

Herefordshire Council

Treasury Management Strategy 2016/17

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Treasury Management Strategy Statement 2016/17

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 (TMS) before the start of each financial year. The TMS also includes the Annual Investment Strategy as required under Investment Guidance provided by Communities and Local Government (CLG).
- 1.2 The council borrows and invests 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 TMS is to approve:
- Treasury Management Strategy for 2016-17 (Borrowing – Section 5 and Investments – Section 6)
 - Minimum Revenue Payment (MRP) Statement – Section 7
 - Prudential Indicators - Appendix 3

2. Summary of Strategy for 2016/17

Borrowing

- 2.1 In 2016/17 council borrowing is estimated to increase by £26.7 million from £209.4 million to £236.1 million. This increase can be analysed as follows.

	£m
Estimated council borrowing as at 31st March 2016	209.4
Investment in ongoing approved capital schemes (Including Energy from Waste Plant £18m; Faster Broadband £5.6m; and Colwall School £4.8m)	33.3
Investment in new capital schemes proposed (Including data centre consolidation £1.2m, corporate accommodation £1.1m and Hereford library accommodation £1m)	9.6
Less: Provision for Repayment of Principal (MRP)	(11.0)
Grants and contributions	(7.2)
Reduction in usable reserves balances	2.0
Estimated council borrowing as at 31st March 2017	236.1

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- 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 additional amounts payable that may fall due in later years.
- 2.3 The borrowing budget for 2016/17 includes provision to pay short-term interest rates of up to 1.5% (including brokers commission), we currently secure short term at 0.6%. The budget also includes the interest cost on existing fixed term borrowing.
- 2.4 Compared to a 20 year EIP loan (currently at 2.96%) short-term finance (at 1.5%) will save the council at least £1.4m in revenue interest costs in 2016/17 (being the estimated average amount of short-term debt outstanding during 2016/17 of £93.5m at 1.5%).
- 2.5 If no longer term PWLB loans are taken out, by 31st March 2017 variable rate short-term loans may total £93.5m (40%) compared to fixed rate longer-term borrowing of £142.6m. This strategy approves a total variable loan stock holding of up to 50% of total loans to minimise the risk of interest rate increases.
- 2.6 The council's exposure to variable rate debt has been discussed with the council's treasury adviser, Capita Asset Services, who agree with the council's borrowing policy and the consideration of our interest rate forecasting.

Investments

- 2.7 As a result of current 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;
 - Keep low but liquid cash balances and invest these mainly in Money Market Funds;
 - Maintain counterparty limits with the banks at prudent levels;
 - Consider other creditworthy investments to increase diversification.

3. Economic Background and Interest Rate Forecast

Economic background

- 3.1 **UK.** UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y). Growth is expected to weaken to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation of Sterling against the Euro and weak

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growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme, although the pace of reductions have been eased in recognition of these statistics. Despite these headwinds, the Bank of England August Inflation Report had included a forecast for growth to remain around 2.4 – 2.8% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth. However, since the report was issued, the Purchasing Manager's Index, (PMI), for services on 5 October would indicate a further decline in the growth rate to only +0.3% in Q4, which would be the lowest rate since the end of 2012. In addition, worldwide economic statistics and UK consumer and business confidence have distinctly weakened so it would therefore not be a surprise if the next Inflation Report in November were to cut those forecasts in August.

- 3.2 The August Bank of England Inflation Report forecast was notably subdued in respect of inflation which was forecast to barely get back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction and Iran expected to soon rejoin the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.
- 3.3 There are therefore considerable risks around whether inflation will rise in the near future as strongly as had previously been expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as was being forecast until recently, especially given the recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets in 2015 so far, which could potentially spill over to impact the real economies rather than just financial markets.
- 3.4 **USA.** The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on 17 September, or if not by the end of 2015, the downbeat news in late August and in September about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from making that start. The nonfarm payrolls figures for September and revised August, issued on 2 October, were disappointingly weak and confirmed concerns that US growth is likely to weaken. This has pushed back expectations of a first rate increase from 2015 into 2016.
- 3.5 **EZ.** In the Eurozone, the ECB, in January 2015 unleashed a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly

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improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

- 3.6 **Greece.** During July, Greece finally capitulated to EU demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.

Interest rate forecast

- 3.7 Investment returns are likely to remain relatively low during 2016/17 and beyond.
- 3.8 Borrowing interest rates have been volatile but consistently low during 2015 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. Gilt yields have continued to remain at historically phenomenally low levels during 2015. The policy of avoiding new borrowing by running down spare cash balances, has proved good cash management over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities may need to enter new borrowing to finance new capital expenditure and/or to refinance maturing debt.
- 3.9 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.
- 3.10 A more detailed interest rate forecast provided by the Capita Asset Services is attached at **Appendix 4**.

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 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, for example through lease 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

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negative and will be managing its position in terms of its borrowings and investments in accordance with its 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.

	31.03.16 Estimate £000	31.03.17 Estimate £000	31.03.18 Estimate £000	31.03.19 Estimate £000
Capital Financing Requirement	285,109	316,677	310,744	296,782
Less: Other Long Term Liabilities: PFI schemes Finance leases Salix loan	26,605	25,576	24,139	22,798
MRP and contributions in year	10,334	11,888	14,198	14,117
CFR excluding other long-term liabilities and MRP provision and grants	248,170	279,213	272,408	259,867
Less: Existing Profile of Longer Term Borrowing – PWLB and bank loans	149,950	142,572	138,178	133,767
Cumulative Maximum External Borrowing Requirement	98,221	136,641	134,230	126,100
Estimated Usable Reserves	38,800	36,900	35,000	33,100
Anticipated Capital receipts	-	6,250	10,500	25,500
Cumulative Net Borrowing Requirement	59,421	93,491	88,730	67,500
Total Council Borrowing	209,370	236,063	226,908	201,267

- 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 £9.9m and £12.8m for the foreseeable future. Therefore if, after the large capital schemes scheduled for the next few years are completed, the new capital spend financed by borrowing can be

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reduced to below the annual MRP 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 both in terms of absolute levels and affordability, Herefordshire Council's CFR is no higher than average.

5 Borrowing Strategy

- 5.1 At 30 November 2015 the council held £181.5m of loans, comprising long-term fixed rate loans totalling £139.0m plus short-term variable rate loans of £42.5m. The balance sheet forecast in table 1 shows that the council's borrowing may need to increase to £209.4m by 31 March 2016 and to £236.1m by 31 March 2017, 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 council'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 council'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 so as 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 the council with 'cost of carry' and breakeven analysis. Its output will determine whether the council borrows additional sums at long-term fixed rates in 2016/17 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.
- 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:

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- 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 £6m 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. Due to the prevailing low interest rate regime, opportunities for debt rescheduling are likely to be very limited. However, this option will be kept under review and will be considered 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 example salary and creditor payments. The council hold balances of around £20m to cover all contingencies. A cash flow 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 council's objective when investing

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money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and 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. For 2016/17 the council will continue to rely on Money Market Funds which are highly diversified and carry reduced credit risk.

Risk Assessment and Credit Ratings

- 6.4 The council applies the credit worthiness service provided by Capita Asset Services. This service employs a sophisticated modelling approach utilising credit rating from three main credit rating agencies (Fitch, Moody's and Standard and Poor's). This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system to which Capita Asset Services allocate a series of colour coded bands with suggested maximum durations for investments (as shown in table 2 below).
- 6.5 Typically the minimum credit ratings criteria the council use will be short term rating (Fitch or equivalents) of F1 and a long term rating of A-. There may be occasions when the counterparty ratings from one agency are marginally lower than these ratings but still may be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.
- 6.6 The council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- (Fitch or equivalents). Currently these countries are:
- Australia (AAA)
 - Canada (AAA)
 - Denmark (AAA)
 - Germany (AAA)
 - Singapore (AAA)
 - Sweden (AAA)
 - Switzerland (AAA0)
 - Finland (AA+)
 - Netherlands (AA+)
 - U.K. (AA+)
 - U.S.A. (AA+)
 - Abu Dhabi UAE (AA)
 - France (AA)
 - Qatar (AA)
 - Belgium (AA-)
 - Saudi Arabia (AA-)

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Approved Counterparties

6.7 The council 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				
		Colour coding or long term rating	£ limit	Time limit
Banks and Building Societies	Term deposits, CDs or corporate bonds	Yellow Purple Orange Blue Red Green No colour	5m 5m 5m 5m 5m 5m nil	5 years 2 years 1 year 1 year 6 months 100 days Not to be used
Council's Banker (NatWest)			5m	Liquid
DMADF	DMADF account	AAA	Unlimited	6 months
UK Government	UK Gilts	UK sovereign rating	Unlimited	1 year
UK Government	Treasury Bills	UK sovereign rating	Unlimited	1 year
Multilateral development banks	Bonds	AAA	5m	6 months
Local Authorities	Term deposits		5m	1 year
Money Market Funds	MMFs	AAA	5m	Liquid
Enhanced Money Market Funds with a credit score of 1.25	MMFs	Dark pink / AAA	5m	Liquid
Enhanced Money Market Funds with a credit score of 1.5	MMFs	Light pink / AAA	5m	Liquid
Other investments:				
Pooled funds		£5m per fund		
Mercia Waste Management (providing finance for Energy from Waste Plant)		£40m over the course of the contract		

Types of Investments

6.8 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.

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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 councils banker) 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 the 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 council's investment objectives will be monitored regularly.

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Specified Investments

6.9 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”.

6.10 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

6.11 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, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments 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 2016/17

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.

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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.

7.3 In line with the CLG Guidance, the policy for the 2016/17 calculation of MRP (unchanged from previous years) is as follows:

- For supported capital expenditure before 31 March 2004 MRP will be determined as 4% of the Capital Financing Requirement in respect of that expenditure.
- For unsupported capital expenditure incurred after 31 March 2011, 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 2016/17 will not be subject to a MRP charge until 2017/18 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 31 March 2017, the budget for MRP has been set as follows:

	31.03.2017 Estimated CFR £000	2016/17 Estimated MRP £000
Pre 31/03/11 Supported borrowing & Adj A	106,981	4,458
Prudential borrowing	184,120	5,073
Finance leases and Private Finance Initiative	25,181	1,282
Other loans (Salix)	395	155
Total	316,677	10,968

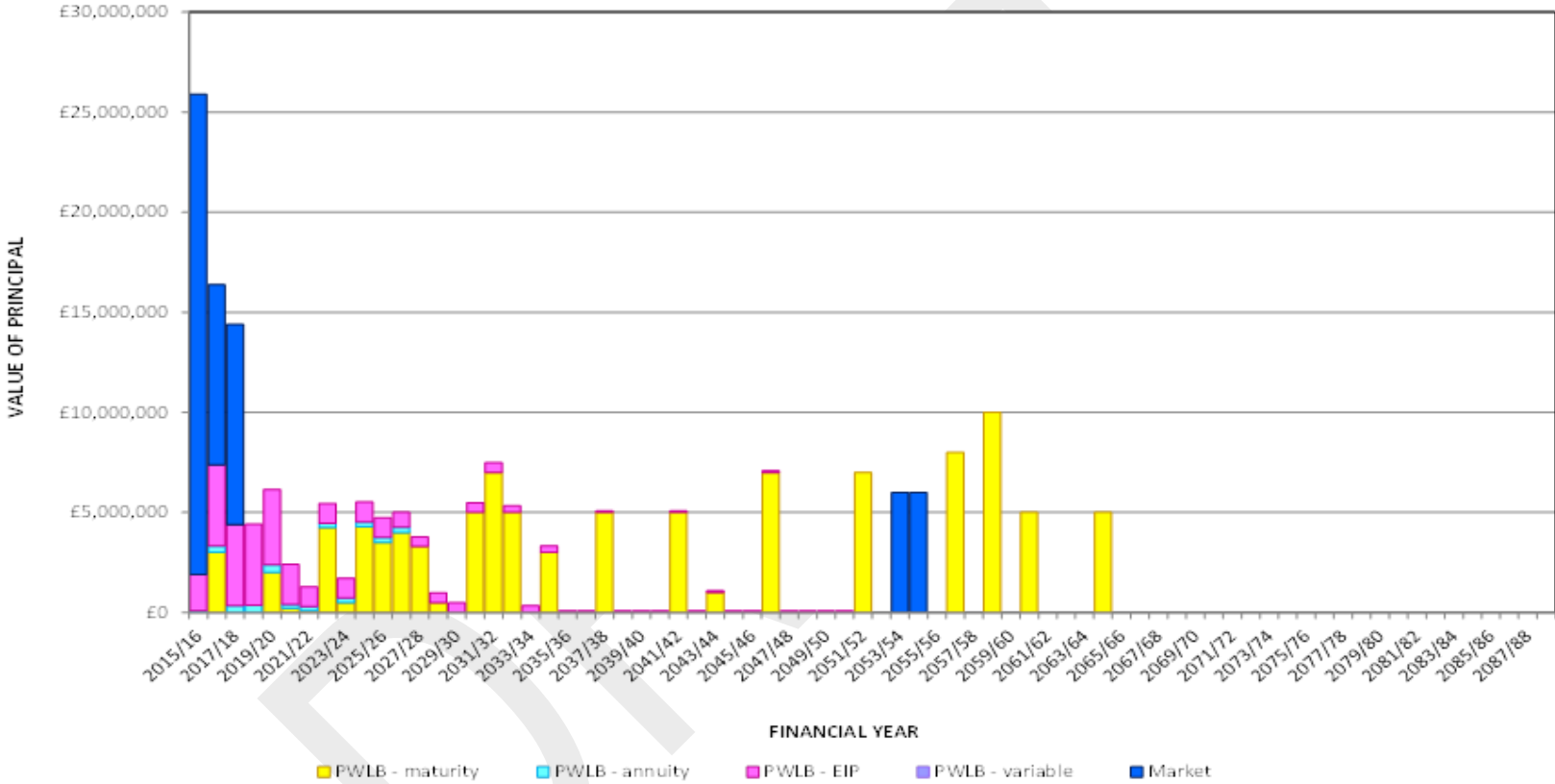
EXISTING BORROWING & INVESTMENTS AS AT 30 NOVEMBER 2015

External Borrowing:	Actual Portfolio £m	Average Rate %
<u>Long-term loans (all fixed rate)</u>		
Public Works Loan Board	127.0	4.16%
LOBO Loans	12.0	4.50%
<u>Short-term loans</u>		
Local Authorities	42.5	0.55%
Total External Borrowing	181.5	3.23%

Investments:	Actual Portfolio £m	Average Rate %
NatWest Liquidity Account (Instant Access)	0.2	0.25%
Money Market Funds (Instant Access)	3.3	0.50%
Close Brothers Bank (One Month Notice Account)	2.5	1.00%
Total Investments	6.0	0.69%

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APPENDIX 2



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 Programme	2015/16 Approved £000	2015/16 Revised £000	2016/17 Estimate £000	2017/18 Estimate £000	2018/19 Estimate £000
Expenditure	66,573	77,089	75,075	50,701	30,462
Funding					
Capital receipts	7,128	5,763	7,900	6,400	0
Capital Grants	14,258	29,167	24,343	35,873	29,386
Prudential Borrowing	45,187	40,809	42,532	8,428	1,076
Other	0	1,350	300	0	0
Total	66,573	77,089	75,075	50,701	30,462

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. The table below includes PFI contracts:

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Capital Financing Requirement	2015/16 Approved £000	2015/16 Revised £000	2016/17 Estimate £000	2017/18 Estimate £000	2018/19 Estimate £000
Total CFR	258,909	285,109	316,677	310,744	296,782

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 should 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 finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the council's debt.

Operational Boundary	2015/16 Approved £m	2015/16 Revised £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Operational Boundary for Borrowing	240	265	295	290	275
Operational Boundary for other Long-Term Liabilities	30	30	30	30	25
Operational Boundary for External Debt	270	295	325	320	300

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.

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Authorised Limit	2015/16 Approved £m	2015/16 Revised £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Authorised Limit for Borrowing	250	275	305	300	285
Authorised Limit for other Long-Term Liabilities	40	40	40	40	40
Authorised Limit for External Debt	290	315	345	340	325

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	2015/16 Approved £'000	2015/16 Revised £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Net Revenue Stream	146,135	145,364	143,529	140,508	139,964
Financing Costs	16,416	15,900	17,096	16,271	17,608
Percentage	11.23%	10.94%	11.91%	11.58%	12.58%

Note: the net revenue stream comprises council tax receipts, inclusive of 2% adults precept, plus government funding excluding specific grants.

7.3 The above table shows budgeted financing costs within the council's medium term financial strategy.

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 treasury management to the estimated tax base.

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	2016/17 Estimate £000	2017/18 Estimate £000	2018/19 Estimate £000
Addition / (reduction) in total treasury budget	1,196	(825)	1,337
Estimated tax base (number)	66,873	67,462	68,013
Estimated impact per Band D council tax charge, per annum	£17.88	(£12.23)	£19.66

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 an unexpected hike in interest rates 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 increased interest rate risk.

	2015/16 Approved	2015/16 Revised	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Upper Limit for Fixed Interest Rate Exposure	100%	100%	100%	100%	100%
Upper Limit for Variable Interest Rate Exposure	50%	50%	50%	50%	50%

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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 date on which the loans could be repaid. The council's two LOBO loans could become repayable within 12 months although, if the lenders do not increase the interest rates being charged, which is the current assumption, then the loans could remain outstanding until 2054.

Maturity structure of fixed rate borrowing	Estimated level at 31/03/16	Lower Limit for 2016/17	Upper Limit for 2016/17
Under 12 months	13.65%	0%	20%
12 months and within 24 months	3.10%	0%	20%
24 months and within 5 years	9.13%	0%	20%
5 years and within 10 years	13.17%	0%	20%
10 years and within 20 years	26.29%	0%	40%
20 years and within 30 years	8.35%	0%	40%
30 years and within 40 years	6.58%	0%	40%
40 years and within 50 years	19.73%	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.

Upper Limit for total principal sums invested over 364 days	2015/16 Approved £m	2015/16 Revised £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
	5	5	5	5	5

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

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Bank Base Rate (%)	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.50	1.50	1.75	1.75
PWLB Rates (%):											
5 years	2.40	2.50	2.60	2.80	2.90	3.00	3.10	3.20	3.30	3.40	3.50
10 years	3.00	3.20	3.30	3.40	3.50	3.70	3.80	3.90	4.00	4.10	4.20
25 years	3.60	3.80	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.60
50 years	3.60	3.80	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.60
The above PWLB rates are noted by Capita Asset Services as being their “central” or most likely forecast, however, they also note that there are downside risks to their forecast.											

Forecast:

- The council’s treasury advisors forecast the bank base rate to stay on hold until quarter two of 2016 at which point small stepped increases are anticipated. It is anticipated the bank base rate standing at 1.75% at March 2018. Capital Economics has a similar interest rate forecast profile to the aforementioned.
- The US is likely to be the first of the major economies to start tightening monetary policy. The timing of the first move is expected to be December 2015.

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Council budget:

- As can be seen from the table above, the council's treasury advisors central forecast is for the Bank Base Rate to increase during 2016/17 from 0.5% to 1.0%. However, they advise that there is a downside risk that they could remain at 0.5% throughout the year. The council's short-term borrowing budget has been based on a rate of up to 1.5% which should incorporate sufficient headroom to accommodate any unexpected changes in the Base Rate.
- The investment budget is based on the council's treasury advisor's central forecast using average interest rates of 0.6%, assuming that investment balances will be lower in 2016/17 with the majority 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.

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 pursuit 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.

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- 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 into 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.