	London Borough of Hammersmith & Fulham **(AUDIT, PENSIONS AND STANDARDS COMMITTEE)** **(11 February 2015)**
TITLE OF REPORT	
Treasury Management Strategy Report 2015/16	
Open Report	
For Information **Key Decision: No**	
Wards Affected: None	
Accountable Executive Director: Executive Director of Finance and Corporate Governance Jane West, Bi-Borough Director of Finance, Hitesh Jolapara Responsible Director	
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1. EXECUTIVE SUMMARY

1.1 The report sets out the Council's Treasury Management Strategy for 2015/16. It seeks approval for the Executive Director of Finance and Corporate Governance to arrange the Treasury Management Strategy in 2015/16 as set out in this report.

2. RECOMMENDATIONS

2.1 That approval is given to the future borrowing and investment strategies as outlined in this report and that the Executive Director of Finance and Corporate Governance be authorised to arrange the Council's cash flow, borrowing and investments in 2015/16.

2.2 In relation to the Council's overall borrowing for the financial year, to note the comments and the Prudential Indicators as set out in this report and the four year capital programme 2015/16 to 2018/19.

2.3 That approval is given to pay the Housing Revenue Account (HRA) investment income on unapplied HRA receipts and other HRA cash balances calculated at the average rate of interest (approximately 0.5% p.a.) earned on temporary investments with effect from 1 April 2014.

3. BACKGROUND

3.1 Treasury Management is defined by the CIPFA[1] Code of Practice as 'The management of the local authority's investments and cash flows, its banking, money market and capital

[1] Chartered Institute of Public Finance and Accountancy

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 Council is required to receive and approve, as a minimum, three main reports each year: a Treasury Strategy Report (this report), Mid-year report and an Outturn report. These reports are required to be adequately scrutinised before being recommended to the Council by the Cabinet. This role is undertaken by the Audit, Pensions and Standards Committee and the Finance and Delivery PAC.

3.3 The Treasury Management Strategy is set out in section 6 of this report, and the remainder of the report cover the following list. These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the CIPFA Treasury Management Code and CLG Investment Guidance.

- prospects for interest rates;
- the current treasury position;
- the proposed investment strategy;
- the borrowing strategy;
- prudential indicators; and,
- approach to debt rescheduling.

3.4 The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes. This will involve both the organisation of the cashflow and, where capital plans require, the organisation of appropriate borrowing facilities. The function covers the relevant treasury and prudential indicators, the current and projected debt positions and the annual investment strategy.

3.5 Under regulations set out by the (now called) Department for Communities and Local Government (CLG) in 2003, a Council's investment policy needs to cover so-called "specified investments" and "non-specified investments". A specified investment is defined as an investment which is denominated in sterling, is less than one year, is made with a body or scheme of high credit quality, UK Government or UK local authority and does not involve the acquisition of share capital or loan capital in any body corporate. Non-specified investments are those that do not meet these criteria.

3.6 Section 6 of this report sets out the investment approach, and takes account of the specified and non-specified approach. The Council is likely only to consider non-specified investments where an investment is made for longer than one year.

3.7 The CIPFA recommendations contained in the Code of Practice and Cross-Sectoral Guidance Notes issued as a revised version in 2011 for Treasury Management in the Public Services require that each Local Authority has a Treasury Management Policy Statement that is approved by the Full Council. This is set out in Appendix A of this report.

4. PROSPECTS FOR INTEREST RATES

4.1 Interest rate projections remain low in the short term, with Bank of England bank rate remaining at 0.5% for up to 12 months. However, market rates remain very volatile and are affected by Quantitative Easing (continuing, unchanging or reducing) and perceived safe haven status of the United Kingdom keeping rates low against risk of macro-economic issues (particularly in Europe) and inflation risk pushing rates higher.

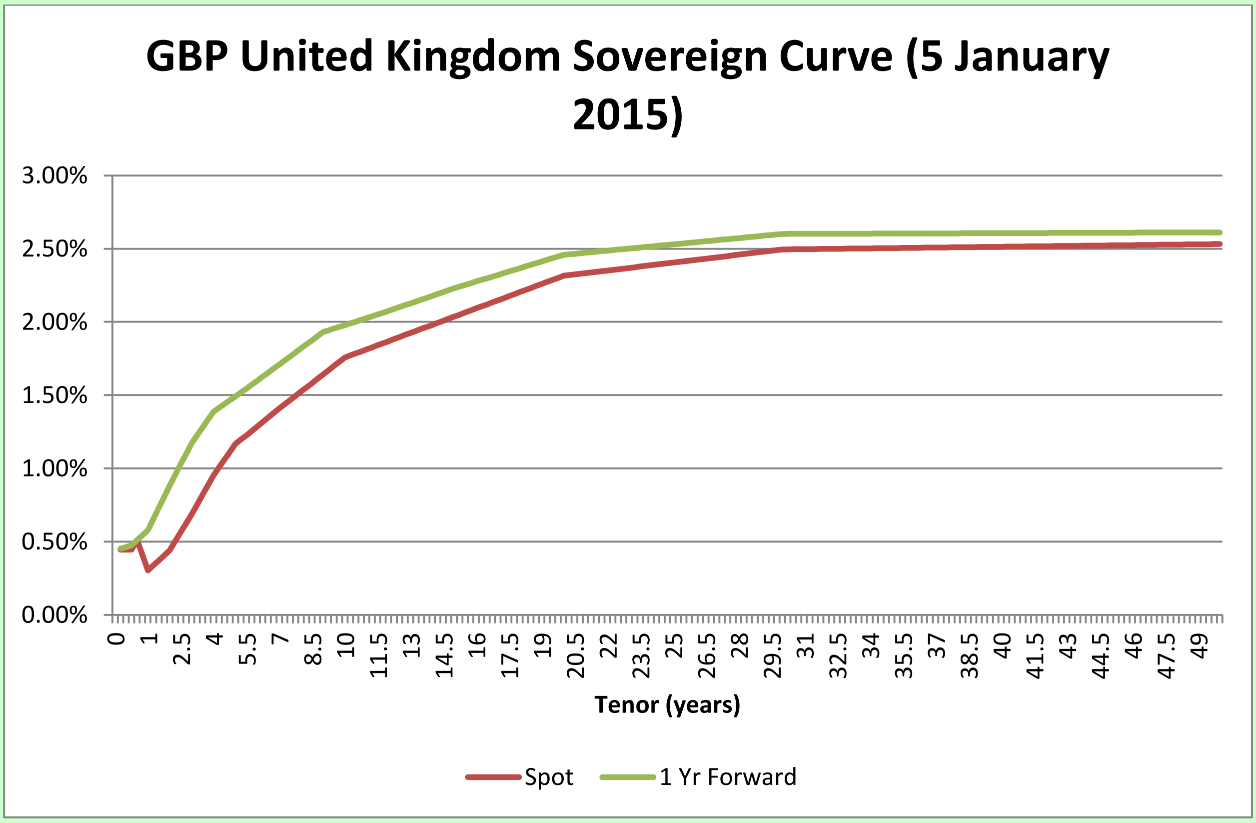
4.2 The current economic outlook and structure of market rates and government debt yields have several key treasury management implications:

As for the Eurozone, concerns in respect of a major crisis subsided considerably in 2013. The downturn in growth and inflation during the second half of 2014, and worries over the Ukraine situation, Middle East and Ebola, have led to a resurgence of those concerns as risks increase that it could be heading into deflation and a triple dip recession since 2008. Sovereign debt difficulties have not gone away and major concerns could return in respect of individual countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Greece and Ireland has done). Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;

Investment returns are likely to remain relatively low during 2015/16 and beyond;

Borrowing interest rates have been volatile during 2014 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. During July to October 2014, a building accumulation of negative news has led to an overall trend of falling rates. The policy of avoiding new borrowing by running down spare cash balances has continued over the last few years.

There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns. The graph below shows the current Gilt rates and those projected (by investors) in a year's time. As is apparent, an increase in interest rates across all maturities is expected – though a limited increase rather than a material change.



5. CURRENT TREASURY POSITION

5.1 As at the 19th December 2014, the Council had £365 million cash investments. The cash is made up of the Council's usable reserves, capital receipts and unspent government grants. Although the level of cash has increased by £45 million to date this financial year it is anticipated the rate of further increases in cash levels will reduce for the remainder of the year and are forecast to be approximately £380 - £400 million.

5.2 The Council has for a number of years maintained a policy of debt reduction in order to deliver savings to the General Fund through reduced debt service payments. No new borrowing has been undertaken since November 2009 and where borrowings have fallen due for repayment, they have not been replaced. This has been the policy for both the General Fund and HRA. Officers periodically review the possibility of the early redemption of external debt.

5.3 The forecast closing General Fund debt as measured by the Capital Financing Requirement (CFR) for 2014/15 is £59.5m. This is subject to the application of forecast capital receipt surpluses to debt reduction at the year-end.

Forecast Movement in the GF Capital Financing Requirement (CFR)

£m	**2015/16 Estimate**	**2016/17 Estimate**	**2017/18 Estimate**	**2018/19 Estimate**
Opening Capital Finance Requirement (CFR)	56.65	43.18	43.18	43.18
Revenue Repayment of Debt	(0.54)	0.0	0.0	0.0
Application of Mainstream Programme (Surplus)	(12.93)	0.0	0.0	0.0
Closing CFR	**43.18**	**43.18**	**43.18**	**43.18**

5.4 The CFR measures an authority's underlying need to borrow for a capital purpose. It is considered by the Chartered Institute of Public Finance Accountancy (CIPFA) as the best measure of Council debt as it reflects both external and internal borrowing. It was introduced by the Government in 2004 and replaced the 'credit ceiling' as the Council's measure of debt.

5.5 The CFR is the difference between capital expenditure incurred and the resources set aside to pay for this expenditure. Put simply it can be thought of as capital expenditure incurred but not yet financed in-full and serves as a measure of an authority's indebtedness. An important caveat is that the CFR does not necessarily equal the outstanding loans of the authority. A council may be 'cash rich' and pay for a new asset in full without entering into new loans. However unless the council simultaneously sets aside reserves (either through recognising a revenue cost or transferring existing reserves from 'usable' to 'unusable') the CFR will increase. In this example the authority has effectively borrowed internally. The CFR should therefore be thought of as the total of internal and external borrowing.

5.6 There are 5 Prudential Indicators for 2014/15 relating to capital stated in the Capital Programme 2015/16 to 2018/19 report to Budget Council in February 2015, (to meet CIPFA's Prudential Code requirements).

5.7 The Council's borrowing and Capital Financing Requirement (CFR) positions are summarised in the tables below.

Current Portfolio Position

£'000	**2013/14 Actual**	**2014/15 Estimate**	**2015/16 Estimate**	**2016/17 Estimate**	**2017/18 Estimate**
Borrowing at 1 April	262,067	250,511	247,599	231,897	224,823
Expected change in borrowing during the year	(11,556)	(2,912)	(15,703)	(7,074)	(7,418)
Actual Borrowing at 31 March	**250,511**	**247,599**	**231,897**	**224,823**	**217,405**

Total investments at 31 March	(320,200)	(380,000)	(350,000)	(330,000)	(300,000)
Net borrowing/(investment)	**(69,689)**	**(132,401)**	**(118,103)**	**(105,177)**	**(82,595)**

Split between the Housing Revenue A/c (HRA) and General Fund (GF):
External borrowing (PWLB) position at Year End

£'000 External Borrowing only	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Housing Revenue A/c (HRA)	207,717	205,302	192,283	186,417	180,266
General Fund (GF)	42,794	42,297	39,614	38,406	37,139
Total borrowing at year end	**250,511**	**247,599**	**231,897**	**224,823**	**217,405**

Sets out the Capital Financing Requirement analysed between General Fund and HRA

£'000 CFR only	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
General Fund CFR	74,200	56,648	43,179	43,179	43,179
HRA CFR	207,260	205,346	205,918	202,650	205,453
TOTAL CFR	**281,460**	**261,994**	**249,097**	**245,830**	**248,632**

6. ANNUAL INVESTMENT STRATEGY

Introduction

6.1 The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a rating 'uplift' due to implied levels of sovereign support. More recently, in response to the evolving regulatory regime, the agencies have indicated they may remove these 'uplifts'. This process may commerce during 2014/15 and/or 2015/16. The actual timing of the changes is still subject to discussion, but this does mean immediate changes to the current credit methodology are required.

6.2 It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of sovereign support that has been built into rating through the financial crisis. The eventual removal of implied sovereign support will only take place when the regulatory and economic environments have ensured the financial institutions are much stronger and less prone to failure in a financial crisis. The results of these changes and consequent rating changes, will be one of the aspects that are kept under review and the implication for LBHF treasury investment may be that funds are moved away from banks and invested elsewhere.

Investment Policy

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

6.4 In line with the guidance, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk.

6.5 Continuing regulatory changes in the banking sector are designed to see greater stability, lower risk and the removal of expectations of government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on rating applied to institutions. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes.

6.6 As with previous practice, ratings will not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will maintain monitor market pricing such as "credit default swaps"[2] and overlay that information on top of the credit ratings.

6.7 Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

6.8 This section sets out the Council's annual investment strategy for 2015/16 and any proposed changes from the 2014/15 Treasury Management Strategy, the table below summarises the maximum amounts and tenors of investments that the Council can hold. The table also shows the maximum proposed limits that Officers can work within.

Institution Type	**Minimum Credit Rating Required (S&P / Moodys / Fitch)**	**Maximum Individual Counterparty Investment limit (£m)**	**Maximum tenor of deposit / investment**	**Treasury Management Strategy 2014/15**
DMO Deposits	UK Government Rating	Unlimited	6 months	No change
UK Government (Gilts / T-Bills / Repos)	UK Government Rating	Unlimited	Unlimited	No change
Supra–national Banks	AA- / Aa3 / AA-	£100m	5 years	£30m / 3 year
European Agencies	AA- / Aa3 / AA-	£100m	5 year	£10m / 1 year
Network Rail	UK Government Rating	Unlimited	Oct 2052	No change
TFL	AA- / Aa3 / AA-	£100m	3 years	£30m
GLA	N/A	£100m	3 years	£30m
UK Local Authorities	N/A	£10m per Local Authority, £50m in aggregate	1 years	No change
Commercial Paper issued by UK and European corporate	A-2 / P-2 / F-2	£20m per name, £80m in aggregate	Six months	£10m per name, £50m in aggregate

[2] Credit ratings are based on historical information and Credit Default Swaps (CDS) reflect current market sentiment if the CDS values fall significantly over a short period this could be an early warning of possible changes in credit rating and trigger further investigation. (see Appendix C for a definition)

Institution Type	**Minimum Credit Rating Required (S&P / Moodys / Fitch)**	**Maximum Individual Counterparty Investment limit (£m)**	**Maximum tenor of deposit / investment**	**Treasury Management Strategy 2014/15**
Covered Bonds issued in sterling	AA+/Aa1/AA+ The bond issue; Investment grade of the underlying issuer	£100m	5 years	New
Money Market Funds MMF	AAA / Aaa / AAA be AAA by at least one of the main credit agencies	£25m per fund manager, £200m in aggregate	Three day notice	£15m per fund manager, £75m in aggregate
Enhanced Money Funds	AAA / Aaa / AAA by at least one of the main credit agencies	£20m per fund manager, £60m in aggregate	Up to seven day notice	£10m per fund manager, £30m in aggregate
UK Bank Fixed Deposits / Certificates of Deposit / Short Dated Bonds	AA- / Aa3 / AA- and above (or UK Government ownership of greater than 25%), subject to minimum ST ratings	£70m	5 years	3 years
UK Bank Fixed Deposits / Certificates of Deposit / Short Dated Bonds	A- / A3 / A- and above, subject to minimum ST ratings	£50m	3 years	£30m / Six months
Non-UK Bank Fixed Deposits / Certificates of Deposit / Short Dated Bonds	AA- / Aa2 / AA- and above, subject to minimum ST ratings	£50m	3 years	£30m / 1 year
Non-UK Bank Fixed Deposits / Certificates of Deposit / Short Dated Bonds	A / A2 / A and above, subject to minimum ST ratings	£30m	1 year	£15m / Six months

6.9 The remainder of this section six covers the following in further detail:

- Current investment types
- Changes for the 2015/16 Treasury Management Strategy
  - Commercial paper to cover European Corporates
  - Covered Bonds
  - Certificates of Deposit
- Proposed changes to investment limits and tenors
- Non-specified investments
- Creditworthiness criteria
- Country limits.

Current Investment Types[3]

6.10 As per the 14/15 Treasury Management Strategy, it is proposed that for 15/16 the Council can continue to invest in financial institutions, external funds and certain capital market instruments as set out below. All investments would be in Sterling. The investment types listed below are as per the current TMS.

(i) Investment with the Debt Management Office with no financial limit (UK government guaranteed)

(ii) Investment in financial institutions of a minimum credit rating, with the parent company domiciled only in certain jurisdictions;

(iii) Investment in UK Treasury Bills (T-Bills) and Gilts (conventional or indexed-linked) with no financial limit (UK government guaranteed)

(iv) Investments in UK Government repurchase agreements (“Repos” and “Reverse Repos”);

(v) Lending to certain public authorities (Unitary Authorities, Local Authorities, Borough and District Councils, Met Police, Fire and Police Authorities)

(vi) Investment in close to maturity AAA-rated corporate bonds and commercial paper backed by UK Government guarantees;

(vii) Investment in supra-national AAA-rated issuer bonds and commercial paper;

(viii) Investment in AAA-rated Sterling Money Market Funds and longer term funds;

(ix) Investment in commercial paper (CP) of UK domiciled entities with minimum short term credit rating of A1/P-1/F-1.

6.11 In determining whether to place deposits with any institution or fund, the Tri–borough Director for Treasury and Pensions will remain within the limits set out above, but take into account the following when deciding how much to invest within the limit set out above:

(i) the financial position and jurisdiction of the institution;

(ii) the market pricing of credit default swaps for the institution;

(iii) any implicit or explicit Government support for the institution;

(iv) Standard & Poor’s, Moody’s and Fitch’s short and long term credit ratings;

(v) Core Tier 1 capital ratios; and

(vi) other external views as necessary.

Changes for the 2015/16 Treasury Management Strategy

6.12 Officers are proposing various changes to the 2015/16 Treasury Strategy, in part to continue to reduce reliance on the Debt Management Office and to provide some flexibility for better investment returns, within the structure of a cautious investment outlook. Continued diversification of investment instrument and counterparty as a way of mitigating risk (while generating some form of return) remains key. There is also uncertainty around the implications of the so-called bank bail-in regulations which are being introduced on a

[3] Appendix B provides more detail on the various asset classes.

phased basis in some EU countries (including UK) to prevent a future bail out of a financial institution by the relevant Government. Such implications may include what this will mean for bank credit ratings, the perceived (and possibly actual) increase in bank risk for depositors, the timing of any introduction as well as increased market concerns within and between jurisdictions.

6.13 As a result of the developments in the paragraph above, the proposals for 2015/16, while building on the Treasury Management Strategy for 2014/15, make a recommendation for the use of Commercial Paper (CP) for European corporates, Covered Bonds and Certificates of Deposit (CDs) as well as adjusting limits and tenors for existing investment classes. The tenors and minimum credit ratings for the various investment classes are set out in the paragraph 6.8.

Commercial Paper issued by European corporates

6.14 While the Council has invested in CP from UK entities (mainly Network Rail and Transport for London), there are significant European companies that issue Sterling CP – such as Volkswagen (VW).Given the investment return, low risk and further diversification (as well as a continued sterling investment), such an investment fits within the investment thesis.

Covered Bonds

6.15 Covered bonds are debt instruments issued by a financial institution, but where security has been granted over a pool of underlying assets (e.g. a pool of mortgage loan or public sector debt) to which investors have a preferential claim in the event of default. The covered bond issue would be rated by the rating agencies, and while the issuer would be allowed to 'swap' some of the underlying collateral, it is up to an independent custodian / agent to validate that what is being taken out of the pool is of no worse status than that being switched in. the issuance of covered bonds enables financial institutions to obtain lower funding in order grant mortgage loans for housing and non-residential property as well as to finance public debt.

Certificates of Deposit

6.16 Financial institutions as well as offering loans, also borrow through the issuance of Certificates of Deposit (CD). These are tradable instruments where the issuer borrows at a set rate for an agreed length of time, before repaying the principal at maturity. CD's tend to have a shorter length tenors, unlike bonds, and enable an investor to manage more actively any credit/ counterparty exposure, rather than waiting for a fixed term deposit to mature.

Proposed changes to investment limits and tenors

6.17 Given investments to date, the shape of the current yield curve, the likely low level of interest rates for the immediate future and the opportunities for investment, it is proposed that limits and tenors of investment are extended for many investment types – both in tenor and / or investment limit.

6.18 Such changes would allow the Council to invest in longer maturities and take advantage in any yield pick-up as well as reducing reliance on the banking institutions – at the moment, there is uncertainty on the timing and impact of any introduction of bail-in regulations. It would be prudent for the Council to be able to remove direct reliance on such an asset class without impacting return too severely.

6.19 The graph in paragraph 4 above shows a steep current and one-year forward yield curve, and that higher returns for tenors up to five years (for a core level of cash) would provide greater returns rather than a shorter investment. Given the predicted rise in interest rates however, the Council while wanting to take advantage of higher rates for longer duration investments will also want to benefit from a rise in rates when they occur rather than locked in to then lower yielding investments.

6.20 The 2014/15 MMF's limit is £15 million per fund (£75 million aggregate) and it is proposed that it is raised to £25 million per fund £200 million for MMFs and also increase the limit for EMFs from £10 million to £20 million (£60 million aggregate).

6.21 The Council places investments / Fixed Deposits/ Certificates of Deposit / Short Dated Bonds with only four UK banks – Barclays, HSBC, Lloyds and Royal Bank of Scotland (RBS and Nat West). For UK banks with Government ownership (and given the increased relative stability over the last 2-3 years), it is proposed that the minimum percentage of UK Government ownership (to qualify within this strategy for such criteria) is maintained at 25%. At present only RBS falls into this category. Given the implied Government support, it is proposed that counterparty limit remains at £70 million and the tenor be increased from three to five years.

6.22 For UK banks with a minimum credit rating of AA-/Aa3/AAA and above it is proposed that the maximum individual investment limit is maintained at £70m and the maximum tenor of investment is changed from three to five years.

6.23 UK banks with a minimum credit rating of A-/A3/A- and above it is proposed that the maximum individual investment limit is increased from £30m to £50m and the maximum tenor of investment is changed from six months to three years.

6.24 Non-UK banks with a minimum credit rating of AA-/Aa2/AA- and above, it is recommended that the maximum individual investment limit is increased from £30m to £50m and that the maximum tenor of investment is changed from one to three years.

6.25 Non-UK banks with a minimum credit rating of A/A2/A and above, it is recommended that the maximum individual investment limit is increased from £15m to £30m and that the maximum tenor of investment is changed from six months to one year.

6.26 In summary, the bank investment limits are shown in the table below. The extension to investment limits and tenor will increase the Council's level of return but the risk may also increase as funds will be tied up for longer.

Institution Type	Minimum Credit Rating Required (S&P / Moodys / Fitch)	Maximum Individual Counterparty Investment limit (£m)	Maximum tenor of deposit / investment
UK Bank Fixed Deposits / Certificates of	With UK Government ownership of greater than 25%. AA- / Aa3 / AA- and above subject to minimum ST	70	Five years

Deposit / Short Dated Bonds	ratings		
UK Bank Fixed Deposits / Certificates of Deposit / Short Dated Bonds	A- / A3 / A- and above, subject to minimum ST ratings	50	Three years
Non-UK Bank Fixed Deposits / Certificates of Deposit / Short Dated Bonds	AA- / Aa2 / AA- and above, subject to minimum ST ratings	50	Three years
Non-UK Bank Fixed Deposits / Certificates of Deposit / Short Dated Bonds	A / A2 / A and above, subject to minimum ST ratings	30	One year

Non-specified investments

6.27 Under section 15(1) of the Local Government Act 2003, restrictions are placed on Local Authorities around the use of so-called specified and non-specified investments. A specified investment is defined as an investment which satisfies all of the conditions below:

(i) The investment and any associated cash flows are denominated in sterling ;

(ii) The investment has a maximum maturity of one year;

(iii) The investment is not defined as capital expenditure; and

(iv) The investment is made with a body or in an investment scheme of high credit quality; or with the UK Government, a UK Local Authority or parish/community council.

6.28 A non-specified investment is any investment that does not meet all the conditions above. The only likely non-specified investment that the Council may make is for any investment greater than one year. For such an investment, a proposal will be made to the Executive Director of Finance and Corporate Governance on the recommendation from the Tri Borough Director of Treasury and Pensions after taking into account cash flow requirements, the outlook for short to medium term interest rates and the proposed investment counterparty.

6.29 Long term investments (for periods over 364 days) will be limited to no more than £120 million with a tenor of up to five year.

Creditworthiness Criteria

6.30 As has been the case for 2014/15, the Council's investment priorities continue to be the security of capital and 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. The risk appetite of this Council is low in order to give priority to security of its investments.

6.31 In accordance with this, and in order to minimise the risk to investments, the Council has set the minimum acceptable credit quality of counterparties for inclusion on the lending list. As at present, 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 and any existing investment will be matured at the earliest possible convenience.

6.32 For the financial institution sector, the Council will invest in entities with a minimum credit as set out above (A-/A3/A- for a UK bank, and A/A2/A for a non-UK bank as appropriate), as long as that entity has a short term rating F2/P-2/A-3 or better. Where a split rating applies the lowest rating will be used. This methodology excludes banks with UK Government ownership. Banks would need to be rated by at least two of the three main credit rating agencies and where there was a split rating the lower rating would be used.

6.33 The limits can change if there are rating changes, however the maximum limit would never be more than specified by institution type in paragraph 6.8. Officers are likely to work well within these limits to ensure headroom for short term liquidity.

Country Limits

6.34 The current TMS is based on a ratings approach to country of domicile, for 2015/16, it is proposed that deposits / investments are made with financial entities domiciled only in the following countries: Australia, Canada, Denmark, Finland, France, Germany, Japan, Luxembourg, Netherlands, Norway, Singapore, Sweden, Switzerland, UK and USA.

7. BORROWING STRATEGY

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

7.2 The HRA will fund its requirements from additional internal borrowing. The General Fund has no expectation of borrowing in the near future.

7.3 Against this background and the investment risks described in this paper, caution will be adopted with the 2015/16 treasury operations. The treasury team will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances and advise the Executive Director of Finance and Corporate Governance accordingly.

7.4 If there was a significant risk of a much sharper rise in long and short term rates than the currently forecast. Then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are still lower then they will be in the next few years.

7.5 The Council has a debt strategy of no new borrowing and where borrowing has fallen due for repayment it has not been replaced. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with borrowing, as cash balances and cash flow has been used as a temporary measure instead. This strategy is prudent as investment returns are low and counterparty risk is high.

7.6 Under the regulatory requirement, there are three borrowing related treasury activity limits. The purpose of these are to monitor and control 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.
- 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.

7.7 The tables below sets out these treasury indicators and limits. The Council is currently compliant with all these indicators. The Council's existing level of fixed interest rate exposure is 100.0% and variable rate exposure is 0.0%.

Interest Rate Exposure for borrowing

£m / %	2015/16		2016/17		2017/18	
Upper Gross Borrowing Limits on fixed interest rates	345	100%	385	100%	385	100%
Upper Gross Borrowing Limits on variable interest rates	69	20%	77	20%	77	20%

Structure limits for debt maturity

Maturity structure of fixed rate borrowing during 2014/15	Upper Limit	Lower Limit	Actual Limits as at 31 March 2014
Under 12 months	15%	0%	1.2%
12 months and within 24 months	15%	0%	6.3%
24 months and within 5 years	60%	0%	7.6%
5 years and within 10 years	75%	0%	10.1%
10 years and above	100%	0%	74.8%

8. POLICY ON BORROWING IN ADVANCE OF NEED

8.1 Under CIPFA's Prudential Code, any decision to borrow in advance of need has to be:

- Within forward approved Capital Financing Requirement (CFR) estimates.
- Would have to be considered carefully to ensure that value for money can be demonstrated;
- And that the Council can ensure the security of such funds.

9. PRUDENTIAL INDICATORS FOR TO BORROWING ACTIVITY

9.1 The Prudential Code requires that the Council set certain limits on the level and type of borrowing before the start of the financial year together with a number of Prudential indicators, for the next three years ensuring the capital investment plans are affordable, prudent and sustainable.

9.2 The Authorised Limit for external borrowing. A control on the maximum level of borrowing 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.

Authorised Limit

£m	**2013/14 Actual**	**2014/15**	**2015/16**	**2016/17**	**2017/18**
Borrowing	325	325	325	325	325
Other long term liabilities	20	20	20	20	20
Total	**345**	**345**	**345**	**345**	**345**

9.3 The Operational Boundary. Is the focus of day to day treasury management activity within the authority and is set at £55m below authorised limit for borrowing. It is a means by which the Council manages its external debt to ensure that it remains within the self-imposed Authorised Limit. Sustained breaches of the Operational Boundary would give an indication that the Authority may be in danger of stepping beyond the Prudential Indicators it set itself.

Operational Boundary

£m	**2013/14 Actual**	**2014/15**	**2015/16**	**2016/17**	**2017/18**
Borrowing	275	275	275	275	275
Other long term liabilities	13	15	15	15	15
Total	**288**	**290**	**290**	**290**	**290**

9.4 The HRA CFR is required to remain within a 'Debt Cap' as set by the Department for Communities and Local Government as part of the transition to HRA self-financing. The Council's debt cap is currently set at £254.617m. The Housing programme is forecast to remain £34m below this threshold for the period 2015-19.

9.5 The Executive Director of Finance and Corporate Governance reports that the Council complied with the prudential indicators in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the budget report.

10. DEBT RESCHEDULING

10.1 Consideration will be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

10.2 However, these savings will need to be considered in the light of the current treasury position and premia incurred in prematurely repaying debt. Given the current approach, Officers monitor the situation continually for an opportunity to repay voluntary any debt. The reasons for any rescheduling to take place will include:

- Generating cash savings.
- Enhancing the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

11. HOUSING REVENUE ACCOUNT

For the period 2015-19 the Housing programme will be borrowing against internal resources. This is principally achieved through the use of monies received in respect of the Earl's Court project. Use of this money is classed as borrowing as although cash is to be received from the developer on a constant and phased basis, the receipt is only deemed usable for funding purposes as land transfers to the purchaser. This does not prevent the Council from spending the cash it receives, but until such time that land transfers any such use is classed as borrowing. This borrowing unwinds when the receipt becomes usable. The total available to the HRA for the purposes of internal borrowing is shown in the table in paragraph 5.7 above. The current Housing Revenue Account borrowing requirement is therefore very sensitive to anything which might change the pattern of the receipts from the Earls Court Programme (for example as a result of the review of the Earls Court programme currently underway) or in any way further restrict the use of these receipts (for example if a partial stock transfer was the outcome of the Strategic Housing Stock Options Appraisal).

12. TRAINING

12.1 The CIPFA Code requires the lead officer to ensure that Members with Treasury Management responsibilities receive adequate training in Treasury Management. This especially applies to Members responsible for scrutiny. Members will be offered training and arrangements will be made as required.

12.2 The Council is a member of the CIPFA treasury management network which provides a forum for the exchange of views of treasury management staff independent of the treasury management consultants. Officers attend the CIPFA network and other providers meetings on a regular basis throughout the year to ensure that they are up to date at all times on developments in treasury management and continue to develop their expertise in this area.

12.3 The training needs of the Treasury Management team are periodically reviewed.

13. GOVERNANCE

13.1 The revised CIPFA Treasury Management Code (2011) requires the Council to outline a scheme of delegation thereby delegating the role of scrutiny of treasury management strategy and policy to a specific named body (Audit, Pensions and Standards Committee). In this way treasury management performance and policy setting will be subject to proper scrutiny. The Code also requires that members are provided adequate skills and training to effectively discharge this function.

13.2 The role of the Section 151 officer is delegated to the Executive Director of Finance and Corporate Governance (the S151 Officer), pursuant to Section 101 of the Local Government Act 1972 and by the Executive under Section 15 of the Local Government Act 2000.

13.3 The S151 Officer may authorise officers to exercise on their behalf, functions delegated to them. Any decisions taken under this authority shall remain the responsibility of the S151 Officer and must be taken within the guidelines of the Treasury Management Strategy.

13.4 The S151 Officer has full delegated powers from the Council and is responsible for the following activities:

- Investment management arrangements and strategy;
- Borrowing and debt strategy;
- Monitoring investment activity and performance;
- Overseeing administrative activities;
- Ensuring compliance with relevant laws and regulations;
- Provision of guidance to officers and members in exercising delegated powers.

Monitoring and Reporting

13.5 The Treasury Management activities during the year will be included in the monitoring reports to the Audit, Pensions and Standards Committee.

13.6 The Council’s Treasury Management Strategy will be approved annually by full Council and there will also be a mid-year report. The aim of these reporting arrangements is to ensure that those with the responsibility for treasury management policies and activities and those implementing policies and executing transactions have properly fulfilled their responsibilities with regard to delegation and reporting. The Council will adopt the following reporting arrangements in accordance with the requirements of the revised code:

Area of Responsibility	**Council / Committee / Officer**	**Frequency**
Treasury Management Strategy	Full Council	Annually, at meeting before the start of the financial year.
Scrutiny of Treasury Management Strategy	Audit, Pensions and Standards Committee	Annually
Treasury Management Strategy: Mid-year report	1. Audit, Pensions and Standards Committee 2. Finance and Delivery PAC	Annually, after the first half of the financial year
Treasury Management Strategy: Updates / revisions at other times	1. Audit, Pensions and Standards Committee 2. Finance and Delivery PAC 3. Full Council	As and when required

Treasury Out-turn Report	1. Audit, Pensions and Standards Committee 2. Finance and Delivery PAC 3. Full Council	Annually, after year-end
Treasury Management Monitoring Reports	Executive Director of Finance and Corporate Governance	Monthly

14. FINANCIAL AND RESOURCE IMPLICATIONS

14.1 The comments of the Executive Director of Finance and Corporate Governance are contained within this report.

14.2 This report is wholly of a financial nature.

15. LEGAL IMPLICATIONS

15.1 The statutory requirements are set out in the body of the report.

15.2 Implications verified/completed by: David Walker, Bi-Borough Principal Solicitor, 020 7361 2211*.*

16. COMMENTS OF THE AUDIT, PENSIONS AND STANDARDS COMMITTEE

16.1 Any comments from the Committee will be reported verbally at the meeting.

LOCAL GOVERNMENT ACT 2000
LIST OF BACKGROUND PAPERS USED IN PREPARING THIS REPORT

No.	Description of Background Papers	Name/Ext of holder of file/copy	Department/ Location
1.	Financial monitoring documents & Capital Programme 2014/18 report	Christopher Harris Tel: 0208 753 6440	Finance Department, 2nd Floor, HTH Extension
2.	Treasury Management Strategy 2014/15 (Approved by Full Council February 2014)	Halfield Jackman Tel: 0207 641 4354	Tri-Borough Treasury and Pensions, WCC City Hall

APPENDIX A

THE TREASURY MANAGEMENT POLICY STATEMENT

The CIPFA recommendations contained in the Code of Practice and Cross-Sectoral Guidance Notes issued as a revised version in 2009 and 2011 for Treasury Management in the Public Services require that each Local Authority has a Treasury Management Policy Statement that is approved by the Full Council.

CIPFA recommends that the Council's treasury management policy statement adopts the following form of words below to define the policies and objectives of its treasury management activities.

This Council defines its Treasury Management activities as:

- The management of the Council's investments and cash flows, its 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.

- This Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of Treasury Management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

This Council acknowledges that effective Treasury Management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance.

APPENDIX B

UK T-Bills: UK Government Treasury Bills (T-Bills) are short term promissory notes issued by the UK Government at a discount to par, for tenors of up to one year. T-Bills provide a greater yield than cash deposits with the DMO and can be bought at the primary sale (by market makers), or in the secondary market.

UK Gilts: UK Government Gilts provide a greater yield than cash deposits with the DMO. At present, there are a limited number of gilts that will mature in the next two years, and as the shorter dated gilts were issued in a higher interest rate environment than at present, the coupons on these gilts are higher than current interest rates.

UK Government repurchase agreements (Repos): UK Government repurchase agreements are the purchase of UK Government securities with an agreement to resell them back at a higher price at a specific future date. By their nature, repos are short term secured investments in UK Government bonds which provide a greater return than cash deposits with the DMO. Ownership of the UK Government bond is temporarily transferred to the Council, thereby providing security over the funds invested.

Commercial Paper (CP) is similar to a very short term bond issue (up to one year), issued to investors on a discounted basis, and with the interest rate based on prevailing rates at the time of pricing.

Supra-national institutions are those that sovereign backed or supported institutions that span more than one country, such as the European Investment Bank, the European Bank of Reconstruction and Development, the World Bank, etc.

Network Rail: All Network Rail infrastructure debt is directly and explicitly backed by a financial indemnity from the Secretary of State for Transport acting for and on behalf of the government of the United Kingdom of Great Britain. The financial indemnity is a direct UK sovereign obligation of the crown and cannot be cancelled for any reason (prior to its termination date in October 2052). Propose to change TMS limit to unlimited and set the maximum maturity to Oct 2052.

APPENDIX C

A Credit Default Swap (CDS) is a contract between two counterparties in which the buyer of the contract makes quarterly payments to the seller of the contract in exchange for a payoff if there is a credit event of the reference entity. The reference entity is the third party on whom the contract is based. A credit event depends on the Doc Clause (terms and conditions) of the CDS agreement but this usually includes events such as default on coupon payments, restructuring of debt, bankruptcy etc.

The contract essentially gives protection, or “insurance”, to the buyer of the CDS in the case of a credit event of the reference entity. As the CDS market is currently unregulated, it cannot technically be seen as insurance as the seller of the contract does not have to set aside any reserves for any possible future credit event.

As with all swap contracts, a CDS has 2 legs: a fee leg and a contingent leg. The fee leg of the CDS is the leg in which the buyer of the protection pays quarterly payments to the seller. The contingent leg of the CDS is the leg in which the seller of the CDS pays the buyer if a credit event occurs.

The fee leg payments are based on the spread currently traded in the market. The spread of a CDS indicates the market perception of the likelihood of a credit event occurring.

The higher the spread, the higher the cost of protecting against a credit event, the more likely the market considers a credit event will occur. The spread can be likened to an insurance premium paid on.

APPENDIX D

CREDIT RATING AGENCY NOMENCLATURE

Long term ratings	**Fitch**	**Moody's**	**S&P**
Investment Grade Focuses on liquidity and ability to meet payment obligations on time	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
	A+	A1	A+
	A	A2	A
	A-	A3	A-
	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
Non-investment grade (junk) Focus on recovery percentage in the event of partial or total default	BB+	Ba1	BB+
	BB	Ba2	BB
	BB-	Ba3	BB-
	B+	B1	B+
	B	B2	B
	B-	B3	B-
	CCC	Caa	CCC
	CC	Ca	CC
	C	C	C
	D		D

Short term ratings	**Fitch**	**Moody's**	**S&P**
Investment Grade	F1+	Prime-1	A-1+
	F1	Prime-2	A-1
	F2	Prime-3	A-2
	F3		A-3
Non-investment grade	B	Not Prime	B
	C		C
	D		D