Stevenage BOROUGH COUNCIL

Part I – Release to Press

Meeting: **Audit Committee/ Executive/ Council** **Agenda Item:** **3**

Portfolio Area: **Resources**

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TREASURY MANAGEMENT REVIEW INCLUDING PRUDENTIAL CODE INDICATORS 2017/18

NON-KEY DECISION

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1. PURPOSE

1.1 To review the current Treasury Management and Investment Strategy including prudential indicators

2. RECOMMENDATIONS

2.1 That subject to any comments from Executive and the Audit Committee, the Treasury Management Review is recommended to Council for approval.

2.2 That Council be recommended to approve the increase in the Treasury Limit for “Fixed Rate more than 12 months to maturity” to £10Million when balances are in excess of £30Million (paragraph 4.2.1.5).

2.3 That Council note the use of short term borrowing where appropriate (paragraph 4.2.1.4).

2.4 That Council be recommended to remove the total limit on the amount of funds invested in Money Market Funds (paragraph 4.2.2.1 refers).

2.5 That Council be recommended to approve the use of property funds, subject to market conditions and in consultation with the Resources Portfolio holder and the Chair of the Audit Committee up to a maximum of £3Million, (paragraph 4.2.6.11)

2.6 That Council be recommended to approve the use of enhanced cash funds up to a limit of £3Million, (paragraph 4.2.7.5).

2.7 That Council be recommended to approve the opening of a custodian account and the use of the Certificates of Deposits (held to maturity) up to a maximum of £5Million (paragraph 4.2.8.5).

2.8 That Council be recommended to approve the 2017/18Treasury Management Strategy as set out Appendix A to this report

3. BACKGROUND

3.1 Treasury Management Strategy

3.1.1 The main priority of the Treasury Management Strategy is to maintain security of principal invested. The with regard to this the aims of the review are:

i) To ensure that there is sufficient counter party availability and to maintain required levels of liquidity.

ii) To look for possible changes to the Treasury Management Strategy which would increase returns on investments made.

iii) To consider alternative investment opportunities to those currently used by the Council with the aim of increasing returns on investments.

3.1.2 The 2016/17 Prudential Code Indicators and Treasury Management Strategy Report were approved by Council on the 24 February 2016, within this report the Chief Finance Officer recognised the need for a fundamental review of the investment portfolio, including alternative investment options and treasury management practices. This could then provide alternative counterparty and instrument options to alleviate the issues that were being experienced in terms of placing investments within the current approved strategy . The 2016/17 Strategy did increase counterpart limits (including money market funds) from £7Million to £8Million for balances in excess of £30Million.

3.1.3 The returns achievable on the Council's investments are currently low. The Bank of England adopted a policy of reducing its Official Bank Rate (Bank Rate) from 5.75% in July 2007 to 0.5%in March 2009 a historic low and a policy of Quantitative Easing was introduced to bring the UK out of recession. On 4 August 2016 the Bank of England Bank Rate was reduced further to 0.25% to help stimulate the UK economy following the EU referendum to leave the European Union. The latest forecast by the Council's treasury advisors Capita is that rates will remain at 0.25% until June 2019. However inflation figures for December rose to 1.6% (CPI) the highest rate since July 2014 which may put pressure on retaining low interest rates.

3.1.4 In addition to low interest rates the Bank of England has introduced funding for lending schemes to provide cheap funding for banks so they increase their lending and pass on the interest rate cuts to households and businesses (the real economy). The latest "Term Funding Scheme" (4 August 2016) provides funding to individual banks at close to Bank Rate as long as they can demonstrate their lending into the real economy has increased. The Council's return on investments will be affected by this, as lower interest rates will be offered by banks as there will be less of a demand for funding from the market.

3.1.5 The Council's current investment portfolio consists of "conventional" cash investments: deposits with banks and building societies, Money Market Funds and loans to other Local Authorities. A review has been undertaken to consider alternative investment opportunities to enhance the Council's returns by diversification of its portfolio into different types of investments. The aim of the review is to increase yield on investments however, security (of principal) remains the overriding objective of the Treasury Management Strategy..

3.1.6 The impact of the European Union (EU) Referendum decision to leave the EU and the implications of this for the UK economy are uncertain and further updates of the Strategy may/will be required once these are known .

3.1.7 Further updates will also be required after the implementation of The Markets in Financial Instruments Directive II (MiFID II) in January 2018. This is EU legislation that regulates firms who provide financial instruments services and venues where those instruments are traded. The Council could face two potential issues that might affect the use of deposits going forward under the MiFID II regime:

a) Firstly the Council is likely to be classified as a "retail" counterparty for financial institutions which would mean that they would be required to undertake more extensive checks on the Council's suitability for products (even for short term deposits) and this may be reflected in lower yields.

b) Secondly some financial institutions run parallel systems, one for their "retail" customers and one for "professional" customers. "Retail" customers may find a smaller choice of products being made available to them under MiFID II.

3.1.8 Once the impact of the MiFID 11 directive is known Members will be updated and any changes required to the Treasury Management Strategy made.

3.2 Prudential Indicators

3.2.1 It is a requirement of the Local Government Act 2003 that from April 2004 Councils must 'have regard to the Prudential Code and set prudential indicators to ensure that capital investment plans are affordable, prudent and sustainable'.

3.2.2 This strategy's prudential indicators (Appendix C) includes HRA debt (relating to the HRA self financing and Decent Homes Programme), and General Fund prudential borrowing.

3.2.3 This report bases its prudential indicators on the Draft Capital Strategy reported to the Executive in January 2017. The Audit Committee is the body nominated to provide scrutiny for the Treasury management strategy prior to approval at Council. Any comments that the Audit Committee has on the Strategy will be reported to Executive (21 February 20176) and to Council (28 February 2017).

4. REASONS FOR RECOMMENDED COURSE OF ACTION AND OTHER OPTIONS

4.1 Performance of the Current Treasury Strategy

4.1.1 The reduction in the Bank of England base rate has seen the Council's average rate of return decline from 5.8% in 2007/08 to 0.61% in 2015/16.

4.1.2 For the 2016/17 financial year to 31 December 2016 returns on investments have averaged 0.59% and the total interest earned was £272,382.

4.1.3 Cash balances as at 31 December 2016 were £62.3Million with a total forecast interest income for 2016/17 of £343,000. The Council's cash balances for 2016/17 have peaked at £70Million and have been consistently above £50Million. This is partly due to restricted use/third party receipts, some of which are listed below and equating to an estimated £17.8Million (or 29% of cash balances) as shown in the table below. In addition HRA balances, (31 March 2018 £19.4Million) are projected to be at minimum level of £2Million by 2021/22.

Ring-Fenced Receipts Included in Cash Balances as at 31/12/2016 (£62.3Millio		
	£'Million	% of investment
New Build Receipts	11.0	18%
Provision for NNDR appeals	6.0	10%
Council surpluses to be repaid-Council tax	0.8	1%
Total	**17.8**	

4.1.4 During 2016/17 no investments have been placed with the Debt Management Office (DMO) as a 'safe haven' when cash balances have been high to ensure that counter party limits are not breached and there have been no treasury management breaches of the Strategy in 2016/17 at the time of writing the report.

4.1.5 There has been no short term borrowing in 2016/17, as a result of removing the requirement to keep £10Million in instant access accounts, however the Audit committee asked officers to report back them if this occurred.

4.1.6 The Treasury Management Strategy has two sets of Treasury limits, (1) balances above £30Million and (2) below £30Million. Current forecasts indicate that cash balances should remain above £30Million in 2017/18 with average balances anticipated to be higher. If due to unforeseen circumstances balances fell below £30Million this could lead to counterparty limits being breached temporarily, should this occur it would be reported to the Chief Finance Officer.

4.2 Review of the Treasury Management Strategy and Proposed Changes

4.2.1 Increasing the Weighted Average Maturity of the Investment Portfolio

4.2.1.1 There were indications following the EU referendum that the Bank of England would make a further cut to the Bank of England Official Bank Rate (Bank Rate to 0.1%), however this has not transpired. The Council's Treasury advisors, Capita's forecast is for Bank Rate to stay at 0.25% until June 2019, however inflationary pressures may put pressure on the base rate. Structuring the portfolio with staggered maturity dates helps minimise the risk of future interest rate changes. Increasing the Weighted Average Maturity of the investment portfolio would lengthen the overall portfolio and should result in increased returns as the Council would lock into investments as demonstrated in the table below.

Example for Investment of £2M			
Bank Rate was 0.25% on 14 December 2016 and forecast to increase to 0.75% by March 2020 (Capita). There were investment opportunities with Local Authorities of 0.98% for 3 years & 3 months and 1.30% for 5 years.			
Interest earned 3 years & 3 months		Interest earned 5 years	
0.98%	average 6 month rate plus forecast interest rate increase	1.30%	average 6 month rate plus forecast increase
£63,687	£32,294	£130,071	£79,571

4.2.1.2 The table above shows that by taking advantage of these longer dated investment opportunities the Council could benefit from higher returns than currently forecast from shorter rated securities. There is a risk in future years that interest rates could increase but with staggered maturity dates this would spread this risk and at the point a potential investment decision is made the options are 'stress tested' to see the impact on the return if interest rates did increase quicker than projected.

4.2.1.3 The 2016/17 Mid-Year Review recommended the removal of the Treasury Limit which required the Council to maintain a minimum of £10Million (or 100% of cash balances if these are below £10 Million) in instant access or overnight balances. Liquidity will be maintained by having due regard to the day to day cash flows required by the Council. The removal of this limit will increase the scope for higher returns on investments as it will reduce the level of cash currently required to be held in instant access accounts earning minimal interest rates. This will facilitate the placing of investments for longer periods of time as outlined above. The Audit Committee requested that the committee is notified if short term borrowing occurs as a result of this change, at the time of writing the report there had been no short term borrowing during 2016/17.

4.2.1.4 However, short term borrowing is permitted to meet unexpected cash flow requirements and bridge temporary shortfalls, as long as the Council remains within its authorised limit and **is recommended if appropriate**. The use of short term borrowing would be monitored to ensure that the Council was not regularly borrowing. An example of indicative rates for short term borrowing is provided in the following table and short borrowing is 12 basis points lower than a three month investment with a local authority.

Amount Invested /borrowed £1Million	Interest Rate	Amount*
Borrow for 2 weeks	0.18%	£69.04
Borrow for 1 month	0.28%	£237.81
Invest for 3 months with a Local Authority	0.30%	£764.38
Invest for 3 months lower rate on offer in the market	0.28%	£713.42
Invest for 3 months higher rate on offer in the market	0.36%	£917.26

**Note assumes 31 day months when borrowing or lending*

4.2.1.5 The Council's cash balances are forecast to be at £50Million by the end of 2017/18, however as outlined in paragraph 4.1.3 a portion of the balances relate to restricted/third party receipts and HRA revenue balances are set to decline over the next few years. The cash balance projections for 2017/18 are sufficiently high to allow an increase to the Treasury Limit for fixed rate investments of more than 12 months to maturity. This would be beneficial in improving the average interest rate at low risk. When balances are in excess of £30Million it is recommended to have a higher limit of £10Million, (currently £5Million).

4.2.1.6 In summary officers recommend increasing the weighted average maturity of the portfolio by:

- No fixed amount of investments held in instant access cash balances (paragraph 4.2.1.3 refers).
- Short term borrowing where appropriate.
- Increasing the Treasury Limit for "Fixed Rate more than 12 months to maturity". When balances are in excess of £30Million to have a r limit of £10Million, (£5Million currently).

4.2.2 **Increasing the Treasury Limit on Money Market Funds**

4.2.2.1 To prevent financial crisis and to make banks more stable, the Bank of England imposed regulatory changes on them. Individual banks are required to hold funds with the Bank of England to cover any monies which they hold for less than 31 days, this is inefficient for the banks as these funds will earn the Bank Rate. This means banks no longer provide competitive call or instant access accounts, which the Treasury team have regularly used. To compensate for this **it is recommended that the treasury management limit on traditional Money Market Funds is changed** as summarised in the following table:

Current Policy- Money Markets	Recommended Policy -Money Markets
Total investment no more than £15Million and no more than 35% of total portfolio	Remove – no limit on cash placed in money market funds (instant access)
The counterparty limits of £8Million per MMF when balances are over £30Million (£5Million when balances under £30Million)	no change

4.2.2.2 Money Market Funds offer a source of instant access funds, increasing their limit and will create flexibility in counter party availability.

4.2.2.3 There have been discussions regarding potential changes to Money Market Funds (MMF) that might affect the liquidity or risk of the fund. These reforms are still to be agreed and are unlikely to be ready for implementation in 2017/18, should the regulations be introduced the Strategy will be amended to reflect any increase in risk.

4.2.3 **Investing in Building Societies Unrated (no credit rating)**

4.2.3.1 The Treasury team looked at rates of return achieved by other benchmarked Local Authorities, one or two were placing investments with unrated building societies in line with their Treasury Strategy. Unrated building societies are those which do not have a credit rating with any of the three credit rating agencies and as a result there is less readily available information which can be used to assess any changes to the financial strength of these building societies.

4.2.3.2 If the Council decide to use unrated building societies it would need to carry out due diligence and undertake a full assessment on any institutions. However, monitoring of counterparties is of critical importance. With rated entities there are credit ratings readily available to monitor on a live basis, along with watches/outlooks and in some cases an overlay of Credit Default Swaps. Unrated building societies do not have this information readily available for monitoring purposes.

4.2.3.3 The Bank of England's funding for lending schemes have lowered demand from smaller entities this includes unrated building societies. This has meant that the yield received from unrated entities is not significantly higher than the rated entities, especially given the risk of having no credit ratings or other related information to monitor.

4.2.3.4 **Using unrated Building Societies is not recommended** because the risk assessments for these entities are not available and the risk to the security of the principal invested will not be offset by compensation in terms of a significant increase in the return from investment.

4.2.4 Building Societies Review of Investment Duration (Lending Lower than the risk assessment recommends)

4.2.4.1 Investments are placed with building societies for the maximum duration per the council's treasury advisors colour coded credit list. This is based on the credit ratings from the three credit rating agencies overlaid with their watches/outlooks. For example Nationwide is currently has a maximum duration of six months, (colour coded red on Capita's Credit List).

4.2.4.2 If the Council were to make an investment for one year with the Nationwide or Coventry building societies (which do have credit ratings for that length of duration), the return would be approximately 0.63% and 0.52%. Furthermore these level of rates can still be achieved within the Strategy limits, e.g. Standard Chartered Bank 0.52% (95 day notice facility).

4.2.4.3 As part of the review of the Council's treasury activity benchmarking was done comparing the Council's performance with other Local Authorities. Two authorities with higher rates of return were using building societies and were lending for beyond the recommended term (for information maximum duration currently six months).

4.2.4.4 The option to extend beyond Capita's suggested durations and is **not recommended.** To get an enhanced yield would be counterintuitive to applying the credit risk ratings for some institutions and not applying for others. The higher potential yield (but not always as the example above) versus the risk means that security would no longer be the overriding principle of the Strategy and the risk assessment of investment duration is based on the perceived risk. The Treasury team will continue to look for investment products which are available within the suggested durations.

4.2.5 **Lowering the Investment Criteria**

4.2.5.1 A relaxation or reduction of the minimum credit criteria for Short and Long Term Ratings by Fitch or equivalent from A (short term) or AA- (long term) to BBB+ was also considered this would be lower than the council's treasury advisors recommend. However, reducing the investment grade only currently adds a very small number of counterparties to the list, (this option has been used by other councils). However the S151 Officer does **not recommend the reduction in the rating** for a small number of counterparties, who would be outside the scope of the colour coded risk assessment approach currently used.

4.2.6 **Alternative Investment Instruments - Property Funds**

4.2.6.1 This involves the indirect investment in property. The investment is obtained through UK authorised property unit trusts or investment trusts, which manage the funds and deal with any custodian account arrangements for surplus cash held by the fund. The cash investment is secured against the assets in the fund and this may mean **the unit value is higher or lower than the sum invested i.e. a £1 investment may not have a value of £1 when it is withdrawn**. The Council would not own the properties involved.

4.2.6.2 Property funds seek reduce risk by diversification across different types of UK properties (commercial, industrial, retail) and regions.

4.2.6.3 The net returns from property funds are made up of three elements:

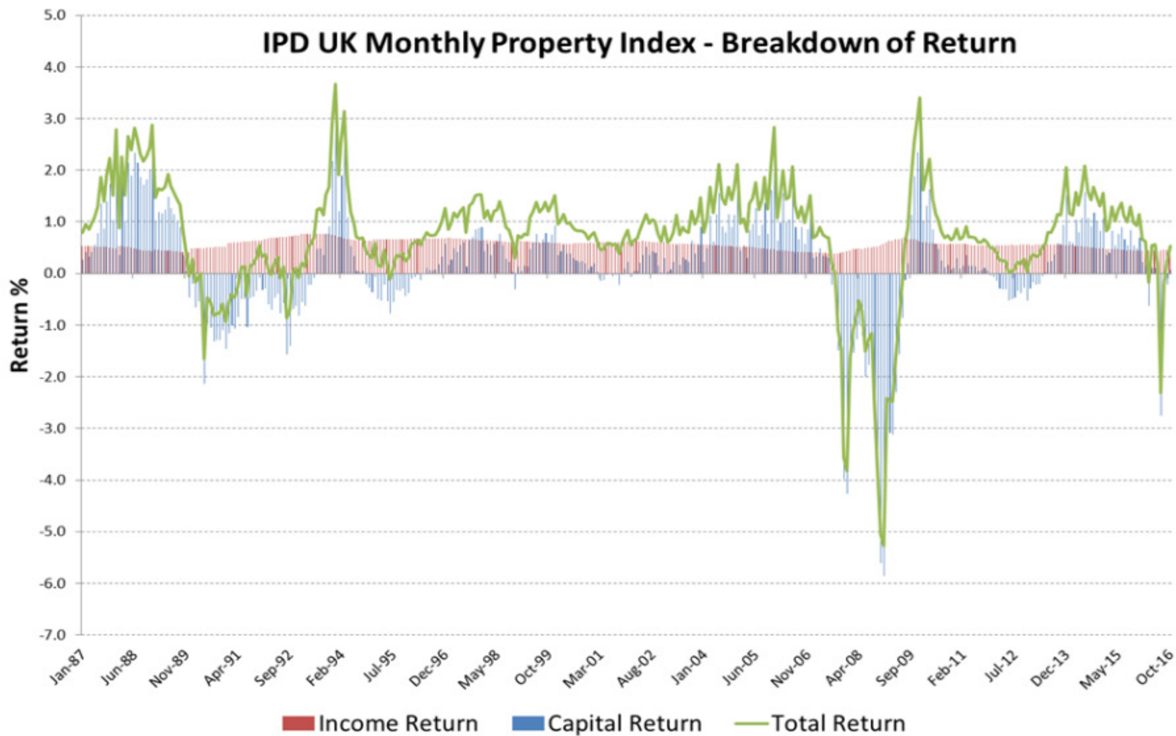
1) Rental streams from tenants within properties.

2) Capital appreciation (or depreciation) – revaluation of properties within the portfolio.

3) Fees (entrance, exit and annual management).

4.2.6.4 There were attractive yields from property funds in 2015, for the period 2017/20 the forecast return is expected to be around 4.4% per annum after deduction of fees (based on latest IPF forecast 25 November 2016). However there is significant volatility in returns throughout the investment cycle mostly caused by changes in the capital value of the properties in the fund.

4.2.6.5 The graph below shows the historical total return from property all property funds and the volatility caused by the capital value of the properties in the funds.



4.2.6.6 There are currently around 16 funds operating, 12 of which the investment would be deemed as capital expenditure and are therefore not a treasury management tool, however the remaining four funds could be used. With property funds resulting losses would be a charge to the council's revenue account.

4.2.6.7 Property funds are not credit rated in the same way an investment in a bank or building society would be as they are property asset based and the risk assessment different. In terms of assessing risk there is scope to ask individual property funds about their tenant quality and covenants which may underpin the security of any rental income.

4.2.6.8 Any Investment period requires a long term commitment horizon of at least 5 years+ this ensures that any losses would be minimised as the vehicle is held for a longer period of time. The level of upfront fees means the breakeven point is not normally reached until 3+ years.

4.2.6.9The table below summarises the benefits and drawbacks of investment in property funds:

Benefits	Drawbacks
Professional management by regulated Fund managers. Active management can achieve higher returns than average	Associated fees - Cost of entry (around 6% to be paid upfront and deducted from net asset value straightaway), exit fee (around 2%), fund provider fees, management costs and upfront cost of fund manager selection (spread may be as high as 8%).

Benefits	Drawbacks
Risk reduced as a result of diversification of investments across different types of properties (industrial, commercial, retail) and regions.	Illiquid – a commitment of at least 5 years is required due to the level of fees to enter and exit funds. The Council will also need to be able to plan its exit approximately 18 months in advance and aim to leave on a capital neutral level.
Stable rental stream from rents after deduction of: voids, management costs, fund provider fees.	Risks to return - include changes in general economic conditions, changes in supply of or demand for competing properties in an area, changes in interest rates. In 2008/09 about 30% of funds value was lost. Risk of property market collapse.
Cheaper costs compared to transacting individually and reduced administration and research requirements by the investor for each investment.	Potentially limited secondary market and options are determined by economic situations - difficult to reverse decision in short term and exit via the secondary market is likely to be at a cost.
	Accounting treatment - changes in legislation in 2018/19 will mean that any losses would be a direct cost to the General Fund and HRA.
	Unknown medium to longer term effect of the decision to leave the EU on property funds

4.2.610 There is uncertainty in the economic performance of the UK at present and property funds carry the risk of a collapse in the property market. Total returns from this type of investment are volatile with the steady part of the return coming from the rental element which could be achieved by investment directly in property.

4.2.6.11 It is **recommended that Property Funds are used for long term investments (up to a maximum of £3Million) over the 5+ year term if appropriate** and the cash flow supports the longer term investment. it is not recommended for short term investments due to the risk of investment loss. The maximum investment duration would also have to extend beyond the current five years allowed in the Strategy. Should the Assistant Director (Finance) consider that the use of property funds is appropriate based on market conditions, the Resources Portfolio holder and the Chair of the Audit Committee will be consulted.

4.2.7 **Alternative Investment Instruments - Enhanced Cash Funds (ECF)**

4.2.7.1 Enhanced Cash Funds (ECF) are different to the traditional Money Market Fund (MMF) which the Council currently uses. They are designed to produce an enhanced rate of return on investments which requires the fund manager to take more risk (whether credit, interest rate or liquidity). ECFs like property investment funds can produce more volatile returns especially in the short term but a better rate of return in the long term. The length of investment is expected to be for a minimum of 2-3 months.

4.2.7.2 ECFs would be in addition to the use of MMFs and there are a wide range of funds which have very different characteristics. Capita's Fund Selection Service

would be required for the initial selection and for the on-going monitoring of the funds.

4.2.7.3 A Fund Manager manages the portfolio and deals with daily changes to credit ratings, interest rate outlook and other issues which impact the performance of the fund.

4.2.7.4 The ability to call any investment back is generally based on next day or six days. The benefits and drawbacks associated with the funds are summarised in the table below.

Benefits	**Drawbacks**
Short term 2-3 months	Not instant access – but can called back between one and five days
Improved rate of return than normal MMF	Unit price can go up or down - risk of principal as value is affected by market circumstances.
Fund manager aims to limit any negative changes in capital value but this is dependent on market circumstances	Unit price is made up of principle plus interest - interest is equal to the difference in price
If investment is retained over the 2 to 3 month horizon it should provide a higher average rate of return	Not all schemes are the same – there would be an additional cost of £1,250 for Capita selection service to provide a full appreciation of the options available to identity the most appropriate fund.
	Cost of annual management fee 10-20 basis points, potentially higher than our traditional MMF of 12 basis points.
	On-going monitoring required ensuring that the fund remains suitable.
	Lack of Council control over day to day investments within the fund, in the same way as traditional MMF.

4.2.7.5 As with property funds there is a risk to the principal amount invested as the unit value of the fund is valued daily and this can mean the price of the investment can go up or down, depending on the underlying market. These fund's can be a useful Treasury Management tool and a number of funds have not made losses based on holding for the minimum periods of 2 to 3 months to deal with any fluctuations in the unit price. The Assistant Director (Finance and Estates) recommends the use of ECF's if appropriate and once due diligence has been completed using the Capita selection service. However the Assistant Director (Finance and Estates) **recommends the use of the funds up to a maximum investment of £3Million,** to limit the potential exposure to any losses on the overall investment portfolio.

4.2.8 **Alternative Investment Instruments - Certificates of Deposits**

4.2.8.1 Certificate of deposits (CDs) are investment instruments issued by banks and other financial institutions. They are similar to fixed term deposits except that they are marketable securities, so can be sold before the maturity date. They act as evidence of a deposit with a specific bank or building society repayable on a fixed date ranging from under a month to over two years. Interest is paid at maturity for deposits of less than one year and annually for deposits over one year.

4.2.8.2 CDs can be traded in the financial markets which means they can be sold before they reach maturity and if the purchaser requires funds. The price of the CD changes throughout its life due to movements in the market. If interest rates fall the price of a CD increases and vice versa.

4.2.8.3 By using CDs, the Council may be able to invest with high credit quality counterparties who aren't accessible in the wholesale fixed deposit market.

4.2.8.4 If the Council invested in CDs it would be expected to hold the instrument to maturity.

Benefits	Drawbacks
Creditworthiness is easily measured as commonly issued by leading banks - subject to greater supervisory scrutiny & credit rated	Custodian service required
More liquid as secondary market - can be sold if required for cash flow as long as there is a liquid market for the instrument	If counterparty in difficulty price in secondary market will be lower and risk to principal value.
Increases the number of counter parties available but aren't active in the traditional wholesale fixed deposit market.	
If interest rates decline the price of a CD increases (vice versa)	

4.2.8.5 The Assistant Director (Finance and Estates) **recommends that Certificates of Deposits are approved**, **purchase to be held to maturity, to a maximum of £5Million.** Any CD's with a maturity of more than one year are included within the overall limit for fixed rate investments more for "Fixed Rate more than 12 months to maturity".

4.2.8.6 It is **recommended that the Council open a custodian account facility**, a custodian account would be needed to pursue the alternative investment option of Certificates of Deposits.

4.2.9 Alternative Investment Instruments - Corporate Bonds

4.2.9.1 The Treasury review considered the purchase of corporate bonds issued by companies and financial institutions to raise long term capital or funding, rather

than issuing equity each has its own individual legal document known as a "bond indenture".

4.2.9.2 Investing in a corporate bond offers a fixed stream of income (except floating rate notes), known as a coupon which is payable twice a year, for a fixed, predetermined period of time in exchange for an initial investment of capital. The amount invested is repayable on maturity but there is the risk of corporate default.

4.2.9.3 The only lending criteria that could be applied would be for bonds from counter parties on the approved lending list and who meet the Council's credit quality criteria. However, bondholders within the approved credit list do not offer a better investment return than cash deposits and the risk therefore outweighs any advantage.

4.2.9.4 The benefits and drawbacks of investing in corporate bonds are summarised in the table below:

Benefits	Drawbacks
Much higher rate of return for a given period compared to Gilts and other assets.	Lower credit rating and perceived security means that market risk is relatively higher compared to Gilts. The lower the rating the greater the potential volatility of price/yield movements.
Greater liquidity than fixed term deposits as they can be sold before maturity.	If counterparty in difficulty price in secondary market will be lower and risk to principal value.
Potential for increased diversification of our investment portfolio by opening up different counter parties.	Custodian facility is required.
	Credit quality/rating deterioration can lead to the value of the bond decreasing.
	Risk of default on interest or principal invested and that repayment of the company's creditors would take priority.

4.2.9.5 Investment in corporate bonds is **not recommended** for the reasons outlined above.

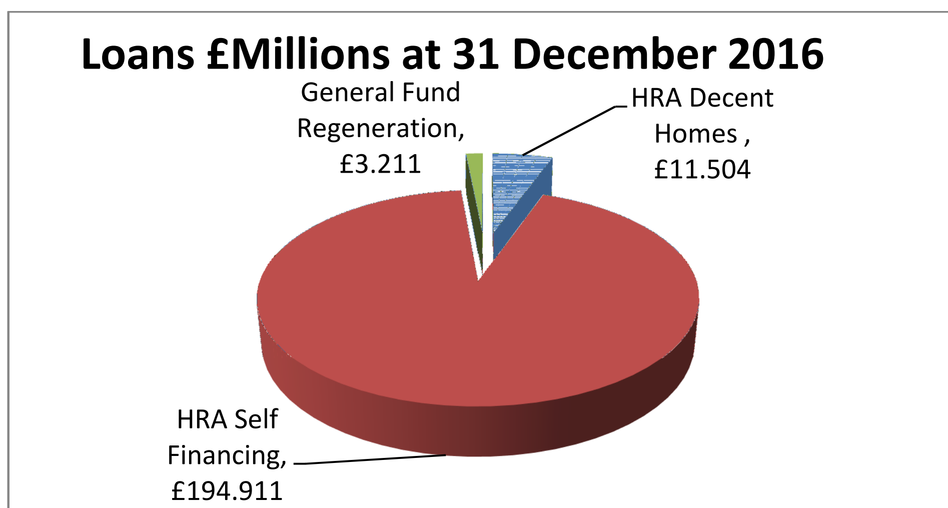
4.2.10 **Investment Comparisons**

4.2.10.1 A summary of the historical returns of different investment vehicles is summarised in **Appendix F** and a glossary of the different investment options is shown in **Appendix G**.

4.3 **Update on the Prudential Indicators**

4.3.1 **The Council's Borrowing Position**

4.3.1.1 The Council had external debt of £209.626Million as at 31 December 2016. This can be broken down as follows:



4.3.1.2 In 2016/17 there no loan repayments scheduled for the HRA. As at the 31 March 2017 the total HRA loans outstanding is forecast to be £206,415,000, loan repayments of £3,741,000 will be made in 2017/18 for the HRA.

4.3.1.3 In 2016/17 there were loan repayments (General Fund (GF)) of £131,579 (August 2016) with a further £131,579 to be repaid in February 2017. As at 31 March 2017 the total GF loans outstanding is forecast to be £3,078,948. For 2017/18 a further £263,158 will be repaid.

4.3.1.4 Since 2011/12 the Council has required £13,542,264 of General Fund borrowing (up to and including the current year) to fund its capital programme. However loans of £4,000,000 have been taken and the General Fund has already set aside £2,611,212 of Minimum Revenue Payment (MRP) to meet the borrowing cost by 31 March 2017.

4.3.1.5 Repayment of the principle as outlined in paragraph 4.3.1.3 is different to the MRP as set out in the table below. The General Fund is required to make a minimum revenue provision based on the life of the asset funded from borrowing regardless of whether the loan has been taken, (see also **Appendix B**). The physical principal repayment is a Treasury Management decision and is not charged to the General Fund.

Financial Year	General Fund £	Regeneration Initiatives £	Total £	MRP Repaid £	MRP Remaining £
2011/12	1,803,028	0	1,803,028	506,949	1,296,078
2012/13	1,560,314	7,039,448	8,599,762	1,742,261	6,857,501
2013/14	1,802,457	28,317	1,830,774	235,492	1,595,282
2014/15	0	1,308,700	1,308,700	126,510	1,182,190
2015/16	0	0	0	0	0
2016/17	0	0	0	0	0

Total	5,165,799	8,376,465	13,542,264	2,611,212	10,931,051

4.3.1.6 Cash and investment balances (effectively internal borrowing) have been used in preference to taking external loans. This is because the cost of the internal debt is in effect the average investment interest foregone (currently 0.57%), is significantly lower than the cost of borrowing externally at 2.82% (based on 25 year maturity rate on the 9 January 2017).

4.3.1.7 It is the view of the Chief Financial Officer that this approach will continue to be considered based on current cash projections for the next few years and while interest rates remain relatively low. This approach has been taken since 2011/12 and with the MRP set aside (as shown in table in 4.3.1.5) the General Fund is effectively reducing the amount it would need to borrow and that need will have reduced by £2.6Million at 31 March 2017.

4.3.1.8 The Council's treasury advisors (Capita Treasury Services) also monitor Public Works Loan Board (PWLB) and market borrowing rates and identify trigger rates at which it may be prudent to take borrowing. The treasury team is mindful of these rates and takes this advice into consideration along with projections for cash balances. Should interest rates rise and/or cash balances fall, circumstances may dictate that it would be preferential to externally borrow rather than use cash balances. Officers will continue to monitor the position.

4.3.1.9 It is not the intention of the Council to borrow in advance of need. However, should this happen as part of optimising the treasury management position of the Council and minimising risk, the transaction will be accounted for in accordance with proper practices.

4.3.1.10 The Council's treasury advisors now forecast Bank of England Base Rate to remain flat and not rise until June 2019 (the 2016/17 Treasury Management Strategy had previously forecast a rise in June 2016, however Base Rate was cut during 2016/17).

4.3.1.11 The Treasury's Certainty Rate for borrowing remains available and enables the Council to take out PWLB loans at 20 basis points below the standard PWLB rate, the 25 year PWLB rate quoted in paragraph 4.3.1.6 includes that adjustment.

4.3.1.12 Members may be aware that there is a proposal to abolish the PWLB and to transfer its lending functions to another body using the process set out in the Public Bodies Act 2011. The Government has given the assurance that the proposals will have no impact on existing loans held by local authorities or the government's policy on Local Authority borrowing.

4.3.2 Investments

4.3.2.1 The Council complies fully with the CIPFA Treasury Management Code 2011, the Guidance on Self Financing and the investment guidance issued by Communities and Local Government (CLG). The following are areas kept under review:

a) A Treasury management presentation was last provided to the Audit Committee on 26th November 2014. Training will be provided as required in 2017/18.

b) Those charged with governance are also personally responsible for ensuring they have the necessary skills and training.

c) A full mid-year review of treasury management strategy and performance will be reported in 2017/18.

4.3.2.2 The 2017/18 Strategy uses the creditworthiness service provided by Capita Treasury Solutions, which complies with the CIPFA Code of Practice. This service uses a sophisticated modelling approach which utilises credit ratings from the three main credit rating agencies. Individual and Support Ratings are no longer relevant indicators, and therefore are removed. (Please refer to **Appendix D** for the Council's Specified and Non-specified Investment Criteria.)

4.3.2.3 The Treasury Management Limits for 2017/18 **(Appendix D)** have been revised to reflect the recommendations included in this report which are portfolio by:

- No fixed amount of investments held in instant access cash balances (paragraph 4.2.1.3 refers)
- Short term borrowing where appropriate
- Increasing the Treasury Limit for "Fixed Rate more than 12 months to maturity". When balances are in excess of £30Million to have a higher limit of £10Million.
- Removal of limit of total amount invested in Money Market Funds
- Use of Property Funds held for 5+ years if market conditions are appropriate
- Use of ECF's up to a maximum of £3Million
- Use of CD's up to a maximum of £5Million (with any investments longer 12 months included in the overall limit for investments of more than year).

4.3.2.4 The latest list of "Approved Countries for Investments" is detailed in **Appendix E.** This lists the countries that the Council may invest with, provided they continue to meet the minimum rating of AA-.

4.4 Prudential Code Indicators

4.4.1 The prudential code indicators as shown in **Appendix C** have been updated for 2017/18 and subsequent years. The 2017/18 **net borrowing requirement** indicator (Appendix C, 3c) is forecast at £160.359Million (2016/17, £162.831Million) which is the total of loans taken less investment held. The detail is shown in the table below.

	2016/17	2017/18
	£M	£M
Loans HRA	206.415	206.174
Loans General Fund	3.079	3.186
Investments	(46.663)	(49.001)

Total	162.831	160.359

4.4.2 The Council's underlying need to prudentially borrow for the General Fund (as measured by the General Fund forecast Capital Financing Requirement (GF CFR)), is £14.769Million for 2016/17, and £14.485Million for 2017/18 (**Appendix C**). This indicator shows the amount of capital expenditure that has been financed from borrowing, less any adjustments for statutory repayments (MRP) and any other adjustments relating to the transfer of assets between the General Fund and HRA.

4.4.3 There is a 2017/18 General Fund budget for interest costs on prior years borrowing (not yet taken) if the circumstances outlined in paragraph 4.3.1.6-4.3.1.7 should change. Borrowing requirements or the need for new future borrowing have not changed since the 2016/17 Mid Year Treasury Management Review and therefore no incremental impact on council tax arising from the draft 2017/18 Capital Strategy in 2016/17 and 2017/18 (Appendix C). This is reflective of the use of the capital reserve and capital receipts rather than prudential borrowing to fund the capital strategy with the exception of the income generating initiatives and the approved 10 year plan for the garages estates.

5 Implications

5.1 Financial Implications

5.1.1 The report is of a financial nature and outlines the Prudential Code Indicators and the principles under which the treasury management functions are managed.

5.2 Risk implications

5.2.1 The current policy of not borrowing externally only remains financially beneficial while prevailing differentials between investment income rates and borrowing rates remain, and balances remain buoyant. When this changes, the Council may need to borrow at a higher rate, leading to a significant additional revenue cost in year.

5.2.2 Risks associated with different investment options and short term borrowing have been included within this report (section 4.2).

5.3 Legal Implications

5.3.1 Approval of the Prudential Code Indicators and the Treasury Management Strategy is intended to ensure that the Council complies with relevant legislation and best practice.

5.4 Policy Implications

5.4.1 The proposed limits are in line with policy.

5.5 Equalities and Diversity Implications

5.5.1 There are no implications associated with equalities and diversity within this report.

6. BACKGROUND DOCUMENTS

- Annual Treasury Management Review of 2015/16, Council 4 October 2016
- Mid-Year Review Report for 2015/16, Council 7 December 2016
- Treasury Management Strategy – Urgency Decision Sovereign Rating Downgrade, Council 20 July 2016
- Agenda Item 4- HRA draft budget setting 2017/18 and rent setting
- Agenda Item 6 Draft 2017/18 Council tax setting and General Fund Budget
- Agenda Item 9 2017/18 Draft Capital Forward Plan & 5 Year Capital Strategy Update

7. APPENDICES

- Appendix A – Treasury Management Strategy
- Appendix B – Minimum Revenue Provision Policy
- Appendix C – Prudential Indicators
- Appendix D – Specified and Non-Specified Investment Criteria
- Appendix E – Approved Countries for Investment
- Appendix F – Performance history of investment instruments
- Appendix G – Glossary of Investment options