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CABINET – 4 DECEMBER 2013

REVISED TREASURY BORROWING AND INVESTMENT STRATEGY 2013/14

1. PURPOSE OF REPORT

1.1 To consider revisions to the Council's Borrowing and Investment Strategy 2013/14 in light of current market conditions.

1.2 The main revisions are to consider:

1.2.1 A limited level of investments to be placed for a period in excess of one year.

1.2.2 The minimum long term credit rating to be A- (Currently A)

2. BACKGROUND

2.1 Each year the Borrowing and Investment Strategy is agreed as part of the overall Treasury Strategy Report. This includes all activities of the Council including General Fund, Housing Revenue Account and Collection Fund (Council Tax and Business Rates).

2.2 The Treasury Strategy Report for 2013/14 was approved by the Council on 25 February 2013 following Audit Committee Scrutiny on 8 February 2013.

2.3 If the Strategy requires amendment during the year a report needs to be approved; this report is requesting that approval.

2.4 In the current approved Treasury Strategy all investments are limited to a maximum period of 1 year. In addition all counterparties used must have at least a long term credit rating of A. This report amends the strategy to allow investments for longer than one year and a minimum long term credit rating of A-.

2.5 Currently Bank Base rate is 0.5% and the market rate for one month money is 0.4% and one year money 0.75%. A small number of counterparties offer slightly improved yields on market indications but rightly the Council has financial limits with the amounts that can be placed with individual counterparties. Currently the yield achieved for the year to date is 0.72% (monthly yield for October was 0.56%).

2.6 Currently the market rates for 2 year and 3 year money with local authorities is in excess of 1% ranging to 1.45%. Broadening the Council strategy beyond 1 year for investments would provide both new counterparties and increased yield. It is suggested that the limit on investments over 1 year and up to 3 years be limited to £10 million (approximately 50% of core funds).

2.7 As a part of the Council's Service Review programme the Executive Director (Finance) and Head of Accountancy have been undertaking a review of Treasury Management Services. This review has been overseen by the Portfolio Holder and two members of the Audit Committee. This review has led to the development and consideration of a Service Level Agreement for the provision of Hampshire County Council's Treasury Management Services to support the Council's activities.

2.8 Currently Hampshire County Council provide the treasury management functions of the Office of the Police and Crime Commissioner for Hampshire, Hampshire Fire and Rescue Authority and (the cash investments of) Hampshire Pension Fund. This scale of portfolio enables the HCC team to operate with a wider breadth of experience and greater level of resilience.

2.9 Subject to finalisation of the Service Level Agreement this operation will commence in 2014. The advantages of this arrangement include:

- Enhanced professional support and back up enabling improved management of risk
- Increased counterparty opportunities providing greater diversification of investments and the spreading of risk
- The ability to benefit from stronger relationships with banks and investment brokers, which can give access to different investments with the potential for improved financial return
- Improved financial efficiencies in operation

2.10 In light of this development the revised strategy has also been amended to align with the Treasury Management Strategy of Hampshire County Council.

2.11 The Borrowing Strategy is shown in full and has been revised to show alternative sources of funding and identifying reasons for debt rescheduling

2.12 The Investment Strategy is shown in full and has been amended to show alternative deposit takers, investment instruments, criteria for investment and a change in the reporting requirements.

2.13 Prudential indicators are only shown where they have been adjusted to reflect the revised strategy.

2.14 Those items highlighted in blue type differ from the current strategy.

2.15 All items that are marked with an asterisk are those that are not currently included in the Council's approved Treasury Management Strategy and would require specific agreement with the Executive Director prior to any investments being placed.

3. BORROWING AND DEBT STRATEGY 2013/14 – 2015/16

3.1 The Council's current strategy is not to be fully funded with loan debt as cash from the Council's reserves and cash flows are used as a temporary measure to support a level of deferred expenditure (mainly Council vehicles). This strategy is prudent as investment returns are low and counterparty risk is high currently.

3.2 Against the economic background and the risks within the economic forecast, caution will continue to be adopted with the 2013/14 treasury operations. The uncertainty over the timing of future interest rates increases the risks associated with treasury activity. As a result the Council will take a cautious approach to its borrowing strategy. The Executive Director will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances. It is unlikely that any General Fund loans will be raised in the immediate future.

3.3 The Executive Director, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time. This may include borrowing in advance for future years requirements if it is prudent to do so. However any risks associated with borrowing in advance will not be purely in order to profit and will be subject to prior appraisal and subsequent reporting through the regular mid-year or annual reports.

3.4 Sources of Borrowing

In conjunction with advice from its treasury advisor the Council will keep under review the following borrowing sources:

- Internal
- Public Works Loan Board (PWLB)
- Local authorities
- European Investment Bank (NB the EIB will only lend up to 50% towards the funding of a specific project and needs to meet the EIB's specific criteria) *
- Leasing *
- Structured finance *
- Capital markets (stock issues, commercial paper and bills) *
- Commercial banks.

3.5 Debt Rescheduling

The Council's debt portfolio can be restructured by prematurely repaying loans and refinancing them on similar or different terms to achieve a reduction in risk and/or savings in interest costs.

The lower interest rate environment and changes in the rules regarding the premature repayment of PWLB loans has adversely affected the scope to undertake meaningful debt restructuring although occasional opportunities arise.

The rationale for undertaking any debt rescheduling or repayment would be one or more of the following:

- Reduce investment balances and credit exposure via debt repayment
- Align long-term cash flow projections and debt levels
- Savings in risk adjusted interest costs
- Rebalancing the interest rate structure of the debt portfolio
- Changing the maturity profile of the debt portfolio.

Borrowing and rescheduling activity will be reported to the Audit Committee in the Annual Treasury Management Report or the treasury management monitoring report.

4. INVESTMENT STRATEGY 2013/14 – 2015/16

4.1 In accordance with Investment Guidance issued by the CLG and best practice the Council's primary objective in relation to the investment of public funds remains the security of capital. The liquidity or accessibility of the Council's investments is secondary, followed by the yield earned on investments which is a tertiary consideration.

4.2 The Council and its advisors remain on a heightened state of alert for signs of credit or market distress that might adversely affect the Council.

4.3 Investments are categorised as "Specified" or "Non-Specified" within the investment guidance issued by the CLG. Specified investments are sterling denominated investments with a maximum maturity of one year. They also meet the "high credit quality" as determined by the Council and are not deemed capital expenditure investments under Statute. Non-specified investments are, effectively, everything else.

4.4 The types of investments that could be used by the Council and whether they are specified or non-specified are shown in the table below, further details can be found in Annexes A & B:

Specified and Non-Specified Investments

Investment	Specified	Non-Specified
Term deposits with banks and building societies	✓	✓
Term deposits with other UK local authorities	✓	✓
Investments with Registered Providers *	✓	✓
Certificates of deposit with banks and building societies *	✓	✓
Gilts *	✓	✓
Treasury Bills (T-Bills) *	✓	×
Bonds issued by Multilateral Development Banks *	✓	✓
Local Council Bills *	✓	×
Commercial Paper *	✓	×
Corporate Bonds *	✓	✓
AAA-Rated Money Market Funds	✓	×
Other Money Market and Collective Investment Schemes *	✓	✓
Debt Management Account Deposit Facility	✓	×

4.5 The minimum credit rating for non-UK sovereigns is AA+ (or equivalent). For specified investments the minimum long term rating for counterparties is A- (or equivalent).

4.6 The other credit characteristics, in addition to credit ratings, that the Council monitors are listed in the Prudential Indicator on Credit Risk in Annex B. Any institution will be suspended or removed should any of the factors identified above give rise to concern. The countries and institutions that meet the criteria for term deposits, Certificates of Deposit (CDs) * and call accounts are included in Annex A.

4.7 The Council banks with the Co-operative Bank. At the current time it does not meet the Council's minimum credit criteria. As its credit rating is below the minimum criteria the position will be monitored to ensure the risk to Council funds is minimised. As the Council's banker the Co-operative Bank may continue to be used for short term liquidity requirements (credit and overdrawn balances) and business continuity arrangements.

4.8 Investment Strategy

With short term interest rates low for some time, an investment strategy will typically result in a lengthening of investment periods, where cash flow permits, in order to lock in higher rates of acceptable risk adjusted returns. The problem in the current environment is finding an investment counterparty providing acceptable levels of counterparty risk.

In order to diversify a portfolio invested in cash, investments will be placed with approved counterparties over a range of maturity periods. Maximum investment levels with each counterparty will be set to ensure prudent diversification is achieved.

The Investment Strategy will provide the flexibility to invest cash for a maximum period of up to two years in order to access higher investment returns in the current low interest rate environment, although lending to UK local authorities and other public sector bodies can be for up to three years. Within this Strategy the duration of actual investments will be determined by the perceived credit risk, based on the creditworthiness criteria outlined at paragraph 5 below. For example, currently new investment deposits with banks and building societies are restricted to between overnight and 12 months based on the assessment of the individual counterparties' credit risk, with lending to some counterparties prohibited completely at the current time.

Money market funds (MMFs) will be utilised but good treasury management practice prevails and whilst MMFs provide good diversification the Council will also seek to mitigate operational risk by utilising at least two MMFs. The Council will also restrict its exposure to MMFs with lower levels of funds under management and will not exceed 0.5% of an individual MMF's net asset value.

4.9 Treasury Management Limit on Activities

The purpose of this prudential indicator is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if the limits are set at a level that is too restrictive they could limit opportunities to reduce costs.

The revised prudential indicator in the table below shows that up to 100% of investments can be placed in either fixed or variable deposits in the short term and that a restriction of £10m is placed on investments of over 12 months.

Investments	2013/14 Upper		2014/15 Upper		2015/16 Upper	
Estimated Maximum sums invested	£60m		£60m		£62m	
Estimated Maximum sums invested for more than 1 year	£10m		£10m		£10m	
Limits - fixed interest rates	100%		100%		100%	
Limits - variable interest rates	100%		100%		100%	
Maturity Structure of investments						
	Lower	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	100%	100%	100%	100%	100%	100%
Over 12 and up to 24 months	£0m	£10m	£0m	£10m	£0m	£10m

4.10 Policy on the use of Financial Derivatives

Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. callable deposits). The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). The CIPFA Code requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

The Council currently has not used and has no plans to make use of financial derivatives. Should this change derivatives will only be used after seeking expert advice, a legal opinion and ensuring officers have the appropriate training for their use.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit.

4.11 Monitoring and Reporting on the Treasury Outturn and Prudential Indicators

Treasury activity is monitored quarterly and reported internally to the Executive Director of Finance. The Prudential Indicators will be monitored through the year by the Executive Director of Finance and reported as set out below. The Executive Director of Finance will report to the Audit Committee on treasury management activity / performance and Prudential Indicators as follows:

- A mid-year and year end review of treasury activity against the strategy approved for the year.
- The Council will produce an outturn report on its treasury activity no later than 30 September after the financial year end.
- The Audit Committee will be responsible for the scrutiny of treasury management activity and practices.

5. TRAINING

5.1 CIPFA's Code of Practice requires a responsible officer, which is the Executive Director of Finance, to ensure that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities. The training needs of the Council's treasury management staff are subject to regular review.

6. CREDIT RISK

6.1 The Council considers security, liquidity and yield, in that order, when making investment decisions.

6.2 Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Council's assessment of counterparty credit risk.

6.3 The Council also considers alternative assessments of credit strength, and information on corporate developments of and market sentiment towards counterparties. The following key tools are used to assess credit risk:

- Published credit ratings of the financial institution (minimum A- or equivalent) and its sovereign (minimum AA+ or equivalent for non-UK sovereigns);
- Sovereign support mechanisms;
- Credit default swaps (where quoted);
- Share prices (where available);
- Economic fundamentals, such as a country's net debt as a percentage of its GDP;
- Corporate developments, news, articles, markets sentiment and momentum;
- Subjective overlay.

The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

7. PERFORMANCE INDICATORS

The Code of Practice for Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. An example of performance indicators often used for the treasury function is:

- Investments – returns should be above the average 7 day LIBID rate

The result of this indicator will be reported in the Annual Treasury Report at each year-end.

8. TREASURY MANAGEMENT CONSULTANTS

The Executive Director of Finance uses external treasury advisers for information, advice and assistance relating to borrowing and investment.

9. PORTFOLIO HOLDER'S COMMENTS

The revisions to the strategy are proposed to provide greater flexibility, leading to improvements in yield, without risking security.

The opportunity to work with Hampshire County Council will provide both an efficiency opportunity and improved management of risk in this period of banking uncertainty.

It should be understood that this Council will continue to set treasury strategy and that it is only the day-to-day treasury operations that will be undertaken by Hampshire County Council. I support the recommendations set out in paragraph 10.

10. RECOMMENDATIONS

Cabinet recommends to Council for approval each of the key elements of this Treasury Management Strategy report:

10.1 The additional information in the borrowing strategy relating to sources of borrowing and debt rescheduling.

10.2 The revised Investment strategy relating to the ability to place deposits of up to £10m for up to 2 years (3 years for other local authorities and other public sector bodies) and the inclusion of counterparties with a long term credit rating of A-, as annex A.

10.3 The revision of the use of non-specified investment instruments, as annex B.

10.4 Revised reporting requirements.

10.5 The strategy for financial derivatives.

Further Information	**Background Papers**
Please contact Jan Hawker, Treasury Management Accountant Ext. 284444 e-mail: jan.hawker@nfdc.gov.uk	The Prudential Code, CIPFA Guidance Notes and CLG Investment Guidance. Treasury Management Strategy Report 2013/14

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Annex A

Current Recommended Sovereign and Counterparty List as at 11/10/2013

Country/ Domicile	Counterparty	Maximum Counter-party Limit 2013/14 £m	Maximum Counter-party Limit 2014/15 £m	Maximum Maturity Limit
UK	Barclays Bank Plc	6	4	2 years
*UK	Close Brothers Bank	6	4	2 years
*UK	Goldman Sachs International Bank	6	4	2 years
UK	HSBC Bank Plc	6	4	2 years
*UK	Leeds Building Society	6	4	2 years
UK	Lloyds TSB (Lloyds Banking Group)	6	4	2 years
UK	Nationwide Building Society	6	4	2 years
UK	NatWest (RBS Group)	6	4	2 years
UK	Santander UK Plc (Banco Santander Group)	6	4	2 years
UK	Standard Chartered Bank	6	4	2 years
Australia	Australia and NZ Banking Group	6	4	2 years
Australia	Commonwealth Bank of Australia	6	4	2 years
Australia	National Australia Bank Ltd (National Australia Bank Group)	6	4	2 years
Australia	Westpac Banking Corp	6	4	2 years
Canada	Bank of Montreal	6	4	2 years
Canada	Bank of Nova Scotia	6	4	2 years
Canada	Canadian Imperial Bank of Commerce	6	4	2 years
Canada	Royal Bank of Canada	6	4	2 years
Canada	Toronto-Dominion Bank	6	4	2 years
Finland	Nordea Bank Finland	6	4	2 years

Country/ Domicile	Counterparty	Maximum Counter-party Limit 2013/14	Maximum Counter-party Limit 2014/15	Maximum Maturity Limit
		£m	£m	
Finland	Pohjola	6	4	2 years
France	BNP Paribas	6	4	2 years
France	Credit Agricole CIB (Credit Agricole Group)	6	4	2 years
France	Credit Agricole SA (Credit Agricole Group)	6	4	2 years
France	Société Générale	6	4	2 years
Germany	Deutsche Bank AG	6	4	2 years
Germany	Landesbank Hessen-Thuringen (Heleba)	6	4	2 years
Netherlands	ING Bank NV	6	4	2 years
Netherlands	Rabobank	6	4	2 years
Netherlands	Bank Nederlandse Gemeenten	6	4	2 years
Singapore	DBS Bank Ltd	6	4	2 years
Singapore	Oversea-Chinese Banking Corporation (OCBC)	6	4	2 years
Singapore	United Overseas Bank (UOB)	6	4	2 years
Sweden	Svenska Handelsbanken	6	4	2 years
Switzerland	Credit Suisse	6	4	2 years
US	JP Morgan	6	4	2 years

Please note this list could change if, for example, a counterparty/country is upgraded, and meets our other creditworthiness tools or a new suitable counterparty comes into the market. Alternatively, if a counterparty is downgraded, this list may be shortened.

Annex B

Non-Specified Investments

Instrument	Maximum maturity	Max % of the portfolio
Term deposits with banks, building societies which meet the specified investment criteria (on advice from TM Adviser)	2 years *	100
Term deposits with local authorities (maximum of £4m per authority)	3 years *	100
CDs and other negotiable instruments with banks and building societies which meet the specified investment criteria (on advice from TM Adviser) *	2 years *	100
Deposits with registered providers *	3 years *	10
Gilts *	3 years *	25
Bonds issued by multilateral development banks *	3 years *	25
Sterling denominated bonds by non-UK sovereign governments *	3 years *	10
Money Market Funds and Collective Investment Schemes *	2 years *	50
Corporate and debt instruments issued by corporate bodies purchased from 01/04/12 onwards *	2 years *	10