COMMISSIONERS MONITORING BOARD **AGENDA ITEM NO: 3a**

16 March 2015

TREASURY MANAGEMENT STRATEGY 2015-16

Purpose of the Report

1. This report discusses and asks the Commissioner to approve:

   a) The proposed Prudential (PrIs) and Treasury (TrIs) Indicators for the next three years (Appendix A);

   b) The proposed Annual Investment Strategy for 2015-16, which incorporates changes to the minimum requirements for high credit quality, to move to the Capita credit list, without the adjustments adopted in the 2013-14, (Appendix B); and

   c) Other Treasury management decisions required for 2015-16 that do not form part of the PrIs/TrIs (paragraphs 16 to 20 below).

Background

2. Prior to the start of each financial year, the Commissioner has to consider and approve a Treasury Management Strategy (TMS), which incorporates the Prudential and Treasury Indicators and an Annual Investment Strategy. This is required under the provisions of the latest CIPFA Code of Practice on Treasury Management in the Public Services (the CIPFA Code) and the Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

3. However, before looking at the TMS for 2015-16, I need to review the current year's treasury management activity and estimate the cash position at 31 March 2015.

Treasury Management Strategy - Review of 2014-15

4. A detailed analysis of the 2014-15 activities will be made in the Annual Treasury Report to be submitted to the Commissioner in June, but a brief review needs to be made to forecast the position at the end of 2014-15.

5. In January 2015 the Commissioner was informed of a revised forecast cash flow surplus for the year of £1.7 million. The latest cash flow forecast reflects the budget underspend with a surplus of £1.7 million currently forecast.

6. Surplus invested funds at the end of January 2015 stood at £26.5 million, invested in the market and £3.4 million in an instant access call account. At this date £11.5m was invested in longer term deposits (for up to 6 months) with the remainder of the £26.5 million in temporary deposits (3 months or less). This money is being invested directly by our local treasury managers (Wiltshire Council) in short-term, approved investments or overnight as HSBC deposits. An analysis of the annual return will be given in the Annual Treasury Report in June 2015 but performance to 31 January 2015 is shown in paragraph 20.

Main Considerations for the Commissioner – Treasury Management Strategy

Prudential and Treasury Indicators

7. The Prudential and Treasury Indicators are of a somewhat theoretical interest, because of our debt-free status. Nevertheless, they do still have to be calculated and formally approved.

8. Issues of affordability, prudence and sustainability of borrowing are of limited relevance when the PCC is debt-free. However, the PrIs/TrIs for borrowing limits, interest rate exposures and maturity structures still have to be considered because short-term borrowing may be necessary to cover in-year cash flow deficits. We will only have to consider the more fundamental issues of affordability, prudence and sustainability in detail if the PCC were to decide to borrow.

9. Our debt-free nature does not exempt the PCC from non-debt related responsibilities under the Prudential Code - to ensure value for money (robust option appraisal) and practicality of capital investment, proper stewardship of assets (asset management planning) and sound links to service objectives.

10. The proposed PrIs and TrIs are set out in Appendix A, together with a brief summary on each one.

11. The PCC is still required to continue to comply with the CIPFA Code and the Investment Guidance in respect of the treasury management carried out by Wiltshire Council on its behalf. This principally involves the setting of the Investment Strategy for the year to be followed by Wiltshire Council in overseeing the management of surplus cash.

12. The proposed Investment Strategy for 2015-16, which incorporates changes to the minimum requirements for high credit quality, is set out in Appendix B.

13. Due to the low returns being made, I have, in liaison with Wiltshire Council, looked at the credit list, with a view to identifying a way of increasing returns whilst managing the risk and maintaining the security and liquidity of investments.

14. Opportunities are slim, however, by moving to the Capita credit list without adjustment, rather than the adjusted list, the number of available banks and building societies is increased by 100% (from 17 to 34) as a result of expanding the list now.

15. Whilst, currently, this may not produce better returns immediately, it will provide opportunities in the future to consider wider options than are presently available.

Operating leases

16. Although there will not be restrictions on capital expenditure approvals, the strategy needs to allow for the possible use of operating leases to finance certain items of a capital nature, notably vehicles and computer hardware. A sum of £0.5 million is suggested.

Cash Deficits and Surpluses

Short Term Deficits and Surpluses

17. Short term cash surpluses and deficits will arise regularly during the year. It is anticipated that the majority of these surpluses will only be available on a very temporary basis. Short term deposits are the most cost effective investment for such

cash surpluses. Therefore, investments will normally be made through short term deposits at fixed rates to specific dates, with reference to the cash flow requirements.

18. Temporary loans (where both the borrower and lender have the option to redeem the loan within twelve months) are occasionally used to cover short term revenue cash deficits, where this is more cost effective than temporarily withdrawing funds from call accounts, pending the receipt of, for example, grant income.

19. I therefore recommend that the PCC continues to utilise temporary loans and deposits to manage these cash flows.

Longer Term Cash Balances

20. The longer term balances are managed by Wiltshire Council and are currently held, partly in longer term (above three and up to 6 months) investments and partly in call accounts. The annualised weighted average return of these long term investments (only) is currently 0.73%. A comparative benchmark, (the three month London Interbank Bid Rate LIBID), reflecting the rate at which a bank is willing to borrow from other banks, is currently 0.43%).

Investment Risk

21. Appendix B identifies the PCC's current approach to investing any surpluses. The strategy is based on high credit quality using the credit list provided by Capita, which includes a credit default swap analysis that effectively provides an early indication of the likelihood that a bank's credit rating will be changed. This should keep any short term investments we have as safe as they could possibly be, even though interest rates may be marginally less attractive.

'Bail-in'

22. By removing the adjustments to the Capita credit list, the proposed Investment Strategy (Appendix B and discussed above) will also be geared up for the likely rating changes due to 'bail-in' regulations. Ratings (set by the rating agencies) currently include a number of 'notches' introduced following the 2008 "credit crunch", which may be removed by the rating agencies before January 2016 when bail-in measures are finally enacted. (When a 'bail in' takes place the interests of the bank's existing (i.e. prior to the failure) shareholders are cancelled, diluted or transferred and the claims of unsecured creditors (e.g. depositors) are written down by an amount sufficient to absorb the losses incurred. The amounts by which deposits are written down are then converted into equity in order to recapitalise the bank and allow it to continue operating.)

23. Credit rating agencies have indicated that, as a result of the impending bail-in measures, they may remove "uplifts" due to implied sovereign support, provided to institutions through much of the financial crisis, in response to this evolving regulatory regime. The actual timing and effects of the changes is still under discussion. However, indications from Fitch are that the removal of these "uplifts" could result in their standalone viability rating becoming redundant and they are considering the effect on all current support ratings of 1 to 5 (1 being the highest), with a view to lowering them all to 5, making it all but redundant also. This would mean that the current adjustments to the Capita credit list for these areas will no longer be viable and would, when implemented, require a change to the current strategy anyway.

24. **It is important to stress that the rating agency changes being considered do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of sovereign support that has been built into ratings during the financial crisis.**

Monitoring and Reporting of the Prudential Indicators

25. Wiltshire Council staff and the finance staff of the PCC will monitor progress against the PrIs/TrIs throughout the year. The PCC will be kept informed of any issues that arise, including potential or actual breaches, as these could be ultra-vires. I will normally update the PCC every six months in the Interim and Annual Treasury Reports.

Collaboration

26. The Treasury Management function is outsourced to Wiltshire Council. Using their skills and contacts with market experts it is believed that value for money is achieved alongside good returns.

Diversity

27. No diversity issues have been identified

Recommendations

28. The Commissioner is asked to:

   a) adopt the Prudential and Treasury Indicators set out in Appendix A;

   b) adopt the Investment Strategy set out in Appendix B, with specific note of the proposed changes to the minimum requirements for high credit quality as discussed in paragraphs 12 to 15;

   c) agree that operating leases of up to £0.5 million can be used to assist in financing the PCC's 2015-16 capital plans where necessary;

   d) agree that short term cash deficits and surpluses continue to be managed through temporary loans and deposits (paragraph 17 to 20); and

   e) agree that, for longer term cash balances, the Chief Finance Officer continues to be delegated to negotiate the terms and conditions of any external arrangement.

Clive Barker
Chief Finance Officer to the PCC

PRUDENTIAL (PrIs) AND TREASURY (TrIs) INDICATORS 2015-16 TO 2017-18

Prudential Indicators

PrI 1 - Capital Expenditure

1. The capital expenditure plans are set out in the Capital Programme report elsewhere on this agenda, but under the Prudential Code, the Authority is required to confirm this as a Prudential Indicator. Capital expenditure for the years 2013-14 to 2017-18 is as follows:

	2013-14 Actual	2014-15 Est Outturn	2015-16	2016-17	2017-18
Capital Expenditure	£4.1m	£4.8m	£10.5m	£5.4m	£3.2m

PrI 2 – Ratio of Financing Costs to Net Revenue Stream

2. PrI 2 expresses the net costs of financing as a percentage of the funding receivable from the Government and council tax payers. The net cost of financing includes interest and principal repayments for long and short term borrowing, as well as other credit-like arrangements, netted off by interest receivable in respect of cash investments. The PrI does not include the revenue contribution to capital expenditure.

3. Of these costs, only interest receivable is at all significant for this Authority (being debt-free) and this means that the resulting PrI is negative.

	2013-14 Actual	2014-15 Est Outturn	2015-16	2016-17	2017-18
Ratio of Financing Costs to Net Revenue Stream	-0.3%	-0.2%	-0.2%	-0.3%	-0.3%

PrI 3 – Estimate of Incremental Impact of Capital Expenditure Decisions on the Council Tax

4. This PrI shows the incremental impact of the capital investment decisions now proposed in these budget reports on the Council Tax, compared to the estimates disclosed in previous years. Each year a four year capital programme is drawn up. This shows in detail plans for expenditure in the forthcoming year. Future years are more of a skeleton programme and will increase when information is available. The impact this has on the PrI is that there is always likely to be a higher effect in the forthcoming year. This calculation is a notional figure due to the use of capital receipts, grants, etc to fund the programme. Negative indicators occur when capital expenditure reduces from the previous year.

	2015-16	2016-17	2017-18
Effect on Band D Council Tax	£9.01	-£8.43	-£3.74

PrI 4 – Gross Borrowing to Capital Financing Requirement

5. PrI 4 measures the so-called "Golden Rule" and focuses on prudence.

6. The Capital Financing Requirement normally increases year-on-year by the amount of capital expenditure that is not funded from sources other than borrowing (i.e. government capital grant, capital receipts, developer contributions, direct revenue), reduced by the amount set-aside from the revenue budget and

capital receipts for the repayment of debt. Gross Borrowing is the PCC's long and short term external debt.

	2013-14 Actual	2014-15 Est Outturn	2015-16	2016-17	2017-18
Capital Financing Requirement	£0.0m	£0.0m	£0.0m	£0.0m	£0.0m
Gross Borrowing	£0.0m	£0.0m	£0.0m	£0.0m	£0.0m
Unused Capital Financing Requirement	**£0.0m**	**£0.0m**	**£0.0m**	**£0.0m**	**£0.0m**

7. Because this PCC's entire capital programme is funded by cash sources (grants, capital receipts, direct revenue), there is no Capital Financing Requirement and because the PCC is debt free there is also no Gross Borrowing.

<u>PrI 5 – Compliance with CIPFA Code of Practice for Treasury Management in the Public Services</u>

8. This PrI simply confirms compliance with the Code of Practice.

The PCC is and will continue to be fully compliant with the latest CIPFA Code of Practice for Treasury Management in the Public Services.

<u>Treasury Management Indicators within the Prudential Code</u>

<u>TrI 1 – External debt</u>

9. Under the Prudential Code, three limits must be set by the PCC for External Debt:
    a) Actuals for last year and an estimate for the end of the current year
    b) An Operational limit for the next three years
    c) An Authorised limit for the next three years.

10. The Operational limit is based on the most likely, prudent, but not worst case scenario of borrowing. The Authorised limit is based on the Operational limit but with an additional margin (in the PCC's case 15% has been used) to allow for unusual or unexpected cash movements. These borrowing limits are to be set gross of investments.

<u>Actuals</u>	31/3/14 Actual	31/3/15 Expected
Borrowing	£0.0m	£0.0m
Other Long Term Liabilities	£0.0m	£0.0m
TOTAL	**£0.0m**	**£0.0m**

11. The PCC has managed to operate on a debt free basis to date and it is anticipated that it can remain in this position throughout the period 2015 to 2018. In these circumstances, the PCC will finance its capital requirement from capital grant, capital receipts, the capital reserve, and direct from revenue.

12. The PCC holds these surplus monies in approved investments in sufficient levels to finance its annual cash flow forecasts for the three years and thus allow it to remain debt free. However, during each year there are fluctuations in cash flow,

the highest deficits are forecast as approximately £5.0 million (2015-16), £5.5 million (2016-17), and £6.0 million (2017-18). There may also be a need to pay out capital expenditure prior to receipt of capital income, although previous experience shows that this is unlikely.

13. Invested cash could be reduced to cover these temporary deficits but this may not be the most cost effective approach for the PCC. Limits for temporary borrowing are therefore proposed, to allow flexibility to use borrowing as an alternative way of financing such temporary deficits, if this is in the PCC's best interest. So, whilst the PCC will remain debt free, the following limits should be authorised to deal with possible in-year cash flow shortfalls.

Operational Limit	**2015-16**	**2016-17**	**2017-18**
Annual gross Borrowing	£0.0m	£0.0m	£0.0m
Temporary borrowing	£5.0m	£5.5m	£6.0m
Total Operational limit	£5.0m	£5.5m	£6.0m

Authorised Limit	**2015-16**	**2016-17**	**2017-18**
Annual gross Borrowing	£0.0m	£0.0m	£0.0m
Temporary borrowing	£5.8m	£6.3m	£6.9m
Total Authorised limit	£5.8m	£6.3m	£6.9m

Treasury Management Indicators within the Treasury Management Code

TrI 2 – Interest Rate Exposures

14. This TrI relates to net borrowing (i.e. borrowing less investments). As the PCC will have no long term borrowing there is no risk to borrowing costs of a change in interest rates. However it does partly rely on returns from invested funds in order to finance revenue and capital expenditure.

15. Future returns will be affected by inflation and the Bank of England's decisions on interest rates. Capita Asset Service's current predictions indicate that the Bank Rate is likely to remain at 0.50% until the first quarter of 2016, when they anticipate it will increase by 0.25%, to 0.75%. The rate is then predicted to remain at 0.75% in the second quarter of 2016, rising further to 1.25% by the end of 2016 and to 1.75% by the end of the fourth quarter of 2017. It is expected to rise to 2% by the end of the first quarter of 2018. At the moment there is no clear indication of when the Bank of England will start tightening policy by raising rates, however, the first rate rise could be delayed further into 2016, depending on the impact of certain issues, such as inflation rates, geo-political risks and Eurozone sovereign debt issues. Although, when rates do start to rise, the Bank of England has stated that rises will be gradual. It is impossible to guarantee the returns based on these factors. Reflecting the low returns in 2014-15 the PCC's expected budgets in 2015-16 mainly set on a return of 0.8%.

16. All funds are internally managed and returns will be maximised whichever way interest rates move. The control of the investments is subject to the approved Annual Investment Strategy and the limits set in this TrI.

17. Any temporary borrowing, as authorised in TrI 1 above, should be taken on a fixed interest rate, as the period of any loan is likely to be only a maximum of a few days. Investments on HSBC Bank Treasury and other financial institutions should also be taken at fixed interest rates.

The PCC's upper limit for fixed interest rate exposure for the period 2015-16 to 2017-18 is 100% of net outstanding principal sums.

The PCC's upper limit for variable interest rate exposure for the period 2015-16 to 2017-18 is 0% of net outstanding principal sums.

TrI 3 – Maturity Structure of Borrowing

While the PCC remains debt free there will be no maturity profile.

TrI 4 – Total Principal Sums invested for periods longer than 364 days

18. This TrI is covered by the Annual Investment Strategy, which is detailed in the following appendix.

INVESTMENT STRATEGY FOR 2015-16

1. The PCC will have regard to the Department for Communities and Local Government's (DCLG's) Guidance on Local Government Investments ("the Guidance") issued in March 2004, any revisions to that guidance, the Audit Commission's report on Icelandic investments and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The general investment policy of the PCC will be the prudent investment of its surplus cash balances, priorities being:
   a) the security of capital and
   b) the liquidity of its investments.

2. Only in so far as is consistent with the priority of security and liquidity, the PCC will aim to achieve the optimum return on its investments.

3. The PCC will not borrow monies purely to invest or lend-on and make a return.

4. All investments of the PCC will be in sterling, as it does not wish to hold investments that are subject to foreign exchange rate risks.

5. All investments made other than those through an External Cash Investment Manager (where applicable – currently no PCC funds are managed by an External Cash Investment Manager) or certain investments placed with local authorities and other public bodies, subject to professional advice will be Specified Investments, as prescribed in the DCLG's Guidance on Local Government Investments (the "Guidance").

6. The investments identified in 5. above are the only non specified investments authorised for use and will only be:

   a) in Sterling;
   b) for investments in excess of 12 months, limited to £10 million; and
   c) not invested for a period exceeding five years.

7. Credit ratings will be monitored on a weekly basis, by the PCC's treasury management providers (Wiltshire Council). The Council uses the creditworthiness service provided by Capita Asset Services. This service is based on a sophisticated modelling approach, with credit ratings from all three rating agencies (Fitch, Moody's and Standard and Poor's), forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays:

   a) credit watches and credit outlooks from credit rating agencies;
   b) CDS spreads to give early warning of likely changes in credit ratings; and
   c) sovereign ratings to select counterparties from only the most creditworthy countries.

"High Credit Quality" Policy

In accordance with DCLG Guidance on Local Government Investments for selecting the creditworthiness of counterparties with whom investments are placed, the Police and Crime Commissioner will comply with the minimum requirements below.

All banks and building societies must be part of the credit list provided by Capita. The PCC will only invest with institutions on the list for the durations as specified by the colour coding used by Capita and they must not be shown as out of range (with no colour) on the credit default swap analysis.

All Local Authorities and public bodies (ratings are not issued for most of these bodies).

Money Market Funds (MMF), must have been awarded the highest possible rating (AAA) from at least one of the credit rating agencies, Standard and Poor's, Moody's Investor Services Ltd and Fitch Ratings Ltd. (Deposits will only be placed with MMFs subject to individual signed management agreements.)

Limits are applied to the amount of money that can be lent to any of these institutions or groups of institutions using the ratings of Fitch Rating Agency as follows:

<u>£8 million</u>
UK incorporated banks with a short term credit rating of at least F1+ and a long term credit rating of at least AA

Overseas banks that have a long term credit rating of at least AA+

Local Authorities and other public bodies

<u>£5 million</u>
Other UK Incorporated banks

Other overseas banks

Building Societies

Money Market Funds