Midlothian

Audit Committee
Tuesday 29 January 2013
Item No 7

Treasury Management and Investment Strategy 2013/14 & Prudential Indicators

Report by Gary Fairley, Head of Finance and Human Resources

1 Purpose of Report

The purpose of the report is to seek agreement to the Treasury Management and Annual Investment Strategies for 2013/14 and the Prudential and Treasury indicators contained therein.

2 Background

2.1 Treasury Management & Investment Strategy 2013/14

Treasury Management Code of Practice

The revised Treasury Management Code of Practice, updated by CIPFA in 2011, requires the Council to receive and approve, in advance of each financial year:-

- A Treasury Management Strategy (covering the capital plans and prudential indicators, and indicating how the borrowings and investments are to be organised for the forthcoming financial year in light of these plans/indicators);
- An Investment Strategy (the parameters on how investments are to be managed for the forthcoming financial year. Investment in each type of instrument must be approved by Council as “permitted” otherwise it will be deemed to be ultra vires).

A detailed document covering both the Treasury Management and Investment Strategies for financial year 2013/14 has been placed in the Members Library. The key points from this strategy are:-

Capital Financing Requirement (CFR)

The Council has an underlying need to borrow (the Capital Financing Requirement, CFR) over the period 2012/13-2015/16 as follows:-

	2011/12 Actual £000	2012/13 Estimate £000	2013/14 Estimate £000	2014/15 Estimate £000	2015/16 Estimate £000
Capital Expenditure					
General Services	21,037	36,140	28,034	15,991	12,425
HRA	25,343	22,069	12,367	13,448	18,078
Total	**46,380**	**58,209**	**40,401**	**29,439**	**30,503**
Financed by:					
Capital receipts	1,754	1,351	1,635	1,635	1,785
Capital grants	15,861	26,407	6,877	8,344	8,344
Reserves	520	0	0	0	0
Developer/Other Contributions	2,649	2,838	1,883	3,413	115
Available Financing	**20,784**	**30,596**	**10,395**	**13,392**	**10,244**
Capital Expenditure less available financing	**25,596**	**27,613**	**30,006**	**16,047**	**20,259**
Principal debt repayments	-7,036	-6,722	-6,967	-7,273	-7,381
Underlying need to borrow	**18,560**	**20,891**	**23,039**	**8,775**	**12,878**
Expected Change in Gross Debt	**37,521**	**17,599**	**21,173**	**8,276**	**12,874**

Borrowing Strategy

The Council is currently maintaining an under-borrowed (internally-borrowed) position of c. £1.5 million. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as some of the cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are generally low and counterparty risk is relatively high.

The Council has also sought to take advantage of the historically low PWLB rates by borrowing to finance the current and future year's CFR, thereby reducing the Council's internal borrowing position and at the same time allowing the Council to cash-back the reserves on its balance sheet through deposits with high credit-worthy and part-nationalised banks.

It is expected that throughout the majority of 2013/14, temporary borrowing from the money markets or other local authorities will remain at historically low levels of below bank base rate (i.e. sub-0.50%), whilst new long term PWLB borrowing sits at somewhere between 3.5%-4.1%. If rates remain at these levels, utilisation of temporary borrowing within the Council's overall loan portfolio would continue to provide the most cost-effective solution to the Council.

However, this will be viewed against the backdrop of potential long term costs if the opportunity is missed to take PWLB loans at historically low medium-long term rates, particularly given the projected gradual rise in PWLB rates from late 2013/14 onwards (quarter ending March 2014). It should therefore be advantageous to time new borrowing around the middle of the year.

Any borrowing undertaken in advance of need will be supported by a business case which will appraise the anticipated savings in borrowing costs (from expected increases in rates later in the year / in forthcoming years) against the carrying cost associated with borrowing in advance of need.

Investment Strategy/Instruments

The Scottish Government Investment Regulations make use of many different types of treasury investment instruments available to the Council, and the recommended list of instruments for approval by Council is included in the detailed strategy and reported in Appendix 1.

In the unlikely event that any other type of treasury investment is thought to be advantageous this will be reported to Council for approval before any commitment is made.

The Council has previously set limits on the total amount of investments it can make with its approved list of counterparties, and it is proposed to retain these at their current levels.

Borrowing in advance of need will temporarily increase the Council's available cash balances, and consideration will be given to the most advantageous counterparty and term to invest these surplus monies with, while ensuring the Council's priorities of security and liquidity of these funds is upheld.

2.2 Prudential Indicators

Prudential Code for Capital Finance in Local Authorities

The Prudential Code for Capital Finance in Local Authorities came into force on 1 April 2004, and was developed to support local authorities in taking decisions relating to their Capital Plans for investment in fixed assets.

The key objectives of the Code are to ensure that:-

- Capital Plans are affordable, prudent and sustainable, taking into account the financial provisions made in current and future Revenue Budgets; and
- Treasury Management decisions are taken in accordance with good practice.

To demonstrate that Local Authorities have fulfilled these objectives, the Prudential Code sets out Prudential Indicators that must be used together with the factors that must be taken into account. They are designed to support and record local decision making in a manner that is publicly accountable.

The Code stipulates that it is for the Local Authority, rather than the Code itself, to set appropriate limits which will ensure that the Capital Plans are prudent, affordable and sustainable. These must be set by the same body that approves the Council's budget, prior to the beginning of the forthcoming financial year.

The required Prudential Indicators relate to both actual, historic outcomes, and future estimated outcomes (covering the same period as the Council's Capital Plans), as follows:-

- Original indicators and actual outcomes for 2011/12;
- Revised estimates of the 2012/13 indicators; and
- Estimates of indicators for 2013/14 to 2015/16.

The Prudential Indicators required by the Code are listed individually in Appendix 2.

3 Report Implications

Resource

There are no direct resource implications arising from this report.

Risk

The strategies outlined in this report are designed to improve the overall risk management of Treasury activity. Providing the limits outlined in the strategies are observed they will enhance the controls already in place in the Treasury Management Policy and the Treasury Management Practices within which the treasury function operates.

The Prudential Indicators contained in Appendix 2 improve the overall risk management of Capital Investment and Treasury Management.

Policy

Strategy

The strategies to be adopted become an integral part of the corporate aim to achieve Best Value as it seeks to minimise the net cost of borrowing by exercising prudent debt management and investment. This in turn helps to ensure that the Council's capital expenditure is sustainable in revenue terms.

Consultation

Although no external consultation has taken place cognisance has been taken of professional advice obtained from Sector, the Council's appointed Treasury Consultants.

Equalities

There are no equality issues arising from this report.

Sustainability

There are no sustainability issues arising from this report.

4 Summary

The Scottish Government, on 1 April 2010, approved new Investment Regulations, and CIPFA, in 2011, updated the Treasury Management Code of Practice and the Prudential Code for Capital Finance in Local Authorities.

The Treasury Management and Investment Strategies have been formulated to comply with the revised Codes and Regulations and provide the framework for achieving best value in the management of the Council's borrowing and investment portfolios.

5 Recommendations

It is recommended that Committee

a) Note the current regulatory regime applicable to Treasury Management & Capital Finance;
b) Approve the Treasury Management and Investment Strategy for the 2013/14 financial year, as summarised in Section 2.1 of this report and as detailed in the in-depth main report that has been placed in the Member's Library;
c) Approve the investment instruments outlined in Appendix 1;
d) Adopt the Prudential Indicators contained in Appendix 2 of this report;
e) Grant permission for total borrowing to be taken up to the Capital Financing Requirement for 2015/16 if market conditions indicate that this is prudent.

Date:- 17 January 2013

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Permitted Investments **Appendix 1**

The Council uses the Sector creditworthiness service. This utilises credit ratings from the three main credit rating agencies – Fitch, Moody's and Standard & Poors, along with credit watches, outlooks, CDS spreads and country sovereign ratings in a weighted scoring system with an end product of a series of colour coded bands which indicate the relative creditworthiness of counterparties for investment.

These colour codes are used by the Council to determine the maximum suggested duration for investment with that counterparty. These are as follows:-

Sector Colour Code	**Maximum Suggested Duration for Investment**
Yellow	5 years
Purple	2 years
Blue	1 year*
Orange	1 year
Red	6 months
Green	3 months
No colour	Not to be used

** Only applies to nationalised or semi-nationalised UK banks*

1.1 Deposits

	Minimum Credit Criteria	**Liquidity risk**	**Market risk**	**Max % of total investments**	**Max. maturity period**
Debt Management Agency Deposit Facility	--	Term	No	**Unlimited**	**6 months**
Term deposits – local authorities	--	Term	No	**Unlimited**	**2 years**
Call accounts – banks and building societies	Green	Instant	No	**100%**	**100-day**
Term deposits – banks and building societies	Orange	Term	No	**50%**	**2 years**
Fixed term deposits with variable rate and variable maturities: -Structured deposits	Orange	Term	No	**50%**	**2 years**

1.2 Deposits with counterparties currently in receipt of government support / ownership

	Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
UK nationalised banks – Call accounts	Blue	Instant	No	**100%**	**100-day**
UK nationalised banks – Term Deposits	Blue	Term	No	**100%**	**2 years**
UK nationalised banks – Fixed term deposits with variable rate and variable maturities: -Structured deposits	Blue	Term	No	**100%**	**2 years**
Non-UK(high sovereign rated country) nationalised banks – Call accounts	Green	Instant	No	**100%**	**100-day**
Non-UK (high sovereign rated country) nationalised banks:- Term Deposits	Orange	Term	No	**50%**	**1 year**
Non-UK (high sovereign rated country) nationalised banks:- Fixed term deposits with variable rate and variable maturities: -Structured deposits	Orange	Term	No	**50%**	**1 year**

1.3 Collective investment schemes structured as Open Ended Investment Companies (OEICs)

	Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
1. Government Liquidity Funds	AAA	instant	No	**50%**	**1 day**
2. Money Market Funds	AAA	instant	No	**50%**	**1 day**

1.4 Other

	Minimum Credit Criteria	Liquidity risk	Market risk	Max % of total investments	Max. maturity period
Local authority mortgage guarantee scheme.	Blue	Term	No	**50%**	**5 years**

1. Prudential Indicators for Affordability

1.1 Estimates of Ratio of Financing Costs to Net Revenue Stream

This indicator measures the proportion of available funds required to support current and planned future capital investment.

	2011/12 Indicator	2011/12 Actual	2012/13 Indicator	2013/14 Indicator	2014/15 Indicator	2015/16 Indicator
General Services	4.73%	4.55%	4.02%	4.66%	4.96%	4.89%
HRA	30.95%	30.29%	29.18%	35.24%	37.69%	38.80%

1.2 Estimates of the Incremental Impact of Investment Decisions on Council Tax and Rents

This indicator shows the change in Council Tax and Rents necessary to support increased spending on the capital account year on year. This is achieved by taking the difference between the capital plan used to calculate last years' prudential indicators and the current capital plan. The loan charges on that difference are then expressed as the change to Council Tax or Rents which would be necessary to support those charges.

	2011/12 Indicator	2011/12 Actual	2012/13 Indicator	2013/14 Indicator	2014/15 Indicator	2015/16 Indicator
Council Tax	-£2.33	-£6.97	-£9.64	£9.09	£22.44	£14.06
HRA Rents	£0.19	-£0.27	-£0.51	-£0.09	-£0.25	£0.95

These figures are based on the latest Capital Plans presented to Council and reflect the current spending plans on HRA and General Fund.

2. Prudential Indicators for Capital Expenditure

2.1 Estimated Capital Expenditure to be financed by new borrowing

This indicator shows the gross capital spend included in the relevant capital plans that is required to be financed by new borrowing.

Financing of Capital Expenditure					
	2011/12	**2012/13**	**2013/14**	**2014/15**	**2015/16**
	Actual	**Estimate**	**Estimate**	**Estimate**	**Estimate**
	£000's	**£000's**	**£000's**	**£000's**	**£000's**
Capital Expenditure					
General Services	£21,037	£36,140	£28,034	£15,991	£12,425
HRA	£25,343	£22,069	£12,367	£13,448	£18,078
Total	**£46,380**	**£58,209**	**£40,401**	**£29,439**	**£30,503**
Financed by:					
Capital receipts	£ 1,754	£ 1,351	£ 1,635	£ 1,635	£ 1,785
Capital grants	£15,861	£26,407	£ 6,877	£ 8,344	£ 8,344
Capital reserves	£ 520	£ -	£ -	£ -	£ -
Developer/Other Contributions	£ 2,649	£ 2,838	£ 1,883	£ 3,413	£ 115
Net financing need for the year	**£25,596**	**£27,613**	**£30,006**	**£16,047**	**£20,259**

2.2 Estimated Capital Financing Requirement

This indicator measures the Council's maximum underlying need to borrow for capital purposes and other long term liabilities over the next three years.

Capital Financing Requirement (CFR)					
	2011/12	2012/13	2013/14	2014/15	2015/16
	Actual	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's
Capital Financing Requirement					
CFR – General Services	£100,849	£108,395	£124,099	£124,099	£124,099
CFR – HRA	£125,447	£138,792	£146,127	£154,902	£167,780
CFR – PFI Schemes	£ 59,306	£ 58,340	£ 57,300	£ 56,180	£ 54,972
Total CFR	**£285,602**	**£305,527**	**£327,526**	**£335,181**	**£346,851**
Movement in CFR	**£ 17,663**	**£ 19,925**	**£ 21,999**	**£ 7,655**	**£ 11,670**
Movement in CFR represented by					
Net financing need for the year (previous table)	£ 25,596	£ 27,613	£ 30,006	£ 16,047	£ 20,259
Less Scheduled Debt Amortisation	£ 7,036	£ 6,722	£ 6,967	£ 7,273	£ 7,381
Less PFI Finance Lease Principal Payments	£ 897	£ 966	£ 1,040	£ 1,120	£ 1,208
Movement in CFR	**£ 17,663**	**£ 19,925**	**£ 21,999**	**£ 7,654**	**£ 11,670**

3. Prudential Indicators for Prudence

3.1 Net Borrowing Requirement

This indicator shows the amount of external borrowing required to finance the current debt outstanding on capital projects.

Net Borrowing Requirement					
	2011/12	2012/13	2013/14	2014/15	2015/16
	Actual	Estimate	Estimate	Estimate	Estimate
	£000's	£000's	£000's	£000's	£000's
External Debt					
Debt at 1 April	£187,280	£224,801	£242,400	£263,573	£271,849
Actual/Expected change in Debt	£ 37,521	£ 17,599	£ 21,173	£ 8,276	£ 12,874
Other long-term liabilities (OLTL)	£ 60,204	£ 59,307	£ 58,370	£ 57,300	£ 56,180
Actual/Expected change in OLTL	£ (897)	£ (937)	£ (1,070)	£ (1,120)	£ (1,208)
Actual/Expected Gross Debt at 31 March	**£284,108**	**£300,770**	**£320,873**	**£328,029**	**£339,695**
The Capital Financing Requirement	**£285,602**	**£305,527**	**£327,526**	**£335,181**	**£346,851**
Under / (over) borrowing	**£ 1,494**	**£ 4,757**	**£ 6,653**	**£ 7,152**	**£ 7,156**

4. Prudential Indicators for External Debt

4.1 Authorised Limit of Total External Debt

This indicator sets the limit for total external debt.

In an active Treasury Management policy it is sometimes prudent to borrow in advance of need if interest rates are expected to rise. Given that in order to continue to service the ongoing external debt and finance the current capital programmes the Council needs to increase its borrowing to £291.9m by 31 March 2016, it is recommended that rather than restrict total borrowing to £247.2m in 2012/13, £270.2m in 2013/14 and £279.0m in 2014/15, permission is granted to borrow up to the 2015/16 authorised limit of £291.9m, in the interim, if market conditions support this action.

Adopting this approach will secure lower costs for future years but care will be taken to ensure that the cost of carry is minimised and that the maturity structure of all debt is sufficiently robust to ensure that the Capital Financing Requirement at 31 March 2016 remains achievable.

Authorised Limit				
	2012/13	**2013/14**	**2014/15**	**2015/16**
	Estimate	**Estimate**	**Estimate**	**Estimate**
Authorised Limit - Borrowing	£291,879	£291,879	£291,879	£291,879
Authorised Limit - Other long term liabilities	£ 58,340	£ 57,300	£ 56,180	£ 54,972
Total Debt	**£350,219**	**£349,179**	**£348,059**	**£346,851**

4.2 Operational Boundary

This indicator will be the focus of day to day treasury management to ensure that external borrowing remains within the authorised limit set out above. For borrowing, this is set to be 95% of the Authorised Limit. For Other Long-Term Liabilities, this is set to be 100% of the Authorised Limit given the long-term PPP commitment to finance these assets.

Operational Boundary				
	2012/13	**2013/14**	**2014/15**	**2015/16**
	Estimate	**Estimate**	**Estimate**	**Estimate**
Operational Boundary - Borrowing	£277,285	£277,285	£277,285	£277,285
Operational Boundary - Other long term liabilities	£ 58,340	£ 57,300	£ 56,180	£ 54,972
Total	**£335,625**	**£334,585**	**£333,465**	**£332,257**

5. Prudential Indicators for Treasury Management

5.1 Adoption of the CIPFA Treasury Management Code of Practice

The adoption of CIPFA's *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes* is an indication of a clear, integrated and prudent approach to Treasury Management.

5.2 Upper limits on Fixed and Variable Interest Rates

This indicator limits the amount of external debt that may be held at fixed or variable rates. These limits are proposed to be as follows:-

Upper Limits on Exposure to Fixed and Variable Interest Rates 2013/14	
Interest rate exposures	**Upper Limit**
Limits on fixed interest rates based on gross debt	100.00%
Limits on variable interest rates based on gross debt	30.00%
Limits on fixed interest rates based on investments	100.00%
Limits on variable interest rates based on investments	100.00%

5.3 Maturity Structure of Borrowing

This indicator sets the upper and lower limits of the time scales within which external debt may be held.

The Treasury Management Code now requires that LOBO's with a call date in the next 12 months are classified as short-term borrowing rather than longer-term (10 year+) borrowing.

In addition, the Code also recommends that where an authority's debt is typically very long term (i.e. for a period of greater than 10 years), that authorities should break down the period in excess of 10 years into several ranges, for example 10 to 20 years, 20 to 30 years, etc.

With the above in mind, the proposed upper and lower limits for each maturity band are shown below, with the overall aim to ensure a spreading approach to avoid a cluster of high value loans maturing/requiring refinancing within a short period of time.

Maturity structure of borrowing 2013/14		
Maturity structure of fixed interest rate borrowing 2013/14	**Lower**	**Upper**
Under 12 months	0.00%	50.00%
12 months to 2 years	0.00%	40.00%
2 years to 5 years	0.00%	40.00%
5 years to 10 years	0.00%	40.00%
10 years to 20 years	0.00%	50.00%
20 years to 30 years	0.00%	50.00%
30 years to 40 years	0.00%	50.00%
40 years to 50 years	0.00%	50.00%
50 years and above	0.00%	50.00%
Maturity structure of variable interest rate borrowing 2013/14	**Lower**	**Upper**
Under 12 months	0.00%	30.00%
12 months to 2 years	0.00%	30.00%
2 years to 5 years	0.00%	30.00%
5 years to 10 years	0.00%	30.00%
10 years to 20 years	0.00%	30.00%
20 years to 30 years	0.00%	30.00%
30 years to 40 years	0.00%	30.00%
40 years to 50 years	0.00%	30.00%
50 years and above	0.00%	30.00%

5.4 Total Principal Sums Invested for Periods Longer than 364 Days

This indicator relates to the total level of investments held for periods longer than 364 days.

Principal Sums Invested for > 364 Days			
Limit			£30m