average rating will be used to assess its suitability. Where an average credit rating cannot be determined the lower credit rating will be applied. Those institutions that have not been rated by a particular agency will not be discarded because of the lack of ratings.

16.7 It is proposed to divide the approved counter parties for specified investments into five categories with the following investment limit applied to each category. The institutions in each category are shown in Appendix E.

<u>Category 1 – Unlimited deposits for up to 1,830 days</u>

United Kingdom Government including the Debt Management Office Deposit Facility

<u>Category 2 - £20m for up to1,830 days</u>

All local authorities in England, Scotland and Wales

<u>Category 3 - £20m for up to 732 days</u>
Short Term - F1+ (or equivalent from Moody's and Standard & Poor)
Long Term - AA- or better (or equivalent from Moody's and Standard & Poor)
Support - 1

<u>Category 4 - £15m for up to 366 days</u>
Short Term - F1 (or equivalent from Moody's and Standard & Poor)
Long Term - A+ or better (or equivalent from Moody's and Standard & Poor)
Support - 1

<u>Category 5 - £10m for up to 366 days</u>
Short Term - F1 (or equivalent from Moody's and Standard & Poor)
Long Term – A- or better (or equivalent from Moody's and Standard & Poor)
Support - 1

16. SPECIFIED INVESTMENTS (Continued)

16.8 It is proposed that the bodies detailed under categories 1 to 5 in Appendix E be approved as repositories of specified investments of the City Council's surplus funds **(Recommendation 4.1(q)).**

16.9 It is recommended that the credit ratings be reviewed monthly and that any institution whose average credit rating falls below the minimum level stated in paragraphs 16.4 and 16.5 be removed from the list of specified investments **(Recommendation 4.1(r)).**

16.10 It is recommended that institutions in category 3 that are placed on negative watch or negative outlook by the credit rating agencies be reassigned to category 4 if a subsequent down-grading means that they no longer meet the category 3 criteria **(Recommendation 4.1(s)).**

16.11 It is recommended that institutions in category 4 that are placed on negative watch or negative outlook by the credit rating agencies be reassigned to category 5 if a subsequent down-grading means that they no longer meet the category 4 criteria **(Recommendation 4.1(t)).**

16.12 It is recommended that institutions in category 5 that are placed on negative watch or negative outlook by the credit rating agencies be removed from the list of specified investments if a subsequent down-grading means that they no longer meet the category 5 criteria **(Recommendation 4.1(u)).**

16.13 It is recommended that the Head of Financial Services and Section 151 Officer be given delegated authority to add counter parties that meet the City Council's approved investment criteria to the list of specified investments **(Recommendation 4.1(v)).**

17. NON-SPECIFIED INVESTMENTS

17.1 The Government's Guidance requires that the general types of investment be identified and that a limit be set on the overall amount that may be held in such investments at any time in the year. Non-specified investments are investments that are not secure, ie. do not have an "A" credit rating or are not liquid, ie. have a maturity in excess of 364 days. Investments that are not denominated in sterling would also be non-specified investments due to exchange rate risks.

17.2 70% of the Council's investments are currently placed with local authorities due to the absence of a sufficient number of counter parties. Whilst other local authorities offer security, they only offer a modest return. It is estimated that the average amount of cash invested in 2012/13 will be £192m. In order to reduce the risks associated with placing funds with a relatively small number of counter parties and to improve returns it is recommended that a further investment category be established for non-specified investments that do not meet the criteria for specified investments.

<u>Category 6 - £6 for 366 days</u>
Short Term – F2 (or equivalent from Moody's and Standard & Poor)
Long Term – BBB or better (or equivalent from Moody's and Standard and Poor)
Support – 5

Category 6 will consist of Lloyds TSB and rated building societies that meet the above criteria.

Lloyds TSB does not meet the criteria for specified investments as it has a Bank Financial Strength Rating (BFSR) of C- on negative watch. Lloyds TSB Bank's BFSR reflects Moody's concerns about changes and "upheaval" to the bank's senior management team. The relatively new Chief Executive Officer, Antonio Horta-Osorio, had started temporary leave due to stress and the Chief Financial Officer had announced his resignation. Moody's believes the group faces "a major challenge in ensuring continuity of leadership" and stressed that these difficulties were taking place during a time of financial market volatility and amid the execution of important strategic decisions including the sale of branches.

The building societies included in category 6 do not have sufficient systemic importance to make a Government rescue likely if they get into financial difficulties. However building societies do not typically have exposure to the Euro zone or riskier investment banking activities. In addition there is an established tradition of intra sector support and when building societies have got into financial difficulties they have always been taken over by another building society.

17. NON-SPECIFIED INVESTMENTS (Continued)

17.3 The Co-operative Bank has merged with the Britannia Building Society. The Britannia Building Society was a financially weaker institution. The Co-operative Bank is also in the process of acquiring some branches of Lloyds TSB. These factors have resulted in Fitch placing the Co-operative Bank's short term rating of F2 on negative watch. The Council's investment criteria for category 6 investments is for a short term credit rating by Fitch of at least F2. The Co-operative Bank offers very competitive interest rates on investments which are out of line with the market. Whilst this does not mean that the Co-operative Bank is in financial difficulties, Northern Rock, the Icelandic banks and the Irish banks all offered interest rates on deposits that were much higher than the rest of the market. The Co-operative Bank is the Council's main bank. If funds are received too late in the day to invest with another bank they will be invested with the Co-operative Bank overnight and re-invested with another counter party the following day. The Co-operative Bank also holds the Council's Euro bank account that may be used for hedging against exchange rate risks when the Council enters into contracts denominated in foreign currencies. The Council's Euro account at the Co-operative Bank is an instant access account. Therefore it is recommended that a further investment category be created.

Category 7 - £5movernight or instant access
Short Term – F3 (or equivalent from Moody's and Standard & Poor)
Long Term – BBB or better (or equivalent from Moody's and Standard and Poor)
Support – 3

17.4 The Council's treasury management operation is exposed to the Council's subsidiary company MMD (Shipping Services) Ltd in two ways. Firstly the Council has £550k lodged with Lloyds TSB to guarantee MMD's banking limits. The Council also lends MMD its insurance premium of £300k.

17.5 The Annual Investment Strategy provides for the Council to lend to the United Kingdom Government and local authorities in England, Scotland and Wales for five years, and AA rated banks for two years. The Annual Investment Strategy also provides for all other investments except for category 7 to have a term of up to 366 days. Financial institutions may prefer 366 day investments as they are beneficial to them in meeting financial regulations and this may provide a means of increasing investment returns without significantly increasing credit and liquidity risk. However as these investments would be just over a year they cannot be included as specified investments.

17. NON-SPECIFIED INVESTMENTS (Continued)

17.6 The Council sometimes enters into contracts denominated in foreign currencies. Such contracts normally relate to civil engineering schemes at the port. It can be beneficial to buy Euros early to fund these projects and avoid the associated currency risk.

17.7 It is recommended that non-specified investments should be limited to the following (**Recommendation 4.1 (w))**:

	£
Financial institutions that are domiciled in the UK & have very limited exposure to the Euro zone periphery & investment banking	29m
Investments in MMD (Shipping Services) Ltd including funds lodged to guarantee the company's banking limits. MMD is a wholly owned subsidiary of the City Council.	2m
Long term investments	110m
Investments in foreign currencies to hedge against contracts priced or indexed against foreign currencies	5m
Total	**146m**

18. MAXIMUM LEVEL OF INVESTMENT IN INDIVIDUAL ORGANISATIONS

18.1 The Government's Guidance does not require a limit to be placed on the amount that can be placed in any one investment. However in order to minimise risk further, it is proposed that the total amount that can be directly invested with any organisation at any time should be limited as follows **(Recommendation 4.1(x)):**

	Maximum Investment in Single Organisation
Category 1	Unlimited for up to 1,830 days
Category 2	£20m for up to 1,830 days
Category 3	£20m for up to 732 days
Category 4	£15m for up to 366 days
Category 5	£10m for up to 366 days
Category 6	£6m for up to 366 days
Category 7	£5m overnight or instant access
MMD (Shipping Services) Ltd including sums lodged to guarantee the company's banking limits	£2m for up to 366 days

18.2 It is recommended that the Head of Financial Services and Section 151 Officer be given delegated authority to revise the total amount that can be directly invested with any organisation at any time **(Recommendation 4.1(y)).**

18. MAXIMUM LEVEL OF INVESTMENT IN INDIVIDUAL ORGANISATIONS (Continued)

18.3 AAA money market funds offer security and same day access. By aggregating investments they can also invest in financial institutions that may not be interested in the relatively small sums that the Council can invest. All the money market funds on the list of specified investments are managed by major banks with considerable investment expertise. There are seven AAA money market funds on the Council's list of approved investments. Although AAA money market funds are well diversified in their investments there is a risk that more than one fund could have investments with the same bank or that the Council may also have invested funds in the same bank as a money market fund. Therefore it is proposed that the Council should aim to have no more than £70m invested in money market funds with an absolute limit of £80m.

18.4 Most building society lending is secured against residential properties. If property prices fall there may be inadequate security to support a building societies lending giving rise to a systemic risk.

18.5 In order to minimise systemic credit risk in any sector it is recommended that the following limits be applied **(Recommendation 4.1(z))**:

Money market funds	£80m
Building societies	£28m

18.4 In order to minimise systemic credit risk in any region it is recommended that the following limits be applied **(Recommendation 4.1(aa))**:

Asia & Australia	£40m
Americas	£40m
Continental Europe	£25m

18. MAXIMUM LEVEL OF INVESTMENT IN INDIVIDUAL ORGANISATIONS (Continued)

18.6 The limits above only apply to direct investments. The City Council's exposure to any institution, sector or region may exceed the limits stated above through indirect investments via money market funds. Money market funds employ specialist staff to assess counter party risks and all investments made by money market funds are short-term.

19. LIQUIDITY OF INVESTMENTS

19.1 The City Council maintains a three year cash flow forecast which is updated daily (See Appendix B). This forecast is used to determine the maximum period for which funds may be prudently committed. ie. the City Council's core cash. This forecast has been used to set the limits on total principal sums invested for periods longer than 364 days (see paragraph 5.7). The City Council maintains at least £10m invested on an instant access basis to ensure that unforeseen cash flows can be financed.

20. INVESTMENT OF MONEY BORROWED IN ADVANCE OF NEED

20.1 Section 12 of the Local Government Act gives a local authority the power to invest for "any purpose relevant to its functions under any enactment or for the prudent management of its financial affairs". While the speculative procedure of borrowing purely to invest at a profit is clearly unlawful, there is no legal obstacle to the temporary investment of funds borrowed for the purpose of funding capital expenditure incurred in the reasonably near future.

20.2 Some of the rental income relating to council housing is currently paid to the Government in the form of negative HRA subsidy. The Localism Act includes measures to repeal the existing Housing Revenue Account (HRA) subsidy system and replace it with powers for the Secretary of State for Communities and Local Government to introduce self-financing. This will be achieved via a reallocation of housing debt on 1st April 2012, after which councils will retain all the rental income they collect. The Council will be required to pay the Government £88.6m on 28th March 2012.

20. INVESTMENT OF MONEY BORROWED IN ADVANCE OF NEED (Continued)

20.3 Lower interest rate expectations and continuing concerns over the Euro zone sovereign debt caused a reduction in gilt yields and PWLB rates in April. With the expected direction of future gilt yields being upwards at that time, consideration was given to borrowing part of the Housing Revenue Account (HRA) Self Financing payment to the Government. With this in mind two loans were taken from the PWLB. The first loan was for £20m for 31 years at 5.01%. The second loan was for £14m for 20 years at 4.52%. Both loans are repayable through equal instalments of principal.

20.4 Risk averse attitudes in the financial markets caused a further reduction in gilt yields and PWLB rates in August. With the expected direction of future gilt yields being upwards consideration was given to borrowing more of the Housing Revenue Account (HRA) Self Financing payment to the Government. With this in mind two further loans were taken from the PWLB. The first loan was taken on 16 August for £25m for 30 years at 4.44%. The second loan was taken on 23 August for £25m for 30 years at 4.19%. Both loans are repayable through equal instalments of principal. All but £4.6m of the City Council's HRA Self Financing payment is now fully funded.

20.5 On 29 September the Chief Secretary to the Treasury announced that local authorities would be allowed to borrow from the Public Works Loans Board (PWLB) at National Loans Fund (NLF) rates to fund the HRA Self Financing payment. NLF rates are typically 1.13% below the rates the PWLB normally offers to local authorities. The PWLB will make NLF rates available to local authorities on 26 March 2012 for the purposes of funding HRA Self Financing payments. Despite local authorities being given indicative HRA Self Financing payment figures before the start of this financial year, there was no indication that the PWLB would offer loans at NLF rates prior to 29 September. The only way that the Council can now benefit from these interest rates would be to borrow in advance of need.

20.6 It is therefore recommended that the Head of Financial Services and Section 151 Officer be given delegated authority to borrow up to £50m in advance of need as measured by the Capital Financing Requirement **(recommendation (ab)).** This is the estimated borrowing required to support the Council's capital programme until 2016/17.

20.7 Borrowing in advance of need may enable the City Council to obtain cheaper loans than those available at the time when expenditure is incurred, although the consequent investment of funds borrowed in advance of need does expose the City Council to credit risk. The interest payable on funds borrowed in advance of need is likely to exceed the interest earned on the investment of those funds in the current economic climate.

21. TRAINING OF INVESTMENT STAFF

21.1 The Finance Manager (Technical & Financial Planning) manages the treasury function with assistance from the Senior Financial Planning Accountant. Both these officers are qualified Chartered Public Finance Accountants. In addition the Finance Manager (Technical & Financial Planning) holds the Association of Corporate Treasurers Certificate in International Treasury Management. The City Council is also a member of CIPFA’s Treasury Management Forum which provides training events throughout the year. Additional training for investment staff is provided as required.

22. DELEGATED POWERS

22.1 Once the Treasury Policy has been approved, the Head of Financial Services and Section 151 Officer has delegated powers under the Standing Orders of the City Council, to make all executive decisions on borrowing, investments or financing in accordance with CIPFA's 'Code for Treasury Management in the Public Services'.

23. TREASURY SYSTEMS AND DOCUMENTATION

23.1 Once the Policy Statement has been approved by the Council, the documentation of the Treasury Systems will be updated so that all employees involved in Treasury Management are clear on the procedures to be followed and the limits applied to their particular activities.

23. TREASURY SYSTEMS AND DOCUMENTATION (CONTINUED)

23.2 The Treasury Management Practices document covers the following topics: -

- risk management
- best value and performance measurement
- decision making and analysis
- approved instruments, methods and techniques
- organisation, clarity and segregation of responsibilities, and dealing arrangements
- reporting requirements and management information arrangements
- budgeting, accounting and audit arrangements
- cash and cash flow management
- money laundering
- staff training and qualifications
- use of external service providers
- corporate governance

24. REVIEW AND REPORTING ARRANGEMENTS

24.1 The Head of Financial Services and Section 151 Officer will submit the following:-

(i) an annual report on the treasury management outturn to the Council by 30 September of the succeeding financial year

(ii) a mid year review to the Council

(iii) the Annual Strategy Report to the Council in March 2013

(iv) quarterly treasury management monitoring reports to the Cabinet and the Governance and Audit Committee