Kirklees COUNCIL

Name and date of meeting: **Corporate Governance and Audit Committee**
30 January 2018

Cabinet
30 January 2018

Council
14 February 2018

Title of report: Treasury Management Strategy 2018-19

Purpose of report

Under the CIPFA Code of Practice on Treasury Management (2011) and accompanying Prudential Code 2011 the Council must present a Treasury Management Strategy at the start of each financial year. Within the Treasury Management Strategy an Investment Strategy must also be approved by Council.

Key Decision - Is it likely to result in spending or saving £250k or more, or to have a significant effect on two or more electoral wards?	**Yes**
Key Decision - Is it in the Council's Forward Plan (key decisions and private reports?)	**Key Decision: Yes** **Private Report/Private Appendix: N/A**
The Decision - Is it eligible for call in by Scrutiny?	**No**
Date signed off by Strategic Director and name **Is it also signed off by Service Director** **Is it also signed off by the Service Director Legal, Governance and Commissioning**	**Jacqui Gedman -** **Debbie Hogg –** **Julie Muscroft –**
Cabinet member portfolio	**Corporate** **Graham Turner** **Musarrat Khan**

Electoral wards affected: **N/A**
Ward councillors consulted: **N/A**
Public or Private: **Public**

1 Summary

1.1 The Council has formally adopted CIPFA's Code of Practice on Treasury Management (2011 Edition), and accompanying Prudential Code 2011, and is thereby required to consider a treasury management strategy before the start of each financial year. In addition, the Department for Communities and Local Government (DCLG) issued guidance on local authority investments in March 2010, which requires the Council to approve an Investment Strategy before the start of each financial year.

1.2 This report meets the requirements of the current CIPFA Codes and current DCLG Guidance (2011 Edition). Both the current CIPFA Treasury Management and Prudential Codes and current DCLG guidance on local authority investments have been subject to recent consultation exercises, with a view to them being revised in time for 2018-19 financial year. .

1.3 Following consultations in February and August last year, CIPFA published its new 2017 editions of *Treasury Management in the Public Services: Code of Practice and Cross-sectoral Guidance Notes* and the *Prudential Code for Capital Finance in Local Authorities* just before Christmas 2017. Updated sector specific guidance notes, which include the treasury management indicators for local authorities, have yet to be published. The timing is unhelpful for many Councils, including Kirklees, in terms of adherence to the 2017 Code of Practice, in light of current Budget and Committee timetable requirements in preparation for 2018-19.

1.4 Before being able to refer to the revised code and guidance, Council officers will need to see the new Treasury Management (TM) Code Guidance Notes which include the TM indicators, and new DCLG Investment Guidance (not finalised at the time of writing this report), to fully appreciate the new regulatory framework for treasury management.

1.5 The 2017 TM guidance also includes the requirement for Councils to draft a capital strategy before the start of the 2018-19 financial year. However, DCLG consultation proposals include some potential overlaps with the CIPFA 2017 TM Code. As noted above, DCLG proposals have yet to be finalised, which means that the 2018-19 TM regulatory framework has yet to be finalised. As reported to full Council on 13 December 2017 as part of the half-yearly monitoring report on Treasury Management activities, which highlighted some of the key proposed Code changes, the existing 12 guideline treasury management practices within the existing code remain intact resultant from the Code 2017 revision , other than an additional section to cover commercial investments. The link to the 13 December 2017 report is included below for information (Agenda Item 11):

Agenda for Council on Wednesday 13th December 2017

1.6 In light of the 2018-19 TM regulatory framework having yet to be finalised, the Council's external treasury management advisors, Arlingclose, have advised its clients to continue to prepare for, and obtain full Council approval for the 2018-19 Treasury Management Strategy, based on the current 2011 Codes of practice. In any case, the requirement for a Treasury Management Strategy remains

unchanged in the 2017 Code. The 2018-19 Treasury Management Strategy is therefore still based on the current CIPFA Codes and current DCLG guidance. It is intended that in preparation for the 2019-20 financial year, the Council's Treasury Management strategy will formally adopt the 2017 CIPFA Code revisions, and any relevant updated DCLG guidance on local Authority Investments.

1.7 Cabinet is responsible for the implementation and monitoring of the treasury management policies. The Corporate Governance and Audit Committee undertake a scrutiny role with regard to treasury management. Recent training for members of this Committee was provided in November 2017 by the Council's treasury management advisors.

1.8 This report will:

(i) outline the outlook for interest rates and credit risk, and in light of this, recommend an investment strategy for the Council to follow in 2018-19;

(ii) outline the current and estimated future levels of Council borrowing (internal and external) and recommend a borrowing strategy for 2018-19;

(iii) review the methodologies adopted for providing for the repayment of debt and recommend a revised policy for calculating the Minimum Revenue Provision from 2017-18 onwards;

(iv) review other treasury management matters including the policy on the use of financial derivatives, prudential indicators, the use of consultants, and the policy on charging interest to the Housing Revenue Account

2 Information required to take a decision

The following paragraphs 2.1 to 2.4 have been provided by our Treasury Management external advisors, Arlingclose:

Economic Background

2.1 The major external influence on the Authority's treasury management strategy for 2018-19 will be the UK's progress in negotiating its exit from the European Union and agreeing future trading arrangements. The domestic economy remains relatively robust since the surprise outcome of the 2016 referendum, but there are indications that uncertainty over the future is now weighing on growth. Transitional arrangements may prevent a cliff-edge, but will also extend the period of uncertainty for several years. Economic growth is therefore forecast to remain sluggish throughout 2018-19.

2.2 Consumer price inflation reached 3.0% in September 2017 as the post referendum devaluation of sterling continued to feed through to imports. However, this effect is expected to fall out of year-on-year inflation measures during 2018, removing pressure on the Bank of England to raise interest rates.

Interest Rate Forecast

2.3 The Authority's treasury adviser (Arlingclose) case is for UK Bank of England Base Rate to remain at 0.50% during 2018-19**.** At the last Monetary Policy Committee the vote was unanimous to keep the base rate at 0.50%. Stilted progress in the EU exit negotiations, softening consumer spending and a tightening of consumer credit are expected to keep the rate low. The risk of a cut to zero or negative rates has diminished.

2.4 Longer-term interest rates have risen in the past year, reflecting the base rate rise to 0.50%. Arlingclose forecasts these to remain broadly constant during 2018-19, but with some volatility as interest rate expectations wax and wane with press reports on the progress of EU exit negotiations.

Borrowing and Investment – General Strategy for 2018-19

2.5 As at 31 March 2018, the Council is expected to have £575.8m of external debt liabilities and £30 million of investments (relevant figures highlighted in Table 1 below, and in more detail at Table 2). Forecast changes in these sums for the next three years are contained in the balance sheet analysis below:

Table 1: Balance Sheet Forecast

	2017-18 £m	2018-19 £m	2019-20 £m	2020-21 £m
General Fund CFR - Non PFI	426.4	458.9	493.9	512.0
PFI	52.3	49.3	45.8	42.6
HRA CFR - Non PFI	182.8	175.3	170.7	165.7
PFI	54.9	52.9	50.5	48.1
Total CFR	716.4	736.4	760.9	768.4
Less: PFI debt liabilities*	107.2	102.2	96.3	90.7
Borrowing CFR	609.2	634.2	664.6	677.7
Finance via;				
Deferred Liabilities	4.0	3.9	3.8	3.6
Internal Borrowing	136.6	136.6	136.6	136.6
External Borrowing	468.6	493.7	524.2	537.5
Total	609.2	634.2	664.6	677.7
Investments	30.0	30.0	30.0	30.0

**£107.2m PFI Liabilities (£5.0m falling due in 2018/19)*

2.6 There are many underlying assumptions within the internal borrowing figures above which include the following;

- No movement in useable reserves, with any potential use of reserves to support the Revenue MTFP offset by increased capital receipts from 2019-20 of £2.0m and due to change of MRP policy this will provide greater resilience and financial grip to the Council.

2.7 The Capital Financing Requirement (CFR) represents the Council's underlying need to finance capital expenditure by borrowing or other long-term liability

arrangements. An authority can choose to borrow externally to fund its CFR. If it does this, it is likely that it would be investing externally an amount equivalent to its total reserves, balances and net creditors. Alternatively, an authority can choose not to invest externally but instead use these balances to effectively "borrow internally" and minimise external borrowing. In between these two extremes, an authority may have a mixture of external and internal investments / external and internal borrowing.

2.8 Prior to 2009-10 the Council's policy had been to borrow up to its CFR, investing externally the majority of its balances. With the onset of instabilities in the financial markets and the economic downturn, the policy changed to one of ensuring the security of the Council's balances. This coincided with dramatic falls in investment returns, making the budgetary benefit of maximising external borrowing more marginal. Thus, the Council has chosen to steadily reduce monies invested externally and instead has used balances to offset new borrowing requirements.

2.9 The Service Director of Finance, IT and Transactional Services supports the approach that the borrowing and investment strategy for 2018-19 continues to place emphasis on the security of the Council's balances. Although credit conditions have been steadily improving, the global recovery is still fragile and regulation changes have increased local authority exposure in the event of a possible default of any financial institutions.

2.10 Until there is further improved confidence in the financial markets, it is recommended that balances should only be invested to a level which is perceived to be reasonably secure and which is needed to meet the day-to-day cash flow requirements of the Council (around £30 million). The remainder of the balances will be effectively invested internally, that is used to offset borrowing requirements.

2.11 In terms of the Council investing more balances and trying to make a return to help budgetary concerns, this would be both difficult and increase risk. To increase investment balances, the Council would have to borrow. To make a material return on investments, the Council would have to invest for longer periods than the borrowing period and/or invest with lower rated bodies.

Borrowing Strategy

2.12 The Council is forecast to hold around £575.8m of external borrowing and other long-term liabilities as at 31 March 2018. This is analysed at Table 2 below:

Table 2 – year end estimate – 31 March 2018

	£m	%
PWLB loans (fixed rate)	286.6	50
LOBOs	76.6	13
Loan stock (fixed rate)	7.0	1
Other long term loans (fixed rate)	30.2	5
Temporary borrowing	68.2	12
Total external borrowing	**468.6**	
Other Long Term Liabilities (mainly PFI)	107.2	19
Total external debt liabilities	**575.8**	

2.13 It is proposed to keep new borrowing to short periods, thus taking advantage of the very low interest rates forecast for the next few years. This will help mitigate budgetary pressures, whilst acknowledging there may be increased interest rate risk in the longer term. This will be monitored and advice sought from Arlingclose.

2.14 The approved sources of borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- Any bank or building society authorised to operate in the UK
- Other local authorities
- Capital market bond investors
- Local Capital Finance Company and other special purpose companies created to enable local authority bond issues
- UK public and private sector pension funds

2.15 Historically, the biggest source of borrowing for local authorities has been PWLB loans. These Government loans have offered value for money and also flexibilities to restructure and make possible savings. The Council also has LOBO (Lender's Option, Borrower's Option) loans, where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. The Council will take the option to repay at no cost, if it has the opportunity to do so. The Council's current limit on LOBO borrowing is set at 30% of long-term debt.

2.16 The Local Capital Finance Company was established in 2014 by the Local Government Association as an alternative source of local authority finance. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable.

2.17 The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. The Council may take advantage of this and replace some of the higher rate loans with new loans at lower interest rates where this will lead to an overall saving or reduce risk.

2.18 Borrowing policy and performance will be monitored throughout the year and will be reported to Members via a Half Yearly Report and also an Outturn Report in line with approved guidance.

Investment Strategy

2.19 Investment guidance issued by DCLG requires that an investment strategy, outlining the authority's policies for managing investments in terms of risk, liquidity and yield, should be approved by full Council or equivalent level, before the start of the financial year. This strategy can then only be varied during the year by the same executive body.

2.20 The guidance splits investments into two types – specified and non-specified.

- Specified investments are those offering high security and liquidity. All such investments should be in sterling with a maturity of no more than a year. Investments made with the UK Government and a local authority automatically count as specified investments, as do investments with bodies or investment schemes of "high credit quality". It is for individual authorities to determine what they regard as "high credit quality"; and

- Non-specified investments have greater potential risk, being either investments of "lower credit quality" or investments made for longer than one year.

2.21 A new regulatory update came into force from 3rd January 2018; the second Markets in Financial Instruments Directive (MiFID II), which meant that the Council had to formally apply to renew its status as a 'professional client' (also referred to as the 'opt up' option), but subject to certain criteria being met. Prior to this regulation update, coming into force, the Council, as with all local authorities, had been treated by regulated financial services firms as professional clients by default.

2.22 The Council would need to opt up for the purposes of being able to continue to invest with, or borrow from, regulated services firms including banks, brokers, advisers, fund managers and custodians, but only where they are selling, arranging, advising or managing designated investments. Otherwise, the default status of the Council would be 'retail client.'

2.23 The key advantage of opting up was set out in the half-yearly 2017-18 treasury management monitoring report, namely that opting up was necessary in order to continue to have the widest opportunities to invest within the scope of the Council's current treasury management strategy, from 3rd January 2018; in particular with regard to continued access to money market funds, not available to retail clients.

2.24 Following full Council approval on 13th December 2017, officers have now successfully 'opted up' the Council to professional client status, effective from 3rd January 2018.

2.25 A key criteria for continuing professional client status is that the authority must have an investment balance of at least £10 million. The proposed investment strategy in para 2.25 below will ensure this this particular criteria will be met throughout 2018-19.

2.26 It is recommended that the investment strategy for 2018-19 continues to maintain a low risk strategy giving priority to security and liquidity, and as such invest an average of around £30 million externally, for the purpose of managing day-to-day cash flow requirements. The remaining balances will be invested "internally", offsetting borrowing requirements.

2.27 Having successfully opted up to professional client status, the Council's investment criteria remain unchanged from current, and are detailed at Appendix A. They contain specified and non-specified investment opportunities, recognising through the limits proposed, the slightly higher risk of non-specified investments.

2.28 The Council uses credit ratings from the three main rating agencies - Fitch, Moody's and Standard & Poor's to assess the risk of investment defaults (Appendix B). The lowest credit rating of an organisation will be used to help determine credit quality. Long term ratings are expressed on a scale from AAA (the highest quality) through to D (indicating default). Ratings of BBB- and above are described as investment grade, while ratings of BB+ and below are described as speculative grade.

2.29 Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria:

- No new investments will be made;
- Any existing investments that can be recalled at no cost will be recalled;
- Full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a rating is on review for possible downgrade ("negative watch") so that it is likely to fall below the required criteria, then no further investments will be made in that organisation until the outcome is announced. This policy will not apply to negative outlooks.

2.30 Full regard will be given to other available information on the credit quality of banks and building societies, including credit default swap prices, financial statements and rating agency reports. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the approved criteria.

2.31 If the UK enters into a recession in 2018-19, there is a small chance that the Bank of England could set its Base Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short term investment options. This situation already exists in many other countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

2.32 Annual cash flow forecasts are prepared which are continuously updated. Investment policy and performance will be monitored continuously and will be reported to Members during the year and as part of the annual report on Treasury Management.

Statement of Policy on the Minimum Revenue Provision (MRP)

2.33 MRP is the statutory requirement for local authorities to set aside some of their revenue resources as provision for reducing the underlying need to borrow (Capital Financing Requirement – CFR), ie the borrowing taken out in order to finance capital expenditure.

2.34 Prior to the Local Authorities (Capital Finance and Accounting) (England) Regulations 2008, which came into force on 31 March 2008, the set aside was specified as a percentage of a council's CFR (2% for HRA debt, 4% for General Fund). The current Regulations are less prescriptive with a requirement to ensure the amount set aside is deemed to be **prudent**, although there is accompanying

current DCLG guidance which sets out possible methods a council might wish to follow.

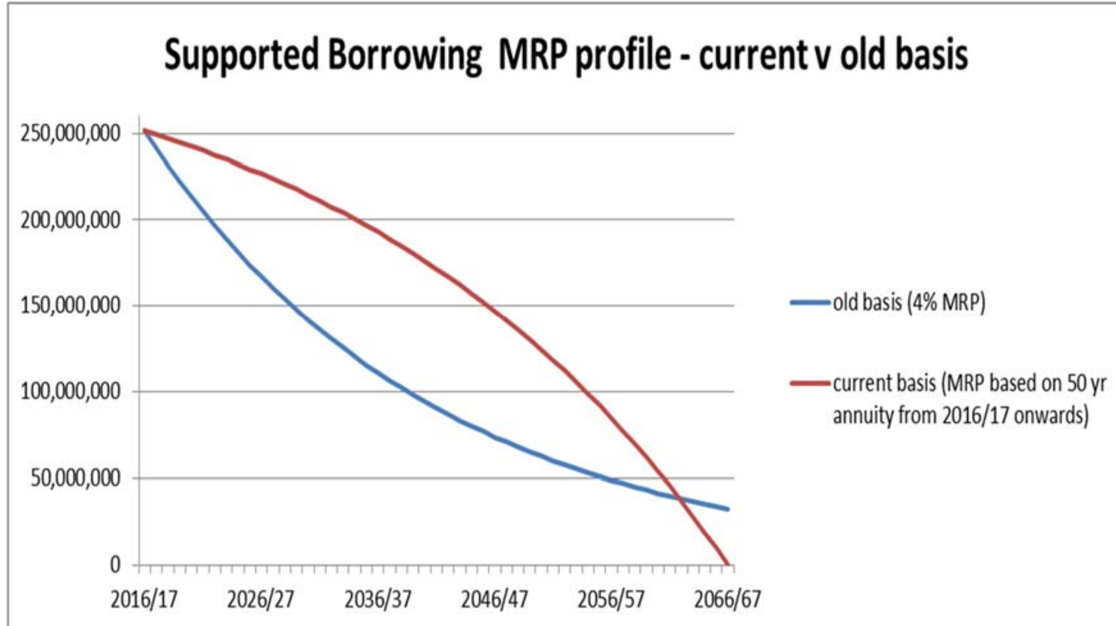
2.35 Paragraph 3 of the current DCLG guidance recommends that authorities prepare a statement of policy on making MRP in respect of the forthcoming year, with approval by full council before the start of the financial year. If these proposals subsequently need to be varied, a revised statement should be put to full council.

MRP – current approach

2.36 The Council formally approved a revised calculation for MRP for supported borrowing, effective from 2016-17 onwards, against the outstanding balance of £251m supported borrowing as at that date. This intention was to more ‘prudently’ align MRP to the average useful life of the assets; in this instance, 50 years.

2.37 The revised MRP calculation was based on the annuity method, which is a more prudent basis for providing for assets that provide a steady flow of benefits over their useful life. The pre-existing calculation had been based on 4% reducing balance basis. The following graph illustrates the impact of the revised MRP calculation implemented on the supported borrowing debt re-payment profile, based on a 50 year annuity period.

Graph – impact of current MRP calculation on supported borrowing debt repayment from 2016-17, over 50 years



2.38 The above graph illustrates that under the revised MRP, the outstanding supported borrowing debt of £251m would effectively be paid off ‘prudently’, by 2066-67. Under the pre-existing method, there would still have been about £32m debt outstanding in 50 years’ time. The revised approach ensured that future Council Tax payers would not be burdened with the cost of debt relating to assets that may no longer be in use.

2.39 The above revision had a significant overall impact on the annual MRP calculation from current budgeted, reducing the annual MRP charge by £8m in 2016-17, with ongoing , albeit reducing, annual revenue treasury management benefits over the following 13 years, before MRP costs started to increase again. The budgeted impact at the time was factored into approved 2017-21 budget plans. The prudential indicator relating to the ratio of financing costs to net revenue stream also reduced from 12.83% pre-existing, to 9.0% revised, by 2021-22.

2.40 The annual budget report to full Council on 15th February 2017 further noted that many Local Authorities were also either reviewing, or had recently revised, their MRP calculations at the same time as this Council. Other aspects of the MRP calculation had also been reviewed by officers, but that officers were not proposing further changes at this time. This included the potential further backdating of annuity calculations on supported borrowing debt outstanding, a further 10 years to 2007/08; allowable under the 2008 Regulations (see paragraph 2.33 earlier).

2.41 The rationale for deferring the potential further backdate to 2007-08 was pending further clarification from both the National Audit Office and Department of Communities & Local Government (DCLG), who were raising some concerns about the approach some Local Authorities were taking with regard to interpretation of the notion of 'prudent' within the 2008 Regulations, to their own MRP calculations.

2.42 With regard to Kirklees Council's approach, the Council's external auditors, KPMG, raised no concerns with the subsequent MRP revision implemented from 2016-17 onwards. As subsequently reported to Corporate Governance & Audit Committee on 17th November 2017, KPMG gave an unqualified opinion on the Council's 2016-17 financial statements, which incorporated the MRP revision.

MRP – further revision proposed from 2017-18 onwards

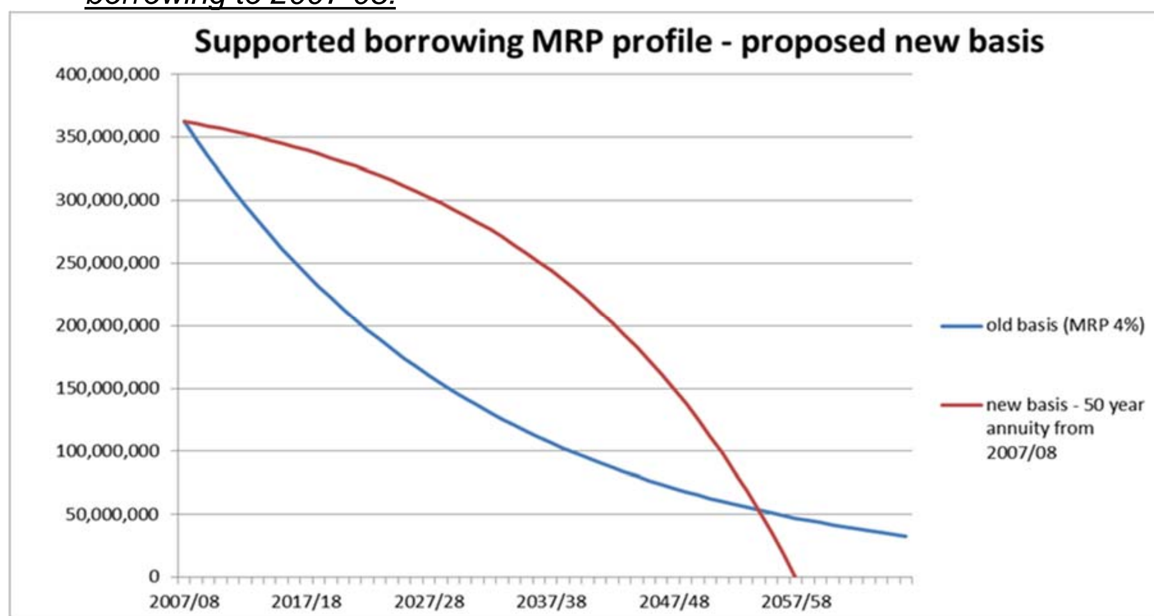
2.43 Officers have further reviewed the MRP calculation for supported borrowing and are proposing a further revision; to 'backdate' the current 50 year annuity basis to 2007-08. This revised MRP would be implemented from 2017-18 onwards.

2.44 The officer rationale for this further revision reflects a more consistent application of the 50 year annuity calculation for supported borrowing outstanding, to 2007-08;the date that the 2008 regulations effectively relaxed the pre-existing prescriptive 4% reducing balance basis for the MRP calculation.

2.45 This proposal also takes account, in conjunction with advice from the Council's external treasury management advisors, Arlingclose, a risk assessment of a recent DCLG consultation which closed on 22 December 2017, on proposals to update their own MRP guidance to Local Authorities from April 2018 onwards (see also, paragraphs 2.63 below).

2.46 The following graph illustrates the impact of the proposed further MRP revision on the supported borrowing debt repayment profile:

Graph – impact of the revised 50 year annuity MRP calculation on supported borrowing to 2007-08:



2.47 Under the revised approach, debt will still be paid off 'prudently' over a 50 year period, but backdated to 2007-08; effectively paid off by 2056-57. The 50 year annuity calculation applied here relates to the supported borrowing debt as at the start of 2007-08; £362m. Under the pre-existing 4% reducing balance method, there would still have been about £50m debt outstanding by 2056-57.

2.48 The proposed MRP revision results in a calculated 'over-provision' of MRP charges made between 2007-08 and 2015-16 compared to the original 4% reducing balance MRP calculation. The over-provision is £91.2m and is summarised at Table 3 below :

Table 3 - *MRP over-provision ; 2007-18 to 2015-16*

Year	Original MRP £	Revised MRP £	Over-provision £
2007-08	14,396,791	1,853,624	12,543,167
2008-09	13,843,068	1,942,412	11,900,656
2009-10	13,310,643	2,035,454	11,275,189
2010-11	12,798,695	2,132,952	10,665,743
2011-12	12,306,437	2,235,121	10,071,316
2012-13	11,833,113	2,342,183	9,490,930
2013-14	11,356,820	2,454,374	8,902,446
2014-15	11,119,891	2,571,938	8,547,953
2015-16	10,476,295	2,695,134	7,781,161
Total	**111,441,753**	**20,263,192**	**91,178,561**

2.49 In terms of options for un-winding the £91.2m over-provision back into general fund revenue, it could be 'front loaded' i.e. maximise the benefit of the un-winding in the early years. However, this unwinding cannot be more than the overall annual MRP calculation, as otherwise the Council would end up in a negative MRP position, which is not allowable under accounting rules. The maximum unwind allowable in

2017-18 would be £13.3m, £13.4m in 2018-19 and £13.6m in 2018-19 (see also paragraph 2.55 further below).

2.50 Some external auditors have also not looked favourably on Councils that have effectively maximised the unwinding of any calculated over-provision, to the extent that there has effectively meant nil MRP charge for the year in question; the auditor argument being that zero annual MRP provision is deemed not prudent.

2.51 An alternative approach could be to stretch the un-wind of the over-provision over the remaining 40 years of the supported borrowing annuity calculation. On an equal instalment basis, this would equate to an annual 'un-wind' of about £2.2m. However, in the context of the overall scale of the over-provision calculation, this approach could be seen as a potentially overly conservative un-wind profile.

2.52 The officer proposal here is to un-wind the £91.2m over-provision over a ten year time-frame, from 2017-18 to 2026-27; equivalent to £9.1m un-wind each year for the next ten years. This still leaves a prudent annual MRP provision in the region of £4.2m in 2017-18, £4.4m in 2018-19 and £4.5m in 2019-20; rising incrementally thereafter over following years.

2.53 The revised MRP proposal re-profiles the repayment of the Capital Financing Requirement (CFR) and therefore increases profiled payments of MRP by approximately £50m, by 2056-57. The additional cost reflects the fact that the revised MRP prudently pays off the totality of the £362m supported borrowing debt by 2056-57, whereas under the old 4% MRP calculation, there would have been a remaining balance of £50m debt still by 2056-57.

2.54 The MRP proposal will also increase annual treasury management costs by £820k from 2018-19 onwards, due to the back-dating of the current 50 year annuity calculation to 2007/08.This has been factored into overall treasury management budget proposals in the annual budget report.

2.55 The overall annual MRP calculations built into treasury management budget proposals over the 2018-20 period, factoring in the back-dated MRP revision, is £13.3m in 2017-18 (current year), £13.4m in 2018-19 and £13.6m in 2019-20.

2.56 Reduced MRP charges in earlier years also means that the Council's capital financing requirement (CFR) correspondingly increases, because MRP charges effectively offset against the annual CFR requirement.

2.57 This means that an increased CFR requirement in the earlier years increases the Council's underlying need to borrow, with a consequential increase in annual interest charges. Current borrowing policy reflects historically low temporary borrowing rates. It is anticipated the increase in CFR requirement resultant from the MRP over-provision un-wind, based on current temporary borrowing rates of 0.45%, would equate to about £45k additional interest charges in 2018-19, with subsequent further £45k increases (i.e. £90k in 2019-20) each year thereafter, for the duration of the unwind period. Clearly any increase in interest rates over the period would increase the calculated interest charge.

2.58 The prudential indicator relating to ratio of financing costs to net revenue stream would also 're-base' from an estimated 9.0% by 2021-22, to under 6.0%

2.59 No changes are proposed to the MRP policy for HRA debt. The current policy is to make provision in line with any scheduled external debt repayments, which currently approximates to 50 year write down, in line with asset lives.

2.60 It is proposed to amend the Council's MRP Policy Statement for 2017-18 in order that the above changes in methodology apply from the current year (2017-18). The revised MRP Policy Statement is attached Appendix C.

2.61 The Council's auditors, KPMG, are aware of the proposed changes but have stated that they cannot provide an opinion until more detailed work is done as part of the interim and final account audits.

2.62 The Council's external treasury management advisors, Arlingclose, have also been commissioned by Council officers to advise on the proposed MRP revision above, taking into account both current DCLG and National Audit Office guidance, and DCLG's proposed changes to its own current MRP guidance to Local Authorities.

2.63 Arlinglose are of the view that the MRP revision proposals set out in this report are within current DCLG and National Audit Office guidelines. DCLG's proposed updated guidance on MRP includes the following key highlights:

i) MRP cannot be a negative charge and can only be zero if the Council's CFR is nil or negative, or if the charge is fully reduced by reversing previous overpayments;

ii) where a local authority has changed the methodology that it uses to calculate prudent provision and generated what the current guidance calls an 'overpayment' (over-provision), it can continue to incorporate that overpayment into future calculations of prudent provision;

iii) maximum asset life used in an MRP calculation of 40 years, except freehold land where the maximum is 50 years. This applies to any calculation method using asset lives.

2.64 Arlingclose's interpretation of the above is that if the Council puts its proposed MRP back-date revision into its MRP policy now, then the Council will be able to continue to unwind the backdated over-provision, over future years. If the Council wishes to take this opportunity, it must do so as soon as is practical. However, the above proposals remain draft pending final confirmation of the updated guidance from DCLG, still pending at the time of writing this report.

2.65 Officers recommend that the revenue resource impact of the proposed over-provision unwind be transferred to Council reserves by default, as part of the Council's overall budget strategy and approach, ring-fenced for future consideration. This is also set out in as part of the overall annual budget report to Cabinet on 30th January and full Council on 14 February 2018.

Policy on the Use of Financial Derivatives

2.66 Local authorities (including this Council) have in the past 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). The Localism Act 2011 includes a general power of competence that appears to remove the uncertain legal position over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). The latest CIPFA Code requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

2.67 The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where it is confident it has the powers to enter into such transactions. They will only be used for the prudent management of its financial affairs and never for speculative purposes and where it can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to.

2.68 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.

Non-Treasury Investments

2.69 Although not classed as treasury management activities and therefore not covered by the current CIPFA Code or the CLG Guidance, the Authority may also purchase property for investment purposes and may also make loans and investments for service purposes, for example in shared ownership housing, loans to local businesses and landlords, or as equity investments and loans to the Authority's subsidiaries. Such loans and investments will be subject to the Authority's normal approval processes for revenue and capital expenditure and need not comply with this treasury management strategy.

Treasury Management Indicators

2.70 The Council is asked to approve certain treasury management indicators, the purpose of which is to contain the activity of the treasury function within certain limits, thereby reducing the risk or likelihood of an adverse movement in interest rates or borrowing decision impacting negatively on the Council's overall financial position. However, if these are set to be too restrictive they will impair the opportunities to reduce costs. The proposed indicators are set out in Appendix D.

Other Matters

2.71 The DCLG Investment Guidance also requires the Council to note the following matters each year as part of the investment strategy:

(i) *Investment Consultants*

The Council's adviser is Arlingclose Limited. The services received include:

- Advice and guidance on relevant policies, strategies and reports;
- Advice on investment and debt management;
- Notification of credit ratings and other information on credit quality;
- Reports on treasury performance;
- Forecasts of interest rates and economic activity; and
- Training courses.

The quality of the service is monitored on a continuous basis by the Council's treasury management team.

(ii) *Investment Training*

The needs of the Council's treasury management staff for training in investment management are assessed on a continuous basis, and formally on a 6-monthly basis as part of the staff appraisal process. Additionally training requirements are assessed when the responsibilities of individual members of staff change. Staff attend training courses and seminars as appropriate.

(iii) *Investment of money borrowed in advance of need*

The Council may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. However, as this would involve externally investing such sums until required and thus increasing exposures to both interest rate and principal risks, it is not believed appropriate to undertake such a policy at this time.

(iv) Policy on charging interest to the Housing Revenue Account (HRA)

Following the reform of housing finance, the Council is free to adopt its own policy on sharing interest costs and income between General Fund and the HRA. The CIPFA code recommends that authorities state their policy each year in the strategy report.

On 1 April 2012, the Council notionally split each of its existing long term loans into General Fund and HRA pools. New long term loans borrowed will be assigned in their entirety to one pool or the other. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. Interest will be applied to this balance using the authority's average investment rate.

3 Implications for the Council

The strategies outlined have been reflected in the treasury management and HRA budgets.

4 Consultees and their opinions

Arlingclose, Treasury Management advisors.

5 Next steps

Treasury management performance will be monitored and reported to members during the year.

6 Officer recommendations and reasons

Corporate Governance and Audit Committee and Cabinet recommend the following for approval by Council:

(i) the borrowing strategy outlined in paragraphs 2.12 to 2.18;
(ii) the investment strategy outlined in paragraphs 2.19 to 2.32 and Appendix A;
(iii) the policy for provision of repayment of debt (MRP) outlined in Appendix C of the report, which reflects the changes in policy outlined in paragraph 2.33 to 2.65, effective from 2017-18 onwards;
(iv) the treasury management indicators in Appendix D;
(v) to note officer proposals to re-fresh the treasury management strategy for financial year 2019-20 to reflect revised 2017 CIPFA Treasury Management & Prudential Codes, and updated DCLG Investment strategy and MRP guidance to Local Authorities (still pending at the time of writing this report)

7 Cabinet Portfolio Holder recommendation

The report and recommendations be submitted to Council on 14 February 2018.

8 Contact officer

Eamonn Croston	Head of Accountancy & Finance	01484 221000
James Buttery	Finance Manager	01484 221000

9 Background Papers and History of Decisions

CIPFA’s Code of Practice on Treasury Management in the Public Services; CIPFA’s Prudential Code for Capital Finance in Local Authorities; Guidance on Local Government Investments (DCLG 2010); The Local Authorities (Capital Finance and Accounting) (England) Regulations 2008; Localism Act 2011.
CIPFA Treasury Management Code and Prudential Code 2017
DCLG consultations; MRP Guidance and Investment Strategies for Local Authorities

10 Service Director responsible

Debbie Hogg 01484 221000

APPENDIX A

Investment Policy for 2018-19

The guidance splits investments into two types – specified and non-specified.

- Specified investments are those offering high security and liquidity. All such investments should be in sterling with a maturity of no more than a year. Investments made with the UK Government and a local authority automatically count as specified investments, as do investments with bodies or investment schemes of "high credit quality". It is for individual authorities to determine what they regard as "high credit quality"; and

- Non-specified investments have greater potential risk, being either investments of "lower credit quality" or investments made for longer than one year.

Specified investments:

- The Council is able to invest an unlimited amount with the UK Government for up to 6 months.
- The Council is able to invest up to £10 million and up to three months with UK banks and building societies with a "high to upper medium grade" credit rating.
- The Council is able to invest up to £10 million and up to two months with foreign banks with a "high to upper medium grade" credit rating.
- The Council is able to invest up to £10 million and up to two months with individual local authorities.
- The Council is able to invest up to £10 million in individual MMFs (instant access or up to 2 day notice). There will be an overall limit of £40 million for MMFs (non-government funds), plus up to £10 million invested in a fund backed by government securities.

Non-specified investments:

- The Council is able to invest up to £3 million and up to two months with individual UK banks and building societies with a mid "medium grade" credit rating.
- The Council is able to invest up to £1 million and up to two months with certain unrated building societies as approved by the Council's treasury advisors.
- The Council adopts an overall limit of £10 million for non-specified investments.

The maximum limits apply to any one counter-party and to a banking group rather than each individual bank within a group.

The Council will not place direct investments in companies as defined by the Carbon Underground 200 on 1 February each year.

Specified

	Short-term Credit Ratings / Long-Term Credit Ratings			Investment Limits per Counterparty		Counterparties falling into category as at Dec 2017
	Fitch	**Moody's**	**S & P**	**£m**	**Period (3)**	
UK Banks / Building Societies (Deposit accounts, fixed term deposits and REPOs)	F1	P-1	A-1	10	<3mth	HSBC Lloyds Group Santander UK Nationwide BS Coventry BS Close Bros
	AAA,AA+,AA, AA-,A+,A	Aaa,Aa1,Aa2, Aa3,A1,A2	AAA,AA+,AA, AA-,A+,A			
Foreign Banks (Deposit accounts, fixed term deposits and REPOs)	F1	P-1	A-1	10	<2mth	Svenska Handelsbanken
	AAA,AA+,AA, AA-,A+,A	Aaa,Aa1,Aa2, Aa3,A1,A2	AAA,AA+,AA, AA-,A+,A			
MMF (2)	-	-	-	10	Instant access/ up to 2 day notice	
UK Government (Fixed term deposits)	-	-	-	Unlimited	<6mth	
UK local authorities (Fixed term deposits)	-	-	-	10	<2mth	

Non-Specified (1)

	Short-term Credit Ratings / Long-Term Credit Ratings			Investment Limits per Counterparty		Counterparties falling into category as at Dec 2017
	Fitch	**Moody's**	**S & P**	**£m**	**Period (3)**	
UK Banks / Building Societies (Fixed term deposits)	F1,F2	P-1,P-2	A-1,A-2	3	<2mth	Barclays Leeds BS Nottingham BS RBS Yorkshire BS
	Higher than BBB	Higher than Baa2	Higher than BBB			
Unrated Building Societies (Fixed term deposits)	-	-	-	1	<2mth	Darlington, Scottish, Furness, Hinckley & Rugby, Leek, Marsden, Loughborough, Mansfield, Nat Counties, Mkt Harborough, Newbury, Melton Mowbray, Tipton & Coseley, Stafford Railway.

(1) Overall limit of £10 million.
(2) Overall limit for investments in MMFs of £50 million – up to £40 million in non-government funds, plus up to £10 million in a fund backed by government securities.
(3) The investment period begins from the commitment to invest, rather than the date on which funds are paid over.

APPENDIX B

Credit ratings

Moody's		S&P		Fitch		
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime
Aa1		AA+		AA+		High grade
Aa2		AA		AA		
Aa3		AA-		AA-		
A1		A+	A-1	A+	F1	Upper medium grade
A2		A		A		
A3	P-2	A-	A-2	A-	F2	
Baa1		BBB+		BBB+		Lower medium grade
Baa2	P-3	BBB	A-3	BBB	F3	
Baa3		BBB-		BBB-		
Ba1	Not prime	BB+	B	BB+	B	Non-investment grade speculative
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		Highly speculative
B2		B		B		
B3		B-		B-		
Caa1		CCC+	C	CCC	C	Substantial risks
Caa2		CCC				Extremely speculative
Caa3		CCC-				In default with little prospect for recovery
Ca		CC				
		C				
C		D	/	DDD	/	In default
/				DD		
/						

APPENDIX C

STATEMENT OF POLICY ON THE MINIMUM REVENUE PROVISION (REPAYMENT OF DEBT)

1. Background

1.1 The Local Authorities (Capital Finance and Accounting) (England) Regulations 2008 requires authorities to make an amount of MRP which the authority considers "prudent".

1.1 The regulation does not itself define "prudent provision". However, guidance issued alongside the regulations makes recommendations on the interpretation of that term.

2 Proposed policy for 2017-18 onwards

2.1 The Service Director - Financial Management, Risk, IT & Performance recommends the following policy for making prudent provision for MRP:

(i) General Fund Borrowing (pre 1st April 2008) - Provision to be made over the estimated average life of the asset (as at 1 April 2008) for which borrowing was taken - deemed to be 50 years (annuity calculation).

(ii) Calculations to compare this to the previous MRP charge indicate that between 2007-08 and 2015-16 the Council provided an additional £91.2m with which it will "un-wind" over the next 10 years.

(iii) General Fund Prudential Borrowing – Provision to be made over the estimated life of the asset for which borrowing is undertaken. Provision to commence in the year following purchase (annuity calculation). Where large loans are made to other bodies for their capital expenditure, no MRP will be charged. However, the capital receipts generated by the annual repayments on those loans will be put aside to repay debt instead.

(iv) HRA Borrowing - Provision to be made for debt repayments equal to its share of any scheduled external debt repayments.

(v) PFI schemes - Provision to equal the part of the unitary payment that writes down the balance sheet liability, together with amounts relating to lifecycle costs incurred in the year.

APPENDIX D

TREASURY MANAGEMENT INDICATORS

Gross Debt and the Capital Financing Requirement (CFR)
The Code requires that where gross debt is greater than the CFR, the reasons for this should be clearly stated in the annual strategy. This does not apply to this Council as its gross debt will not exceed the CFR.

Interest Rate Exposures
While fixed rate borrowing can contribute significantly to reducing the uncertainty surrounding future interest rate scenarios, the pursuit of optimum performance justifies retaining a degree of flexibility through the use of variable interest rates on at least part of the treasury management portfolio. The Code requires the setting of upper limits for both variable rate and fixed interest rate exposure.

It is recommended that the Council sets an upper limit on its fixed interest rate exposures for 2018-19, 2019-20 and 2020-21 of 100% of its net interest payments. It is further recommended that the Council sets an upper limit on its variable interest rate exposures for 2018-19, 2019-20 and 2020-21 of 40% of its net interest payments.

This means that fixed interest rate exposures will be managed within the range 60% to 100%, and variable interest rate exposures within the range 0% to 40%.

Maturity Structure of Borrowing
This indicator is designed to prevent the Council having large concentrations of fixed rate debt* needing to be replaced at times of uncertainty over interest rates. It is recommended that the Council sets upper and lower limits for the maturity structure of its borrowings as follows:

Amount of projected borrowing that is fixed rate maturing in each period as percentage of total projected borrowing that is fixed rate		
	Upper Limit (%)	**Lower Limit (%)**
Under 12 months	20	0
Between 1 and 2 years	20	0
Between 2 and 5 years	60	0
Between 5 and 10 years	80	0
More than 10 years	100	20

*LOBOs are classed as fixed rate debt unless it is considered probable that the loan option will be exercised.

Total principal sums invested for periods longer than 364 days
The Council is not intending to invest sums for periods longer than 364 day.