APPENDIX 3

TREASURY MANAGEMENT STRATEGY STATEMENT 2013/14 – 2015/16

1.0 Introduction

The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, reflecting the outcome of the Council's underlying capital appraisal systems. This report updates currently approved indicators.

Within this overall prudential framework there is an impact on the Council's treasury management activity – as it will directly impact on borrowing or investment activity. As a consequence the treasury management strategy for 2013/14 to 2015/16 is included to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

2.0 The Capital Plans and the Prudential Indicators 2013/14 – 2015/16

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

Capital Expenditure

The Council's capital expenditure plans were approved by Cabinet and Council on 21 January and 30 January 2013 respectively and form the first of the prudential indicators. A certain level of capital expenditure is grant supported by the Government; any decisions by the Council to spend above this level will be considered unsupported capital expenditure. This unsupported capital expenditure needs to have regard to:

- Service objectives (e.g. strategic planning);
- Stewardship of assets (e.g. asset management planning);
- Value for money (e.g. option appraisal);
- Prudence and sustainability (e.g. implications for external borrowing and whole life costing);
- Affordability (e.g. implications for the council tax);
- Practicality (e.g. the achievability of the forward plan).

The revenue consequences of capital expenditure, particularly the unsupported capital expenditure, will need to be paid for from the Council's own resources.

This capital expenditure can be paid for immediately (by applying capital resources such as capital receipts, capital grants etc., or revenue resources), but if these resources are insufficient any residual capital expenditure will affect the Council's borrowing need.

The key risks to the plans are that the level of capital receipts, may be subject to change over this timescale. For instance anticipated asset sales may be postponed due to the poor condition of the property market.

Approving capital expenditure plans is the first prudential indicator.

3.0 The Council's Borrowing Need - The Capital Financing Requirement (CFR)

The second prudential indicator is the Council's CFR which is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

Following accounting changes, the CFR includes any other long term liabilities (e.g. finance leases) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council is asked to approve the CFR projections below:

Capital Financing Requirement	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Capital Financing Requirement	£3.0m	£3.0m	£3.0m	£3.0m	£3.0m
Adjustment A	£3.1m	£3.1m	£3.1m	£3.1m	£3.1m
Movement in the CFR	£0.0m	£0.0m	£0.0m	£0.0m	£0.0m

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments if required (Voluntary Revenue Provision - VRP).

Watford Council's approach has been to comply with the previous MRP regulations which allowed for an adjustment A which allowed debt free authorities to continue to **not** make an MRP. Any new capital expenditure if unfunded and requiring credit cover above adjustment A would however need to generate a MRP.

4.0 Minimum Revenue Provision (MRP) Strategy and Policy Statement

Communities and Local Government Regulations have been issued which require Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement

The Council currently has no debt and a zero adjusted CFR (as per table above). It is probable however that the Council will borrow up to a maximum of £10m to forward fund regeneration projects. The majority of this funding (£6m) will have a reasonable expectation of a repayment return within the period of the loan (5years) and relates to Growing Places funding at the Health Campus and, under CLG regulations no MRP would be necessary. The residual £4m of potential borrowing has yet to be earmarked and it is feasible that an investment return would be realised too far in the future. In these circumstances, and to provide maximum flexibility, a provision within the accounts of £150k per annum by way of a Minimum Revenue Provision is recommended from 2014/2015 onwards (as the MRP Regulations do not require the provision to be made until the year following the taking of any loan which would not be until 2014/2015 at the earliest).

This £150k is calculated on the **Asset Life Method whereby** MRP will be based on the estimated life of the assets and is in accordance with the proposed regulations. It is anticipated that this £150k addition to revenue can be accommodated in 2014/2015 without increasing the use of reserves currently earmarked / estimated within the Medium Term Financial Strategy.

Other options include the **Depreciation method –** MRP will follow standard depreciation accounting procedures and again is related to the life of the asset.

5.0 Treasury Indicators: Limits to Borrowing Activity

Long Term Borrowing- the Council has previously been debt free. At the present time there are a number of sources of external funding which have historically low borrowing costs. So for example, Growing Places Funding can either be interest free or geared to Public Works Loans Board rates which are themselves currently very low.

External Borrowing	2012/2013 Estimate	2013/2014 Estimate	2014/2015 Estimate	2015/2016 Estimate
Long Term	£10m	£10m	£10m	£10m

The Operational Boundary - this is the limit beyond which short term (cash flow) external borrowing is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual borrowing.

Operational Boundary	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Borrowing	£3m	£3m	£3m	£3m

The Authorised Limit for External Borrowing - A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external long and short term borrowing is prohibited, and this limit needs to be set or revised by the Council.
This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

The Audit Committee/ Council is asked to approve the following Authorised Limit and Maximum Gross Borrowing Position:

Authorised Limit & Maximum Gross Borrowing Position	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Borrowing-long and short	£13m	£13m	£13m	£13m
Other long term liabilities	£0m	£0m	£0m	£0m
Total	£13m	£13m	£13m	£13m

6.0 Treasury Management Issues

6.1 Treasury Management Strategy

The treasury management strategy is an important part of the overall financial management of the Council and it is a requirement that it is adopted by Council as one of the prudential indicators.

The Constitution requires a strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year. There is also a requirement for a mid-year monitoring report although for Watford, the Council's investment strategy is reported in detail to every meeting of the Audit Committee.

This strategy covers:

- The Council's debt and investment projections;
- The Council's estimates and limits on future debt levels(borrowing activity);
- The expected movement in interest rates;
- The Council's borrowing and investment strategies;
- Specific limits on treasury activities;
- Treasury performance indicators;
- Treasury advice;

- Training of Officers and Members.

The capital expenditure plans set out to provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

6.2 Current Portfolio Position

The Council's treasury portfolio position at 31 March 2012, with forward projections are summarised below.

Treasury Portfolio	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Total Investments 31 March	£29.112m	£25.000m	£20,000m	£15.000m	£10.000m
Investment Change	-8.67%	-14.13%	-20.00%	-25.00%	-33.33%

Another key prudential indicator is that the Council needs to ensure that its total borrowing, net of any investments, does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2013/14 and the following two financial years (shown as long term borrowing above).

The Head of Strategic Finance reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals within this report regarding future external borrowing.

6.3 Prospects for Interest Rates where a Council wishes to Borrow

The Council has appointed Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates and the following table and accompanying comments **provides Sector's views**.

Annual Average	Bank Rate	PWLB Borrowing Rates (including certainty rate adjustment)		
		5 year	25 year	50 year
Month/Year	**%**	**%**	**%**	**%**
December 2012	0.50	1.50	3.70	3.90
March 2013	0.50	1.50	3.80	4.00
June 2013	0.50	1.50	3.80	4.00
September 2013	0.50	1.60	3.80	4.00
December 2013	0.50	1.60	3.80	4.00
March 2014	0.50	1.70	3.90	4.10
June 2014	0.50	1.70	3.90	4.10
September 2014	0.50	1.80	4.00	4.20
December 2014	0.50	2.00	4.10	4.30
March 2015	0.75	2.20	4.30	4.50
June 2015	1.00	2.30	4.40	4.60
September 2015	1.25	2.50	4.60	4.80
December 2015	1.50	2.70	4.80	5.00
March 2016	1.75	2.90	5.00	5.20

The economic recovery in the UK since 2008 has been the worst and slowest recovery in recent history, although the economy returned to positive growth in the third quarter of 2012. Growth prospects are weak and consumer spending, the usual driving force of recovery, is likely to remain under pressure due to consumers focusing on repayment of personal debt, inflation eroding disposable income, general malaise about the economy and employment fears.

The primary drivers of the UK economy are likely to remain external. 40% of UK exports go to the Euozone so the difficulties in this area are likely to continue to hinder UK growth. The US, the main world economy, faces similar debt problems to the UK, but urgently needs to resolve the fiscal cliff now that the the Presidential elections are out of the way. The resulting US fiscal tightening and continuing Eurozone problems will depress UK growth and is likely to see the UK deficit reduction plans slip.

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

- The Eurozone sovereign debt difficulties provide a clear indication of high counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2013/14 and beyond;
- Borrowing interest rates continue to be attractive and may remain relatively low for some time. The timing of any borrowing will need to be monitored carefully;
- There will remain a cost of carry – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

(end of Sector's advice)

6.4 Borrowing Strategy

The Council has a number of regeneration projects and it is probable that the Council will need to take up external medium term borrowing in order to pump prime necessary infrastructure works. This report has highlighted elsewhere the need to permit a long term borrowing (over 365 days) facility of up to £10m. This loan facility should however provide future investment returns well in excess of conventional investment rates of interest.

6.5 Annual Investment Strategy

Key Objectives

The Council's investment strategy's primary objectives are safeguarding the re-payment of the principal and interest of its investments on time, and then ensuring adequate liquidity, with the investment return being the final objective. The current economic ensures that the current investment climate has one over-riding priority which is the management of counterparty security risk.

Investment Policy

The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then yield.

S ecurity
L iquidity
Y ield

Investment instruments identified for use in the financial year are listed below under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices Schedules.

Creditworthiness policy

The Council will ensure:

- It maintains a policy covering both the categories of investment types it will invest in and the criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

The Head of Strategic Finance will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary and will provide an overall pool of counterparties considered high quality.

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

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

Counterparty Categories

The Council uses the following criteria in choosing the categories of institutions in which to invest:

- **Banks 1 - Good Credit Quality**
  The Council will only use UK banks or foreign banks trading in the UK in sterling denomination and which meet the Rating criteria.

- **Banks 2 – Eligible Institutions**
  The Council will use organisations considered an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008, with the necessary short and long term ratings required in Banks 1 above. Note: Sector advice is for a cautious approach when using these Institutions.

- **Banks 3 – The Council's Own Banker**
  For transactional purposes, if the bank falls below the above criteria, it will be included, although in this case balances will be minimised as far as possible in both monetary size and time within operational constraints.

- **Bank Subsidiary and Treasury Operations –** the Council will use these where the parent bank has the necessary ratings outlined above and the parent has provided an indemnity guarantee.

- **Building Societies**
  The Council will use all Societies which:

  Either,
  i. **meet the ratings for banks outlined above;**

  Or,
  ii. **are eligible Institutions; and have assets in excess of limits for each category.**

- **Specific Public Bodies**
  The Council may lend to Public Bodies other than Local Authorities. The criterion for lending to these bodies is that the loan has been approved by Council.

- **Money Market Funds AAA Rated**
  The Council may lend to Money Market Funds in order to spread its investment risk.

- **Local Authorities**
  A limit of £2m per authority will be applied.

- **Debt Management Deposit Account Facility**
  A Government body which accepts local authority deposits.

Country and Sector Considerations

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

Use of Additional Information Other Than Credit Ratings

Additional requirements under the Code of Practice require the Council to supplement credit rating information. Whilst the above criteria rely primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

Time and Monetary Limits Applying to Investments

The time and monetary limits for institutions on the Council's Counterparty List summarised in the table below, are driven by the above criteria. These limits will cover both Specified and Non-Specified Investments.

The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then return.

Exceptional Circumstances

The criteria for choosing counterparties set out above provide a sound approach to investment in "normal" market circumstances. Whilst Members are asked to approve this base criteria above, under the exceptional current market conditions The Head of Strategic Finance may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval. These restrictions will remain in place until the banking system returns to "normal" conditions. Similarly, the time periods for investments will be restricted.

Examples of these restrictions would be the greater use of the Debt Management Deposit Account Facility (DMO) – a Government body which accepts local authority deposits, Money Market Funds, and strongly rated institutions. The credit criteria have been amended to reflect these facilities.

Sensitivity to Interest Rate Movements

Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 1% increase / decrease in all interest rates to the estimated treasury management costs / income for next year. That element of the debt and investment portfolios which are of a longer term, fixed interest rate nature will not be affected by interest rate changes.

Revenue Budgets	2013/14 Estimated + 1% £m	2013/14 Estimated - 1% £m
Interest on Borrowing	0.100	0.100
Investment income	0.200	-0.200

6.6 Investment Strategy

In-House Funds - Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

Investment Returns Expectations - Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2015. Bank Rate forecasts for financial year ends (March) are:

- 2012/ 2013 0.50%
- 2013/ 2014 0.50%
- 2014/ 2015 0.50%
- 2015/ 2016 1.50%

There are downside risks to these forecasts (i.e. start of increases in Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if Bank of England inflation forecasts for two years ahead exceed the Bank of England's 2% target rate.

The suggested budgeted investment earnings rates for returns on investments during each financial year for the next four years are as follows:

- 2012/13 1.15%
- 2013/14 1.00%
- 2014/15 1.15%
- 2015/16 1.75%

Invesment Treasury Indicator and Limit - total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Council is asked to approve the treasury indicator and limit: -

Treasury Indicator & Limit	2013/14	2014/15	2015/16
Maximum Principal Sums Invested > 364 days	£2m	£2m	£2m

Treasury Management Limits on Activity

There are three debt related treasury activity limits which are:

- **The Authorised Limit for Borrowing** - the authorised limit is the "affordable borrowing limit" required by section 3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. Proposed limit of £13m for 2013/14 to 2015/16.

- **The Operational Boundary** – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached. Proposed limit of £3m for 2013/14 to 2015/16.

- **Maximum gross borrowing position** – this is the absolute value of borrowing excluding investment balances – Proposed limit £13m for 2013/14 to 2015/16.

6.7 Investment Risk & Security Benchmarking

These benchmarks are simple guides to maximum risk and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

Security - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:

- 0.01% historic risk of default when compared to the whole portfolio.

Liquidity – In respect of this area the Council seeks to maintain:

- Bank overdraft - £0.5m
- Liquid short term deposits of at least £2m available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.5years, with a maximum of 10 years for an individual loan with a public body.

Yield - Local measures of yield benchmark is (Performance Indicator):

- Investments – returns 0.12% above average bank rate.

Security of the investments – In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard and Poors). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy. The table beneath shows average defaults for differing periods of investment grade products for each Fitch/Moody's Standard and Poors long term rating category over the period 1990 to 2009.

Years	1	2	3	4	5
AAA	0.00%	0.01%	0.05%	0.10%	0.17%
AA	0.03%	0.06%	0.08%	0.14%	0.20%
A	0.08%	0.22%	0.37%	0.52%	0.70%
BBB	0.24%	0.68%	1.19%	1.79%	2.42%
BB	1.22%	3.24%	5.34%	7.31%	9.14%
B	4.06%	8.82%	12.72%	16.25%	19.16%
CCC	24.03%	31.91%	37.73%	41.54%	45.22%

The Council's minimum long term rating criteria is currently "AA", meaning the average expectation of default for a one year investment in a counterparty with an "AA" long term rating would be 0.03% of the total investment (e.g. for a £1m investment the average loss would be £300). This is only an average - any specific counterparty loss is likely to be higher - but these figures do act as a proxy benchmark for risk across the portfolio.

The Council's investments in rated institutions are all for periods of less than one year, so the average loss will be scaled down by the length of investment.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

- 0.01% historic risk of default when compared to the whole portfolio.

As the Council has no investment in rated institutions for more than 364 days, the security benchmark for more than one year is not applicable:

Security Benchmark	1 year	2 years	3 years	4 years	5 years
Maximum	**0.01%**	**N/A**	**N/A**	**N/A**	**N/A**

Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

6.8 Performance Indicators

The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. The performance indicators used by this Council for the treasury function is:

- Investments – returns 0.12% above average bank rate.

The results of this indicator will be reported in the Treasury Annual Report.

6.9 Reporting Requirments

End of Year Investment Report - At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Management Report.

Mid-year Investment Report - In the middle of the financial year, the Council will report on its investment activity as part of its Mid Year Treasury Management Report. In addition the Audit Committee will receive quarterly investment reports.

6.10 Policy on the Use of External Service Providers

The Council uses Sector as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the Council at all times and will ensure that undue reliance is not placed upon our external service providers. It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

6.11 Member and Officer Training

The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers. This Council has addressed this important issue by:

- Ensuring that officers attend suitable courses and seminars to keep their technical knowledge up to date;
- Keeping up to date with CIPFA publications on Treasury Management;
- Regular briefings both by e mail and face to face with the Council's consultants;
- Membership of the CIPFA Corporate Services Benchmarking Club for Treasury Management;
- Reports and briefing sessions to Members on major changes to Treasury policies and strategies.