Treasury Management Policy Statement, Treasury Management Strategy Statement and Annual Investment Strategy for 2014-15

1. Treasury Management Policy Statement

Chichester District 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.

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

- The 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.

- The investment policy objective for this Council is the prudent investment of its treasury balances. The Council's investment priorities are security of capital and liquidity of its investments so that funds are available for expenditure when needed. Both the CIPFA Code and the DCLG guidance require the Council 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 generation of investment income to support the council's spending plans is an important, but secondary objective.

- The Council's borrowing objective, being debt free and with relatively substantial resources still available for its capital investment spending plans, means that it does not intend to borrow any monies, except for short term cash flow purposes for revenue and capital commitments.

2. Treasury Management Strategy Statement

The Treasury Management Strategy details the expected activities of the treasury function in the forthcoming year 2014-15. The publication of the strategy is a statutory requirement.

3. The Treasury Management Strategy Statement and Annual Investment Strategy are underpinned by the CIPFA Code of Practice and Treasury Management Practices (TMPs) which provide prescriptive information as to how the treasury management function should be carried out.

External Context

4. **Economic background**

The Bank of England's Monetary Policy Committee (MPC) through its recent forward guidance is committed to keeping policy rates low for an extended period using the Labour Force Survey unemployment rate of 7% as a threshold for when it would consider whether or not to raise interest rates, subject to certain knock-outs. Unemployment was 7.7% in August 2013, but is not forecast to fall below the threshold until 2016, due to the UK's flexible workforce.

The flow of credit to households and businesses is slowly improving but is still below pre-crisis levels. The fall in consumer price inflation from the high of 5.2% in September 2011 to 2.7% in September 2013 will allow real wage increases (i.e. after inflation) to slowly turn positive and aid consumer spending.

Stronger growth data in 2013 (0.4% in Q1, 0.7% in Q2 and 0.8% in Q3) alongside a pick-up in property prices mainly stoked by government initiatives to boost mortgage lending have led markets to price in an earlier rise in rates than warranted under Forward Guidance and the broader economic backdrop. However, with jobs growth picking up slowly, many employees working shorter hours than they would like and benefit cuts set to gather pace, growth is likely to only be gradual. Arlingclose forecasts the MPC will maintain its resolve to keep interest rates low until the recovery is convincing and sustainable.

In the US expectations for the slowing in the pace of asset purchases ('tapering') by the Federal Reserve and the end of further asset purchases will remain predominant drivers of the financial markets. The Fed did not taper in September and has talked down potential tapering in the near term. It now looks more likely to occur in early 2014 which will be supportive of bond and equity markets in the interim.

5. **Credit outlook**

The credit risk of banking failures has diminished, but not dissipated altogether. Regulatory changes are afoot in the UK, US and Europe to move away from the bank bail-outs of previous years to bank resolution regimes in which shareholders, bond holders and unsecured creditors are 'bailed in' to participate in any recovery process. This is already manifesting in relation to holders of subordinated debt issued by the Co-op which have suffered a haircut on its conversion bail-in to alternative securities and/or equity. There are also proposals for EU regulatory reforms to Money Market Funds which will, in all probability, result in these funds moving to a VNAV (variable net asset value) basis and losing their 'triple-A' credit rating wrapper. Diversification of investments between creditworthy counterparties to mitigate bail-in risk will become even more important in the light of these developments.

6. **Prospects for Interest Rates**

As part of the service to the Council its appointed treasury adviser Arlingclose assist the Council to formulate a view on interest rates. Arlingclose forecast that the Bank Rate will remain flat until late 2016.The Bank of England Base Rate, the official base rate paid on commercial bank reserves has been 0.50% since March 2009.

7. The table below shows the November 2013 HM Treasury Survey Medium Term forecasts for the average annual Official Bank Rate.

Table 1: HM Treasury Survey Medium Term Forecasts for Average Annual Official Bank Rate

	Average Annual Official Bank Rate %			
	2014	**2015**	**2016**	**2017**
Highest	0.90	1.80	2.20	2.63
Average	0.53	0.78	1.34	2.11
Lowest	0.50	0.50	0.69	1.40

For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 1.00% for 2014-15.

8. Current Portfolio Position

The Council's treasury portfolio position as at 3rd January 2013 comprised:

Table 2: Current Investment Portfolio Position.

Investments	**Actual Portfolio £m**	**Average Rate %**
Call Accounts	5.2	0.64
Short Term investments	30.5	0.53
Long Term Investments	11.0	1.91
Total Investments	**46.7**	**1.18**

Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 3: Balance Sheet Summary and Forecast

	31.3.13 Actual £m	**31.3.14 Estimate £m**	**31.3.15 Estimate £m**	**31.3.16 Estimate £m**	**31.3.17 Estimate £m**	**31.3.18 Estimate £m**
General Fund CFR	-1.297	-1.440	-1.440	-1.440	-1.440	-1.440
Internal borrowing	-0.143	0	0	0	0	0
Borrowing CFR	**-1.440**	**-1.440**	**-1.440**	**-1.440**	**-1.440**	**-1.440**
Fund Balances						
Usable reserves	-32.584	-26.471	-22.831	-21.516	-20.920	-20.413
Working capital	-0.826	-1.289	-1.106	-0.859	-0.619	-0.400
Investments	**34.850**	**29.200**	**25.377**	**23.815**	**22.979**	**22.253**

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment.

The Council is currently debt free and its capital expenditure plans do not currently imply any need to borrow over the forecast period. Investments are forecast to fall to £22.253m as capital receipts and other revenue resources are used to finance capital expenditure, and reserves are used to finance the revenue budget.

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Authority expects to comply with this recommendation during 2014-15 as it maintains its debt free status.

9. Borrowing Strategy

As part of the Council's Financial Strategy the Resources and Capital Principles are stated as:

"Borrowing could be used for "invest to save" projects providing the cost of servicing the debt is contained within the revenue savings/income the project generates. The payback period for invest to save projects should be shorter than the life of the asset.

(a) At present, there are no plans to borrow to finance new capital expenditure in the current 5 year plan but this remains an option if deemed to be prudent. Short term internal borrowing (for schemes that pay back within the 5 year time frame of the capital programme) can be accommodated without incurring external interest charges, provided the resulting savings are recycled into reserves. Longer term pay back periods will have to accommodate both the external interest and a minimum revenue provision (MRP) in accordance with the Council's MRP policy, which links repayment of the debt to the life of the asset.

(b) Borrowing would add pressure on the revenue budget as MRP and interest would become payable. The capacity to make these payments would need to be identified in advance, namely the further efficiency savings generated by the investment in the assets."

10. Investment Strategy

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £34.85 and £50.35 million, but this is expected to reduce to lower levels in the forthcoming year due to the anticipated capital programme spending.

11. Both the CIPFA Code and the CLG Guidance require the Council 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 money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk receiving unsuitably low investment income.

12. The Council may invest its surplus funds with any of the counterparties in table 4 below, subject to the cash and time limits shown.

Table 4: Approved Investment Counterparties

Counterparty		Cash limit	Time limit
Banks, building societies, other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:	AAA	~~£8m~~ £5m each, of which no more than £3m over 1 year	5 years
	AA+		5 years
	AA		4 years
	AA-		3 years
	A+		2 years
	A	£2m each	1 year
	A-		6 months
UK Central Government (irrespective of credit rating)		unlimited	5 years
UK Local Authorities (irrespective of credit rating)		~~£8m~~ £5m each	~~5~~ years 15 years
UK Registered Providers of Social Housing whose lowest published long-term credit rating is A- or higher		£4m each	5 years
UK Registered Providers of Social Housing whose lowest published long-term credit rating is BBB- or higher and those without credit ratings		£2m each	5 years
UK Building Societies whose lowest published long-term credit rating is BBB+ or BBB and societies without credit ratings with assets greater than £250m		£2m each	~~6 months (Higher Rated) 3 months (Lower Rated)~~ 6 months
Money market funds and similar pooled funds		£4m each ~~£5m each~~	1 year

13. There is no intention to restrict investments to bank deposits, and investments may be made with any public or private sector organisations that meet the above credit rating criteria. This reflects a lower likelihood that the UK and other governments will support failing banks as the bail-in provisions in the *Banking Reform Act 2014* and the EU *Bank Recovery and Resolution Directive* are implemented.

14. In addition, the Council may invest with organisations and pooled funds without credit ratings, following an external credit assessment and advice from the Council's treasury management adviser.

15. **Current Account Bank**: Following a competitive tender exercise held in 2008, the Council's current accounts are held with HSBC plc which is currently rated above the minimum A- rating in table 4.

16. **Registered Providers**: Formerly known as Housing Associations, Registered Providers of Social Housing are tightly regulated by the Homes and Communities Agency and retain a high likelihood of receiving government support if needed. The Authority will consider investing with unrated Registered Providers with adequate credit safeguards, subject to receiving independent advice.

17. **Building Societies**: The Council takes additional comfort from the building societies' regulatory framework and insolvency regime where, in the unlikely event of a building society liquidation, the Council's deposits would be paid out in preference to retail depositors. The Council will therefore consider investing with unrated building societies where independent credit analysis shows them to be

suitably creditworthy and with assets greater than £250m. The Government has announced plans to amend the building society insolvency regime alongside its plans for wide ranging banking reform, and investments in lower rated and unrated building societies will therefore be kept under continuous review.

18. **Money Market Funds**: These funds are pooled investment vehicles consisting of money market deposits and similar instruments. They have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Council. 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.

19. **Other Pooled Funds:** Table 3 above indicates that the Council will have substantial cash balances available for investment over the medium term. It will therefore consider using pooled bond, equity and property funds that offer enhanced returns over the longer term, but are potentially more volatile in the shorter term. These allow the Council 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.

20. **Risk Assessment and Credit Ratings**: The Council uses long-term credit ratings from the three main rating agencies Fitch Ratings, Moody's Investors Service and Standard & Poor's Financial Services to assess the risk of investment default. The lowest available counterparty credit rating will be used to determine credit quality, unless an investment-specific rating is available. Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

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

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

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

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

will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

24. **Specified Investments**: 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”.

The Authority defines “high credit quality” organisations 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 AAA. For money market funds and other pooled funds “high credit quality” is defined as those having a credit rating of A- or higher.

25. **Non-specified Investments**: Any investment not meeting the definition of a specified investment is classed as non-specified. The Council 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 5 below.

Table 5: Non-Specified Investment Limits

	Cash limit
Total long-term investments	£15m
Total investments without credit ratings or rated below A-	£10m
Total investments in foreign countries rated AAA	£10m

26. **Investment Limits**: The Authority’s revenue reserves available to cover investment losses are forecast to be £25.64 million on 31st March 2014. In order that no more than 19.5% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £5 million. A group of banks under the same ownership or a group of funds under the same management will be treated as a single organisation for limit purposes. Limits will also be placed on investments in brokers’ nominee accounts, foreign countries and industry sectors as below:

Table 4: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£5m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£5m per group
Any group of pooled funds under the same management	£4m per manager
Negotiable instruments held in a broker’s nominee account	£5m per broker
Foreign countries	£5m per country

Registered Providers	£4m in total
Building Societies	£5m in total
Money Market Funds	£4m in total

27. **Approved Instruments:** The Council may lend or invest money using any of the following instruments:

- interest-bearing bank accounts,
- fixed term deposits and loans,
- callable deposits and loans where the Council may demand repayment at any time (with or without notice),
- callable deposits and loans where the borrower may repay before maturity, but subject to a maximum of £3 million in total,
- certificates of deposit,
- bonds, notes, bills, commercial paper and other marketable instruments, and
- shares in money market funds and other pooled funds.

Investments may be made at either a fixed rate of interest, or at a variable rate linked to a market interest rate, such as LIBOR, subject to the limits on interest rate exposures below.

28. **Liquidity management**: The Council uses spread sheets for cash flow forecasting to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a pessimistic basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast.

29. **Treasury Management Indicators**

The Authority measures and manages its exposures to treasury management risks using the following indicators.

a. **Security:** The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target
Portfolio average credit rating	A+

b. **Liquidity:** The methods for cash flow forecasting is set out in paragraph 28, and the on long-term investments are set by reference to the Council's medium term financial planning for both revenue and capital spending plans.

The Council seeks to maintain its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments by adhering to the limit below and minimising the use of its overdraft facility:

- Liquid short term deposit limit of 65% of investments to remain liquid (specified investments) with a maturity date of 12 months or less.
- Bank overdraft of £350,000.

c. **Interest Rate Exposures**: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as an amount of net principal of investments will be:

	2014/15	2015/16	2016/17
Upper limit on fixed interest rate exposure of net investment principal	£22m	£20m	£18m
Upper limit on variable interest rate exposure of net investment principal	£55m	£50m	£45m

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

d. **Maturity Profile of Borrowing**

As the Council is debt free it currently holds no fixed long term borrowing for which a maturity profile exists. The investment profile needs to take account of the liquidity requirement of maintaining 60% of investments under 364 days, and the long term investment limits as set in paragraph 29 e.

e. **Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2014/15	2015/16	2016/17
Limit on principal invested beyond year end	£6m	£5m	£4m

30. <u>Other Items</u>

There are a number of additional items that the Authority is obliged by CIPFA or CLG to include in its Treasury Management Strategy.

31. **Policy on 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. LOBO loans and 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 Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Authority is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

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 and the relevant foreign country limit.

32. **Investment Training:**

Member and officer training is an essential requirement in terms of understanding roles, responsibilities and keeping up to date with changes and in order to comply with the CIPFA Treasury Management Code of Practice.

The training needs of the officers involved on treasury management are identified through the annual performance and development appraisal process, and additionally when the responsibilities of individual members of staff change. Staff attend relevant training courses, seminars and conferences.

To address the training need of members, training will be provided to members of both Cabinet and the Corporate Governance and Audit Committee in advance of them considering the forthcoming year's strategies. The training will be provided by Arlingclose in January 2014.

33. **Treasury Management Advisers:** The Council contracts with Arlingclose Limited as its treasury management advisers and receives specific advice on investment, debt and capital finance issues. However, responsibility for final decision making remains with the Council and its officers.

The quality of this service is controlled and monitored against the contract by the Accountancy Services Manager.

34. The current contract ends May 2014, so a procurement exercise, in accordance with the Council's Contract Standing Orders, will be undertaken to obtain a new contract.

35. **Investment of Money Borrowed in Advance of Need**: As the Council does not anticipate the need to borrow in the foreseeable future, except in the short-term for cash flow purposes only, it is therefore not expecting to borrow in advance of need, and so does not need to set out any operational criteria for this situation in 2013-14 Strategy.

36. **Financial Implications**

The budget for investment income in 2014-15 is £0.331million, based on an average investment portfolio of £33.1 million at an interest rate of 1.00%. If actual levels of investments and actual interest rates differ from those forecast, performance against budget will be correspondingly different.