Appendix 6

Herefordshire Council

Treasury Management Strategy 2015/16

Contents

Appendices

1. Introduction

1.1 The Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) requires the council to approve a Treasury Management Strategy Statement (TMSS) before the start of each financial year. The TMSS also includes the Annual Investment Strategy as required under Investment Guidance provided by Communities and Local Government (CLG).

1.2 The council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the council's treasury management strategy.

1.3 The purpose of this TMSS is to approve:

- Treasury Management Strategy for 2015-16
  (Borrowing – Section 5 and
  Investments – Section 6)
- Minimum Revenue Payment (MRP) Statement – Section 7
- Prudential Indicators - Appendix 3

2. Summary of Strategy for 2015/16

<u>Borrowing</u>

2.1 In 2015/16 council borrowing is estimated to increase by £26.9 million from £215.4 million to £242.3 million. This increase can be analysed as follows.

	£m
Estimated council borrowing as at 31st March 2015	**215.4**
Investment in ongoing approved capital schemes (Including Energy from Waste Plant £14.3m; Faster Broadband £6.2m; Road improvements £5m; Leisure Centres £4m; Inner city link road £2.5m and LED street lighting £2.4m)	**36.9**
Investment in new capital schemes proposed (Including South Wye Transport Package £1m; Three Elms Trading Estate £1.8m and Colwall School £1.6m)	**7.5**
Less: Provision for Repayment of Principal (MRP)	**(10.5)**
Less: Increase in council reserves	**(7.0)**
Estimated council borrowing as at 31st March 2016	**242.3**

2.2 The increase in debt will be largely financed by increasing the council's short-term variable rate borrowing. Short-term rates are currently significantly lower than longer-term rates and long-term analysis, comparing short-term finance with a long-term loan, has shown this to be the most cost effective approach with savings in the early years outweighing any additional amounts payable in later years.

2.3 The borrowing budget for 2015/16 includes provision to pay short-term interest rates of up to 1.25% (including brokers' commission). It also includes interest on existing fixed term borrowing plus capacity to take out £5m of longer term finance (at a rate of around 3.00%) if it is considered prudent to do so.

2.4 Compared to, say, a 20 year EIP loan (currently at 3.00%) short-term finance (at 1.25%) will save the council at least £1.6 million in revenue interest costs in 2015/16 (being the estimated average amount of short-term debt outstanding during 2015/16 of £93m at 1.75%).

2.5 If no longer term PWLB loans are taken out, by 31st March 2016 variable rate short-term loans may total £118m compared to fixed rate longer-term borrowing of £132m. This increase in the proportion of variable rate borrowing has required an increase in the council's upper limit for variable interest rate exposure (see performance indicator Appendix 4, point 10.)

2.6 The council's exposure to variable rate debt has been discussed with the council's treasury adviser, Arlingclose, who agree with the council's borrowing policy and the consideration of our interest rate forecasting.

Investments

2.7 As a result of new banking regulations which, in the absence of government support, put the council's deposits at risk when banks get into difficulty, the council will:

- Maintain lower investment balances during the year (a policy only possible with short-term loans which can be matched to the council's cash-flow profile);
- Keep low but liquid cash balances and invest these mainly in Money Market Funds;
- Reduce counterparty limits with banks;
- Consider other creditworthy investments to increase diversification.

2.8 The investment counterparty list includes making payments of up to £40m (over three years) to Mercia Waste Management to fund the Energy from Waste Plant. This investment will be made through a joint Credit Control Committee with Worcester County Council. The Committee will have both authorities S151 officers as members who will be advised by external financial and legal advisers. The Committee may decide matters within its terms of reference or refer them to full Council for determination in accordance with the usual rules of delegation.

3. Economic Background and Interest Rate Forecast

Economic background

3.1 There is momentum in the UK economy, with a continued period of growth. However, Consumer Price Inflation fell to 1.2% year-on-year to September 2014, from 1.5% in August. This was a larger fall than expected and inflation is likely to remain low in the short-term. There have been large falls in unemployment but levels of part-time working, self-employment and underemployment are significant and nominal earnings growth remains weak and below inflation.

3.2 In considering an increase in the Bank Base Rate there is no pressure from high inflation and the focus of the Monetary Policy Committee is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee. Despite two MPC members having voted for a 0.25% increase in rates at each of the meetings August 2014 onwards, some Committee members have become more concerned that the economic outlook is less optimistic than at the time of the August Inflation Report.

Interest rate forecast

3.3 The council's treasury management adviser, Arlingclose, forecasts the first rise in The Bank Base Rate in August 2015 and a gradual pace of increases thereafter, with the average for 2015/16 being around 0.75%. Arlingclose believes the normalised level of the Bank Rate post-crisis to range between 2.5% and 3.5%.

3.4 Economic weakness in the Eurozone, and the threat of deflation, have increased the risks to the durability of UK growth. If the negative indicators from the Eurozone become more entrenched, the Bank of England will likely defer rate rises to later in the year.

3.5 Arlingclose projects gilt yields on an upward path in the medium term, taking the forecast average 10 year PWLB loan rate for 2015/16 to 3.40%.

3.6 A more detailed interest rate forecast provided by Arlingclose is attached at ***Appendix 4***.

Credit outlook

3.7 The implementation of two European Union directives into UK legislation in the coming months will place the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors. The *Bank Recovery and Resolution Directive* promotes the interests of individual and small businesses covered by the Financial Services Compensation Scheme and similar European schemes, while the recast *Deposit Guarantee Schemes Directive* includes large companies in these schemes. The combined effect of these two changes is to leave public authorities and financial organisations (including pension funds) as the only senior creditors likely to incur losses in a failing bank after July 2015.

3.8 The continued global economic recovery has led to a general improvement in credit conditions since last year. However, due to the above legislative changes, the credit risk associated with making unsecured bank deposits will increase relative to the risk of other investment options available to the Authority**.**

4. Capital Financing Requirement

4.1 Capital expenditure can be financed in a number of ways including the application of usable capital receipts, a direct charge to revenue, capital grant or by securing an up-front contribution from another party towards the cost of a project.

4.2 Capital expenditure not financed by one of the above methods will increase the capital financing requirement (CFR) of the council.

4.3 The CFR reflects the council's underlying need to finance capital expenditure by borrowing or by other long-term liability arrangements.

4.4 The use of the term "borrowing" in this context does not necessarily imply external debt since, in accordance with best practice; the council has an integrated treasury management strategy. Borrowing is not associated with specific capital expenditure. The council will, at any point in time, have a number of cash flows both positive and negative and will be managing its position in terms of its borrowings and investments in accordance with this treasury management strategy.

4.5 The forecast movement in the CFR over future years is one of the Prudential Indicators which can be found in ***Appendix 3****.* The movement in actual external debt and usable reserves (which have a direct bearing on when any internal borrowing may need to be externalised) combine to identify the council's borrowing requirement and potential investment strategy in the current and future years.

	31.03.15 Estimate £'000	**31.03.16 Estimate £'000**	**31.03.17 Estimate £'000**	**31.03.18 Estimate £'000**
Capital Financing Requirement	258,909	291,450	304,451	291,346
Less: Other Long Term Liabilities: PFI schemes Finance leases Salix loan	 25,882 319 249	 24,708 319 95	 23,426 319 0	 22,144 319 0
CFR excluding other long-term liabilities	**232,459**	**266,328**	**280,706**	**268,883**

Less: Existing Profile of Longer Term Borrowing – PWLB and bank loans	132,523	124,285	117,243	113,185
Cumulative Maximum External Borrowing Requirement	**99,936**	**142,043**	**163,463**	**155,698**
Estimated Usable Reserves*	**17,000**	**24,000**	**34,000**	**59,000**
Cumulative Net Borrowing Requirement	**82,936**	**118,043**	**129,463**	**96,698**
Usable reserves are estimated to be £17 million for each year plus proceeds from the sale of fixed assets of £7 million for 2015/16, £10 million for 2016/17 and £25 million for 2017/18.				
Total Council Borrowing	**215,459**	**242,328**	**246,706**	**209,883**

4.6 The above table shows the council's net borrowing requirement over and above its existing long-term loan finance. Part of this requirement relates to the refinancing of principal repaid on long-term EIP and annuity loans with the balance relating to additions to the capital programme financed by borrowing.

4.7 Increased borrowing increases both interest payable and the amount to be set aside from revenue each year for the repayment of loan principal (called Minimum Revenue Provision (MRP)). Annual MRP is estimated to be between £10 million and £12 million for the foreseeable future. Therefore, if the large capital schemes scheduled for the next few years are completed, then the new capital spend financed by borrowing can be reduced to below the annual MRP so the council's total borrowing will fall, as shown in ***Appendix 2.***

4.8 When comparing the council's Capital Financing Requirement with other English unitary authorities as at 31st March 2013 (later values are not yet published), both in terms of absolute levels and affordability, Herefordshire Council's CFR is no higher than average.

5 Borrowing Strategy

5.1 At 31st October 2014 the council held £168 million of loans, comprising long-term fixed rate loans totalling £134.5 million plus short-term variable rate loans of £33.5 million. The balance sheet forecast in table 1 shows that the council's borrowing may need to increase to £215 million by 31st March 2015 and to £242 million by 31st March 2016, assuming the timing and levels of capital expenditure are as budgeted.

Objective

5.2 The council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Authority's long-term plans change is a secondary objective.

Strategy

5.3 Given the significant cuts to public expenditure and in particular to local government funding, the Authority’s borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is more cost effective in the short-term to use internal resources and borrow using short-term loans.

5.4 This enables the council to reduce net borrowing costs (despite foregone investment income) and reduce overall credit risk by tailoring the timing of borrowing to minimise balances held. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. The councils treasury advisors will assist with ‘cost of carry’ and breakeven analysis. Its output may determine whether the Authority borrows additional sums at long-term fixed rates in 2015/16 with a view to keeping future interest costs low, even if this causes additional cost in the short-term. The council budget includes provision to take out additional long-term borrowing of £5 million each year.

5.5 Short-term loans leave the council exposed to the risk of short-term interest rate rises; they are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

Sources

5.6 The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB)
- UK local authorities
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds
- capital market bond investors
- Local Capital Finance Company and other special purpose companies created to enable local authority bond issues.

5.7 In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

LOBO loans

5.8 The council has two LOBO loans (Lender's Option Borrower's Option) of £6 million, each on which the council pays interest at 4.5%. Every six months, when the interest charges become due, the lenders have the option to increase the interest rate being charged at which point the council can accept the revised terms or reject them and repay the loan. LOBO loans present a potential refinancing risk to the council since the decision to amend the terms is entirely at the lender's discretion.

Debt rescheduling

5.9 The PWLB allows the repayment of loans before maturity by either paying a premium or receiving a discount according to a set formula based on current interest rates. The council have explored the possibility of doing this in 2014/15 but due to low interest rates, opportunities for debt rescheduling are limited. However, this option will be kept under review and the council may replace some loans with new loans, where this is expected to lead to an overall saving or reduction in risk.

6 Investment Strategy

6.1 The council needs to hold adequate funds to meet day to day liquidity needs, for salary and creditor payments. The council holds balances of around £20 million to cover all contingencies. A cashflow forecast is maintained that includes all known receipts and payments so that the council can take action to ensure that it can meet all its liabilities when they fall due.

Objective

6.2 Both the CIPFA Code and the CLG Guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Strategy

6.3 Given the increasing risk and continued low returns from short-term unsecured bank deposits, the council will aim to keep its invested funds as low as possible and reduce the amounts invested with banks and building societies. The council currently has a counterparty limit of £5 million with each bank but for 2015/16 this limit will be reduced as shown in table 2 below.

6.4 For 2015/16 the council will increase its reliance on Money Market Funds which are highly diversified and carry reduced credit risk.

Approved Counterparties

6.5 The Authority will invest its surplus funds with any of the counterparty types in table 2 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 2: Approved Investment Counterparties and Limits

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£2.5m 5 years	£5m 20 years	£5m 50 years	£2.5m 20 years	£2.5m 20 years
AA+	£2.5m 5 years	£5m 10 years	£5m 25 years	£2.5m 10 years	£2.5m 10 years
AA	£2.5m 4 years	£5m 5 years	£5m 15 years	£2.5m 5 years	£2.5m 10 years
AA-	£2.5m 3 years	£5m 4 years	£5m 10 years	£2.5m 4 years	£2.5m 10 years
A+	£2.5m 2 years	£5m 3 years	£2.5m 5 years	£2.5m 3 years	£2.5m 5 years
A	£2.5m 13 months	£5m 2 years	£2.5m 5 years	£2.5m 2 years	£2.5m 5 years
A-	£2.5m 6 months	£5m 13 months	£2.5m 5 years	£2.5m 13 months	£2.5m 5 years
BBB+	£1.5m 100 days	£2.5m 6 months	£1.5m 2 years	£1.5m 6 months	£1.5m 2 years
BBB or BBB-	£1.5m next day only	£2.5m 100 days	n/a	n/a	n/a
None	£1m 6 months	n/a	£2.5m 25 years	n/a	£2.5m 5 years

Other investments:

Pooled funds	£5m per fund
Mercia Waste Management (providing finance for Energy from Waste Plant)	£40m over the loan period

<u>Types of Investments</u>

6.6 The following types of investments are included in the table above:

- **Banks Unsecured:** Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. Unsecured investment with banks rated BBB or BBB- will not be made unless the bank concerned is National Westminster Bank (the council's own bank) when investments will be restricted to overnight deposits.

- **Banks Secured:** Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment-specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

- **Government:** Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

- **Corporates:** Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made as part of a diversified pool in order to spread the risk widely.

- **Registered Providers:** Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services; they retain a high likelihood of receiving government support if needed.

- **Pooled Funds:** Shares in diversified investment vehicles consisting of any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Money Market Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

  Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority to diversify into asset classes other than cash, without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives will be monitored regularly.

<u>Risk Assessment and Credit Ratings</u>

6.7 Investment decisions are made by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

6.8 Credit ratings are obtained and monitored by the Authority's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

6.9 Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") and it may fall below the approved rating criteria, then only instant access investments will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

6.10 Credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

6.11 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Authority will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Authority's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

Specified Investments

6.12 The CLG Guidance defines specified investments as those:

- denominated in pound sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
    - the UK Government,
    - a UK local authority, parish council or community council, or
    - a body or investment scheme of "high credit quality".

6.13 The Authority defines “high credit quality” organisations and securities as those having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher.

Non-specified Investments

6.14 Any investment not meeting the definition of a specified investment is classed as non-specified. The Authority does not intend to make any investments denominated in foreign currencies. It will be providing investment in capital expenditure through the loan arrangement with Mercia Waste Management. Other non-specified investments will be limited to long-term (over twelve months) investments. Limits on non-specified investments (excluding the waste loan arrangement) are shown in table 3 below.

Table 3: Non-Specified Investment Limits	**Cash limit**
Total long-term investments	£5m
Total investments with unrecognised credit ratings	£2.5m
Total investments with institutions domiciled in foreign countries rated below AA+	£0m
Total non-specified investments	£7.5m

7. Annual Minimum Revenue Provision Statement 2015/16

7.1 Where the council finances capital expenditure by debt, it must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The Local Government Act 2003 requires the Authority to have regard to the Department for Communities and Local Government’s *Guidance on Minimum Revenue Provision* (the CLG Guidance) most recently issued in 2012.

7.2 The broad aim of the CLG Guidance is to ensure that debt is repaid over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant (RSG), reasonably commensurate with the period implicit in the determination of that grant.

7.3 In line with the CLG Guidance, the policy for the 2015/16 calculation of MRP (unchanged from previous years) is as follows:

- For supported capital expenditure before 31st March 2011, MRP will be determined as 4% of the Capital Financing Requirement in respect of that expenditure.
- For unsupported capital expenditure incurred after 31st March 2004, MRP will be determined by charging the expenditure over the expected useful life of the relevant assets in equal instalments starting in the year after the asset becomes operational.

Therefore, capital expenditure incurred during 2015/16 will not be subject to a MRP charge until 2016/17 at the earliest.

- For assets acquired by finance leases or Private Finance Initiatives, MRP will be determined as being equal to the element of the rent or charge that goes to write down the balance sheet liability.

- For loans and grants towards capital expenditure by third parties, prudential borrowing will be repaid over the life of the asset in relation to which the third party expenditure is incurred.

7.4 Based on the Authority's latest estimate of its Capital Financing Requirement on 31st March 2015, the budget for MRP has been set as follows:

	31.03.2015 Estimated CFR £m	**2015/16 Estimated MRP £m**
Pre 31/03/11 Supported borrowing & Adj A	**119.14**	4.84
Prudential borrowing	**113.32**	5.09
Finance leases and Private Finance Initiative	**26.20**	1.10
Other loans (Salix)	**0.25**	0.16
Total	**258.91**	**11.19**

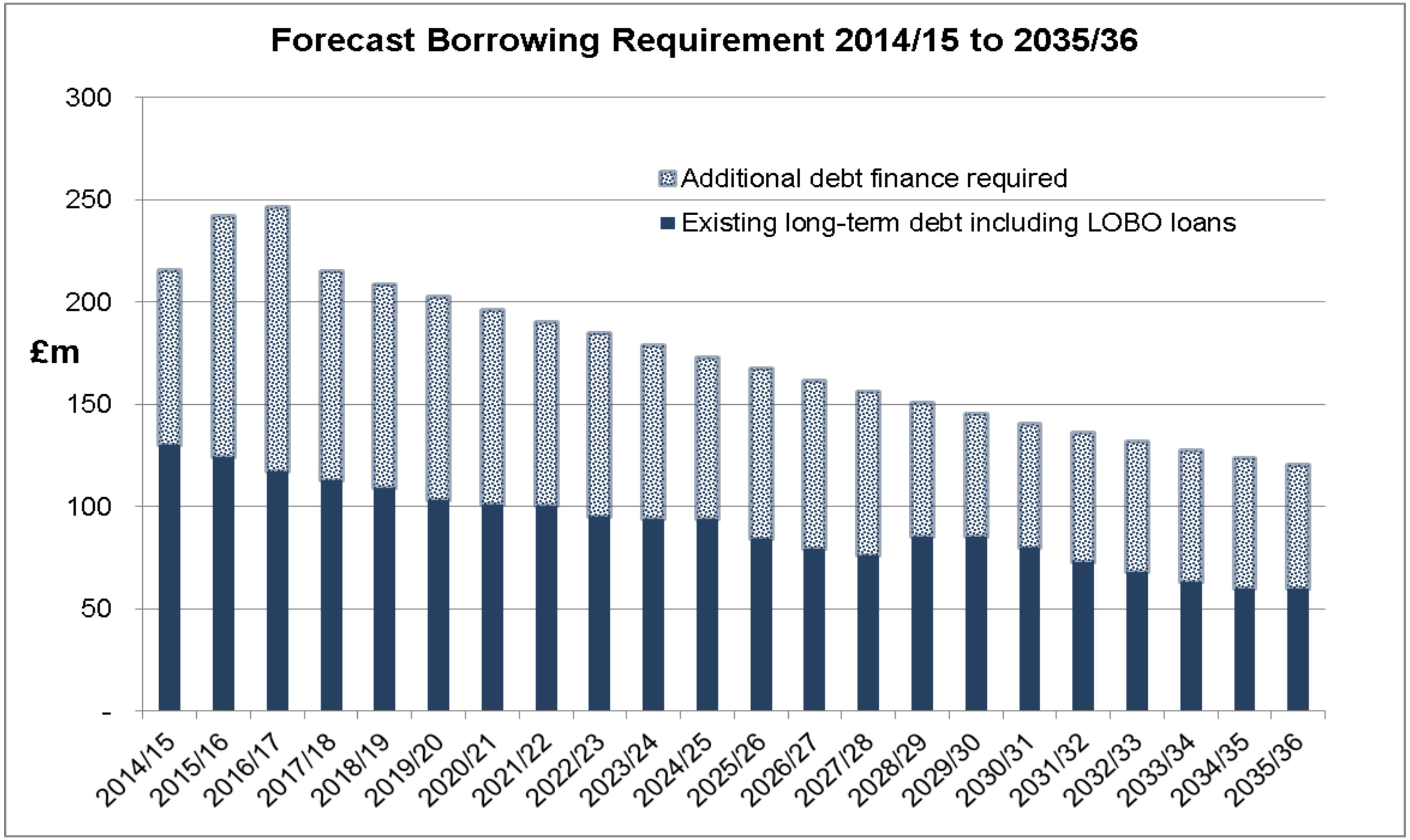
APPENDIX 1

EXISTING BORROWING & INVESTMENTS AS AT 31 OCTOBER 2014

External Borrowing:	**Actual Portfolio £m**	**Average Rate %**
Long-term loans (all fixed rate)		
Public Works Loan Board	**123**	**4.04%**
LOBO Loans	**12**	**4.50%**
Short-term loans		
Local Authorities	**33**	**0.49%**
Total External Borrowing	**168**	**3.38%**

Investments:	**Actual Portfolio £m**	**Average Rate %**
Handelsbanken (Instant Access Account)	**5**	**0.45%**
Money Market Funds (Instant Access)	**8**	**0.48%**
Close Brothers Bank (One Month Notice Account)	**5**	**1.00%**
Term deposits (all returning before 31st March 2015)	**11**	**0.84%**
Total Investments	**29**	**0.70%**

APPENDIX 2



Forecast Borrowing Requirement 2014/15 to 2035/36
£m
300
250
200
150
100
50
-
Additional debt finance required
Existing long-term debt including LOBO loans
2014/15
2015/16
2016/17
2017/18
2018/19
2019/20
2020/21
2021/22
2022/23
2023/24
2024/25
2025/26
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2027/28
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2035/36

APPENDIX 3

PRUDENTIAL INDICATORS

1. Background

There is a requirement under the Local Government Act 2003 for local authorities to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Authority has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

2. Estimates of Capital Expenditure

2.1 This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council Tax levels.

Capital Expenditure	2014/15 Approved £'000	2014/15 Revised £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Existing capital programme	85,351	95,014	39,909	21,436	0
This year's additions to programme			26,664	25,918	28,445
Total	**85,351**	**95,014**	**66,573**	**47,354**	**28,445**

2.2 Capital expenditure will be financed as follows:

Funding	2014/15 Approved £'000	2014/15 Revised £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Capital receipts	3,209	5,098	7,128	7,100	4,000
Capital Grants	24,905	34,954	14,258	12,499	23,613
Reserves	0	1,300	0	0	0

Prudential Borrowing	57,237	53,662	45,187	27,755	832
Total	**85,351**	**95,014**	**66,573**	**47,354**	**28,445**

3. Capital Financing Requirement

3.1 The Capital Financing Requirement (CFR) measures the council's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and financing inclusive of PFI contracts.

Capital Financing Requirement	2014/15 Approved £'000	2014/15 Revised £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Total CFR	**264,038**	**258,909**	**291,450**	**304,451**	**291,346**

4. Gross Debt and the Capital Financing Requirement

4.1 In order to ensure that over the medium term debt will only be for a capital purpose, the local authority will ensure that debt does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years.

4.2 The Section 151 Officer reports that the council currently has no difficulty meeting this requirement nor are there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

5. Operational Boundary for External Debt

5.1 The operational boundary is based on the Authority's estimate of the most likely (i.e. prudent but not worst case) level for external debt. It links directly to the Authority's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise of finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Authority's debt.

Operational Boundary	2014/15 Approved £m	2014/15 Revised £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Operational Boundary for Borrowing	240	240	270	285	270

Operational Boundary for other Long-Term Liabilities	30	30	30	25	25
Operational Boundary for External Debt	**270**	**270**	**300**	**310**	**295**

6. Authorised Limit for External Debt

6.1 The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	**2014/15 Approved £m**	**2014/15 Revised £m**	**2015/16 Estimate £m**	**2016/17 Estimate £m**	**2017/18 Estimate £m**
Authorised Limit for Borrowing	250	250	280	295	280
Authorised Limit for other Long-Term Liabilities	40	40	40	40	40
Authorised Limit for External Debt	**290**	**290**	**320**	**335**	**320**

7. Ratio of Financing Costs to Net Revenue Stream

7.1 This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs. The definition of financing costs is set out in the Prudential Code and includes both interest payable and provision for repayment of loan principal.

7.2 The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**2014/15 Approved £’000**	**2014/15 Revised £’000**	**2015/16 Estimate £’000**	**2016/17 Estimate £’000**	**2017/18 Estimate £’000**
Net Revenue Stream	**146,456**	146,135	**141,318**	140,474	139,994
Financing Costs	**18,288**	16,633	**18,502**	19,804	21,704

Percentage	**12.49%**	**11.38%**	**13.09%**	**14.10%**	**15.50%**

Note: the net revenue stream comprises council tax receipts plus government funding excluding specific grants.

7.3 The above table shows gross financing costs payable without deducting any savings or revenue contributions receivable. Financing costs also include the capital element of PFI contracts (relating to Whitecross School, waste disposal and Shaw Homes).

8. Incremental Impact of Capital Investment Decisions

8.1 This is an indicator of affordability that shows the impact of capital investment decisions on council tax levels. The incremental impact is calculated by comparing the total revenue budget requirement of the approved capital programme with an equivalent calculation of the revenue budget requirement arising from the additional capital schemes approved by Cabinet on 13th November 2014.

	15/16 Estimate £'000	**16/17 Estimate £'000**	**17/18 Estimate £'000**
Additional borrowing required for proposed capital programme	5,162	5,665	482
Estimated interest charges	30	113	264
Provision for debt repayment (MRP)	0	256	311
Total additional finance charges	30	369	575
Estimated tax base (number)	65,848	66,638	67,438
Estimated cumulative increase in Band D council tax	**£0.46**	**£5.54**	**£8.53**

9. Adoption of the CIPFA Treasury Management Code

9.1 This indicator demonstrates that the council has adopted the principles of best practice.

9.2 The council has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies, procedures and practices. The council's Treasury Management Policy Statement is attached at **Appendix 5**.

10. Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

10.1 These indicators allow the council to manage the extent to which it is exposed to changes in interest rates.

10.2 Due to the large difference between short-term and longer-term interest rates, the limit has been increased to accommodate the council financing the capital programme by short-term variable rate borrowing. Interest rates are forecast to remain low for the next few years and analysis (comparing a twenty year loan with short-term borrowing over the same period) indicates that short-term savings in the next few years will exceed any increased amounts payable in five to ten years time. In pursuing this policy, the council recognises that it is more exposed to unexpected increases but the benefits of affordability and flexibility (enabling the council to reduce its short-term borrowing either to reduce cash investments at times of heightened credit risk or when the borrowing can be replaced by the proceeds from fixed asset sales) outweigh the potential increase in interest rate risk.

	2014/15 Approved	2014/15 Revised	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Upper Limit for Fixed Interest Rate Exposure	100%	100%	**100%**	100%	100%
Upper Limit for Variable Interest Rate Exposure	45%	45%	**50%**	50%	50%

11. Maturity Structure of Fixed Rate Borrowing

11.1 The council will also limit and monitor large concentrations of fixed rate debt needing to be replaced. Limits in the following table are intended to control excessive exposures to volatility in interest rates when refinancing maturing debt.

11.2 The maturity of borrowing is determined by reference to the earliest date on which the loans could be repaid. Therefore, the council’s two LOBO loans are included as being repayable within 12 months, although if the lenders do not increase the interest rates being charged, the loans could remain outstanding until 2054.

Maturity structure of fixed rate borrowing	Estimated level at 31/03/15	Lower Limit for 2015/16	Upper Limit for 2015/16
Under 12 months (including £12m of LOBO loans)	15.27%	0%	20%
12 months and within 24 months	5.31%	0%	20%
24 months and within 5 years	10.53%	0%	20%
5 years and within 10 years	11.08%	0%	20%
10 years and within 20 years	25.36%	0%	40%
20 years and within 30 years	8.30%	0%	40%
30 years and within 40 years	6.79%	0%	40%
40 years and within 50 years	17.36%	0%	40%
Total	100.00%		

10. Upper Limit for total principal sums invested over 364 days:

10.1 The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the council having to seek early repayment of the sums invested.

	2014/15 Approved £m	2014/15 Revised £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Upper Limit for total principal sums invested over 364 days	**10**	**10**	**5**	**5**	**5**

10.2 The limit has been reduced for 2015/16 as the strategy is to keep investments low and therefore liquid.

APPENDIX 4

OUTLOOK FOR INTEREST RATES
(FORECAST & ECONOMIC COMMENT PROVIDED BY TREASURY ADVISORS)

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Bank Base Rate (%)	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	1.75
PWLB Rates (%):													
5 years	2.50	2.55	2.70	2.80	2.65	2.90	3.00	3.10	3.20	3.30	3.40	3.50	3.60
10 years	3.20	3.25	3.35	3.40	3.45	3.50	3.55	3.60	3.65	3.70	3.75	3.80	3.85
20 years	3.70	3.75	3.85	3.90	3.95	4.00	4.05	4.10	4.15	4.20	4.25	4.30	4.35
50 years	3.80	3.85	3.90	3.95	4.00	4.05	4.10	4.15	4.20	4.25	4.30	4.35	4.40

The rates quoted above are the “Certainty Rates” which are the rates at which the council could borrow and are 0.20% lower than the published PWLB rates.

The above PWLB rates are noted by Arlingclose as being their “central” or most likely forecast, however, they also note that there are significant upside and downside risks to their forecast.

Forecast:

- Arlingclose continues to forecast the first rise in official interest rates in Q3 2015 and general market sentiment is now close to this forecast. There is momentum in the economy, but inflationary pressure is benign and external risks have increased, reducing the likelihood of immediate monetary tightening.

- A slow rise in the Bank Rate is projected. The pace of interest rate rises will be gradual and the extent of rises limited; we believe the normalised level of Bank Rate post-crisis to range between 2.5% and 3.5%.

- Fears for the Eurozone are likely to maintain a safe haven bid for UK government debt, keeping gilt yields artificially low in the short term. We project gilt yields on an upward path in the medium term.

COUNCIL BUDGET:

- **As can be seen from the table above, Arlingclose's central forecast is for the Bank Base Rate to increase during 2015/16 from 0.50% to 0.75%. However, they advise that there is an upside risk of 0.25% and a downside risk that they could remain at 0.50% throughout the year. The council's short-term borrowing budget has been based on a rate of 1.25% which should incorporate sufficient headroom to accommodate any unexpected changes in the Base Rate.**
- **The investment budget is based on Arlingclose's central forecast using average interest rates of 0.45% for the first six months and 0.70% for the second half of the year, assuming that investment balances will be lower in 2015/16 with a higher proportion of funds held in instant access accounts.**
- **Should the Bank Base Rate increase sooner or more rapidly than forecast, the increased yield on investments will partly offset any increase in short-term variable rates.**

APPENDIX 5

TREASURY MANAGEMENT POLICY STATEMENT

1. Statement of Purpose

1.1 Herefordshire council adopts the recommendations made in CIPFA's *Treasury Management in the Public Services: Code of Practice,* which was revised in 2011. In particular, the council adopts the following key principles and clauses.

2. Key Principles

2.1 Herefordshire council adopts the following three key principles (identified in Section 4 of the Code):

- The council will put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of its treasury management activities.

- The council will ensure that its policies and practices make clear that the effective management and control of risk are prime objectives of its treasury management activities and that responsibility for these lies clearly with the council. In addition, the council's appetite for risk will form part of its annual strategy and will ensure that priority is given to security and liquidity when investing funds.

- The council acknowledges that the pursuits of best value in treasury management, and the use of suitable performance measures, are valid and important tools to employ in support of business and service objectives, whilst recognising that in balancing risk against return, the council is more concerned to avoid risks than to maximise returns.

3. Adopted Clauses

3.1 Herefordshire council formally adopts the following clauses (identified in Section 5 of the code):

- The council will create and maintain, as the cornerstones for effective treasury management:

  - A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities;

  - Suitable treasury management practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

  The content of the policy statement and TMPs will follow the recommendations contained in Sections 6 and 7 of the Code, subject only to amendment where necessary to reflect the particular circumstances of the council. Such amendments will not result in the organisation materially deviating from the Code's key principles.

- Full council will receive reports on treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close.

- The responsibility for the implementation and regular monitoring of treasury management policies and practices is delegated to Cabinet and for the execution and administration of treasury management decisions to the Chief Officer-Finance and Commercial, who will act in accordance with the organisation's policy statement and TMPs and, if he or she is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management.

- Overview and Scrutiny Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

4. Definition of Treasury Management

4.1 Herefordshire council defines its treasury management activities as: -

'The management of the organisation'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.'

5. Policy Objectives

5.1 Herefordshire 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 council, and any financial instruments entered in to manage these risks.

5.2 Herefordshire 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 measurement techniques, within the context of effective risk management.