TREASURY MANAGEMENT POLICY STATEMENT INCLUDING:

- **TREASURY MANAGEMENT STRATEGY**
- **ANNUAL MINIMUM REVENUE PROVISION FOR DEBT REPAYMENT STATEMENT**
- **ANNUAL INVESTMENT STRATEGY 2016/17**

Portsmouth City Council
Director of Finance and Information Services (Section 151 Officer)

TREASURY MANAGEMENT POLICY STATEMENT 2016/17

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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 treasury management activities are governed by various codes of practice and guidance that the Council must have regard to under Local Government Act 2003. The main codes and guidance that the Council must have regard to are:

- Treasury Management in the Public Services Code of Practice published by the Chartered Institute of Public Finance and Accountancy (CIPFA) which sets out the key principles and practices to be followed.

- The Prudential Code for Capital Finance in Local Authorities published by CIPFA which governs borrowing by local authorities.

- The Guidance on Local Government Investments published by the Department for Communities and Local Government which governs local authorities investment activities and stipulates that investment priorities should be security (protecting the capital sum from loss) and liquidity (keeping money readily available for expenditure when needed), rather than yield.

2 BORROWING LIMITS AND THE PRUDENTIAL CODE

2.1 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. These were approved by the City Council on 9th February 2016.

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	487
Other Long Term Credit Liabilities	81
	568

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 (above) being breached.

	£m
Borrowing	468
Other Long Term Credit Liabilities	81
	549

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
- Housing Revenue Account (HRA) limit on indebtedness
- Incremental effect of capital investment decisions on council tax at band D
- Incremental effect of capital investment decisions on housing rents

These are contained in Appendix 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 TREASURY MANAGEMENT POLICY STATEMENT

3.1 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.

- 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.

3.2 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.

3.3 It is proposed that the Director of Finance and Information Services (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 2.1(a))**.

4 TREASURY MANAGEMENT STRATEGY FOR 2016/17

4.1 Objectives

It is estimated that the net interest and debt repayment costs for 2016/17 will amount to approximately £32.3m. The Treasury Management policy will therefore form a cornerstone of the Medium Term Resource Strategy. Specific objectives to be achieved in 2016/17 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
- To effect funding in any one year at the cheapest long term cost commensurate with future risk
- To forecast 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.

(b) Lending

- To ensure the security of lending (the maximisation of returns remains a secondary consideration) by investing in:
  - the United Kingdom Government and institutions or projects guaranteed by the United Kingdom Government;
  - Other local authorities in England, Scotland and Wales
  - Aa rated money market funds including enhanced money market funds;
  - British institutions including commercial companies and registered social landlords (RSLs) that meet the City Council's investment criteria
  - Foreign institutions including commercial companies that meet the City Council's investment criteria within the jurisdiction of a AA+ government
- To maintain £10m in instant access accounts
- To make funds available to Council's subsidiaries
- To make funds available for the regeneration of Hampshire
- 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

4.2 Risk Appetite Statement

The Council attaches a high priority to a stable and predictable revenue cost from treasury management activities in the long term. This reflects the fact that debt servicing represents a significant cost to the Council's net revenue budget. The Council's objectives in relation to debt and investment can accordingly be stated as follows:

To assist the achievement of the council's service objectives by obtaining funding and managing the debt and treasury investments at a net cost which is as low as possible, consistent with a high degree of long term interest cost stability. Sums are invested with a diversified range of counter parties using the maximum range of instruments consistent with a low risk of the capital sum being diminished through movements in prices.

This means that the Council is not totally risk averse. Treasury management staff have the capability to actively manage treasury risks within the scope of the Council's treasury management policy and strategy.

In particular when investing surplus cash, the Council will not necessarily limit itself to making deposits with the UK Government and local authorities, but may invest in other bodies including unrated building societies, RSLs and corporate bonds. The Council may invest surplus funds through tradable instruments such as treasury bills, gilts, certificates of deposit and corporate bonds. The duration of such investments will be limited so that they do not have to be sold (although they may be) prior to maturity thus avoiding the risk of the capital sum being diminished through movements in prices. The Council may invest in low risk structured investment products that follow the developed equity markets where movements in prices may diminish the capital sum invested.

It is recommended that the Council adopts a risk appetite statement that permits investments to be made in instruments that do not guarantee that the capital sum will not be diminished through movements in prices **(Recommendation 3.1(b))**. These investments, and indeed any other investment, could also be diminished if the counter party defaults. Although the Council only invests in counter parties offering good credit quality, the credit quality of an investment counter party can decline during the life of the investment. This is particularly the case with long term investments.

4.3 Gross Debt and the Capital Financing Requirement

In order to ensure that over the medium term, debt will only be for a capital purpose, CIPFA's Prudential Code which the City Council is legally obliged to have regard to requires the City Council to ensure that debt does not, except in the short term, exceed the total of capital financing requirement (CFR). The CFR measures the Council's underlying need to borrow. If in any year there is a reduction in the capital financing requirement, this reduction is ignored in estimating the cumulative increase in the capital financing requirement which is used for the comparison with gross external debt. The Council's forecast gross debt is shown in the table below.

	2015/16 £'000	**2016/17** £'000	**2017/18** £'000	**2018/19** £'000
Borrowing	391,120	387,769	384,417	381,066
Finance leases	4,100	3,479	2,828	2,171
Service Concessions (including Private Finance Initiative schemes)	82,109	79,639	76,456	73,769
Total Gross debt	**477,329**	**470,887**	**463,701**	**457,006**
Capital Financing Requirement (CFR):				
Opening CFR in 2015/16	403,990			
Change in CFR in 2015/16	56,142			
Closing CFR in 2015/16	460,132	460,132	460,132	460,132
Cumulative increase in CFR in future years		89,407	98,304	-
Closing CFR	**460,132**	**549,539**	**558,436**	**558,436**
Under / (Over) Borrowing	**(17,197)**	**78,652**	**94,735**	**101,430**

The Council's gross debt exceeds its estimated CFR, ie. it is over borrowed, in 2015/16 because £18m was borrowed from the Public Works Loans Board (PWLB) at the project rate which is 0.20% below the certainty rate at which the PWLB normally lends to local authorities. The Council had an £18m allocation of project rate funding for 2015/16 to finance the development of Dunsbury Hill Farm, Tipner and Horsea Island.

The capital programme approved by the City Council on 9th February 2016 includes £99.3m of capital expenditure financed by borrowing in 2016/17. This includes £66.0m of expenditure on the acquisition of commercial properties to provide an income stream to support the Council's services. This is expected to cause the Council's CFR to rise above its gross debt, ie. it is expected to become under borrowed in 2016/17.

4.4 Gross and Net Debt

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

	2015/16 £'000	**2016/17** £'000	**2017/18** £'000	**2018/19** £'000
Gross Debt at 31 March	477,329	470,887	463,701	457,006
Investments at 31 March	(324,659)	(117,000)	(89,000)	(75,000)
Estimated Net Debt	**152,670**	**353,887**	**374,701**	**382,006**

4.4.2 The Council currently 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. However the Council's treasury management investments are expected to decline in 2016/17 as funds are used to invest in commercial properties.

4.5 Interest Rates

4.5.1 Interest Rate Forecasts for 2016/17

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

4.5.2 Long Term Borrowing Interest Rates

The following table gives Capital Asset Services central view.

	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%
5yr PWLB rate	2.00%	2.10%	2.20%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%
10yr PWLB rate	2.60%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.60%	3.70%
25yr PWLB rate	3.40%	3.40%	3.50%	3.60%	3.70%	3.70%	3.80%	3.90%	4.00%	4.00%	4.10%	4.10%	4.10%
50yr PWLB rate	3.20%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	3.90%	4.00%	4.00%	4.00%

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and although the 2015 growth rate is likely to be a leading rate in the G7 again, it looks likely to disappoint previous forecasts and come in at about 2%. Quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a slight increase in quarter 2 to +0.5% (+2.3% y/y) before weakening again to +0.4% (2.1% y/y) in quarter 3. The August Bank of England Inflation Report included a forecast for growth to remain around 2.5 – 2.7% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero since February 2015. Investment expenditure is also expected to support growth. However, since the August Inflation report was issued, most worldwide economic statistics have been weak and financial markets have been particularly volatile. The November Inflation Report flagged up particular concerns for the potential impact of these factors on the UK.

The Inflation Report was also notably subdued in respect of the forecasts for inflation; this was expected to barely get back up to the 2% target within the 2-3 year time horizon. The increase in the forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon was the biggest since February 2013. However, the first round of falls in oil, gas and food prices over late 2014 and also in the first half 2015, will fall out of the 12 month calculation of CPI during late 2015 / early 2016 but a second, more recent round of falls in fuel and commodity prices will delay a significant tick up in inflation from around zero: this is now expected to get back to around 1% by the end of 2016 and not get to near 2% until the second half of 2017, though the forecasts in the Report itself were for an even slower rate of increase. However, more falls in the price of oil and imports from emerging countries in early 2016 will further delay the pick up in inflation. There is therefore considerable uncertainty around how quickly pay and CPI inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate.

The weakening of UK GDP growth during 2015 and the deterioration of prospects in the international scene, especially for emerging market countries, have consequently led to forecasts for when the first increase in Bank Rate would occur being pushed back to quarter 4 of 2016. There is downside risk to this forecast i.e. it could be pushed further back.

Borrowing interest rates have been highly volatile during 2015 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. Gilt yields have continued to remain at historically phenominally low levels during 2015.

There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

4.5.3 Short Term Investment Interest Rates

Investment returns are likely to remain relatively low during 2016/17 and beyond.

4.6 Borrowing / Lending Requirements

Over the last few years the Council has had an overall net lending requirement. However the considerable amount of estimated capital expenditure in 2016/17 financed from borrowing is expected to turn this into an overall net borrowing requirement from 2016/17 onwards.

The Council does not expect to run out of cash until 2021/22. This will enable the Council to delay actually undertaking further borrowing until 2021/22, ie. the Council will be able to borrow internally from its own reserves. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when the Council will not be able to avoid new borrowing to finance new capital expenditure and / or to refinance maturing debt.

It has been assumed that existing maturing debt of £3.4m in 2016/17 will not be replaced. Instead this debt will be repaid using internal funds (see paragraph 6.1(g)). It is recommended however, that the Director of Finance and Information Services (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 3.1(c)).**

4.7 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 4.5. 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 invest up to £325m of surplus cash in the short term.

The Council 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 £1,625k below budget in 2016/17. 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 £1,625k in 2016/17.

4.8 Upper limits for fixed 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 fixed interest rate exposures.

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

	2015/16 £m	2016/17 £m	2017/18 £m	2018/19 £m
Maximum Projected Gross Borrowing – Fixed Rate	391	464	479	482
Minimum Projected Gross Investments – Fixed Rate	(196)	(106)	(33)	-

It is recommended that the upper limits for fixed interest rate exposures be set as follows **(Recommendation 3.1(d)**):

2015/16	£195m
2016/17	£358m
2017/18	£446m
2018/19	£482m

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.

4.9 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:

	2015/16 £m	2016/17 £m	2017/18 £m	2018/19 £m
Minimum Projected Gross Borrowing – Variable Rate	-	-	-	-
Maximum Projected Gross Investments – Variable Rate	(265)	(444)	(526)	(555)

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's maximum projected gross variable interest rate investments increases as existing long term fixed interest rate investments mature. Some of this risk may be mitigated through making further long term fixed rate 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 3.1(e))**:

2015/16 (£265m) – Investments up to £265m

2016/17 (£444m) – Investments up to £444m

2017/18 (£526m) – Investments up to £526m

2018/19 (£555m) – Investments up to £555m

4.10 <u>Limits on total principal sums invested for periods longer than 364 days</u>

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.

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 2% 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. There are regular fluctuations in the Council's cash balances which can amount to £110m. In addition cash balances are expected to be at their lowest at the end of the financial year as tax receipts are lower in March. On this basis it is recommended that the following limits be placed on total principal sums invested for periods longer than 364 days to **(Recommendation 3.1(f))**:

31/3/2016 = £286m
31/3/2017 = £196m
31/3/2018 = £123m
31/3/2019 = £90m

4.11 Limits for the maturity structure of borrowing

The Government has issued guidance on making provision for the repayment of General Fund debt (see paragraph 8) which the Council is legally obliged to have regard to. The City Council is required to begin to make provision for the repayment of debt in advance of most of the Council's debt falling due for repayment. Therefore the City Council is required to provide for the repayment of debt well in advance of it becoming due. This is illustrated in the table below. 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 3.1). 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 4.12).

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 the past. The high upper limit for debt maturing in over 40 years time reflects existing borrowing as the upper limit cannot be set lower than the existing maturity profile and is also necessary because no provision is being made for the repayment of debt incurred by the Housing Revenue Account apart from the Self Financing payment.

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

In order to ensure a reasonably even maturity profile (paragraph 4.1(a)), it is recommended that the council set upper and lower limits for the maturity structure of its borrowings as follows **(Recommendation 3.1(g)).**

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

	Loan Debt Maturity	**Loans Minimum Revenue Provision (MRP)**	**% Over / (Under) Loans MRP**	**Upper limit**	**Lower limit**
Under 12 months	4%	3%	1%	10%	0%
12 months and within 24 months	1%	3%	(2)%	10%	0%
24 months and within 5 years	3%	8%	(5%)	10%	0%
5 years and within 10 years	4%	14%	(10%)	20%	0%
10 years and within 20 years	19%	27%	(8%)	30%	0%
20 years and within 30 years	10%	22%	(12%)	30%	0%
30 years and within 40 years	23%	16%	7%	30%	0%
40 years and within 50 years	36%	7%	29%	40%	0%

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

4.12 <u>Debt Rescheduling</u>

4.12.1 At the present time, all the City Council's long term external debt has been borrowed at fixed interest rates ranging from 2.73% to 5.01%. 59% of the Council's debt matures in over 30 years' time. Appendix B shows the long term loans maturity pattern. Therefore debt rescheduling could be beneficial in evening out the debt maturity profile.

4.12.2 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.

4.12.3 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.

4.12.4 The Director of Finance and Information Services (Section 151 Officer) will continue to monitor the Council's debt and will undertake further rescheduling if it would be beneficial.

4.12.5 It is recommended that authority to reschedule debt during the year be delegated to the Director of Finance and Information Services (Section 151 Officer) subject to conditions being beneficial to the City Council **(Recommendation 3.1(h))**.

5 APPROVED METHODS OF RAISING CAPITAL FINANCE

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

	Variable	Fixed
PWLB	Y	Y
Market Long-term	Y	Y
Municipal Bonds Agency		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

5.2 The main methods of raising capital finance used by the City Council are discussed in greater detail within Section 6 of this policy. 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.

5.3 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.

6 APPROVED SOURCES OF BORROWING

6.1 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.

(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) Municipal Bonds Agency (MBA)

A municipal bonds agency has been established by the Local Government Association (LGA) to enable local authorities to undertake long term borrowing at lower rates than those offered by the PWLB. The MBA is expected to issue its first bond and advance its first loans to local authorities in 2016/17. Loans will be advanced on fixed dates determined by the municipal bonds agency. Loans will be repayable at maturity with the duration of the loan being fixed by the MBA.

(e) 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 2016/17 of £568m set by the City Council on 9 February 2016 must not be exceeded. It is anticipated that the City Council will not need to use the temporary borrowing facility in 2016/17.

(f) Overdraft

An overdraft limit of £2m has been agreed with the Barclays 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 2016/17 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.

(g) 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 finance capital expenditure or the repayment of debt, thus delaying the need to borrow externally.

6.2 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 3.1(i)).**

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

7.1 The Localism Act 2011 requires local authorities to allocate existing and future borrowing costs between council housing (the HRA) and the General Fund. It is for local authorities to choose an allocation method that achieves the principles detailed in their treasury management strategies.

7.2 In 2011/12 the Council was required to make an £88.6m payment to the Government under the HRA Self Financing scheme. The expected direction of gilt yields at that time was upwards and the Council borrowed £84m. Subsequently the Government announced that they would allow local authorities to borrow this sum from the Public Works Loans Board at National Loans Fund (NLF) rates. NLF rates are typically 1.13% below the rates the PWLB normally offers to local authorities. The Council therefore took advantage of this and borrowed a further £88.6m. The Council then switched the original PWLB borrowing of £84m taken earlier in the year and applied that to fund existing and future General Fund capital expenditure.

7.3 The approved Treasury Management Strategy for 2012/13 provided for a single loans pool to be maintained for both HRA and General Fund. This reflects the previous co-operation between the General Fund and the HRA and provides for the loans portfolio to be managed in the best interests of the whole authority. If the HRA had its own loans pool, having already borrowed £84m at an average rate of 4.51% to fund the Self Financing payment, it would not have been able to borrow much at the NLF rates that were subsequently offered. A single loans pool means that the HRA gets more of the long term benefits of the 3.49% NLF rate loans than it could have done on its own. Although a single loans pool does not allow the HRA to directly benefit from the NLF rate loans, it is felt that a single loans pool is broadly equitable between the HRA and the General Fund in the Council's circumstances.

7.4 It is proposed to continue to operate with a single loans pool and apportion costs according to locally established principles. It is recommended that the principles upon which the apportionment of borrowing costs should be based are as follows **(recommendation 3.1(j))**:

- 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 costs and benefits of over and under borrowing above or below the capital financing requirement (CFR) are equitably shared between the General Fund and the HRA.

7.5 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.

8 ANNUAL MINIMUM REVENUE PROVISION FOR DEBT REPAYMENT STATEMENT

8.1 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.

8.2 The guidance also requires the Council to adopt an Annual Minimum Revenue Provision (MRP) for Debt Repayment Statement. This is contained within paragraphs 9 to 15 below.

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

9.1 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.

9.2 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.

9.3 Alternatively, for debt that is supported by Formula Grant, it is suggested that authorities could 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 would be £320k less per annum than under the CFR method. The Council has previously adopted the Regulatory Method of calculating MRP to be applied to pre 1 April 2008 debt and new government supported debt.

9.4 However, 62% of the Council's borrowings mature in over 30 years' time. All but £11m of the Council's borrowing is PWLB debt. The PWLB introduced new lower discount rates to calculate premiums on the early repayment of debt in 2010. The increased premiums resulting from this means that the existing debt is unlikely to be repaid early or rescheduled. In the meantime providing MRP on the basis of a 4% reducing balance is contributing to the Council's high cash balances. The need to invest such high cash balances exposes the Council to credit risk in the event that one of the Council's investment counterparties gets into financial difficulties. In addition an MRP policy based on a reducing balance will never fully provide for the repayment of the debt.

9.5 Authorities must always have regard to the guidance, but having done so, may consider that a more individually designed MRP approach is justified. It is therefore recommended that the Council adopts a MRP policy for supported borrowing based on a straight 2% **(Recommendation 3.1(k))**. This will ensure that provision was made for the repayment of all unsupported borrowing in a way that better reflects the maturity pattern of the Council's borrowing and avoids the credit risk associated with providing for the repayment of debt long before there is any realistic chance of the debt actually being repaid. The graph in Appendix C illustrates these points. It should also be borne in mind that the real value of the Council's long term borrowing will be considerably eroded by inflation prior to it becoming due for repayment which is a further argument for not providing for its repayment excessively early.

10. FINANCE LEASES AND SERVICE CONCESSIONS INCLUDING PRIVATE FINANCE INITIATIVE SCHEMES

10.1 It is recommended that MRP continues to be provided for finance leases and service concessions (including Private Finance Initiative schemes) as principal repayments are made to the lessor or the PFI operator **(Recommendation 3.1 (i))**. The principal repayments made to lessors and PFI operators are already calculated on an annuity basis.

11. SELF- FINANCED BORROWING EXCLUDING BORROWING TO FUND LONG TERM DEBTORS (INCLUDING FINANCE LEASES), INVESTMENT PROPERTIES AND EQUITY SHARES PURCHASED IN PURSUIT OF POLICY OBJECTIVES

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 suggested 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. In 2014/15 and prior years the Council adopted the Asset Life (Equal Instalment) Method with MRP being made from the year following completion of the asset with the exception of:

- Finance Leases
- Service concessions (including Private Finance Initiative schemes)
- Borrowing to fund long term debtors (including finance leases)

11.2 Providing MRP using the asset life equal instalment method contributed to the Council's high cash balances. The need to invest such high cash balances exposes the Council to credit risk in the event that one of the Council's investment counterparties gets into financial difficulties.

11.3 Authorities must always have regard to the guidance, but having done so, may consider that a more individually designed MRP approach is justified. It is recommended that the annuity method of calculating the minimum revenue provision (MRP) for the repayment of debt is applied to General Fund post 1 April 2008 self-financed borrowing with MRP being made from the year after practical completion of the scheme **(Recommendation 3.1(m))**. This will still ensure that provision is made for the repayment of unsupported borrowing within the life of the assets that it is used to finance, but in a way that better reflects the maturity pattern of the Council's borrowing and avoids the credit risk associated with providing for the repayment of debt long before there is any realistic chance of the debt actually being repaid. The graph in Appendix D illustrates this point. It should also be borne in mind that the real value of the Council's long term borrowing will be considerably eroded by inflation prior to it becoming due for repayment which is a further argument for not providing for its repayment excessively early.

12 SELF FINANCED BORROWING TO FUND LONG TERM DEBTORS INCLUDING FINANCE LEASES

12.1 The income received from long term debtors has an interest and a principal element. The interest element is credited to the revenue account. The principal part of the income receivable will be taken to reduce the loan asset on the balance sheet rather than being credited to the revenue account. This part of the rent receivable generates a capital receipt. Capital receipts can principally be used to finance new capital expenditure or repay debt. It is recommended that the principal element of the rent receivable be set aside to repay the borrowing that financed these assets **(recommendation 3.1(n))**. This is in line with the MRP policy adopted for 2015/16 for long term debtors funded by unsupported borrowing.

12.2 Under finance leases the risks and rewards of asset ownership rest with the lessee and the assets are not shown on the City Council's balance sheet. These leases are therefore in effect a form of lending. A part of the rent receivable will be taken to reduce the loan asset value on the balance sheet rather than being credited to the revenue account. This part of the rent receivable generates a capital receipt which can principally be used to finance new capital expenditure or repay debt. It is recommended that the principal element of the rent receivable be set aside to repay the borrowing that financed these assets **(recommendation 3.1(o))**. This is in line with the MRP policy adopted for 2015/16 for finance leases funded by unsupported borrowing.

13 SELF FINANCED BORROWING TO FUND INVESTMENT PROPERTIES

13.1 The Council has purchased investment properties in 2015/16 with a view to generating long term rental income streams to support the delivery of Council services in the future and reduce dependence on Government grant. The Council plans to purchase more investment properties in 2016/17. The Property Investment Strategy approved by the Council on 7 July 2015 provides for an investment "holding period" before sale to be defined from purchase with a view to preventing significant depreciation eroding the value of the property or the need for re-development arising. As the investment properties will be sold before there is significant consumption of the assets, it is recommended that the Council provides for the repayment of the unsupported borrowing by setting aside the capital receipt on disposal rather than providing a revenue provision **(recommendation 3.1(p))**.

14 SELF FINANCED BORROWING TO FUND EQUITY SHARES PURCHASED IN PURSUIT OF POLICY OBJECTIVES

14.1 The Council has purchased £150k of ordinary shares in the Municipal Bonds Agency (MBA). The establishment of the MBA will offer a number of long term benefits including:

- Cheaper access to borrowing for local authorities - expected to be between 20 to 25 basis points (or £20,000 p.a. to £25,000 p.a. per £10m borrowed or £600,00 to £750,000 over the life of a 30 year loan;
- Loans from the MBA should be cheaper to reschedule;
- Increased opportunities for local authorities to lend to each other;
- The ordinary shares purchased may provide a dividend in future years
- Insulate local authorities from future policy changes by the PWLB regarding interest rates.

14.2 The Council has also purchased ordinary share capital in Hampshire Community Bank (HCB) and plans to increase its shareholding to £5m in 2016/17. The primary purpose of this capital expenditure is to create a local bank that will focus on lending to small and medium sized enterprises and thus be a powerful force in achieving the following:

- Securing a strong and sustainable local economy in Hampshire
- Working with businesses, councils and charities to deliver sustainable economic growth
- Retaining wealth in the local area

Creation of the HCB will be line with the following strategies:

- the LEP Strategy for Growth
- PCC's Regeneration Strategy
- the Medium Term Financial Strategy that aims to drive regeneration, and reduce the demand for council services.

The bank is expected to generate a 6% return for its founding investors. On this basis we expect the value of shares in the bank to increase rather than decrease in value.

14.3 The Government's statutory guidance suggests that MRP for the acquisition of share capital should be made over 20 years to discourage the use of this form of investment (paragraph 45 of Part 1 of the Guidance). The Council see the MBA and HCB as important policy tools rather than primarily as an investment. 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. However, the MBA and HCB will have indeterminate lives and therefore it is not recommended that the Council makes MRP in relation to its unsupported borrowing in respect of the MBA and HCB. Instead it is recommended that the Council sets aside the capital receipt to provide for the repayment of the unsupported borrowing in the event of it selling its shares in the MBA or HCB **(recommendation 3.1(q))**.

15 HOUSING REVENUE ACCOUNT (HRA) BORROWING

15.1 There is no statutory requirement for the HRA to provide for the repayment of its debt. On 28 March 2012 the HRA was 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 3.1(r))**. The HRA will continue its practice of not providing for the repayment of its other debts.

16 ANNUAL INVESTMENT STRATEGY

16.1 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 16 to 22 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.

16.2 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.

16.3 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.

16.4 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.

16.5 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.

17. INVESTMENT CONSULTANTS

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

- Interest rate forecasts
- Credit ratings
- CDS prices

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

18. SPECIFIED INVESTMENTS

18.1 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 in any corporate body.

18.2 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 E.
- Viability Rating (where available 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)

18.3 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 for specified investments 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.

18.4 The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. Commencing in 2015, in response to the evolving regulatory regime, all three agencies have begun removing these "uplifts" with the timing of the process determined by regulatory progress at the national level. The process has been part of a wider reassessment of methodologies by each of the rating agencies. In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A consequence of these new methodologies is that they have also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

18.5 In keeping with the agencies' new methodologies, the rating element of our own credit assessment process now focuses solely on the Short and Long Term ratings of an institution. While this is the same process that has always been used for Standard & Poor's, this has been a change in the use of Fitch and Moody's ratings. It is important to stress that the other key elements to our process, namely the assessment of Rating Watch and Outlook information as well as the Credit Default Swap (CDS) prices have not been changed.

18.6 It is important to stress that these rating agency changes do not reflect any changes in the underlying status or credit quality of the institution. They are merely reflective of a reassessment of rating agency methodologies in light of enacted and future expected changes to the regulatory environment in which financial institutions operate. While some banks have received lower credit ratings as a result of these changes, this does not mean that they are suddenly less credit worthy than they were formerly. Rather, in the majority of cases, this mainly reflects the fact that implied sovereign government support has effectively been withdrawn from banks. They are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In fact, in many cases, the balance sheets of banks are now much more robust than they were before the 2008 financial crisis when they had higher ratings than now. However, this is not universally applicable, leaving some entities with modestly lower ratings than they had through much of the “support” phase of the financial crisis.

18.7 It is recommended that specified investments should only be placed with institutions that have a long term credit rating of at least A- from at least two rating agencies except registered social landlords for which a single credit rating will be required **(Recommendation 3.1s).** Registered social landlords (RSLs) are regulated by the Government and their debts can be secured on their housing stock. However, most RSLs are only rated by a single agency.

18.8 In addition to rating financial institutions the rating agencies also rate governments. These are known as sovereign credit ratings. The evolving regulatory environment, in tandem with the rating agencies’ new methodologies also means that sovereign ratings are now of lesser importance in the assessment process with the new regulatory environment attempting to break the link between sovereign support and domestic financial institutions. However ssovereign 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 AA+ credit rating **(Recommendation 3.1t).**

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

18.10 It is proposed that investments be allowed in government bodies, banks including supranational banks, building societies, money market funds, enhanced money market funds, RSLs and corporate bonds that meet the Council’s investment criteria.

18.11 Money market funds are well diversified funds that invest in high quality very short term instruments enabling investors to have instant access to their funds. Enhanced money market funds, also known as short dated investment funds, are also well diversified funds investing in high quality counter parties, but for longer periods, and require a few days' notice of withdrawals.

18.12 Corporate bonds are tradable loan instruments issued by commercial companies. Credit ratings measure the risk of default, ie. the risk of not receiving principal and interest when it is due, across these institutions in a way that allows them to be compared. However, other measures of credit risk such as CDS prices are not available for all institutions including most building societies, RSLs and commercial companies.

18.13 There are over 30 registered social landlords (RSLs) with a single or double A credit rating. RSLs are subject to Government regulation but their debts are not guaranteed by the Government. As RSLs own houses, lending to RSLs can be secured by a charge against the RSLs properties.

18.14 The risk of loss following a default is much smaller for building societies. Building societies also operate under a separate legal regime to banks, which limits the amount of lending not secured on residential property and limits the amount of wholesale funding.

18.15 It is recommended that the Council's investments be limited to senior debt **(Recommendation 3.1(u))**. Subordinated corporate bonds are sometimes issued by financial institutions and commercial companies. Subordinated corporate bonds offer higher yields, but in the event of an institution defaulting, senior debtors are repaid before subordinated debtors. Because of this, subordinated bonds often have a lower credit rating than senior debt issued by the same institution.

18.16 On 25 September 2015 the Council gave the Director of Finance and Information Services (Section 151 Officer) delegated authority to invest the Council's funds in equity trackers which follow the developed stock markets with a floor of 100% of the capital invested, ie. the Council's capital was guaranteed. Market conditions for equities have deteriorated and there is evidence to suggest that the probability of a fully capital protected equity tracker paying a return is less than 60%. There are structured investment products available that pay returns in excess of 6% per annum provided that neither the FTSE 100, S&P 500 or Eurostoxx 50 decline by more than 40% over 5 years and repay the capital invested if the worst performing index and the Eurostoxx 50 do not fall by more than 65%. There are also similar structured investment products available that will pay in excess of 6% per annum provided that none of the indices decline by more than 50% over 6 years. It is therefore recommended that the Director of Finance and Information Services (Section 151 Officer) be given delegated authority to invest the Council's funds in structured investment products which follow the developed stock markets that do not fully protect the Council's capital invested **(Recommendation 3.1(v))**. In order to accommodate this type of investment it is also recommended that the maximum duration of investments in categories 1, 2, 4, 6, 7, and 8 below be increased from 5 years to 6 years. These products are effectively bank deposits where the return is determined by stock market performance. As such they are subject to credit risk if the issuer defaults.

18.17 It is proposed to divide the approved counter parties for specified investments into eight categories as follows:

	Recommended Maximum Investment in a Single Organisation
Category 1 United Kingdom Government including the Debt Management Office Deposit Facility	Unlimited investments for up to 6 years
Category 2 Local authorities in England, Scotland and Wales	£30m for up to 6 years
Category 3 RSLs with a single long term credit rating of Aa-	£30m for up to 10 years
Category 4 Banks with a short term credit rating of F1+ and a long term rating of Aa-. Aaa rated money market funds, Aa rated enhanced money market funds	£26m for up to 6 years
Category 5 RSLs with a single A long term credit rating of A-	£20m for up 10 years
Category 6 Banks and corporate bonds with a short term credit rating of F1 and a long term rating of A+. Building societies with a short term credit rating of F1 and a long term rating of A.	£20m for up to 6 years.
Category 7 Banks and corporate bonds with a short term credit rating of F1 and a long term rating of A. Building societies with a short term credit rating of F1 and a long term rating of A-.	£13m for up to 6 years
Category 8 Banks and corporate bonds with a short term credit rating of F1 and a long term rating of A-.	£10m for up to 6 years

18.18 It is proposed that the bodies meeting the criteria of categories 1 to 8 in paragraph 18.17 be approved as repositories of specified investments of the City Council's surplus funds **(Recommendation 3.1(w)).** A list of financial institutions currently meeting the Councils investment criteria is contained in Appendix F. There are too many RSLs and companies issuing corporate bonds to include in the list.

18.19 It is recommended that the credit ratings be reviewed weekly and that any institution whose lowest credit rating falls below the criteria for category 8 in paragraph 18.17 be removed from the list of specified investments **(Recommendation 3.1(x)).**

18.20 It is recommended that institutions that are placed on negative watch or negative outlook by the credit rating agencies be reassigned to a lower category **(Recommendation 3.1(y)).**

19. NON-SPECIFIED INVESTMENTS

19.1 The Government's Guidance requires that other less secure 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.

19.2 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 further investment categories be established for non-specified investments that do not meet the criteria for specified investments.

Category 9 - £10m for 2 years
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)

Category 9 will consist of rated building societies that meet the above criteria.

Category 10 - £6m for 2 years

Many smaller building societies that have been more conservative in their lending approach do not have credit ratings. An analysis of building society accounts suggests that many of those without credit ratings are in a better financial position than some of the larger ones who do hold credit ratings.

Category 10 consists of the unrated building societies in the strongest financial position.

The limits on these building societies are less than £6m to take account of their small size in terms of assets.

Building Society	**Limit**
Leek United	£4.5m
Furness	£4.4m
Newbury	£4.1m
Market Harborough	£2.1m
Melton Mowbray	£1.9m
Marsden	£1.9m
Tipton and Coseley	£1.9m
Hanley Economic	£1.8m
Dudley	£1.6m
Harpenden	£1.5m
Loughborough	£1.4m
Staffordshire Railway	£1.3m
Swansea	£1.1m
Chorley and District	£1.1m
Buckinghamshire	£1.1m

Category 11 - £6m for 364 days

Category 11 consists of the unrated building societies that are in a strong financial position.

The limits on some building societies are less than £6m to take account of their small size in terms of assets.

Building Society	**Limit**
Nottingham	£6.0m
Progressive	£6.0m
Monmouthshire	£5.2m
Hinkley & Rugby	£2.7m
Darlington	£2.7m
Scottish	£1.9m
Mansfield	£1.4m
Vernon	£1.4m

19.3 The Council's treasury management operation is exposed to the Council's subsidiary company MMD (Shipping Services) Ltd. The Council has £550k lodged with Lloyds Bank to guarantee MMD's banking limits.

19.4 The Annual Investment Strategy provides for the Council to lend to the United Kingdom Government and local authorities in England, Scotland and Wales, A rated financial institutions and A rated corporate bonds for 6 years, and to RSLs for 10 years. However as these investments would be over a year they cannot be included as specified investments.

19.5 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.

19.6 It is recommended that non-specified investments should in aggregate be limited to the following (**Recommendation 2.1 (z))**:

	£
Building societies with a BBB credit rating and unrated building societies	81m
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	286m
Investments in foreign currencies to hedge against contracts priced or indexed against foreign currencies	5m
Total	**374m**

20. MAXIMUM LEVEL OF INVESTMENT IN INDIVIDUAL ORGANISATIONS

20.1 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 3.1(aa)):**

	Maximum Investment in Single Organisation
Category 1	Unlimited for up to 6 years
Category 2	£30m for up to 6 years
Category 3	£30m for up to 10 years
Category 4	£26m for up to 6 years
Category 5	£20m for up to 10 years
Category 6	£20m for up to 6 years
Category 7	£13m for up to 6 years
Category 8	£10m for up to 6 years
Category 9	£10m for up to 2 years
Category 10	£6m for up to 2 years
Category 11	£6m for up to 364 days
MMD (Shipping Services) Ltd including sums lodged to guarantee the company's banking limits	£2m for up to 364 days

The duration limits for categories 1, 2, 4, 6, 7 and 8 was previously 5 years. It is recommended that the duration limits for these categories be increased to 6 years to facilitate the purchase of structured investment products that follow the developed equity markets (see paragraph 18.5)

20.2 It is recommended that the Director of Finance and Information Services (Section 151 Officer) in Consultation with the Leader of the Council be given delegated authority to revise the total amount that can be directly invested with any organisation at any time **(Recommendation 3.1(ab)).**

20.3 AA 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. Although AA 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.

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

20.5 As RSL's offer one principal service and their assets principally consist of residential properties, excessive investments in RSLs would also expose the Council to a systemic risk.

20.6 Excessive investments in investment products tracking equity markets could also expose the Council to a systemic risk.

20.7 In order to minimise systemic credit risk in any sector it is recommended that the following limits be applied **(Recommendation 3.1(ac))**:

Money market funds	£80m
Building societies	£107m
Registered Social Landlords	£80m
Investments tracking the equity markets	£70m

20.8 In order to minimise systemic credit risk in any region it is recommended that the following limits be applied to the geographic areas where investments can be made in foreign countries.

20.9 It is recommended that the following limits be applied **(Recommendation 3.1(ad))**:

Asia & Australia	£60m
Americas	£60m
Eurozone	£30m
Continental Europe outside the Eurozone	£30m

20.10 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.

21. LIQUIDITY OF INVESTMENTS

18.1 The Council's cash flow forecast for the current year is updated daily. In addition, the Council maintains a long term cash flow forecast that extends to 2023/24. These forecast are used to determine the maximum period for which funds may be prudently committed, ie. the City Council's core cash. The City Council maintains at least £10m invested on an instant access basis to ensure that unforeseen cash flows can be financed.

21. INVESTMENT OF MONEY BORROWED IN ADVANCE OF NEED

21.1 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.

21.2 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.

21.3 The Council's gross debt currently exceeds its estimated CFR by £17m, ie. it is over borrowed, in 2015/16 because £18m was borrowed from the Public Works Loans Board (PWLB) at the project rate which is 0.20% below the certainty rate at which the PWLB normally lends to local authorities. The Council had an £18m allocation of project rate funding for 2015/16 to finance the development of Dunsbury Hill Farm, Tipner and Horsea Island.

21.4 The capital programme approved by the City Council on 9th February 2016 includes £99.3m of capital expenditure financed by borrowing. This is expected to cause the Council's CFR to rise above its gross debt, ie. it is expected to become under borrowed in 2016/17.

22. TRAINING OF INVESTMENT STAFF

22.1 The Finance Manager (Technical & Financial Planning) manages the treasury function and is a qualified Chartered Public Finance Accountant and holds the Association of Corporate Treasurers Certificate in International Treasury Management. The Finance Manager (Technical & Financial Planning) is assisted by the Treasury Manager who is a qualified Chartered Certified Accountant. The City Council is also a member of CIPFA's Treasury Management Network which provides training events throughout the year. Additional training for investment staff is provided as required.

23. DELEGATED POWERS

23.1 Once the Treasury Policy has been approved, the Head of Financial Services and Section 151 Officer has delegated powers under the constitution of the City Council, to make all executive decisions on borrowing, investments or financing.

24. TREASURY SYSTEMS AND DOCUMENTATION

24.1 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.

24.2 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

25. REVIEW AND REPORTING ARRANGEMENTS

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

(i) an annual report on the treasury management outturn to the Cabinet 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 2017

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