Title: **Treasury Management Strategy 2012/13 (incorporating the Annual Investment Strategy 2012/13 and the Annual Minimum Revenue Provision Statement)**

Wards Affected: **All Wards in Torbay**

To:	**Audit Committee** **Council**	On:	**18 January 2012** **1 February 2012**

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1. Key points and Summary

1.1 The overall objectives of the Treasury Management Strategy are:

- To ensure sufficient funding is available for day-to-day activities and capital projects through effective cash flow management
- To seek to reduce the impact on the revenue account of net interest costs through optimal levels of borrowing and investment levels
- To prioritise control of risks in investing cash and to then achieve maximum returns from those investments commensurate with proper levels of security and liquidity.

1.2 Following significant changes to the Capital Investment Plan the current level of borrowing (£153M) is currently surplus to capital financing requirements over the medium term. As a result the proposed borrowing strategy is to reduce the level of external borrowing over the next four years by a minimum target of £20 million to realign funding levels with the revised Capital Investment Plan and projected Capital Financing Requirement.

1.3 The current low interest rate environment creates high penalty costs for repaying loans and forecasts indicate this position will continue through the next financial year giving little opportunity to carry out the strategy in para 1.2 during 2012/13.

1.4 However, economic and market conditions are highly volatile and extremely difficult to predict and repayments of borrowing will be implemented as soon as favourable conditions arise.

1.5 Further reductions in the level of borrowing, potentially up to a total £40 million, will also form part of this Strategy to reflect the effect of current interest rate conditions on the revenue budget. Any such repayment will depend on an assessment of market conditions, anticipated cash flow, the Capital Investment Plan and associated borrowing requirement going forward.

1.6 The Annual Investment Strategy incorporates robust processes for managing credit risk which will be appropriate for varying levels of cash balances arising from this Strategy while maintaining the ability to maximise interest returns.

1.7 Other key points in the Treasury Management Strategy are as follows:

- A challenging interest rate environment with Bank Rate to remain at a very low level for an extended period and not to begin rising before late 2013.
- The Council's return on investments continues to out-perform the benchmark.
- Borrowing portfolio well positioned to meet the Capital Investment Plan in terms of funding and affordability in the long term with no exposure to increased interest rate risk.

2 Recommendation(s) for decision

<u>Audit Committee</u>

2.1 That Audit Committee endorse the Treasury Management Strategy for 2012/13.

<u>Council</u>

2.2 That the Treasury Management Strategy for 2012/13 (incorporating the Annual Investment Strategy 2012/13) as set out in the submitted report be approved;

2.3 that, in line with the Council's Constitution and Financial Regulations:

(i) the Chief Finance Officer be authorised to take any decisions on borrowing and investments. (Delegations to the Section 151 Officer, paragraph 3.1(a)); and

(ii) the Chief Finance Officer be authorised to invest temporarily or utilise surplus monies of the Council; (Financial Regulations, paragraph 14.5); and

2.4 that the Annual Minimum Revenue Provision Policy Statement for 2012/13 as set out in Annex 7 to this report be approved.

3 Introduction

3.1 The Council defines its treasury management activities as:

"The management of the authority's investments and cash flows, it's 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".

3.2 The Treasury Management Strategy is considered under a requirement of the CIPFA Code of Practice on Treasury Management which was adopted by the Council on 25th March 2010.

3.3 The approval of an Annual Investment Strategy by Council is a requirement of the Guidance on Local Government Investments issued by the Secretary of State under section 15(1)(a) of the Local Government Act 2003.

3.4 In addition, the Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

3.5 The Act therefore requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy; this sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

3.6 The suggested strategy for 2012/13 is based upon the Treasury officers' views on interest rates, supported by market forecasts provided by the Council's treasury advisor. The full strategy covers:

- the current portfolio position;
- prospects for interest rates;
- economic conditions and scenario planning;
- treasury management indicators;
- the borrowing strategy;
- the Annual Investment Strategy;
- policy on the use of external service providers;
- risk assessment;
- reporting arrangements and management evaluation;
- policy on Minimum Revenue Provision;
- other matters

3.7 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This report, together with the Capital Plan, forms an integrated strategy to ensure the affordability of capital projects.

3.8 The provisional 2012/13 budget for interest payments has therefore been set at a level which will cover the Council's borrowing requirements in the Capital Investment Plan together with cash flow costs arising from capital projects and capital receipts.

3.9 The interest receipts budget for 2012/13, which is directly linked to the Council's borrowing position, is based on an average investment balance of £79 million and an average investment rate of 1.31% (the estimate for 2011/12 was 1.17%). This includes monies held by the Council's external Fund Manager

3.10 The budget for payment of interest on debt for 2012/13 is based on an overall borrowing rate of 4.31% (the estimate for 2011/12 was 4.23%).

3.11 The Treasury Management Strategy is directly linked to the Council's policy on reserves and balances, to be presented to Council in February 2012. From this report a mid-range target of £22 million has been extrapolated for which cash backing should be maintained in the medium term. This level has been factored into the investment balance in paragraph 3.9 above.

3.12 The core balances for which cash backing reflects the level of Council reserves, provisions, unapplied grants and contributions and working capital. This links to the Capital Plan and Medium Term Resource Plan which form the Council's longer term strategic cash flow forecasts.

4 Current Portfolio Position

4.1 The Council's treasury portfolio position at 23rd December 2011 comprised:

BORROWING		**Principal**	**Average Rate**
Fixed Rate Funding	PWLB	£143.461m	4.2957%
	Market	£ 10.000m	4.5475%
Variable Rate Funding		£ 0,000m	0.0000%
Total Debt		**£153.461m**	**4.3122%**
INVESTMENTS			
Investments Managed In-House – weighted average for year		£ 66.755m	1.4269%
Fund Manager- weighted average for year		£ 35.500m	1.0940%
Total Investments		**£102.255m**	**1.3425%**
NET BORROWING		**£ 51.206m**	

4.2 The Council has a difference between gross borrowing and net borrowing (after deducting cash balances). This difference in the long term would usually be equal to the Council's core cash balances.

4.3 The general aim of this treasury strategy is, in combination with the anticipated significant reduction in investments as capital expenditure is incurred, to further reduce the difference between the level of total and net borrowing over the next four years in order to reduce the cost of borrowing and the credit risk incurred by holding investments.

4.4 The overall investment rate exceeds the benchmark return of 0.48% and over-performance is expected again in 2012/13.

5 Prospects for Interest Rates

5.1 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. Annex 1 draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates with Annex 2 providing a detailed economic commentary provided by Sector. The following table gives the Sector central view.

Annual Average %	Bank Rate	Money Rates		PWLB Borrowing Rates *		
		3 month	1 year	5 year	25 year	50 year
March 2012	0.50	0.70	1.50	2.30	4.20	4.30
June 2012	0.50	0.70	1.50	2.30	4.20	4.30
Sept 2012	0.50	0.70	1.50	2.30	4.30	4.40
Dec2012	0.50	0.70	1.60	2.40	4.30	4.40
March 2013	0.50	0.75	1.70	2.50	4.40	4.50
June 2013	0.50	0.80	1.80	2.60	4.50	4.60
Sept 2013	0.75	0.90	1.90	2.70	4.60	4.70
Dec 2013	1.00	1.20	2.20	2.80	4.70	4.80
March 2014	1.25	1.40	2.40	2.90	4.80	4.90
June 2014	1.50	1.60	2.60	3.10	4.90	5.00

** Rates for repayment of existing loans are generally around 1% below these levels.*

5.2 Bank Rate, currently 0.5%, underpins investment returns and is not expected to start increasing before quarter 3 of 2013 despite inflation currently being well above the Monetary Policy Committee inflation target and could remain at these levels for longer.

5.3 Fixed interest borrowing rates are based on UK gilt yields. The outlook for borrowing rates is currently much more difficult to predict. The UK total national debt is forecast to continue rising until 2015/16; the consequent increase in gilt issuance is therefore expected to be reflected in an increase in gilt yields over this period. However, gilt yields are currently at historically low levels due to investor concerns over Eurozone sovereign debt and have been subject to exceptionally high levels of volatility as events in the Eurozone debt crisis have evolved.

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

- The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher counterparty risk. This continues to suggest the use of higher quality counterparties for generally shorter time periods;
- Investment returns are likely to remain relatively low during 2012/13;
- Borrowing interest rates difficult to predict but look unlikely to provide repayment or rescheduling opportunities in the short term;
- There will remain a cost of capital – advance borrowing will incur a short term revenue cost between borrowing and investment returns, however this is offset by the fixing of a low rate in the long term.

5.5 **Sensitivity of Forecasts.** The projections within this report are based on officers “central” view of market rates applicable in 2012/13. These are subject to variation from interest rate changes and cash flow changes. An illustration of the potential impact of these changes is shown in the following table:

Variation	Central Case	Change +/-	£ Variation*
Change in Investment rates (new investments)	1.34%	1%	£0.790 million
Change in Borrowing Rates (change in penalty cost on early repayment of an indicative £5 million)*	n/a	1%	-£0.8million/ +£1.0 million
Change in Average cash flow (assume increased investments)	£79 million	£10 million	£0.134 million

** Based on current levels of borrowing and investment*

***The strategy provides for no additional borrowing in 2012/13 for capital funding and all existing borrowing is at fixed rate so any change in Borrowing Rates will have no effect on interest payable.*

6 Economic Conditions and scenario planning

6.1 The volatility of economic conditions over both recent months and years (see commentary included at Annex 2) will continue to have a significant impact on the Council's Treasury Management function.

6.2 The Council is still facing a situation where Bank Rate and therefore investment returns are at record lows, well below the level payable on borrowings.

6.3 The Council has linked its medium term financial planning to these uncertain conditions. The impact of these conditions on the Councils investment budget has been identified and has formed part of the budget planning process for future years.

6.4 The impact of the economic conditions will continue to be identified in Treasury Management strategies linked to the Council's medium term financial planning.

6.5 The current economic conditions are still very unstable and as a result there are a range of market movements that could occur over the next few years which will provide a challenge to officers. The current strategy and budgets reflect that uncertainty and are based on prudent views of market movements and counterparty limits are set to minimise the Council's exposure to risk.

6.6 The crisis in the Eurozone and the potential effect on markets will continue to be monitored by Officers for threats to treasury activities. In September 2011 the Chief Finance Officer (CFO) repeated a measure taken the previous year in placing a blanket duration limit of three months on all deposits (except to UK part-nationalised banks) to mitigate potential risks arising from the problems in Greece and other countries.

6.7 Varying the Council's counterparty limits could increase or decrease investment yield with a corresponding change in the level of security (risk) over the counterparty. In the current market conditions any extension of counterparty limits and maximum length of investments could increase investment yield. However this would need to be considered against the higher risk of impairment.

6.8 A repayment of borrowing of £1million in 2012/13 could yield a saving, in interest terms, of £26,600:

Saving on interest payable (4% loan assumed)	£40,000
Less: Loss of investment interest (at budgeted rate of 1.34%)	£13,400
Net Interest saving	£26,600

However, this assumes repayments at rates levels where no penalty is applicable. As outlined later in para 8.4 this position is not anticipated in 2012/13

7 Treasury Management Indicators for 2011/12 – 2015/16

7.1 Annex 3 sets out the treasury indicators relevant for the purpose of setting an integrated treasury management strategy.

8 Borrowing Strategy

8.1 The table in Annex 4 provides an analysis of current borrowing levels against the Capital Financing Requirement (CFR) derived from the approved Capital Investment Plan. It also summarises the effects of the Borrowing Strategy detailed below.

8.2 No new borrowing is planned for 2012/13.

8.3 The Council's revenue provision for repayment of principal over the next four years is approximately £20million which will reduce the CFR by that value. This change in CFR combined with changes in the Capital Investment Plan results in a borrowing strategy to reduce the level of external borrowing over the next four years by a minimum of £20 million to realign funding levels with the revised Capital Investment Plan thereby reducing the risks involved in holding cash balances.

8.4 The current market conditions make repayment prohibitive due to high penalty costs and these conditions are forecast to continue until 2013/14 (see section 4). Opportunities to repay borrowing are therefore not expected in 2012/13. However, the volatile conditions in the economic climate make predicting rate movements extremely difficult and Officers will act on this strategy as soon as the rate environment moves to favourable position.

8.5 Gilt yields need to rise by around 0.50%-0.75% on their current levels for any repayment to be affordable and by 0.75%-1.00% to reach the level at which the Council would ideally begin to make repayments.

8.6 The option to further reduce borrowing, potentially up to an additional £20million above that in para 8.3., will also form part of this strategy to reduce the risks involved in holding cash balances and the impact in the short term on revenue resources.

8.7 Any repayment of borrowing will only be applied following a thorough assessment of:

- any change to the level of the borrowing requirement
- additional capital projects funded from borrowing

- assessment of working capital and other Council cash backed resources such as Reserves, Provisions and capital grants
- prevailing market conditions
- anticipated cash flow and any temporary borrowing requirements
- future market expectations
- the need to re-borrow in the medium to longer term as loans reach maturity

8.8 Rescheduling of existing debt will also be considered if opportunities arise, to supplement the primary aim of repaying loans.

8.9 The majority of the Council's cost of interest and associated Revenue Provision relate to borrowing "supported" by central government. This supported borrowing along with prudential borrowing for capital resources leads to an increase in the value attached to the Council's own assets on its Balance Sheet.

8.10 Borrowing from PWLB or other sources is only one option the Council has to cover its Capital expenditure e.g. the Council could use finance leases or PFI agreements such as the Energy from Waste Plant.

8.11 As a matter of policy approved borrowing sources are from the Public Works Loan Board and market instruments from counterparties listed by the Financial Services Authority. Local Authority Bonds will also be considered going forward.

9 ANNUAL INVESTMENT STRATEGY

Investment Policy

9.1 The Council will have regard to the CLG's Guidance on Local Government Investments and the (2009 revised) CIPFA Treasury Management in Public Services Code of Practice.

9.2 The Council's investment priorities, in line with CLG Guidance, are: -
  (a) the security of capital
  (b) the liquidity of its investments.

9.3 The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

9.4 The borrowing of monies purely to invest or on-lend and make a return is unlawful and the Council will not engage in such activity.

9.5 Annex 5 to this report details the policy for selection of counterparties and management of investments to achieve the objectives of the Investment Policy.

9.6 Investment instruments identified for use in the financial year are listed at Annex 6 under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be set within the schedules accompanying the Council's Treasury Management Practices.

Investment Strategy

9.7 The investment strategy for 2012/13 is strongly influenced by the market and credit risks outlined above but needs to be balanced with the need to maximise revenue within these risks.

9.8 Officers consider the government guarantee implicit in deposits with UK part-nationalised banks offers the safest haven for cash to the extent that further longer term deposits will be allowed with these institutions where rates offer a premium on market levels.

9.9 Deposits with other counterparties will generally be for shorter durations while the current uncertainties prevail in the market.

9.10 A proportion of funds will be held in business reserve and notice accounts to ensure appropriate liquidity is maintained.

9.11 The Fund Managers strategy and performance will be subject to continuous monitoring and the CFO will vary the size of the holding in line with the aims of the overall strategy.

10 Policy on the use of external advisors

10.1 The Council re-appointed Sector Treasury Services as its external treasury management advisor in January 2010.

10.2 The Council recognises the value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Chief Finance Officer 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.

10.3 The Council acknowledges that the responsibility for treasury management decisions remains with the Council at all times and will ensure that undue reliance is not placed upon the external advisors.

11 **Risk Assessment**

11.1 The main risks to Treasury Management activities will arise from interest rate levels and volatility, liquidity and cash flow requirements and creditworthiness of investment counterparties.

11.2 The management of specific risks is outlined in the Treasury Management Practices as required by the CIPFA Code of Practice approved by Council on 25th March 2010. Detailed controls are set by the Chief Financial Officers within the Schedules to the Treasury Management Practices and these are reviewed annually.

11.3 Other sections of this report below deal further with risk management and mitigation of particular elements of the 2012/13 Strategy.

12 Reporting Arrangements and Management Evaluation

12.1 The CFO will inform the Executive Lead for Finance of any long-term borrowing/repayment undertaken or any significant events that may affect the Council's treasury management activities. The CFO will maintain a list of staff authorised to undertake treasury management transactions on behalf of the Council.

12.2 The Chief Finance Officer is authorised to approve any movement between borrowing and other long-term liabilities within the Authorised Limit. Any such change will be reported to the next meeting of the Council.

12.3 The impact of these policies will be reflected as part of the Council's revenue budget and therefore will be reported through the quarterly budget monitoring process.

12.4 The Council's management and evaluation arrangements for Treasury Management are as follows:

- Weekly monitoring report to the Chief Finance Officer, Executive Lead for Finance and majority opposition Group
- Monthly meeting of the Treasury Manager/Chief Accountant to review previous months performance and plan following months activities
- Regular meetings with the Council's treasury advisors
- Annual meetings with the Council's appointed Fund Managers
- Membership and participation in the CIPFA Benchmarking Club
- Reports to Audit Committee as the body responsible for scrutiny of Treasury Management.

12.5 The CFO will ensure adequate training provision is available to staff and Members. The Treasury Manager holds the Certificate in International Treasury Management – Public Finance, a dedicated qualification issued jointly by CIPFA and the Association of Corporate Treasurers.

13 Policy on Minimum Revenue Provision

13.1 The proposed Policy is outlined at Annex 5 to this report.

14 Other Matters

14.1 **Advancing cash**. If approved the Council will advance cash to Torbay Council schools at a rate equivalent to that of the forecast investment yield (to reflect the lost investment opportunity), with the option of an additional 0.25% risk premium. The service will have to identify the funding for this advance from revenue or reserves in the year of the advance.

14.2 **Investing cash for Local Payment Scheme (LPS) Schools.** If agreed by the Chief Finance Officer the Council will invest LPS school surplus balances on a temporary basis and endeavour to match Bank Rate on these investments on a variable basis. This will be for cash on a longer-term basis and will not apply to daily cash flow balances.

14.3 **Soft Loans.** New Financial Instruments require the recognition of soft loans i.e. where a loan is made at a lower than 'competitive' rate the cost implicit in achieving the lower rate must be reflected in the Council's accounts.

14.4 **Anti-Money Laundering.** New legislation came into force in December 2007. Training has been undertaken to ensure relevant staff are able to comply with

Regulations.

14.5 **Intranet**. The Council's treasury management procedures and other relevant documents can be accessed on the Council's intranet site within the financial services pages.

Paul Looby
Executive Head of Finance

Annexes

Annex 1	Interest Rate Forecasts 2011 - 2015
Annex 2	Economic Commentary
Annex 3	Treasury Management Indicators 2011/12 – 2015/16
Annex 4	Analysis of Borrowing against the Capital Financing Requirement
Annex 5	Investment Policy
Annex 6	Specified and Non-specified Investments
Annex 7	Policy on Minimum Revenue Provision for 2012/13

Documents available in members' rooms

Background Papers:
The following documents/files were used to compile this report:

Capital Strategy
Capital Investment Plan

Annex 1

Interest rate Forecasts 2011 - 2015

Sector's Interest Rate View															
	Now	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Sector's Bank Rate View	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
3 Month LIBID	**0.87%**	0.70%	0.70%	0.70%	0.70%	0.70%	0.75%	0.80%	0.90%	1.20%	1.40%	1.60%	2.10%	2.40%	2.60%
6 Month LIBID	**1.16%**	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.20%	1.40%	1.60%	1.80%	2.00%	2.50%	2.70%	2.90%
12 Month LIBID	**1.65%**	1.50%	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.20%	2.40%	2.60%	3.10%	3.20%	3.30%
5yr PWLB Rate	**2.25%**	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
10yr PWLB Rate	**3.33%**	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
25yr PWLB Rate	**4.24%**	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
50yr PWLB Rate	**4.26%**	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%
Bank Rate															
Sector's View	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
UBS	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-	-	-	-	-
Capital Economics	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yr PWLB Rate															
Sector's View	**2.25%**	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
UBS	**2.25%**	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	**2.25%**	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	-	-	-	-	-
10yr PWLB Rate															
Sector's View	**3.33%**	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
UBS	**3.33%**	3.45%	3.45%	3.50%	3.60%	3.65%	-	-	-	-	-	-	-	-	-
Capital Economics	**3.33%**	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	-	-	-	-	-
25yr PWLB Rate															
Sector's View	**4.24%**	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
UBS	**4.24%**	4.80%	4.90%	4.90%	4.90%	4.90%	-	-	-	-	-	-	-	-	-
Capital Economics	**4.24%**	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	-	-	-	-	-
50yr PWLB Rate															
Sector's View	**4.26%**	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%
UBS	**4.26%**	4.80%	4.95%	4.95%	5.00%	5.00%	-	-	-	-	-	-	-	-	-
Capital Economics	**4.26%**	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	-	-	-	-	-

Annex 2

Economic Background provided by Sector (at 17th November 2011)

Global economy

The outlook for the global economy remains clouded with uncertainty with the UK economy struggling to generate sustained recovery that offers any optimistim for the outlooks for 2012, or possibly even into 2013. Consumer and business confidence levels are low and with little to boost sentiment, it is not easy to see potential for a significant increase in the growth rate in the short term.

At the centre of much of the uncertainty is the ongoing **Eurozone sovereign debt crisis** which has intensified, rather than dissipated throughout 2011. The main problem has been **Greece**, where, even with an Eurozone/IMF/ECB bailout package and the imposition of austerity measures aimed at deficit reduction, the lack of progress and the ongoing deficiency in addressing the underlying lack of competitiveness of the Greek economy, has seen an escalation of their problems. These look certain to result in a default of some kind but it currently remains unresolved if this will be either “orderly” or “disorderly”, and/or also include exit from the €uro bloc.

As if that were not enough there is growing concern about the situation in **Italy** and the risk that contagion has not been contained. Italy is the third biggest debtor country in the world but its prospects are limited given the poor rate of economic growth over the last decade and the lack of political will to address the need for fundamental reforms in the economy. The Eurozone now has a well established track record of always doing too little too late to deal with this crisis; this augurs poorly for future prospects, especially given the rising level of electoral opposition in northern EU countries to bailing out profligate southern countries.

The US economy offers little to lift spirits. With the next Presidential elections due in November 2012, the current administration has been hamstrung by political gridlock with the two houses split between the main parties. In quarter 3 the Federal Reserve started “Operation Twist” in an effort to re-ignite the economy in which growth is stalling. High levels of consumer indebtedness, unemployment and a moribund housing market are weighing heavily on consumer confidence and so on the abiltity to generate sustained economic growth.

Hopes for broad based recovery have, therefore, focussed on the **emerging markets** but these areas have been struggling with inflationary pressures in their previously fast growth economies. China, though, has maintained its growth pattern, despite tightening monetary policy to suppress inflationary pressures, but some forward looking indicators are causing concern that there may not be a soft landing ahead, which would then be a further dampener on world economic growth.

UK economy

The Government’s austerity measures, aimed at getting the public sector deficit into order over the next four years, have yet to fully impact on the economy. However, coming at a time when economic growth has virtually flatlined and concerns at the risk of a technical recession (two quarters of negatibe growth) in 2012, it looks likely that the private sector will not make up for the negative impact of these austerity measures given the lack of an export led recovery due to the downturn in our major trading partner – the EU. The housing market, a gauge of consumer confidence, remains weak and the outlook is for house prices to be little changed for a prolonged period.

Economic Growth. GDP growth has flatlined since the election of 2010 and the economic forcecasts for 2012 have been revised lower on a near quarterly basis as the UK recovery has, effectively, stalled. With fears of a potential return to recession the Bank of England embarked on a second round of Quantitive Easing to stimulate ecomnomic activity.

Unemployment. With the impact of the Government's austerity strategy impacting the trend for 2011 of steadily increasing unemployment, there are limited prospects for any improvement in 2012 given the deterioration of growth prospects.

Inflation and Bank Rate. For the last two years, the MPC's contention has been that high inflation was the outcome of temporary external factors and other one offs (e.g. changes in VAT); that view remains in place with CPI inflation standing at 5.2% at the start of quarter 4 2011. The MPC remain of the view that the rate will fall back to, or below, the 2% target level within the two year horizon.

AAA rating. The ratings agencies have recently reaffirmed the UK's AAA sovereign rating and have expressed satisfaction with Government policy at deficit reduction. They have, though, warned that this could be reviewed if the policy were to change, or was seen to be failing to achieve its desired outcome. This credit position has ensured that the UK government is able to fund itself at historically low levels and with the safe haven status from Eurozone debt also drawing in external investment the pressure on rates has been down, and looks set to remain so for some time.

Sector's forward view

Economic forecasting remains troublesome with so many extermal influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains weak and whilst there is still a broad range of views as to potential performance, they have all been downgraded throughout 2011. Key areas of uncertainty include:

- a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to exporting manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that inceasingly seem likely to be undershot;
- a continuation of high levels of inflation ;
- the economic performance of the UK's trading partners, in particular the EU and US, with some analysts suggesting that recession could return to both;
- stimulus packages failing to stimulate growth;
- elections due in the US, Germany and France in 2012 or 2013;

- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.

The overall balance of risks remains weighted to the downside. Lack of economic growth, both domestically and overseas, will impact on confidence putting upward pressure on unemployment. It will also further knock levels of demand which will bring the threat of recession back into focus.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes before mid-2013 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Annex 3

Treasury Management Indicators 2011/12 – 2015/16

Limits on Borrowing and Long-Term Liabilities

The Operational Boundary. This is the limit beyond which external borrowing and long-term liabilities are 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 £m	2011/12 Current	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Borrowing	163	163	163	163	163
Other long term liabilities	10	10	9	8	58
Total	173	173	172	171	221

The Authorised Limit for external borrowing and long-term liabilities. A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external borrowing is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

Authorised limit £m	2011/12 Current	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Borrowing	182	182	187	192	197
Other long term liabilities	10	10	9	8	58
Total	192	192	196	200	255

Limits on Activity

There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs / improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

£m	2012/13	2013/14	2014/15	2015/16
Interest rate Exposures				
	Upper	**Upper**	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	**150**	**150**	**150**	**150**
Limits on variable interest rates based on net debt	**41**	**41**	**41**	**41**
Limits on fixed interest rates: • ***Debt only*** • ***Investments only***	 **163** **85**	 **163** **68**	 **163** **67**	 **163** **64**
Limits on variable interest rates • ***Debt only*** • ***Investments only***	 **41** **70**	 **41** **65**	 **41** **65**	 **41** **65**
Maturity Structure of fixed interest rate borrowing 2012/13				
	Lower		**Upper**	
Under 12 months	0%		7%	
12 months to 2 years	0%		7%	
2 years to 5 years	0%		7%	
5 years to 10 years	6%		19%	
10 years to 25 years	12%		32%	
25 years to 40 years	12%		45%	
Over 40 years	10%		35%	

<u>Invesment Treasury Indicator and Limit</u>

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 limits below allow for the external Fund Manager holding along with 50% of the in-house total to be fixed longer term.

Maximum principal sums invested for over 364 days				
£m	**2012/13**	**2013/14**	**2014/15**	**2015/16**
Principal sums invested > 364 days	£m 66	£m 56	£m 55	£m 54

Annex 4

Analysis of Borrowing against Capital Financing Requirement

£m At 31/03/xx	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2015/16 Estimate Assuming £20M repayment of borrowing	2015/16 Estimate Assuming £40M repayment of borrowing *
External Borrowing	**153**	**153**	**153**	**153**	**153**	**133**	**113**
Other long-term liabilities (OLTL)	11	10	9	8	58 **	58 **	58 **
Total borrowing and long term liabilities	**164**	**163**	**162**	**161**	**211**	**191**	**171**
CFR – the borrowing need including long term liabilities	**139**	**141**	**141**	**139**	**194 ****	**194 ****	**194 ****
Under / (over) borrowing	(25)	(22)	(21)	(22)	(17)	3	23
Total investments	82	67	65	64	60	40	20
Net borrowing	**71**	**86**	**88**	**89**	**93**	**93**	**93**

<u>**Projected Revenue Implications**</u>	**£m**	**£m**	**£m**
Interest payable on Borrowings	6.62	5.82***	5.02***
Interest Receivable on Investments	(1.35)	(1.0)	(0.6)
Net Cost	**5.27**	**4.82**	**4.42**

* *Subject to assessment as outlined in para 8.7 of this report*
** *Reflects the estimated impact of the PFI contract for the Energy from Waste Plant*
*** *Based on repayment of loans averaging 4%*

Annex 5

Investment Policy

1. This Council applies the creditworthiness service provided by Sector. This service employs a sophisticated modelling approach utlilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors.

2. This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of Credit Default Swap (CDS) spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. The Chief Finance Officer applies and monitors suitable financial and durational limits to each of these bands.

3. This methodology does not apply the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties. The Sector creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

4. All credit ratings will be monitored on a weekly basis. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service and the CFO will vary the approved lending list as appropriate to these changes.

5. The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA+.The list of countries that qualify using this credit criteria as at the date of this report are shown below and this list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

AAA		**AA+**
Australia	Netherlands	Belgium
Canada	Norway	Hong Kong
Denmark	Singapore	USA
Finland	Sweden	
France	Switzerland	
Germany	United Kingdom	
Luxembourg		

6. Sole reliance will not be placed on the use of this external service. In addition the CFO will also use market data and market information, information on government support for banks and the credit ratings of that government support.

7. The Council uses an external fund manager to manage a proportion of the investment portfolio available to offset the borrowing requirement. The use of an external fund manager allows the Council to spread its treasury risk in relation to type of investment, investment counterparties and manager opinion.

8. The external fund manager will comply with the Annual Investment Strategy. The agreement between the Council and the fund manager additionally stipulates guidelines and duration and other limits in order to contain and control

risk.

9. The fund manager mandate allows for additional amounts to be placed and the CFO will exercise this option if this is deemed to be in the best interests of the Council up to a limit of 35% of the total portfolio. As Council’s cash investment reduce it is likely the Fund Manager holding will be correspondingly decreased. The Council retains the right to withdraw all or part of the fund at seven days notice.

Annex 6

Specified and Non-Specified Investments

SPECIFIED INVESTMENTS: All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' quality criteria where applicable.

	Minimum 'High' Credit Criteria	Use
Debt Management Agency Deposit Facility	--	In-house
Term deposits – local authorities	--	In-house
Term deposits – banks and building societies	Creditworthiness system colour band "Green"	In-house and Fund Manager
UK nationalised/part-nationalised banks	Sovereign rating AA+	In-house and Fund Manager
Government guarantee (explicit) on ALL deposits by high credit rated (sovereign rating) countries	Sovereign rating AA+	In-house and Fund Manager
UK Government support to the banking sector (implicit guarantee) (see note 1)	Sovereign rating AA+	In-house
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs): - 1. Government Liquidity Funds 2. Money Market Funds 3. Enhanced Cash Funds	AAA	In-house and Fund Manager

NON-SPECIFIED INVESTMENTS: These are any investments which do not meet the Specified Investment criteria.
A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories.

The maturity limits recomended will not be exceeded. Under4 the delegated powers the Chief Finance Officer can set limits that are lower based on the latest economic conditions and credit ratings. As at December 2011 there is an overlay of three months and one year durations.

	Minimum Credit Criteria	Use	Max % of total investments	Max. maturity period *
UK nationalised/part-nationalised banks (maturities over one year)	Sovereign rating AA+	In-house and Fund Manager	50%	3 years
Term deposits (over one year) – local authorities	--	In-house	50%	5 years
Term deposits (over one year) – banks and building societies	Creditworthiness system colour band "Purple"	In-house and Fund Manager	75%	2 years
Collateralised deposit	See note 2	In-house	20%	5 years
Certificates of deposits issued by banks and building societies (maturities under one year)	Creditworthiness system colour band "Green"	In-house and Fund Manager	50%	1 year
Certificates of deposits issued by banks and building societies (maturities over one year)	Creditworthiness system colour band "Purple"	In-house and Fund Manager	50%	1 year
UK Government Gilts/Treasury Bills	Sovereign rating AA+	In-house and Fund Manager	100%	5 years
Bonds issued by multilateral development banks	AA+	In-house and Fund Manager	50%	5 years
Sovereign bond issues (other than the UK govt)	Sovereign rating AA+	In-house and Fund Manager	50%	5 years
Structured Deposits	Creditworthiness system colour band "Orange"	In-House	25%	2 years
Term deposits with unrated counterparties with unconditional guarantee from HMG or credit-rated parent institution. Specific counterparty to be approved by CFO	Sovereign rating (guarantor) Sovereign AA+ or Creditworthiness system colour band "Red"	In-house and Fund Manager	20%	1 year
Commercial paper issuance by UK banks covered by UK Government guarantee	Sovereign rating AA+	Fund Manager	35%	5 years
Commercial paper other	Creditworthiness system colour band "Red"	Fund Manager	35%	5 years
Floating Rate Notes : *the use of these investments would constitute capital expenditure (although this is currently under review) unless they are issued by a multi lateral development bank*	Long-term AA	In-house and Fund Manager	35%	5 years

	Minimum Credit Criteria	Use	Max % of total investments	Max. maturity period*
Property Fund: *the use of these investments would constitute capital expenditure although this is currently under review*	--	In-house and Fund Manager	35%	5 years
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs):- 1. Government Liquidity Funds 2. Money Market Funds	AAA	Fund Manager	35%	5 years
Corporate Bonds issued by UK Banks covered by UK Government guarantee : *the use of these investments would constitute capital expenditure although this is currently under review*	Sovereign rating AA+	In-house and Fund Manager	35%	5 years
Corporate Bonds other: *the use of these investments would constitute capital expenditure although this is currently under review*	AA	In-house and Fund Manager	35%	5 years
Other debt issuance by UK Banks covered by UK Government guarantee	Sovereign rating AA+	In-house and Fund Manager	35%	5 years

*Of which in any class of investment:

- 10% maximum 3 years (or over)
- 25% maximum 2 to 3 years

Notes

1. The original list of banks covered when the support package was initially announced was: -
   - Abbey (now part of Santander)
   - Barclays
   - HBOS (now part of the Lloyds Group)
   - Lloyds TSB
   - HSBC
   - Nationwide Building Society
   - RBS
   - Standard Chartered

   Banks eligible for support under the UK bail-out package and which have issued debt guaranteed by the Government are eligible for a continuing Government guarantee when debt issues originally issued and guaranteed by the Government mature and are refinanced. However, no other institutions can make use of this support as it closed to new issues and entrants on 28.2.10. The banks which have used this explicit guarantee are as follows: -

- Bank of Scotland
- Barclays
- Clydesdale
- Coventry Building Society
- Investec bank
- Nationwide Building Society
- Rothschild Continuation Finance plc
- Standard Life Bank
- Tesco Personal Finance plc
- Royal Bank of Scotland
- West Bromwich Building Society
- Yorkshire Building Society

2. As collateralised deposits are backed by collateral of AAA rated local authority LOBOs, this investment instrument is regarded as being a AAA rated investment as it is equivalent to lending to a local authority.

Annex 7

Policy on Minimum Revenue Provision for 2012/13

1. The minimum revenue provision is a charge to its revenue budget that Councils are required to make to generate cash resources to enable the repayment of borrowing. The 2011/12 budget for this is £4 million. The calculation of this charge is guided by legislation issued over a number of years. (Note there is revised MRP legislation proposed for 2012/13 but the changes are primarily in relation to Council's with Housing Revenue Accounts so not applicable to Torbay)

2. Councils are now required to "determine for the current financial year an amount of MRP that it considers to be prudent" and prepare an annual statement on their MRP calculation to their full Council.

3 The aim of this legislation is to ensure that the repayment of principal owed for capital expenditure funded from unsupported borrowing is charged on a prudent basis more closely linked to the asset's life. The provision for all assets, irrespective of asset life, for expenditure funded from supported borrowing will continue to be charged at a minimum 4% per annum which is in line with central government's "support" for these costs within the Council's formula grant.

4 The <u>Annual Minimum Revenue Provision Policy Statement</u> states that the calculation of the MRP is as follows:

The Council will budget for a provision of 4% of its capital financing requirement calculated as at 31st March of the preceding financial year. The capital financing requirement (CFR) is a calculation of a Council's "need to borrow" which is, in summary, the total of expenditure funded from borrowing less any repayments or similar previously made.

To calculate the 4% provision the Council will use the "regulatory method" as identified in Department of Communities and Local Government (DCLG)'s Informal Commentary on the legislation.

1) This calculation allows for the adjustments of the following items:

    - Deducting any expenditure (and revenue provision made) in relation to unsupported borrowing
    - Commutation Adjustment
    - "Adjustment A" which relates to a previous calculation change in 2004
    - Adjustment of MRP to ensure no disadvantageous results to Councils from the new regulations compared to previous MRP regulations
    - Adjustment of MRP to ensure no disadvantageous results to Councils from the new requirements for accounting for Private Finance Initiative schemes

2) For capital expenditure funded from unsupported or prudential borrowing the Council will make a provision based on the cumulative expenditure incurred on each asset in the previous financial years using a prudent asset life less

any MRP to date on that expenditure, which reflects the estimated usable life of that asset. The Council will use the “asset life method”

Within the asset life method the MRP for each asset will be calculated using an annuity calculation using the Council’s estimated pooled borrowing interest rate for the relevant year as detailed in the Treasury Management Strategy for that year. This will be adjusted by

- an adjustment to the MRP calculation will be used where there is expenditure in the previous financial year, but the asset is not yet operational. MRP will be calculated on the total expenditure on that asset in the year after the asset becomes operational.

- where relevant, the suggested asset lives for certain types of capitalised expenditure as detailed in the MRP guidance issued by DCLG will be used.

3) The Council will continue to charge services for their use of unsupported borrowing using a prudent asset life (or a shorter period) and an annuity calculation. Where possible the same asset life and borrowing interest rate will be used for both the charge to services and the calculation of the MRP.

4) Where assets prior to 2007/08 have been purchased by unsupported borrowing (before the new legislation applied) and a MRP at 4% is provided for, the Council will aim, over the long term, to balance the annual costs of the MRP on these assets with the repayments made by services. This may result in a Voluntary Revenue Provision (VRP) or reserve transfer being made.

5) The Council will not change its existing “Adjustment A” calculation.

6) To mitigate any negative impact from the changes in accounting for leases and PFI schemes the Council will include in the annual MRP charge an amount equal to the amount that has been taken to the balance sheet to reduce the balance sheet liability for a PFI scheme or a finance lease. The calculation will be based on the annuity method using the Internal Rate of Return (IRR) implicit in the PFI or lease agreement.