Appendix 2

South Derbyshire District Council

Treasury Management and Investment Strategy 2012/13

February 2012

1.0 Introduction

1.1 The treasury management service is an important part of the overall financial management of the Council's affairs. Supplemented by a series of Prudential Indicators, this helps to consider the affordability and impact of capital expenditure decisions, together with the associated borrowing and investment.

1.2 The treasury service considers the effective funding of these decisions. It forms part of the process that ensures the Council achieves a balanced budget requirement under the Local Government Finance Act 1992.

1.3 The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management).

1.4 The Council has adopted the Code and as a result, has adopted a Treasury Management Policy Statement. This Strategy and the associated Policy Statement have been updated to reflect new requirements arising from the Localism Act 2011 and in particular, the move to self-financing for the Housing Revenue Account (HRA).

1.5 On 28th March 2012, the Council will need to undertake new borrowing to pay its share of the debt take-on to the Government. The amount of £57,423,000 is substantially higher than anything that the Council has borrowed previously.

1.6 The Strategy is based on currently projected interest rates for the debt-take as set out in the detailed analysis. Any significant changes will be reported to the Council's Finance and Management Committee with the Strategy being reviewed and updated if necessary.

1.7 The Council has had very little debt outstanding having repaid previous borrowings several years ago. Clearly, new debt of this magnitude increases the risks surrounding treasury management. The options and strategy for borrowing the required resources was considered by the Council's Finance and Management Committee in October 2011 and January 2012.

1.8 The funding source and maturity structure, together with the strategy for servicing and repaying the debt were approved by the Committee on 23rd January 2012. Detailed figures have subsequently been built into the HRA's 30-year Business Plan following consideration by the Housing and Community Services Committee on 2nd February 2012.

1.9 A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year.

1.10 This strategy covers:

- The management of debt
- The Council's debt and investment projections.
- The expected movement in interest rates.

- The Council's borrowing and investment strategies.
- Treasury performance indicators.
- Specific limits on treasury activities.
- Any local treasury issues.

2.0 Debt and Investment Projections

2.1 The table below shows the expected debt position of the Council over the Medium Term Financial Planning (MTFP) period.

External Debt	2011/12 £'000	2012/13 £'000	2013/14 £'000	2014/15 £'000	2015/16 £'000	2016/17 £'000
Debt 1st April	1,430	58,833	58,813	58,793	58,773	58,753
New Debt	57,423	0	0	0	0	0
Maturing Debt	-20	-20	-20	-20	-20	-20
Debt 31st March	**58,833**	**58,813**	**58,793**	**58,773**	**58,753**	**58,733**
Annual Change in Debt	57,403	-20	-20	-20	-20	-20
Long-term Investments	0	0	0	0	0	0
Short-term Investments	1,000	1,000	1,000	1,000	1,000	1,000
Investment Change	1,000	0	0	0	0	0

2.2 A comparison of this estimated debt position with the various borrowing limits is shown below.

Limits compared to Actual Debt	2011/12 £'000	2012/13 £'000	2013/14 £'000	2014/15 £'000	2015/16 £'000	2016/17 £'000
Authorised Limit	75,041	74,779	74,529	74,291	74,067	73,855
Financing Requirement	71,070	70,808	70,558	70,320	70,096	69,884
Operational Boundary	63,423	63,423	63,423	63,423	63,423	63,423
Debt Outstanding	57,833	57,813	57,793	57,773	57,753	57,733

2.3 The above table shows that debt outstanding is expected to be comfortably below the Financing or underlying Borrowing Requirement (CFR) and well within the Authorised Limit or Cap.

2.4 The Operational Boundary allows a temporary borrowing requirement of £5m. However, it is expected that the Council will continue to be a net lender of funds on a day to day basis.

Management of Debt

2.5 As approved by the Finance and Management Committee on 23rd January 2012, the Council has decided to adopt a "two pool" approach to debt management. This involves splitting existing loans between the General Fund and the HRA and then allocating new loans to each pool as required.

2.6 This has been adopted for clarity and transparency and ensures that there is no detriment to the General Fund on transition to HRA self-financing. Treasury Management decisions on the structure and timing of borrowing will be made independently for the General Fund and HRA.

2.7 Interest on loans will be calculated in accordance with proper accounting practice and allocated to either pool accordingly.

2.8 It is not anticipated that there will be a requirement to transfer loans between the two pools. If this is the case, then it will be considered separately by the Council.

Internal Borrowing

2.9 Both the HRA or General Fund are likely to have surplus cash balances which will allow either account to have external borrowing below its Capital Financing Requirement.

2.10 The interest earned will be attributable to the General Fund with a proportion allocated to the HRA based on the average rate of interest earned on cash balances during the year.

Use of Financial Instruments

2.11 The Council does not use any type of derivative instruments, such as interest rate swaps or hedge accounting, to manage the risk of borrowing.

General Fund Debt

2.12 The General Fund does not currently have any actual debt outstanding and its underlying borrowing requirement is financed from reserves and balances as follows:

General Fund - Net Indebtedness	2011/12 £'000	2012/13 £'000	2013/14 £'000	2014/15 £'000	2015/16 £'000	2016/17 £'000
CFR	8,188	7,926	7,676	7,438	7,214	7,002
Estimated Reserves	9,977	8,364	6,598	5,632	4,762	3,703
Net Indebtedness	**-1,789**	**-438**	**1,078**	**1,806**	**2,452**	**3,299**

2.13 However, the table also shows that by 2013/14, the underlying indebtedness increases to a position where borrowing may apply. This will depend on overall cash flow and this is likely to be a temporary position. However, it will need to be kept under review.

HRA and Limit on Indebtedness

2.14 Under self-financing, the HRA pool will be set a cap over which no borrowing is allowed. This is prescribed by the Government and will be fixed.

2.15 The Cap is shown in the following table with a comparison to the CFR and expected level of actual debt on the HRA.

HRA Limit on Indebtedness	2011/12 £'000	2012/13 £'000	2013/14 £'000	2014/15 £'000	2015/16 £'000	2016/17 £'000
HRA Debt Cap	66,853	66,853	66,853	66,853	66,853	66,853
HRA CFR	62,882	62,882	62,882	62,882	62,882	62,882
Difference	3,971	3,971	3,971	3,971	3,971	3,971
HRA Debt	58,700	58,680	58,660	58,640	58,620	58,600
Borrowing Headroom	**8,153**	**8,173**	**8,193**	**8,213**	**8,233**	**8,253**

2.16 It is expected that the CFR and actual debt on the HRA will remain fairly flat over the current MTFP. It is planned to start repaying the debt take-on from 2017/18 and this is detailed in the HRA's Business Plan.

2.17 As the actual level of debt is below the Debt Cap, this creates headroom for further borrowing. Any additional borrowing would be undertaken within the affordability of the Business Plan.

HRA Debt Take-on

2.18 The maturity structure was approved by the Finance and Management Committee on 23rd January 2012. The structure is based on a balanced approach to fit the needs of the HRA's Business Plan.

2.19 It allows some variable rate funding and is designed to balance out risks associated with long dated money, whilst maintaining flexibility and achieving a low rate portfolio in accordance with the current level of rates available from the PWLB. The structure is shown below.

LOANS

Interest Calculation	Repayment Method	Principal (£)	Period (Years)	Rate (%)
Variable	Maturity	10,000,000	10	0.70%
Fixed	Maturity	10,000,000	12	2.88%
Fixed	Maturity	10,000,000	15	3.09%
Fixed	Maturity	10,000,000	20	3.29%
Fixed	Maturity	10,000,000	25	3.40%
Fixed	Maturity	7,423,000	30	3.45%
	TOTAL	**57,423,000**	**18.7**	**2.78%**

Revenue Implications

2.20 The effect of the Council's expected debt management transactions have been included in the MTFP and are summarised in the following table.

Interest Payable and Receivable	2011/12 £'000	2012/13 £'000	2013/14 £'000	2014/15 £'000	2015/16 £'000	2016/17 £'000
General Fund						
Interest Payable	19	2	2	3	4	6
Interest Received	-25	-27	-34	-56	-71	-108
HRA						
Interest Payable	73	1,675	1,675	1,668	1,776	1,895
Interest Received	-34	-19	-21	-19	-24	-25

3.0 Current Economic Outlook

3.1 Stress in the financial markets continues to remain extremely high. Banks continue to fund most of their day to day operations internally (between each other) and this is a clear signal that there is risk within the markets.

3.2 Inflation has moderated slightly over the last couple of months. The Bank of England expects domestic inflation to reduce significantly in 2012 as the twin effects of the VAT and oil price increases fall out of the 12 month series.

3.3 Economic growth remains very low and uncertain. The UK position is being exacerbated by the situation in Europe and a prolonged period of subdued or even negative growth is expected. Recent data and surveys highlight low confidence and weakness and this is leading to tighter credit conditions.

3.4 Therefore, it is considered unlikely that interest rates will rise in the foreseeable future to force a rise in the price of money. The UK is still seen as a safe haven for investment and ensures that gilts (effectively the Government's cost of borrowing) remain low. This is the basis on which the PWLB fix their rates.

3.5 Some investors are questioning the UK's credit worthiness given the fragile state of the economy and the public finances. However, the current problems in Europe could take months and even years to fix.

3.6 Therefore, as long as the UK is able to hold onto its AAA rating status, UK bonds will continue to be regarded as the best option. Given the situation in Europe, this has left some commentators predicting interest rates may not rise until 2016.

Borrowing Strategy 2012/13 and Longer-Term Plan

4.1 For several years, the Council has not been required to enter into any form of long-term borrowing and in fact repaid all of its long-term Government debt in March 2004. This was due to substantial capital receipts that the Council had generated, a significant proportion of which had been set-aside to repay debt in accordance with accounting regulations.

4.2 These receipts were placed on deposit and earned interest for the Council's revenue funds. In addition, these receipts have effectively been used to finance new capital expenditure and to meet the Council's shorter-term cash flow requirements when this was negative.

Existing Debt

4.3 The only debt outstanding is one money market loan for £1m. This is a fixed rate loan at 4.875%, maturing in 2032 with interest payments of £48,750 per year. In addition, the Council reimburses a neighbouring authority for managing debt in respect of transferred assets.

4.4 This debt is due to be fully repaid in instalments by 2025. Principal outstanding is £277,000 and interest payable is calculated on an annual basis in accordance with prevailing market rates.

HRA Debt

4.5 Clearly, the Council's debt position will change significantly with the HRA debt take-on. Around 20% of the debt will be borrowed at variable rates, with 80% at fixed rates. The debt will mature between 2022 and 2042 at periodic intervals. The HRA Business Plan allows for these repayments by generating resources from 2017.

Debt restructuring

4.6 This strategy will be kept under review and the Council has retained the services of Treasury Advisors to assist the Council. It is possible that the Council will be in a position to repay debt earlier and may also wish to reschedule some longer-term debt depending on future interest rates.

4.7 Although this is not anticipated over the current MTFP it will be kept under review. Any early repayment or rescheduling decision will be based on a Net Present Value calculation taking into account the relevant premium or discount.

Variable Rate Debt

4.8 As some of the debt is being borrowed at variable rates, this will be kept under closer scrutiny. This proportion of the portfolio (£10m) will be at around 0.7%. Allowance has been made in the Business Plan for this rate to increase to around 5% in future years.

Additional Borrowing

4.9 The Prudential System for Capital Finance provides flexibility for local authorities to borrow within their overall limit. Effectively, councils can borrow money as long as they are able to demonstrate that the associated interest and principal repayments are affordable and sustainable within their longer-term financial resources.

4.10 Additional borrowing can also be undertaken on an "invest to save" basis, i.e. the cost of loan finance is met from the payback of the investment (efficiencies, greater income, etc).

4.11 The Council's approved Capital Investment Strategy does not contain provision for any additional prudential borrowing. The investment programme will be financed from a mixture of external funding and capital receipts.

4.12 The HRA self-financing framework provides an opportunity for the Council to undertake additional borrowing as detailed in Section 2 (above). Although this is not anticipated over the current MTFP, it will be kept under review in accordance with the HRA Business Plan requirements.

Borrowing in Advance

4.13 The Council will only borrow in advance of need if it is felt that the benefits of borrowing at interest rates now, compared to where they are expected to be in the future, outweighs the current cost and risks associated with investing the proceeds until the borrowing was actually required.

4.14 In summary, the proposed borrowing strategy for 2012/13 is as follows:

- Meeting the Council's cash flow requirements, primarily through its Investment Strategy.
- Keeping under review the HRA debt pool and in particular the variable rate borrowing.
- Keeping under review the Net Indebtedness position on the General Fund Pool.
- Reviewing options for the outstanding money market loan of £1m.

Money Market Loan

4.15 Potentially, there is a break clause. The lender has the option of reviewing the interest rate at any time and increasing it if they so wish. However, the Council then has the option of rejecting this and can instead choose to repay without incurring any penalty.

4.16 The current strategy is that should the lender exercise their option to increase the interest rate and then the loan should be repaid at that time. It is proposed that this strategy continues to be adopted.

5.0 Treasury Management Prudential Indicators and Limits on Activity

5.1 There are four further treasury prudential indicators. The purpose of these 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.

5.2 However, if these are set too restrictively, they will impair the opportunities to reduce costs. The indicators are detailed in the following sections.

Upper limits on variable interest rate exposure

5.3 This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments. This is set at **5.2%** and is based on the affordability in the HRA Business Plan.

Upper limits on fixed interest rate exposure

5.4 This is set at **4.5%** and again is based on the affordability of the HRA Business Plan.

Maturity structure of Fixed Rate Borrowing

5.5 Based on the HRA debt take-on and the money market loan outstanding, the maturing structure is as follows:

Under 12 months	0%
12 months to 2 years	0%
2 years to 5 years	0%
5 years to 10 years	0%
10 years and above	100%

5.6 Although all fixed rate debt is expected to be repaid beyond 10 years, this is spread over a period up to a maximum of 30 years.

Total principal funds invested for greater than 364 days.

5.7 This indicator does not apply to the Council.

6.0 Investment Counterparty and Liquidity Framework

6.1 In accordance with Government Guidance, the primary principle governing the Council's investment criteria is the security and liquidity of its investments. Once that is achieved, then yield and length of investment are considered. The Council will also ensure that:

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.

Specified Investments

6.2 The purpose of specified investments is to identify investments offering high security and high liquidity. These investments should be in sterling and with a maturity of no more than a year. They are intended to be used with minimal procedural formalities. Any investments made with the UK Government, another local authority or parish council automatically counts as specified investments.

6.3 In addition, short-term investments with bodies or investment schemes with "high credit ratings" will count as specified investments. However, it is left to each authority to determine these institutions, and the Council must determine investment limits and how frequently these ratings are to be monitored.

Non-Specified Investments

6.4 Basically, these are all other investments not meeting the above criteria. Due to the fact that these investments could carry more risk than specified ones, the Council needs to set limits on these investments and determine guidelines on when they should be used.

6.5 The regulations make it clear that they do not wish to discourage authorities from using non-specified investments. The aim is to ensure that proper procedures are in place for undertaking risk assessments of investments made for longer periods or with bodies that do not carry such a high credit rating.

Credit Quality

6.6 The credit worthiness of counterparties remains paramount in any investment decision and this is reflected in the approved lending policy and counterparty list. This is more important given the current economic situation and the credit risk in financial markets. This has seen many traditional "high street" financial institutions being downgraded in recent times.

6.7 The Council primarily relies on one of the 3 recognised credit rating agencies under the regulations, i.e. the "Fitch" IBCA Rating" to assess credit quality. Using this agency, the Council monitors the outlook or watch rating on an on-going and regular basis to determine whether the institution provides a safe investment.

6.8 Besides the use of the credit rating agency, the Council refers to the financial press, government support for banks and other market data. This is backed up by information and advice from the Council's appointed Treasury Advisors.

6.9 Based on the core principles, the following strategy is adopted.

7.0 Investment Strategy 2012/13

7.1 The Council is expected to have a regular short-term investment requirement to enable it to manage its day-to-day financial affairs. There is no current proposal to enter into longer term and externally managed funds. Where the Council should need to borrow in advance of need, this strategy also applies.

7.2 The current approved investment list is based on best practice and is serving the short-term investment needs of the Council. It is kept under review and will be updated in line with the Treasury Management Policy Statement if and when necessary.

7.3 The approved lending list and policy is shown at **Appendix 3.** In accordance with regulations, it sets out where the Council will invest surplus funds and places limits upon the various institutions.

7.4 A summary is shown in the following table.

Institution	Limit
Specified Investments	
• UK Debt Management Office (DMO)	£10m
• Local, Police, Fire and Parish Authorities	£5m
• Other Bodies with a High Credit Rating of F1+/AA-	£7.5m
Non-Specified Investments	
• F1/AA Rated Bodies – First Call	£2m
• F1/A Rated Bodies – Second Call	£1m
• F2/A Rated Bodies – Third Call	£0.25m

Definition of Credit Ratings

7.5 The long-term rating is based on an investment grade categorised by "Fitch" on the following scale.

AAA: the best quality companies, reliable and stable
AA: quality companies, a bit higher risk than AAA
A: economic situation can affect finance
BBB: medium class companies which are satisfactory at the moment.

7.6 Intermediate modifiers are also used for each category between AAA and BBB (i.e. AA+, AA, AA-, A+, A, A-, etc.).

7.7 Short-term credit ratings indicate the potential level of default within a 12-month period, based on the following scale.

F1+: best quality grade, indicating exceptionally strong capacity to meet financial commitments.
F1: best grade, indicating strong capacity to financial commitments.
F2: good quality grade with satisfactory capacity to financial commitments.

7.8 The scale then falls from F3 to B, then C and finally down to D, which indicates the institution is likely to, or as failed to meet its financial commitments.

General Policy

7.9 As approved, priority is given to specified investments in any investment decision. The length of investment is made in accordance with overall cash flow requirements.

7.10 The Council's policy is to seek investments with those institutions graded at least AA and F1+. The policy is to focus on the credit quality of investment counterparties rather than amounts invested and returns.

Use of Non-Specified Investments

7.11 This generally covers building societies and the merchant or secondary-banking sector. It is proposed that these are only used as a "lender of last resort" and in the order listed in the above table.

7.12 In particular this may be the case where limits on specified investments are likely to be exceeded and where there is a temporary need to place money.

7.13 It should be noted that F1 and F2 credit ratings are still considered to be fairly high ratings for short-term deposits.

Use of Treasury Advisors

7.14 The Council uses a firm of advisors on a retained basis. Their role is to provide market analysis and advice, together with literature and updates on key treasury management developments. They do not offer any of their own or 3rd party products/instruments for borrowing or investing.

7.15 They also provide training workshops and seminars. They are appointed through the Council's procurement framework.

Performance Indicators

7.16 The main indicator is for the return on short-term investments to, average over the year, the Market 7-Day Rate, this being a standard measure of performance. Performance in recent years is shown in the following table.

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
7-Day Rate (target)	4.47%	4.44%	4.82%	5.61%	3.57%	0.39%	0.51%
Actual Rate	4.63%	4.50%	4.86%	5.81%	4.38%	0.72%	0.78%