**Meeting:** **Audit Committee** — **Date: 19th December 2012**
**Council** — **6th February 2013**

**Wards Affected: All Wards in Torbay**

**Report Title: Treasury Management Strategy 2013/14 - (incorporating the Annual Investment Strategy 2013/14 and the Minimum Revenue Provision Policy 2013/14)**

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## 1. Purpose

1.1 The Strategy outlined in this report aims to support the provision of all Council services by the management of the Council's cash flow, debt and investment operations in 2013/14 and effectively control the associated risks and the pursuit of optimum performance consistent with those risks.

## 2. Proposed Decisions

2.1 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.

2.2 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.

2.3 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.

2.4 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. **Action Needed**

Audit Committee

**3.1 It is recommended that Audit Committee endorse the Treasury Management Strategy for 2013/14.**

Council

**3.2 The Council is recommended to approve the Treasury Management Strategy for 2013/14 (incorporating the Annual Investment Strategy 2013/14) set out at Appendix 1 to this Report;**

**3.3 The Council is recommended to approve the Prudential and Treasury Indicators 2013/14 laid out in Annex 1 of this report;**

**3.4 The Council is recommended in line with the Council's Constitution and Financial Regulations to approve:**

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

**3.5 The Council is recommended to approve the Annual Minimum Revenue Provision Policy Statement for 2013/14 as shown in Annex 2 to this report.**

4. **Summary**

4.1 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.

4.2 Following changes to the Capital Investment Plan in terms of timing of both expenditure and funding, an element of borrowing is currently surplus to capital financing requirements over the medium term. As a result, the proposed borrowing strategy is to not borrow until future schemes are approved and, if borrowing is required, delay borrowing until rates are due to rise. The aim is to reduce the level of external borrowing over the next four years by a minimum target of £25 million to realign funding levels between the revised Capital Investment Plan and projected Capital Financing Requirement.

4.3 As at 31st March 2012 the Council's long term liabilities exceeded its Capital Financing Requirement by £26m, however the Council's Capital Investment Plan 2012/13 - quarter two shows schemes totaling £30m to be funded from borrowing over the four years, of which £9m is temporary pending confirmation of capital resources.

4.4 Further reductions in the level of borrowing, potentially up to another £25 million, will also form part of this Strategy to reflect the effect of current interest rate conditions on the revenue budget. Any such repayment, if market conditions permit, would require ongoing capital expenditure to be funded from the Council's internal cash resources. These would need to be financed when the Council's internal balances reduce e.g. by reserves being spent or as borrowing reach maturity.

4.5 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 4.2 during 2013/14. Rates are forecast to start to rise in 2014/15.

4.6 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. Risks include the impact of a reduction in the UK credit rating and the effect of Quantitative Easing.

4.7 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. The Council's investment priorities, in line with CLG Guidance, are: -

(a) the security of capital
(b) the liquidity of its investments.

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

4.8 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 the end of 2014.
- The Council's return on investments continues to out-perform the benchmark.
- Borrowing portfolio well positioned to meet the Capital Investment Plan without exposure to increased interest rate risk
- Capital Investment Plans include £30M of schemes funded from borrowing of which £9M is temporary
- Long term liabilities are set to increase significantly over the next four years as a result of the Energy from Waste scheme
- Threat to the UK's AAA sovereign credit rating

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**Supporting Information**

5. **Position**

5.1 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".***

5.2 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 Investment Plan, forms an integrated strategy to ensure the affordability of capital projects.

5.3 The provisional 2013/14 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.

5.4 The interest receipts budget for 2013/14, which is directly linked to the Council's borrowing position, is based on an average investment balance of £76 million and an average investment rate of 1.45% (the estimate for 2012/13 was 1.34%). This includes monies held by the Council's external Fund Manager and well exceeds the benchmark rate forecast to remain at around 0.50%

5.5 The budget for payment of interest on debt for 2013/14 is based on an overall borrowing rate of 4.31% which is unchanged from the previous year.

5.6 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 £32 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 5.4 above.

5.7 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 Investment Plan and Medium Term Resource Plan which form the basis of the Council's longer term strategic cash flow forecasts.

5.8 The proposed strategy for 2013/14 is set out at Appendix 1 to this report and covers the following:

- Prudential and Treasury Indicators;
- Capital expenditure and the Capital Financing Requirement
- the minimum revenue provision (MRP) policy
- prospects for interest rates;
- economic conditions and scenario planning;
- the borrowing strategy;
- the Annual Investment Strategy;
- policy on use of external service providers;
- reporting arrangements and management evaluation;
- lending to Housing Associations and alternative investments
- other matters

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, CLG MRP Guidance, the CIPFA Treasury Management Code and CLG Investment Guidance.

6. **Possibilities and Options**

6.1 NA

7. **Preferred Solution/Option**

7.1 NA

8. **Consultation**

8.1 NA

9. **Risks**

9.1 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.

9.2 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 Officer within the Schedules to the Treasury Management Practices and these are reviewed annually.

9.3 Other sections of this report below deal further with risk management and mitigation of particular elements of the 2013/14 Strategy.

**Appendices**

| | |
|---|---|
| Appendix 1 | Treasury Management Strategy 2013/14 |
| Annex1 | Prudential and Treasury Management Indicators |
| Annex 2 | Policy on Minimum Revenue Provision for 2013/14 |
| Annex 3 | Interest Rate Forecasts 2012 – 2016 |
| Annex 4 | Economic Background |
| Annex 5 | Creditworthiness Policy |
| Annex 6 | Specified and Non-specified Investments |

**Additional Information**

**Appendix A**

## Treasury Management Strategy 2013/14

This Appendix sets out full details for all aspects of the Treasury Management Strategy for 2013/14.

### A1 Prudential Indicators and Treasury Indicators

Local Authorities are required to set indicators to demonstrate they have fulfilled the objectives of the Prudential Code and CIPFA Code of Practice on Treasury Management. The indicators for 2013/14 and future years are set out at Annex1

### A2 Capital Expenditure and the Capital Financing Requirement

A2.1 Capital expenditure plans are a key element in the form the first of the Prudential Indicators at Annex 1. Figures are as per the Capital Investment Plan Quarter 2 2012/13 report and are summarised below.

| Capital expenditure £M | 2011/12 Actual | 2012/13 Estimate | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|---|
| **Total** | **22.1** | **24.8** | **23.0** | **8.6** | **7.6** | **4.2** |

A2.2 The figures include a borrowing requirement of £30M over the medium term of which £9M is temporary awaiting confirmation of capital income.

A2.3 These plans feed into the overall Capital Financing Requirement (CFR) which is explained at Annex 1 and summarised below.

| CFR £M | 2011/12 Actual | 2012/13 Estimate | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|---|
| **Total** | **137** | **137** | **138** | **185** | **186** | **185** |

### A3 Minimum Revenue Provision (MRP) policy statement

A3.1 The Council is required to set aside an amount for the repayment of borrowing used for capital spend each year (the CFR) through a revenue charge (the minimum revenue provision - MRP). It is also allowed to undertake additional voluntary payments if required (voluntary revenue provision - VRP).

A3.2 CLG regulations have been issued which require the full Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision.

A3.3 The MRP Policy for 2013/14 is set out at Annex 2 to this report.

## A4 Core funds and expected investment balances

A4.1 The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end balances for each resource and anticipated day to day cash flow balances.

| Year End Resources £M | 2011/12 Actual | 2012/13 Estimate | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|---|
| Fund balances/reserves | 51 | 38 | 26 | 22 | 21 | 23 |
| Capital receipts | 0 | 0 | 0 | 0 | 0 | 0 |
| Provisions | 2 | 1 | 1 | 1 | 1 | 1 |
| Other | 1 | 0 | 0 | 0 | 0 | 0 |
| **Total core funds** | **54** | **39** | **27** | **23** | **22** | **24** |
| Working capital | 25 | 12 | 17 | 18 | 16 | 15 |
| **Total Cash Requirement** | **79** | **51** | **44** | **41** | **38** | **39** |
| Excess LTL>CFR | 26 | 27 | 24 | 26 | 25 | 24 |
| **Expected Investments** | **105** | **78** | **68** | **67** | **63** | **63** |

## A5 Prospects for Interest Rates

A5.1 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 3 draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. The following table gives the Sector central view.

| Annual Average % | Bank Rate | PWLB Borrowing Rates (including certainty rate adjustment) | | |
|---|---|---|---|---|
| | | 5 year | 25 year | 50 year |
| Dec 2012 | 0.50 | 1.50 | 3.70 | 3.90 |
| March 2013 | 0.50 | 1.50 | 3.80 | 4.00 |
| March 2014 | 0.50 | 1.70 | 3.90 | 4.10 |
| March 2015 | 0.75 | 2.20 | 4.30 | 4.50 |
| March 2016 | 1.75 | 2.90 | 5.00 | 5.20 |

A5.2 These levels are artificially low in the short term due to market conditions and the impact of quantitative easing.

A5.3 **Sensitivity of Forecasts.** The projections within this report are based on officers "central" view of market rates applicable in 2013/14. 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) | 1.45% | 1% | £1.102 million |
| Change in Borrowing Rates (change in penalty cost on early repayment of an indicative £5 million)** | n/a | 1% | -£0.9million/ +£0.8 million |
| Change in Average cash flow (assume increased investments) | £76 million | £10 million | £0.145 million |

** Based on current levels of borrowing and investment*

***The strategy provides for no additional borrowing in 2013/14 for capital funding and all existing borrowing is at fixed rate so any change in Borrowing Rates will have no effect on interest payable.*

## A6 Economic Conditions and scenario planning

A6.1 An commentary on the economic background to this strategy, issued by Sector, is provided at Annex 4.

A6.2 The volatility of economic conditions will continue to have a significant impact on the Council's Treasury Management function.

A6.3 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.

A6.4 A lack of growth in the economy could mean a threat to the UK's AAA sovereign rating which would drive up gilt yields and therefore PWLB borrowing (and early repayment) rates.

A6.5 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.

A6.6 The impact of the economic conditions will continue to be identified in Treasury Management strategies linked to the Council's medium term financial planning.

A6.7 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.

A6.8 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. This measure remains in place.

A6.9 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.

## A7 Borrowing Strategy

A7.1 The following table provides an analysis of current borrowing levels against the Capital Financing Requirement (CFR) derived from the approved Capital Investment Plan. This also forms one of the Prudential Indicators at Annex 1.

| £m | 2011/12 Actual | 2012/13 Estimate | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|---|
| **External Debt at 31 March** | | | | | | |
| External Borrowing | 153 | 153 | 153 | 153 | 153 | 152 |
| Other long-term liabilities (OLTL) | 10 | 10 | 9 | 58 | 58 | 57 |
| **Total Borrowing and Other Long Term Liabilities** | **163** | **163** | **162** | **211** | **211** | **209** |
| **The Capital Financing Requirement** | **137** | **137** | **138** | **185** | **186** | **185** |

A7.2 In previous years, based on approved capital schemes and with uncertainty over market and regulatory risks, the Council adopted a strategy to take full funding of its capital borrowing in advance prior to predicted rate increases.

A7.3 Following changes to the Capital Investment Plan in terms of timing of both expenditure and funding, an element of borrowing is currently surplus to capital financing requirements over the medium term. As a result, the proposed borrowing strategy is to not borrow until future schemes are approved and, if borrowing is required, delay borrowing until rates are due to rise. The aim is to reduce the level of external borrowing over the next four years by a minimum target of £25 million to realign funding levels with the revised Capital Investment Plan and projected Capital Financing Requirement.

A7.4 The option to further reduce borrowing, potentially up to an additional £25 million above that in para A7.3., 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. This measure would require the Council to internally borrow cash resources to fund capital spending. At some point in the future the Council would have to re-borrow when these internal resources fell below operational cash flow requirements or borrowing reaches maturity.

A7.5 The current market conditions make repayment prohibitive due to high penalty costs and these conditions are now forecast to continue further until 2014/15 (see section A5). Opportunities to repay borrowing are therefore not expected in 2013/14. 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.

A7.6 The Mayor has been in correspondence with HM Treasury over the option of an early repayment of £50m of PWLB. If this results in an early repayment of PWLB borrowing the Treasury Management Strategy will be reviewed.

A7.7 Based on current PWLB repayment terms, gilt yields need to rise by around 0.50%-0.75% on their current levels for any repayment to be affordable and by 1.00%-1.50% to reach the level at which the Council would ideally begin to make repayments.

A7.8 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

A7.9 Rescheduling of existing debt will also be considered if opportunities arise, to supplement the primary aim of repaying loans.

A7.10 No new borrowing is envisaged for 2013/14. However, if in future years capital plans change and there is a borrowing need based on internal cash levels, the Council may seek to secure new funding prior to the anticipated rise in borrowing rates in future years.

A7.11 The majority of the Council's cost of interest and associated Revenue Provision relate to historic borrowing "supported" by central government and other debt transferred from Devon County Council on Local Government Reorganisation in 1998. (Borrowing is no longer fully supported due to reductions in Council grant) This supported borrowing along with prudential borrowing for capital resources which leads in most cases to an increase in the value of the Council's own assets on its Balance Sheet.

A7.12 Borrowing from PWLB or other sources is only one option the Council has to finance its expenditure on capital projects e.g. the Council could use finance leases or provide financing via PFI agreements such as the Energy from Waste Plant.

A7.13 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 but in the short term is unlikely to be progressed as the Council does not have a borrowing need.

## A8 ANNUAL INVESTMENT STRATEGY

### Investment Policy

A8.1 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments and the (2011 revised) CIPFA Treasury Management in Public Services Code of Practice.

A8.2 The Council's investment priorities, in line with CLG Guidance, are: -

the security of capital
the liquidity of its investments.

A8.3 The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

A8.4 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.

A8.5 Annex 5 to this report details the policy for selection of counterparties and management of investments to achieve the objectives of the Investment Policy.

A8.6 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.

A8.7 In view of the difficult market conditions officers continue to review alternative investment instruments such as loans to Housing Associations (see section A11) and diversification in investment property.

A8.8 The Investment Strategy is based on current projected cash levels. If any significant changes occur to cash levels, such as the early repayment of PWLB borrowing, then the Investment Strategy will need to be reviewed.

### Investment Strategy

A8.9 The investment strategy for 2013/14 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.

A8.10 Officers consider the government guarantee implicit in deposits with UK part-nationalised banks continue to offer the safest haven for cash to the extent that a proportion of funds have been locked in with these institutions at rates over the normal market levels. Further sums and maturities will be invested on this basis subject to liquidity requirements and changes in market conditions.

A8.11 Opportunities for deposits with other counterparties remains limited and will generally be for shorter durations while the current uncertainties prevail in the market.

A8.12 A proportion of funds will be held in business reserve and notice accounts to ensure appropriate liquidity is maintained.

A8.13 The Fund Manager's 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.

**A9 Policy on the use of external advisors**

A9.1 The Council re-appointed Sector Treasury Services as its external treasury management advisor in January 2010. The position is to be reviewed in 2013.

A9.2 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.

A9.3 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.

**A10 Reporting Arrangements and Management Evaluation**

A10.1 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.

A10.2 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.

A10.3 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.

A10.4 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, Director of Place & Resources 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
- The Audit Committee is the body responsible for scrutiny of Treasury

Management.

### A11 Lending to Housing Associations

A11.1 The Council has been in discussion with Housing Associations seeking loan facilities. In the current economic climate Housing Associations can find it difficult to secure funding for new affordable housing. Use of the Council's cash resources in this manner will reduce the differential between borrowed funds and poor investment returns.

A11.2 The CFO has agreed to offer to lend £10 million to Chapter One over 25 years at a rate based on the PWLB equivalent plus an appropriate margin. For security purposes the loan is to be secured against existing commercial assets owned by the Housing Association.

A11.3 The Chief Finance Officer will consider extending the offer of lending to other Housing Associations if conditions allow.

A11.4 Consideration of any and all loans will be subject to due diligence.

### A12 Other Matters

A12.1 **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.

A12.2 **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.

A12.3 **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.

A12.4 **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.

A12.5 **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.

A12.6 **Loans to linked organisations**. The Chief Finance Officer, in consultation with the Executive Lead for Finance, is authorised to agree loans to linked organisations, (such as academy schools, housing associations, Council associate and subsidiary companies).

**Annex 1**

## Prudential &Treasury Management Indicators 2011/12 – 2015/16

### Capital expenditure

This prudential indicator is a summary of the Council's capital expenditure plans (per the Capital Investment Plan Q2 2012/13 report).

| Capital expenditure £M | 2011/12 Actual | 2012/13 Estimate | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|---|
| Adults & Operations | 2.2 | 3.1 | 1.6 | 0.1 | 0 | 0 |
| Children, Schools & Families | 10.1 | 8.4 | 8.1 | 2.4 | 0.2 | 0 |
| Place & Environment | 9.2 | 12.0 | 13.3 | 6.1 | 7.4 | 4.2 |
| Communities and Local Democracy | 0.6 | 1.3 | 0 | 0 | 0 | 0 |
| **Total** | **22.1** | **24.8** | **23.0** | **8.6** | **7.6** | **4.2** |

### Capital Financing Requirement (CFR)

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

The CFR does not increase indefinitely. The minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each asset's life.

The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £10M of such schemes within the CFR which is expected to rise in 2014/15 with the Councils share of the Energy from Waste liability.

| £m | 2011/12 Actual | 2012/13 Estimate | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|---|
| **Capital Financing Requirement** | | | | | | |
| **Total CFR** | **137** | **137** | **138** | **185** | **186** | **185** |
| **Movement in CFR** | **(1)** | **0** | **1** | **47** | **1** | **(1)** |
| **Movement in CFR represented by** | | | | | | |
| Net financing need for the year - capital | 5.4 | 5.4 | 6.4 | 2.4 | 6.4 | 4.4 |
| Long Term Liabilities | (0.4) | (0.4) | (0.4) | 49.6 | (0.4) | (0.4) |
| Less MRP/VRP and other financing movements | (6) | (5) | (5) | (5) | (5) | (5) |
| **Movement in CFR** | **(1)** | **0** | **1** | **47** | **1** | **(1)** |

Temporary borrowing of £9million is not included in the above CFR. Capital resources to this amount are expected and once confirmed will reduce the CFR by £9million.

**Gross Borrowing & Long term Liabilities and the Capital Financing Requirement**

In order to ensure that borrowing will only be for a capital purpose, the Council should ensure that gross external borrowing does not, except in the short term, exceed the total CFR .

| £m | 2011/12 Actual | 2012/13 Estimate | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|---|
| **External Debt at 31 March** | | | | | | |
| External Borrowing | 153 | 153 | 153 | 153 | 153 | 152 |
| Other long-term liabilities (OLTL) | 10 | 10 | 9 | 58 | 58 | 57 |
| **Total Borrowing and Other Long Term Liabilities** | **163** | **163** | **162** | **211** | **211** | **209** |
| **The Capital Financing Requirement** | **137** | **137** | **138** | **185** | **186** | **185** |
| **Excess of LTL>CFR** | **(26)** | **(27)** | **(24)** | **(26)** | **(25)** | **(24)** |

**Affordability Prudential Indicators**

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

**<u>Ratio of financing costs to net revenue stream</u>.**

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

| % | 2011/12 Actual | 2012/13 Estimate | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|---|
| Ratio | 8.57 | 8.48 | 8.47 | 8.74 | 8.49 | 8.27 |

**<u>Incremental impact of capital investment decisions on council tax</u>.**

This indicator identifies the revenue costs associated with capital decisions as part of the next year's budget process. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

| £ | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|
| **Council tax** - **band D** | 0.00 | 0.00 | 0.00 | 0.00 |

The Council approved a 4- year Capital Investment Plan in 2012/13. There are no new schemes being presented for approval for 2013/14 and central government has removed supported borrowing. Therefore, there will be no new incremental increases to Council Tax.

However, if £9 million of temporary borrowing becomes permanent (expected capital receipts and grants are not confirmed) there will then be an incremental impact of £12.85 on the Torbay element of a Band D Council Tax.

**<u>Limits on Borrowing and Long-Term Liabilities</u>**

***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 linked to the CFR, but may be lower or higher depending on the levels of actual borrowing.

| Operational boundary £m | 2012/13 Current | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|
| Borrowing | 163 | 163 | 163 | 163 | 162 |
| Long term liabilities | 10 | 10 | 59 | 58 | 58 |
| Total | 173 | 173 | 222 | 221 | 220 |

***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** <br> **£m** | **2012/13** <br> **Current** | **2013/14** <br> **Estimate** | **2014/15** <br> **Estimate** | **2015/16** <br> **Estimate** | **2016/17** <br> **Estimate** |
|---|---|---|---|---|---|
| Borrowing | 182 | 182 | 187 | 192 | 197 |
| Other long term liabilities | 10 | 10 | 59 | 58 | 58 |
| Total | 192 | 192 | 246 | 250 | 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

| Interest rate Exposures | | | | |
|---|---|---|---|---|
| **£m** | **2013/14** | **2014/15** | **2015/16** | **2016/17** |
| | **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*** | **163** | **163** | **163** | **163** |
| • ***Investments only*** | **70** | **61** | **60** | **57** |
| ***Limits on variable interest rates*** | | | | |
| • ***Debt only*** | **41** | **41** | **41** | **41** |
| • ***Investments only*** | **62** | **59** | **58** | **56** |

| Maturity Structure of fixed interest rate borrowing 2013/14 | | |
|---|---|---|
| | **Lower** | **Upper** |
| Under 12 months | 0% | 5% |
| 12 months to 2 years | 0% | 20% |
| 2 years to 5 years | 0% | 20% |
| 5 years to 10 years | 0% | 50% |
| 10 years to 25 years | 0% | 100% |
| 25 years to 40 years | 0% | 100% |
| Over 40 years | 0% | 80% |

**Investment Treasury Indicator and Limit**

Total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end. The 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** | **2016/17** |
| Principal sums invested > 364 days | £m<br>66 | £m<br>66 | £m<br>58 | £m<br>56 | £m<br>52 |

**Annex 2**

## Policy on Minimum Revenue Provision for 2013/14

1. The Minimum Revenue Provision is a statutory charge that the Council is required to make from its revenue budget. This provision enables the Council to generate cash resources for the repayment of borrowing. The 2013/14 budget is £4.9 million.

2. The calculation of the provision is prescribed by legislation, which states that Councils are 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. One of the aims 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 which closely links to the asset's life. The provision for all assets, irrespective of asset life, for expenditure funded from supported borrowing and prudential borrowing prior to 2007/08 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. Torbay Council's Annual Minimum Revenue Provision Policy Statement states that the calculation of the MRP is as follows which has 2 stages:

   i) The Council will budget as a minimum 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 the Department of Communities and Local Government's (DCLG) Informal Commentary on the legislation.

      This calculation allows for the adjustments of the following items:

      - Deducting any expenditure and revenue provision made in relation to unsupported borrowing after 2007/08. The charge for unsupported borrowing after 2007/08 is calculated separately as described in paragraph ii below.
      - "Adjustment A" which relates to a previous calculation change in 2004
      - Adjustment of MRP to ensure no disadvantage results to Councils from the regulations compared to previous MRP regulations
      - Adjustment of MRP to ensure no disadvantage results to Councils from the requirements for accounting for Private Finance Initiative schemes

ii) 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, which reflects the estimated usable life of that asset.

The Council will use the “asset life method” for the calculation, the MRP for each asset will be calculated using an annuity calculation based on 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 for:-

- An adjustment to the MRP calculation will be made 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.

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

6) 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.

7) Where assets prior to 2007/08 have been purchased by unsupported borrowing (before the current 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.

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

9) 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.

8) In relation to borrowing transferred to the Council from Devon County Council for the Council’s share of the Devon County Council debt for local government reorganisation, the Council will budget to make a VRP over 40 years to ensure cash resources for the repayment of the debt is available on maturity.

Annex 3

Interest Rate Forecasts 2013 – 2016

| Sector's Interest Rate View | Now | Dec-12 | Mar-13 | Jun-13 | Sep-13 | Dec-13 | Mar-14 | Jun-14 | Sep-14 | Dec-14 | Mar-15 | Jun-15 | Sep-15 | Dec-15 | Mar-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Sector's Bank Rate View | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.75% | 1.00% | 1.25% | 1.50% | 1.75% |
| 3 Month LIBID | 0.40% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.60% | 0.60% | 0.70% | 0.80% | 1.10% | 1.40% | 1.70% | 1.90% |
| 6 Month LIBID | 0.56% | 0.70% | 0.70% | 0.70% | 0.70% | 0.70% | 0.70% | 0.80% | 0.90% | 1.00% | 1.10% | 1.30% | 1.60% | 1.90% | 2.20% |
| 12 Month LIBID | 0.92% | 1.00% | 1.00% | 1.00% | 1.00% | 1.00% | 1.10% | 1.10% | 1.20% | 1.30% | 1.30% | 1.50% | 1.80% | 2.10% | 2.40% |
| 5yr PWLB Rate | 1.66% | 1.50% | 1.50% | 1.50% | 1.60% | 1.60% | 1.70% | 1.70% | 1.80% | 2.00% | 2.20% | 2.30% | 2.50% | 2.70% | 2.90% |
| 10yr PWLB Rate | 2.64% | 2.50% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.70% | 2.80% | 3.00% | 3.20% | 3.30% | 3.50% | 3.70% | 3.90% |
| 25yr PWLB Rate | 3.88% | 3.70% | 3.80% | 3.80% | 3.80% | 3.80% | 3.90% | 3.90% | 4.00% | 4.10% | 4.30% | 4.40% | 4.60% | 4.80% | 5.00% |
| 50yr PWLB Rate | 4.04% | 3.90% | 4.00% | 4.00% | 4.00% | 4.00% | 4.10% | 4.10% | 4.20% | 4.30% | 4.50% | 4.60% | 4.80% | 5.00% | 5.20% |
| **Bank Rate** | | | | | | | | | | | | | | | |
| Sector's View | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.75% | 1.00% | 1.25% | 1.50% | 1.75% |
| UBS | 0.50% | 0.50% | 0.50% | 0.50% | 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 | 1.66% | 1.50% | 1.50% | 1.50% | 1.60% | 1.60% | 1.70% | 1.70% | 1.80% | 2.00% | 2.20% | 2.30% | 2.50% | 2.70% | 2.90% |
| UBS | 1.66% | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Capital Economics | 1.66% | 1.30% | 1.30% | 1.30% | 1.30% | 1.30% | 1.30% | 1.30% | 1.50% | 1.60% | - | - | - | - | - |
| **10yr PWLB Rate** | | | | | | | | | | | | | | | |
| Sector's View | 2.64% | 2.50% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.70% | 2.80% | 3.00% | 3.20% | 3.30% | 3.50% | 3.70% | 3.90% |
| UBS | 2.64% | 2.80% | 3.00% | 3.10% | 3.20% | 3.40% | 3.50% | 3.60% | 3.70% | 3.80% | - | - | - | - | - |
| Capital Economics | 2.64% | 2.30% | 2.30% | 2.30% | 2.30% | 2.30% | 2.30% | 2.30% | 2.30% | 2.30% | - | - | - | - | - |
| **25yr PWLB Rate** | | | | | | | | | | | | | | | |
| Sector's View | 3.88% | 3.70% | 3.80% | 3.80% | 3.80% | 3.80% | 3.90% | 3.90% | 4.00% | 4.10% | 4.30% | 4.40% | 4.60% | 4.80% | 5.00% |
| UBS | 3.88% | 4.00% | 4.20% | 4.30% | 4.40% | 4.50% | 4.50% | 4.50% | 4.50% | 4.50% | - | - | - | - | - |
| Capital Economics | 3.88% | 3.50% | 3.50% | 3.50% | 3.50% | 3.50% | 3.50% | 3.50% | 3.50% | 3.50% | - | - | - | - | - |
| **50yr PWLB Rate** | | | | | | | | | | | | | | | |
| Sector's View | 4.04% | 3.90% | 4.00% | 4.00% | 4.00% | 4.00% | 4.10% | 4.10% | 4.20% | 4.30% | 4.50% | 4.60% | 4.80% | 5.00% | 5.20% |
| UBS | 4.04% | 4.10% | 4.30% | 4.40% | 4.50% | 4.60% | 4.60% | 4.60% | 4.60% | 4.60% | - | - | - | - | - |
| Capital Economics | 4.04% | 3.80% | 3.80% | 3.80% | 3.80% | 3.80% | 3.80% | 3.80% | 3.80% | 3.80% | - | - | - | - | - |

**Annex 4**

## Economic Background (provided by Sector on 20th November 2012)

### The Global economy

The Eurozone debt crisis has continued to cast a pall over the world economy and has depressed growth in most countries. This has impacted the UK economy which is unlikely to grow significantly in 2012 and is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy; this recession is the worst and slowest recovery of any of the five recessions since 1930. A return to growth @ 1% in quarter 3 in unlikely to prove anything more than a washing out of the dip in the previous quarter before a return to weak, or even negative, growth in quarter 4.

The **Eurozone sovereign debt crisis** has abated somewhat following the ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement was Spain which continues to prevaricate on making such a request and so surrendering its national sovereignty to IMF supervision. However, the situation in Greece is heading towards a crunch point as the Eurozone imminently faces up to having to relax the time frame for Greece reducing its total debt level below 120% of GDP and providing yet more financial support to enable it to do that. Many commentators still view a Greek exit from the Euro as inevitable as total debt now looks likely to reach 190% of GDP i.e. unsustainably high. The question remains as to how much damage a Greek exit would do and whether contagion would spread to cause Portugal and Ireland to also leave the Euro, though the longer a Greek exit is delayed, the less are likely to be the repercussions beyond Greece on other countries and on EU banks.

Sentiment in financial markets has improved considerably since this ECB action and recent Eurozone renewed commitment to support Greece and to keep the Eurozone intact. However, the foundations to this "solution" to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse.

**The US economy** has only been able to manage weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing (QE) combined with a commitment to a continuation of ultra low interest rates into 2015. Unemployment levels have been slowly reducing but against a background of a fall in the numbers of those available for work. The fiscal cliff facing the President at the start of 2013 has been a major dampener discouraging business from spending on investment and increasing employment more significantly in case there is a sharp contraction in the economy in the pipeline. However, the housing market does look as if it has, at long last, reached the bottom and house prices are now on the up.

Hopes for a broad based recovery have, therefore, focused on the **emerging markets**. However, there are increasing concerns over flashing warning signs in various parts of the Chinese economy that indicate it may be heading for a hard landing rather than a gradual slow down.

### The UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order over the next four years, now look as if they will fail to achieve their objectives within the original planned timeframe. Achieving this target is dependent on the UK economy growing at a reasonable pace but recession in the Eurozone, our biggest trading partner, has depressed growth whilst tax receipts have not kept pace with additional welfare benefit payments. It will be important for the Government to retain investor confidence in UK gilts so there is little room for it to change course other than to move back the timeframe.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. There is, though, little evidence that consumer confidence levels are recovering nor that the manufacturing sector is picking up. On the positive side, growth in the services sector has rebounded in Q3 and banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lending scheme, which started in August 2012, has not yet had the time to make a significant impact. Finally, the housing market remains tepid and the outlook is for house prices to be little changed for a prolonged period.

**Economic Growth.** Economic growth has basically flat lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation quarterly report for August 2012 and were then further lowered in the November Report. Quantitative Easing (QE) was increased again by £50bn in July 2012 to a total of £375bn. Many forecasters are expecting the MPC to vote for a further round of QE to stimulate economic activity regardless of any near-term optimism. The announcement in November 2012 that £35bn will be transferred from the Bank of England's Asset Purchase Facility to the Treasury (representing coupon payments to the Bank by the Treasury on gilts held by the Bank) is also effectively a further addition of QE.

**Unemployment.** The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years as over one million jobs have been created in the private sector in the last two years.

**Inflation and Bank Rate.** Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. However, inflation increased back to 2.7% in October though it is expected to fall back to reach the 2% target level within the two year horizon.

**AAA rating.** The UK continues to enjoy an AAA sovereign rating. However, the credit rating agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years.

### Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains relatively fragile and whilst there is still a broad range of views as to potential performance, expectations have all been downgraded during 2012. Key areas of uncertainty include:

- the potential for the Eurozone to withdraw support for Greece at some point if the costs of such support escalate were to become prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;

- inter government agreement on how to deal with the overall Eurozone debt crisis could fragment; 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 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 are unlikely to be achieved;

- the risk  of the UK's main trading partners, in particular the EU and US, falling into recession ;
- stimulus packages failing to stimulate growth;
- elections due in Germany in 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.
- the potential for action to curtail the Iranian nuclear programme
- the situation in Syria deteriorating and impacting other countries in the Middle East

The focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015 as very limited.  There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

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.  The interest rate forecast in this report represents a balance of downside and upside risks.  The downside risks have already been commented on.  However, there are specific identifiable upside risks as follows to PWLB rates and gilt yields, and especially to longer term rates and yields: -

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields
- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting in new purchases,  followed later by outright sale of gilts currently held
- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Eurozone
- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth
- The possibility of a UK credit rating downgrade (Moody's has stated that it will review the UK's Aaa rating at the start of 2013).

**Annex 5**

## Creditworthiness 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. The credit ratings are supplemented by with the following overlays:
   - Credit watches and credit outlooks from the credit rating agencies
   - Credit Default Swap (CDS) spreads to give early warning of likely changes in credit ratings
   - Sovereign ratings to select counterparties from only the most creditworthy countries

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. 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.

   - if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
   - in addition to the use of credit ratings the Council will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

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 | France |
| Canada | Norway | Hong Kong |
| Denmark | Singapore | USA |
| Finland | Sweden | |
| Germany | Switzerland | |
| Luxembourg | United Kingdom | |

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.

## 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 – non UK | Sovereign rating AA+ | In-house and Fund Manager |
| Collective Investment Schemes structured as Open Ended Investment Companies (OEICs): -<br><br>1. Government Liquidity Funds<br>2. Money Market Funds<br>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. Under the delegated powers the Chief Finance Officer can set limits that are lower based on the latest economic conditions and credit ratings.

| | **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 1 | 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 |

| | **Minimum Credit Criteria** | **Use** | **Max % of total investments** | **Max. maturity period*** |
|---|---|---|---|---|
| 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.<br><br>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 | Long-term AA | In-house and Fund Manager | 35% | 5 years |
| Property Fund: *the use of these investments would constitute capital expenditure* | -- | In-house and Fund Manager | 35% | 5 years |

| | Minimum Credit Criteria | Use | Max % of total investments | Max. maturity period* |
|---|---|---|---|---|
| Collective Investment Schemes structured as Open Ended Investment Companies (OEICs):- 1.Bond Funds 2.Gilt Funds | AAA | Fund Manager | 35% | 5 years |
| Corporate Bonds | 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. 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.